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Perspective from the Buyside

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Ladies and gentlemen,

I am delighted to be here at the 2016 Global Capital Markets Conference and I want to thank the Investment Company Institute Global for inviting me to give the closing speech today.

I will firstly provide some thoughts on the topics that have been on the agenda of the conference so far today. I will then speak about how ESMA's work is contributing to the development of the Capital Markets Union (CMU) and give you a flavour in particular of the shift in ESMA's focus towards supervisory convergence work. Finally, I will briefly update you on a number of asset management issues which ESMA is currently working on.

The new MiFID regime for execution quality and bond market liquidity and trading

On today's agenda was the important topic of execution quality. As you know the European Commission provided evidence in the MiFID Review in 2010 that difficulties in assessing the quality of execution of client orders impede compliance with the best execution requirement. A similar argument was also made by the buy–side, in particular fund managers, who argued that there was a dearth of information on execution quality available from their brokers. At ESMA, during our peer review on best execution carried out in 2014, we saw at first hand the difficulties faced by both financial market participants, and the competent authorities who supervise them, in properly assessing the quality of execution of client orders.

Let's be clear, best execution is an important aspect of investor protection and in our view a proper assessment can only be made when there is sufficient data on execution quality. MiFID II addresses this lack of information on execution quality in a comprehensive and consistent manner. As you know execution venues, including systemic internalisers and market makers, must now publish every quarter, execution quality data - such as information on the price, cost, speed and likelihood of execution. This information must be published for each financial instrument traded on that venue and most of the data must be compiled on a daily basis. This data, which must be freely available for downloading, will give retail and professional investors and indeed industry as a whole, a transparent view of the execution quality available on each trading venue. In addition, MiFID II requires brokers and other executing firms to publish annual information on the venues that they use. Firms need to set out how they used the information published by the venues in determining where to send client orders. This drives a clear obligation for firms to seek out the best venues to execute their client orders. As MiFID II also limits the possibility for brokers to receive any remuneration, discount or non-monetary benefit for routing client orders to execution venues, there is a clear onus on firms to ensure that the execution quality achievable at a venue is the driver for sending client orders to such a venue – and not any payment for order flow. Taken together these requirements should boost competition between the various players, improve the overall efficiency of the market and improve the outcome for the end investor.

The publication of this data on execution quality both from the venues and firms will also allow supervisory authorities to monitor much more effectively how firms are achieving best execution for their clients. It is difficult to quantify how improvements in best execution can benefit investors. There is one interesting reference point though. In 2014, the FCA conducted a thematic review in the area of best execution. They estimated, based on equities under management in the UK, at that time of circa £2.2 trillion, that every basis point of costs saved by improving client order execution could translate into £264mn in additional client returns each year.

I would contend therefore that there is clearly scope for greater compliance with the best execution requirements to lead to greater efficiencies, more transparent activities, increased competition and better outcomes for all investors.

Now turning to another area of MiFID II, just before this speech I believe you had an interesting panel discussion on bond market liquidity and trading. I am sorry I missed it, as this is an area which ESMA is actively working on and monitoring closely.

MiFID II/MiFIR significantly broadens the scope of transparency by extending transparency requirements to all equity instruments, and by introducing transparency requirements for non-equity instruments such as bonds and derivatives. In order to avoid a negative impact on market liquidity, MiFIR does permit some waivers to the obligations to make pre-trade information public and to make post-trade information public immediately after the transaction has been executed, instead allowing for a time delay.

Over the past few years ESMA has devoted significant time and resources to appropriately calibrate the transparency regime; to find an approach that allows for meaningful transparency while avoiding market participants being exposed to undue risks. On this important topic, we conducted two public consultations, two open hearings and a number of bilateral meetings with stakeholders, including of course the buy-side. I remember from the feedback we received from the buy-side that you were particularly concerned about the liquidity of bond markets, in particular corporate bonds and I assume that in today's panel those concerns remain. We at ESMA are conscious of these concerns and are closely monitoring the liquidity of the bond markets.

I am convinced that the final approach that the technical standards now incorporate provides for strong safeguards to avoid a negative impact. In my view the amendments introduced by the Commission, which we broadly supported, will provide additional safeguards by allowing for a gradual phase-in into the MiFIR bond market transparency requirements.

Before explaining these safeguards, I will briefly touch upon the current state of bond markets which – as I said – we are closely monitoring.

The important thing to mention is that in our view there is no conclusive evidence of declining liquidity in bond markets.[1] While it is true that liquidity today is lower than it was in the years preceding the crisis, I don't believe this is a fair comparison. Recent research undertaken by ESMA on corporate bond market liquidity could not find systematic, significant positive or negative trends in liquidity levels between March 2014 and March 2016. Having said this, in phases of high volatility in EU financial markets, episodes of declining market liquidity can be observed.[2] There appears also to be some evidence of bifurcated liquidity in bond markets. That is, liquidity has become more concentrated in more liquid assets such as benchmark bonds, and scarcer in less liquid assets.[3]

These liquidity trends are driven by several factors. Whereas many (industry) reports focus on the role of regulatory changes in declining inventories of brokers/dealers and in the reduced willingness of brokers/dealers to provide firm quotes, it is important to also take into consideration other factors that secondary markets experienced over the last few years. These include monetary policy, technological developments, the growth of the asset management industry, changes in market structure, changing risk appetites of investors, and the rise in corporate issuance.

Moreover, we should not forget that it was the objective of financial regulation that was passed in reaction to the financial crisis to establish a more resilient, transparent and responsible financial system. Some changes in the way markets work were therefore intended and are inevitable if we indeed want to make the financial system more resilient and transparent.

But I am very aware that these changes will require some time and that we will need to keep a close eye on the liquidity of (corporate) bond markets. A first step here is a better understanding of how the corporate bond markets work and what is driving liquidity in these markets. This is why expert groups at both EU level and on the global level have been set up to study this issue.

In any case, I agree that we need to have safeguards in place to avoid unintended consequences.

[1] See for instance: AMF (2015): Study of liquidity in French bond markets, 16 November 2015 and FCA (2016): Liquidity in the UK corporate bond market: evidence from trade data, March 2016.
[2] See: "EU corporate bond market liquidity – recent evidence, ESMA report on trends, risks and vulnerabilities, No. 2 2016. Available under: https://www.esma.europa.eu/sites/default/files/library/2016-1234_-_trv_no._2_2016.pdf
[3] See CGFS (2016): Fixed income market liquidity, CGFS papers, No. 55, January 2016 (http://www.bis.org/publ/cgfs55.pdf).

Such safeguards are part of the MiFIR transparency regime that ESMA has worked on over the last few years. In particular, they include:

- Liquidity assessment: National competent authorities may waive instruments that are not liquid from pre-trade transparency and allow the publication of transactions in illiquid instruments to be deferred up to 4 weeks. We will perform the liquidity assessment for bonds instrument by instrument, thereby allowing for a very granular assessment of liquidity taking the heterogeneity of bonds into account. Furthermore, the most recent amendments to the Level 2 - introduced by the Commission and supported by us - provide for a phase-in, starting initially only with the most liquid bonds, and gradually extending the scope to other bonds. This is going to be based on a prior assessment by ESMA that such an extension is appropriate. According to our calculations initially only 2% (1%) of all bonds (corporate bonds) in terms of ISINs, which cover 79% in terms of number of trades, will be subject to transparency.

- Waiver/deferral thresholds: Orders/trades in liquid bonds may also benefit from waivers and deferrals if they are above a certain size, that is either large in scale (LIS) or of a size specific to the instrument (SSTI). With the amendments introduced by the Commission, trades that are above a trade size below which lie 30% of the transactions may benefit from the SSTI-waiver. We believe that this will result initially in very low thresholds, thereby introducing an additional safeguard.

- Annual reviews by ESMA: Starting in 2019, ESMA will carry out yearly assessments measuring the impact of the transparency provisions on bond market liquidity and on the operation of liquidity providers. Only where ESMA concludes that the transparency provisions did not negatively impact liquidity, will we propose to move to the next stage of the phase-in which introduces more stringent requirements.

- Temporary suspension of transparency requirements: Last, but not least, MiFIR provides for the possibility to temporarily suspend transparency requirements in case of significant drops in liquidity. This is another safeguard that can be used should we observe significant drops in liquidity.

Therefore, I believe that MiFIR will not harm liquidity. On the contrary, increased price transparency should be beneficial to investors and may thereby have positive impacts on market liquidity and further contribute to achieving an efficient operation of the markets in the European Union.

The Capital Markets Union and ESMA's supervisory convergence agenda

Having briefly touched upon the topics discussed previously this afternoon, I would now like to move on to talk about the importance of well-functioning capital markets in the European Union and the project of the Capital Markets Union (CMU)

We all understand the importance of capital markets and the need to create a more diversified financial system that reduces dependence on the banking system. The CMU should help to provide investment opportunities, both for professionals and for retail consumers promoting a shift of European households' savings from bank accounts to the capital markets. While it must remain up to investors to determine which sector best fits their investment and funding needs, the CMU also needs to be designed to enable retail investors to feel safe when investing.

We have been pleased to see the European Commission confirmed its commitment to the CMU project through the publication of the recent progress report, in September, accelerating some reforms.

When we talk about the CMU in Europe and the need to break down cross-border barriers, we have to necessarily also talk about convergence in the implementation and enforcement of the rules. As you will be aware, in its strategic orientation published last year, ESMA said it would focus its activities increasingly on the important topic of supervisory convergence - in order to ensure that investor protection, orderly markets and financial stability are achieved in practice in the EU.

Let me focus quickly on the recent supervisory convergence work carried out by ESMA in particular in the context of the new MiFID framework. Our aim is to lay the foundations for the consistent application of MiFID II/MiFIR from January 2018 onwards.

MiFID II was adopted with the objective to design robust and targeted rules governing the market in financial instruments.

In the area of the investor protection the new framework is based on the assumption that transparency is important but not sufficient. More substantive requirements have been developed to ensure a more effective protection of investors: product governance requirements have been introduced; distribution regulation has been tightened (inducements, self-placement); the access for retail investors to execution-only sales has been restricted; independent advice has been regulated; product intervention powers have become a part of the toolbox of EU supervisors).

ESMA is strongly committed to continue delivering on its investor protection objectives and has developed guidance addressed to market participants and supervisors on many important topics.

In some cases, ESMA's work has taken the form of formal guidelines, in other cases Q&As have been identified as a more appropriate tool to express ESMA's common position.

In relation to guidelines, I would just like to mention the guidelines on complex debt instruments and structured deposits; on knowledge and competence; on cross-selling; and, most recently, the draft guidelines on product governance and suitability of management bodies on which we are currently consulting. These tools will result in greater standards of services to clients, in stronger financial institutions and, overall, in a higher degree of investor protection.

In the secondary markets area, we are currently working on a number of guidelines on the management bodies of trading venues and data reporting services providers as well as on the calibration of trading halts. We plan to complement the guidelines on trading halts with some own initiative guidelines that we consider necessary. We expect to finalise both sets of guidelines in early 2017.

Furthermore, through the use of Q&As, we are providing further guidance on the application of the revised MiFID framework which will help to ensure a smooth transition into the new regime and ensure consistent application across the EU. We have already issued some Q&As both on the investor protection side of MiFID and on the markets side.

ESMA is also developing additional measures and tools aiming at facilitating and supporting NCAs in the effective application of common standards of supervision. These will take various forms such as supervisory training, workshops for supervisors, fora for discussion of live issue cases, thematic reviews, etc.

In addition to these activities, ESMA is also continuing to prepare for the other tasks that have been set out in MiFID II/MiFIR such as delivering opinions to the Commission on position limits, and on waivers for equity and non-equity instruments. Furthermore, we have started working on the transitional calculations for the transparency regime ahead of the application of MiFID II/MiFIR.

All of these measures will help to ensure – as far as possible – convergence of the new requirements coming into force with the new MiFID framework in a year's time. They show the importance of moving from the single rulebook work of designing technical standards to a focus on the actual implementation and the day-to-day supervision of the requirements across the EU.

ESMA's agenda on the asset management side

Finally, as promised I will give you an update on the latest developments on five key work streams in the asset management space: asset segregation under the AIFMD and UCITS, our PRIIPs work, the AIFMD passport for third countries, the role we play in international work on asset management regulation, and how our asset management activities are contributing to the Commission's CMU initiative.

Starting with asset segregation, ESMA has been working on this area under UCITS and AIFMD since 2014. It is a difficult work stream that raises a number of issues, many of them very technical in nature. There are questions of legal interpretation, not only in relation to the specific provisions in the relevant pieces of legislation but also with regard to how those pieces of legislation interact. The most important factor from ESMA's perspective when considering all these questions is how best to ensure investor protection. Asset segregation rules are ultimately in place to protect investors and so we should always have that in mind when we are looking at the different options available. Our most recent efforts on this topic took the form of a call for evidence published before the summer. The 45 responses we received contained a huge amount of feedback, much of it setting out in great technical detail the different approaches that are currently being taken towards segregation. We have been analysing that feedback closely since the consultation closed and are now considering the best way forward.

To be clear, a number of options still remain open at this stage. One of those options is to address the EU institutions through an opinion under Article 34 of the ESMA Regulation suggesting clarifications of the AIFMD/UCITS legislative frameworks. This option is part of our considerations as we are conscious that the segregation requirements that we set out and consulted on originally in 2014 received a lot of push back. At the same time the policy objective of the current legislative framework, namely ensuring an adequate level of investor protection in case of insolvency of any of the entities in the custody chain, is also clear and needs to be respected. We hope to be able to reach a final position in the first half of next year on this topic.

Moving on, the work on the Key Information Document (KID) under the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation has been one of the most important projects undertaken so far by the European Supervisory Authorities (ESAs). This is particularly true given the relevance of this initiative to investor protection – after all, in future every investor will have such a KID available to compare different products and make his or her choice on the basis of the risk/cost/return information that is included.

I would like to recall briefly the main developments in the PRIIPs work in recent months and say a word on the next steps.

In April of this year the three ESAs submitted to the Commission the draft regulatory technical standards (RTS) which we had to develop under the PRIIPs Regulation. The Commission subsequently adopted the RTS, which triggered the objection period of the European Parliament and Council.

Following the proposal of the Economic and Monetary Affairs (ECON) Committee of the European Parliament (EP), in September the EP adopted a motion objecting to the RTS and asking for a delay to the application date of the Regulation. The topics referred to in the EP's motion were the 'Comprehension Alert', Performance Scenarios and the treatment of Multi-Option Products. Some Members of the European Parliament raised other issues, such as credit risk and the disclosure requirements on the biometric risk premium for insurance products.

As you will have seen, on 9 November the Commission took two important steps. First, it adopted a proposal for a delay of one year to the implementation deadline of the PRIIPs Regulation. Secondly, it sent a letter to the ESAs proposing amendments to the RTS on the points I mentioned earlier, in line with the motion adopted by the EP. The ESAs have 6 weeks to respond to the Commission's letter, meaning that we have to deliver by Christmas.

As I speak the ESAs are working intensively to prepare the response to the Commission. This is not an easy task given the number of issues involved – many of them very technical in nature – and the challenges that inevitably come with finding a common approach across the ESAs. We are confident though that we will be able to deliver this Christmas present to the Commission.

Looking slightly further ahead, once the situation with the RTS is more stable, we plan to develop guidance on a number of aspects of the PRIIPs Regulation and have already been conducting preparatory work to that end within the Joint Committee of the ESAs. The guidance, which will most likely take the form of Q&As, will seek to facilitate the implementation of the PRIIPs rules by firms and ensure convergent practices across the EU.

I would now like to say a few words on the work on asset management that has been taking place at international level. You will be aware that asset management activities have been very much in the spotlight in recent years, including by macroprudential authorities. I would mention specifically the work of the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO), and the efforts of the European Systemic Risk Board. Before going into more detail on these initiatives, allow me to explain first of all the relevance to ESMA of this work.

ESMA was created as part of the European System of Financial Supervision (ESFS). According to its Founding Regulation, ESMA's objective is to protect the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system, for the Union economy, its citizens and businesses. Historically rather unusually for a securities regulator, ESMA is therefore entrusted with financial stability responsibilities for all markets under its remit.

Based on this mandate, ESMA has done significant work in the financial stability area around the non-bank financial services industry and this expertise has been recognised in the financial stability discussions with respect to this area. For the EU market ESMA has developed an advanced system of risk indicators and metrics, both in terms of coverage (securities markets, investors, infrastructures) and sophistication, building on internal research and latest quantitative techniques allowing to assess complex activities (including such issues as market liquidity, interconnectedness, and the systemic dimension of hedge funds). This work serves another key ESMA activity outlined in the strategic orientation I already mentioned earlier, the activity of risk monitoring and assessment.

Turning to the FSB/IOSCO work, I am sure that many of you will have read with interest the FSB consultation paper (CP) of June this year on Structural Vulnerabilities from Asset Management Activities. The 14 recommendations set out in the FSB paper seek to address four potential sources of systemic risk

i. liquidity mismatch between fund investments and redemption terms and conditions for fund units;

ii. leverage within investment funds;

iii. operational risk and challenges in transferring investment mandates in stressed conditions; and

iv. securities lending activities of asset managers and funds.

Once the FSB has finalised the work on its side, which is expected to happen by the end of this year, it will pass the baton to IOSCO to operationalise some of the recommendations.

From an EU perspective, it is important to recall that many of the FSB's recommendations are already addressed through the existing legislative and regulatory framework. However, we should also be conscious that a number of them – such as on stress testing and leverage – could lead to changes to the current rules. That is why we will be seeking to follow the FSB and IOSCO work as closely as possible as it develops.

On the ESRB side, work has also started in the European context on leverage, liquidity and stress testing of investment funds. I am pleased to say that there is a substantive presence of securities regulators – including ESMA – involved in the ESRB work. This will allow the specificities of the asset management sector, and the existing regulatory framework, to be fully taken into account as recommendations are developed. The presence of ESMA will also help to ensure good coordination with respect to the work streams that ESMA itself is currently carrying out. For example, you may have seen from our Supervisory Convergence Work Programme for 2016 that we are working on the leverage limitation powers set out in Article 25 of the AIFMD. We are also gathering information and sharing supervisory experiences on the use of liquidity management tools.

Finally, allow me to say a few words on how ESMA's work in the particular area of asset management is contributing to the Commission's work on the CMU.

As already mentioned earlier, the CMU Action Plan highlighted the potential merits of identifying alternative sources of funding for the economy, and in this context explicitly mentioned loan-originating funds as one such source. Some Member States have already introduced bespoke regimes for loan origination by funds in their national legal frameworks. Such national initiatives have however also led to difficulties in carrying out business on a cross-border basis. The Commission noted that clarification of the treatment of loan-originating funds in the regulatory framework across the EU could facilitate cross-border development while ensuring they are regulated appropriately from an investor protection and financial stability perspective.

Leveraging on the Action Plan, and taking into account further discussions with the Commission, ESMA started work to develop what it considered to be the key elements of a common European framework for loan origination by investment funds and this work led to the opinion that we published earlier this year. The opinion covered a number of elements of a common framework for this activity including organisational requirements, eligible investors and eligible debtors. The European Commission is now considering the next steps in light of our opinion.

Another important topic covered in the CMU relates to barriers to the cross-border distribution of investment funds. These barriers could include discriminatory tax treatment, varying national requirements on the marketing of funds and fees for cross-border notifications. The overall aim of this work is to increase the volume of funds marketed and sold across the EU.

ESMA contributed to this work initially by gathering information on the practices of national competent authorities in this respect. We then provided that information to the Commission. The mapping that we did was very comprehensive in nature, covering not only AIFMD and

UCITS but also EuSEF, EuVECA and ELTIF. The Commission used our input as a basis for the consultation that closed last month, and we will work closely with them to ensure coordination of our respect follow-up actions.

Conclusion

That brings me to the end of my speech during which I have focused on how important capital markets will be in financing our future and how ESMA's role should contribute towards achieving this objective. The project of the Capital Markets Union is built on investors' trust in the financial markets and on their ability to take good investment decisions. In order to realise this main objective, we need to achieve for the investor a modern, state-of-the art, genuinely European approach towards disclosure, distribution, execution quality, transparency, and cross-border supervision.

At ESMA we will continue our efforts across our activities of rule-making, supervision, convergence and risk analysis to contribute to a strong investor focus and to sound financial markets in general.

Thank you for your attention.