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Keeping on track in an evolving digital world

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Introduction

It's a pleasure to be here with you. Today I will reflect on how the growth of digital technology is radically altering the financial sector, mirroring changes in broader society. These innovations bring benefits, but also risks. I will then explore how financial regulation can adapt, to ensure that investors and markets can thrive in this new environment. In short, how do we keep on track in an evolving digital world?

Digitalisation brings radical changes

Digital technologies continue to reshape financial services and the wider economy. It is easy to forget how fast digital technology changes. But consider the world of fifteen years ago, for instance. It was not possible to trade stocks on your mobile phone – let alone to trade crypto-assets, which were some years away. Large-scale remote working, on which we have been so dependent in the last two years, was not an option. The major social media platforms, so prominent today, were just getting started (e.g. Facebook in 2004).

While the overall pace of technological change is rapid, the digital world does not always evolve uniformly. Some inventions of a new technology represent a step change and we can't imagine life without them. Others are popular for a short period, such as suddenly hyped apps, but then disappear.

As regulators the challenge is to be timely in considering the implications of new technology. We need to identify those innovations that are here to stay and will have a real impact on the markets and/or investors. Take for example the creation of blockchain just over a decade ago. There was a big question at the time how impactful this new technology would be. By now we know a bit more. Several tokenised securities have been successfully issued and transacted on blockchain.[1] Elsewhere in the value chain, market participants are experimenting with the technology to enhance post-trade processes.[2] And more recently we saw the growth of so-called stablecoins, designed to be used as a means of payment and a store of value. But the story is still unfolding. One of the most prominent stablecoin initiatives so far, the Facebook-led Diem project, was recently put to an end. Meanwhile, new applications of the technology are emerging, including Decentralised Finance or 'DeFI'.[3]

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[1] For example, in February 2021, Rabobank completed the first real-time commercial paper transactions using blockchain technology, following a successful two-year pilot in partnership with Commerzbank and Euroclear. In April 2021, the EIB launched a digital bond issuance on a blockchain platform, in collaboration with commercial banks. In September 2021, Société Générale-Forge completed a security finance transaction on a digital bond issued on blockchain.

[2] For example, the HQLAx initiative from Deutsche Boerse and Clearstream aims to enhance collateral management for securities lending of high quality assets. The first live transactions went live in 2019.

[3] DeFI aims to replicate certain functions of the traditional financial system in an open and decentralised way, using blockchain and smart contracts. The size of the DeFI market has increased from less than EUR 2bn in July 2020 to c. EUR 80bn as of end-January 2022

A world of new influences and expectations

Firms develop technologies to cater to consumer preferences. At the same time, our preferences and expectations are shaped by technology. As we use digital tools in more and more situations, we expect greater convenience. Like food that is delivered at our door by Uber Eats or Deliveroo, we now have financial products and services at our fingertips on our smartphones, and the menu is expanding fast.

The pandemic has been a catalyst for changes across society. The working lives of many of us with (what used to be) ‘office jobs’ have moved online. As Covid gradually becomes endemic, we can expect a range of hybrid working environments to emerge. Remote interactions have become the norm in many situations, shifting our expectations.

In securities markets, the pandemic has spurred the growth of online brokers, who have seen a marked increase in new accounts and in their trading activity. This activity was driven by a spike in the overall savings rate when many people were looking for ways to fill their time during lockdowns. The convenience and user-friendly features of mobile trading platforms attract new investors. But features that ‘gamify’ the investing experience may lead some investors to trade excessively, or to take on too much risk.

Ideas and information spread in new ways in the age of social media. A year ago, we saw the rise of ‘meme stocks’, where participants in online communities started buying shares in companies such as the US-based retailer GameStop. Their motivations included the expectation of rapid returns, but also the prospect of punishing short-sellers. The concept of a meme in fact comes from evolutionary theory.[4] In its original sense, it refers to a cultural practice – such as a language or a social norm – that is passed down the generations. In current usage, however, it means an idea spreading like wildfire on the internet. Such memes are not a reliable source of information for prospective investors.

Alongside this we have the rise of so-called financial influencers or "Finfluencers" on social networks. Such developments clearly bring risks to investors, a topic I will return to in more detail.

In short, consumers expect greater convenience and more choice. And increasingly, they receive ideas and information from social media. This is in great contrast to the pre-digital world, where 'gatekeepers' such as news outlets and official publications – or traditional advisers and brokers, in the financial sector – played a greater role.

If we can harness the benefits of digital technology, we may hope to see a more democratised, even more inclusive, financial sector. But there are serious risks that investors will be subject to misinformation, and that the lines between regulated and unregulated products become blurred.

A new digital marketplace in finance

Financial firms are capitalising on – and contributing to – these trends, with new business models and tools.

Their common currency is data. We create data every time we talk on the phone, send a text, tweet or email, use Facebook, watch a video, withdraw

[4] Dawkins, R. (1989): *The Selfish Gene*. Oxford University Press.

money from an ATM, use a credit card, or even walk past a security camera. New data-centric business models are emerging in response. Traditional financial firms increasingly rely on third-party services, including from the technology giants. Elsewhere in the value chain, FinTechs enter the market offering specialist services – such as Know Your Customer checks or reporting tools. Digital platforms are serving as new venues for financial (and non-financial) products or services.

Some BigTechs already provide payment services. And we can expect them to play an increasing role in the wider financial sector, given their competitive advantages. They have vast datasets from their consumer networks which they can analyse with advanced tools. In keeping with my theme of evolution, this is known as the 'DNA loop', where DNA stands for 'Data-Network-Activities'. Put simply, consumer data strengthens network effects, in turn generating more consumer activity and yet more data.

The entry of FinTech and BigTech firms – bringing with them a growing range of specialist services and data-based tools – increases fragmentation and complexity of the financial services value chain. Supervisors need a clear view of the roles played by these new market entrants and the dependencies between them. Equally, we need to understand their data-focused business culture and reflect on the opportunities and risks it presents for consumers and investors.

Opportunities

Digitalisation, then, is radically changing consumers' preferences, the information they receive. Digitalisation is also radically altering the profile of the firms offering financial services to consumers. In doing so, digitalisation creates new opportunities. Consumers can receive seamless, 'real-time' 24/7 access to financial products and services, across borders, and without the need for physical presence. They can compare a wide range of choices at the touch of a button. Some digital platforms bring together financial and non-financial products, acting as a 'one stop shop' for consumers. In short, digital services can bring greater convenience. This may help boost financial inclusion, at least among those consumers comfortable using new technology.

Digital innovation also provides opportunities for firms. It helps them develop and distribute their products and services to a wider consumer base. In reducing the need for established branch networks, it reduces barriers to entry and time to market for new products. Online services may have lower fixed costs. And depending on the situation, third-party digital infrastructure may be cheaper and less risky than developing and putting in place systems for a new product in-house.

The data-centric business models I mentioned bring opportunities too. Using data in sophisticated ways help firms to understand consumer demand. This knowledge facilitates the personalised financial products and services that consumers increasingly expect.

More broadly, technology-driven changes to market structure may create efficiencies. Business partnerships between incumbents and FinTechs or

BigTechs can streamline internal processes, enhance fraud detection and support risk management.

Risks

However, the evolving digital world inevitably also brings risks. In the financial sector, we as regulators and supervisors face some major challenges.

With digitalisation, financial firms increasingly rely on third-party providers. Some third-party providers are not easily substitutable and may have the bargaining power to impose terms and conditions. Some may provide technology and other services – including data analytics and advertising – at such a scale that they become systemically important.

The new players in the financial markets are creating a new landscape, in places more fragmented and complicated. Existing reporting and supervisory frameworks may contain blind spots, especially if financial firms and technology companies interact in complex ways, as illustrated by the Wirecard case.

Importantly, the evolving digital world also brings risks to individual consumers. New digital distribution channels, offering instant trading, coupled with sometimes aggressive marketing techniques and gamified services, are providing a very different environment to traditional investing. Consumers increasingly have easy access to complex and highly risky products, such as crypto-assets and Contracts for Differences (known as CFDs), or even CFDs on cryptos. And this new environment may exacerbate the behavioural biases which we are all subject to. Social media information overload and gamification of financial decisions may prevent consumers from making well-informed decisions - putting them at risk.

ESMA's response

Investors need to tread carefully in this environment, and we as regulators and supervisors need to provide them with stable ground on which to stand. As digital technology evolves, we must continually assess the effectiveness of our rules and the way we supervise and enforce them. Ultimately, we need to adapt to a changing environment to protect investors and support thriving EU capital markets for the good of our economy and the EU citizens.

We want to make sure that investors are empowered to make informed choices and have access to innovations that bring them tangible benefits. That said, where we identify new risks that are not addressed within the current regulatory and supervisory framework, we (ESMA and national authorities) will need to take firm action.

Let me illustrate this through two examples: our digital finance advice, and our public communications on crypto-assets.

1) Digital finance

Two days ago, the ESAs published their joint response to the Commission's request for technical advice on digital finance and related issues.[5] Our report includes ten recommendations for actions to ensure the EU regulatory and supervisory framework remains fit for the digital

[5] The joint ESA report in response to the European Commission's call for advice on digital finance and related issues was published on 7 February 2022

age. In summary, these recommendations relate to having adequate supervisory oversight over the entire financial value chain, enhancing consumer protection in a digital context and ensuring a level playing field between incumbent financial firms and groups combining financial and non-financial activities.

My counterparts at EIOPA and EBA have already outlined important aspects of this work. So I will focus my remarks on a key topic that ESMA has particularly focused on, and which I have already mentioned: the rise of Finfluencers.

Finfluencers are individuals who leverage social media to provide their followers with information and recommendations on a variety of financial products. Their followers discuss and exchange information about many topics related to investing. While most Finfluencers are themselves retail investors, some are financial services professionals. Platforms such as YouTube, Instagram and TikTok, provide access to a wide audience, especially among the young. For example, on the TikTok app, the investing-related hashtag #StockTok has gained popularity through the pandemic. This certainly makes a change from the dance videos and mouth-watering recipes often seen on the app. Data show that the hashtag has been viewed more than a billion times.[6]

This is just one example of a general trend, as tech-savvy retail investors turn to social media to inform their financial decision-making. They seek information from "like-minded" peers, rather than from traditional financial

[6] The Guardian, 10 July 2021, FinTok: how TikTok is helping young people use cash wisely

advisors.[7] 'Social trading' and 'copy trading', where you can automatically copy trades executed by someone else, are growing in popularity.[8]

In a sense, these developments are democratising the financial sphere. People are free to choose and to discuss their investments. They now have greater means than ever before to do so. But just as democratic institutions can be undermined by the spread of misinformation, unchecked rumours and bad advice can undermine investor confidence and ultimately orderly markets.

It is vital that we as public authorities, acting in the interest of (particularly retail) investors and of orderly and stable markets, retain our own influence over financial markets. We need to ensure our collective voice remains loud and clear despite the noise.

A year ago, the GameStop episode illustrated how social media may lead to herding and increased risk-taking among retail investors.[9] They were not always able to identify and separate misleading and harmful information from real facts and proper advice. In this context, ESMA published a statement, clarifying the applicability of market abuse rules when investment recommendations are provided on social media.[10] The statement recalls that investment recommendations must be done in a specific and transparent way so that investors, before making a decision, can know and assess the credibility of the recommendation – and how objective it is.

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[7] CNBC/Momentive (2021), "CNBC/Momentive Poll: "Invest in You" August 2021

[8] See for example eToro as Europe's most popular social trading platform

[9] Financial Times (2021), How herd behaviour drives action on r/WallStreetBets, 10 February

[10] ESMA (2021), Statement on Investment Recommendations on Social Media, ESMA70-154-2780, 28 October

But I know that this fast-moving phenomenon requires active monitoring. As ESMA we are committed, together with the national supervisors and the other EU authorities to continue our focus on this area. And we will continue to adapt our communications to aim to reach consumers who seek information from social media.

2) *Crypto-assets*

I now move to a second, related topic on which ESMA is focused – the ongoing speculation around certain crypto-assets. Total market capitalisation of crypto-assets has increased eightfold over the last two years to around EUR 1.5tn now, though around EUR 1tn below its peak in November 2021. This suggests that crypto-assets are gaining mainstream acceptability. According to recent research, 6% of Slovakians[11] and 8% of Dutch[12] people own crypto-assets.

Most of these assets are not backed by any tangible value and their price is highly volatile. Also, the majority operate outside of the EU regulated space, meaning that consumers do not have rights or protections if things go wrong. Many scams and fraudulent activities have already been reported.

Yet we see growing investor interest in crypto-assets. Large-scale marketing campaigns in our streets and public media aim to legitimise those assets and boost confidence in them among the public. Perhaps you have seen in your home country adverts similar to a recent, infamous poster on the London tube. It says – with questionable logic – "*if you are*

[11] Source: Bank of Slovakia, survey conducted among a representative sample of 1010 respondents in December 2021
[12] Source: AFM, Q3 2021 research among 33,900 respondents shows that 1 in 12 Dutch people own cryptos

seeing Bitcoin on the Underground, it's time to buy". A flurry of celebrities and so-called crypto-influencers are promoting these assets, including on YouTube channels. Some have tens of thousands of followers.

At the same time, even more complex products are being developed, including some leveraging on DeFI protocols. Some are marketed with promises that seem too good to be true, and probably are, such as returns above 10% per annum.

As you may recall, the three ESAs issued a first EU level Warning[13] on crypto-assets in February 2018 and reminded[14] consumers of the high risks of these assets in March 2021. But we remain highly concerned about severe risks to consumers here. Some are buying these assets with unrealistic expectations of price growth, and without realising the high risks involved.

At the same time, we see the consumer detriment that is being caused by scams and frauds in the crypto space. The current EU regulatory framework is not capturing most crypto assets and thus investors are not protected. You might say that if they want to speculate and lose money, that is their own problem. But I believe that for many of us, it can be hard to tell the difference between a regulated financial instrument and an unregulated one, particularly if they are made available side by side in a trading app on a smart phone. In addition, much of the aggressive marketing and exciting promises hide the fact that the firms that investors sign up to are not regulated and thus investors have no protection when

[13] ESAs (2018), ESAs warn consumers of risks in buying virtual currencies, 12 February
[14] ESMA (2021), ESMA sees high risks for investors in non-regulated crypto-assets, 17 March

something goes wrong. Digitalisation has made it easier to get in touch with and attract retail investors also cross-border, and often from outside the EU. This is the new world that we live in and therefore as regulators and supervisors we need to adjust to it.

We, at ESMA, would like to see as soon as possible the right EU regulatory framework come into being, through the finalisation of the legislative process around MiCA (the Markets in Crypto-Assets regulation). So far, only some national supervisors can rely on a domestic legislative regime for crypto assets, but most cannot. This does not offer the common EU approach to the risks that we see at the moment. Until MiCA is agreed and in force, we are working actively with the national supervisors to ensure information exchange about scamps and frauds, learning from each other's experiences when it comes to authorising and supervising new crypto asset products and services and finding common ways to address the risks across the EU.

Conclusion

To conclude, digitalisation is bringing profound changes across the economy, and the financial sector is no exception. It creates new linkages and dependencies, as incumbent firms partner with technology companies, and social media affects the way potential investors receive and spread information.

Opportunities from digital services include greater efficiencies and convenience. But as I have highlighted, there are considerable risks, especially to retail investors. At ESMA will continue to monitor developments, cooperate closely with other authorities at EU and national level and take action wherever it is needed.