



EURO AREA

PUBLICATION OF FINANCIAL SECTOR ASSESSMENT PROGRAM DOCUMENTATION—TECHNICAL NOTE ON CAPITAL MARKETS UNION—IMPLICATIONS FOR SUPERVISION AND INSTITUTIONAL ARRANGEMENTS

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FINANCIAL SECTOR ASSESSMENT PROGRAM

TECHNICAL NOTE

CAPITAL MARKETS UNION – IMPLICATIONS FOR
SUPERVISION AND INSTITUTIONAL ARRANGEMENTS

Prepared By
**Monetary and Capital Markets
Department**

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program (FSAP) in the euro area. It contains the technical analysis and detailed information underpinning the FSAP findings and recommendations. Further information on the FSAP can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>

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Glossary

AIFM	Alternative Investment Fund Manager
BoS	Board of Supervisors
CCP	Central Counterparties
CMU	Capital Markets Union
CRA	Credit Rating Agency
CSA	Common Supervisory Action
CSD	Central Securities Depository
CSDR	Central Securities Depositories Regulation
CTP	Consolidated Tape Provider
CTPTP	Critical Third-Party Technology Provider
DRSP	Data Reporting Service Provider
ECB	European Central Bank
EMIR	European Market Infrastructure Regulation
ESA	European Supervisory Authority
ESMA	European Securities and Markets Authority
ESMAR	ESMA Regulation
IOSCO	International Organization of Securities Commissions
ITS	Implementing Technical Standard
MiFID II	Markets in Financial Instruments Directive and Regulation
MS	Member State
NCA	National Competent Authority
NRA	National Resolution Authority
RBS	Risk-Based Supervision
RTS	Regulatory technical standards
SIU	Savings and Investments Union
SSF	Senior Supervisors Forum
SSM	Single Supervisory Mechanism
TR	Trade Repository
UCITS	Undertakings for Collective Investment in Transferable Securities
USSPs	Union Strategic Supervisory Priorities

EXECUTIVE SUMMARY¹

The European Union (EU) recently sought to give fresh impetus to longstanding efforts to grow and deepen its capital markets—the Capital Markets Union (CMU). Building on the earlier Financial Services Action Plan and work to remove barriers to consolidation and efficiency in post-trade arrangements, the European Commission has set out various legislative and non-legislative initiatives to enable easier access to capital, enhance the efficiency and scalability of EU capital markets, and by doing so reduce the extent of the dependence on bank financing. Fragmentation of capital markets in the euro area (EA) is driven by many factors including national differences in securities, corporate, tax and pensions laws, policies. These can create significant uncertainty, e.g., determining which law is applicable and how cross-border financial investments will be treated in insolvency, and barriers to cross-border provision of investments products. For the CMU to be successful these barriers will need to be reduced over time. However, the focus of this note is on proposals pertaining to the institutional arrangements and supervisory framework, including how to enable a safe transition towards centralizing supervision of at least some types of entity at the EA level.

The supervisory approach of ESMA has evolved and matured over the last decade. ESMA has taken over direct supervision of a portfolio of specific market players which primarily pose risks through their conduct rather than their prudential significance. ESMA supervises credit rating agencies, certain benchmark administrators and several categories of firms providing infrastructure relating to market data. While these entities play important roles in the market, the risks they entail primarily do not relate to their financial soundness, rather to the resilience and quality of their operations and conduct matters such as the management of conflicts of interest. ESMA has put in place a structured approach to the identification and prioritization of inherent and control risks, demonstrated that it is able to take effective supervisory and, where necessary, enforcement action, and made efforts to communicate its key supervisory expectations and priorities.

ESMA should articulate the appropriate risk tolerance and resources to attach to its direct supervision work in the future. It is natural and prudent that as a relatively young supervisory authority being tasked with new rather than “traditional” supervisory mandates, ESMA had a relatively low implicit risk tolerance in the early years. In the light of increased maturity, and to ensure an appropriate calibration of risk across the whole supervisory system, ESMA should consider whether the intensity of supervision for its firms is appropriate relative to that in place for the types of entity regulated at national level. In addition, as a risk-based supervisor ESMA should prepare to set expectations among stakeholders that no supervisory regime delivers “zero-failure” and take structured decisions internally about the inevitable trade-offs between risk and resources which will become more acute as its mandate expands.

¹ This Technical Note was prepared by Cristina Cuervo, Senior Financial Sector Expert and Jennifer Long, Consultant, Monetary and Capital Markets Department, in the context of the 2025 Euro Area Financial Sector Assessment Program.

ESMA has also built a high degree of technical expertise in relation to CCPs, which it should build upon in refining its supervisory strategy. ESMA now needs to focus on determining an appropriate supervisory strategy for third-country Tier 2 CCPs guided by risk as well as the letter of European Market Infrastructure Regulation (EMIR), and how it will support national competent authorities (NCAs) to articulate and deliver appropriate strategies involving the EMIR colleges. Within the constraints of its EMIR mandate, ESMA should reinforce the connection between its risk analysis work and its supervisory response and ensure that in areas relevant across entity types (e.g., governance, internal control frameworks, methods for setting and following up on supervisory expectations) there is appropriate coherence between the approach taken in relation to CCPs and in relation to ESMA's other supervisory mandates.

Consolidation, reinforcement and simplification of institutional arrangements will be needed to enable ESMA to 'scale-up' further its supervisory role. ESMA needs a sustainable funding mechanism, including the ability to hold reserves, to allow it greater agility in matching expenditure to need during the seven-year funding period, and in particular allowing it to finance for the essential and intensive preparatory work for new mandates during the period where it is unable to charge fees to the relevant entities. ESMA should be given a wider, "default" set of supervisory powers in its founding regulation applicable to all mandates. This approach would enable ESMA to be more proportionate and targeted in its use of resources, and less reliant on enforcement tools which are more costly and time-consuming for both the authority and regulated entities. Opportunities to streamline governance and increase independence from the Commission and co-legislator as well as from NCAs, for example through the addition of independent non-executive directors and enhanced use of delegations, should also be pursued.

An important lesson from ESMA's experience to date is that the addition of any further supervisory mandates needs to be carefully sequenced. The transfer of Data Reporting Service Providers (DRSP) supervision from NCAs to ESMA posed challenges from which important lessons needed to be learned before any further transfers of mandate with the potential for more immediate and significant market impact. Funding from the EU budget, time, and planning for transfer of expertise from staff in NCAs will all be needed to ensure that there is no disruption in the transition of mandates which—unlike most of those for which ESMA has been given responsibility to date—are already well-established. It is also important to avoid wherever possible arguably disproportionate fee increases attached to the transition, particularly mid-year. This creates challenges for both the entities and NCAs required to pay them, in some cases calling into question the viability of business models, and may act as a disincentive to effective consolidation of supervisory responsibilities.

Initiatives to increase retail investor participation in capital markets need to go hand-in-hand with the provision of effective investor protection EA-wide. Key safeguards on the segregation and safeguarding of client assets are currently left largely to national level. The adequacy of the legal protections, including in case of insolvency, and the extent to which supervisors ensure firms are operating in such a way that those protections are available, need to be carefully examined. Supervisory convergence, facilitated by ESMA, is needed on how national competent authorities

(NCAs) can effectively supervise this complex area. Consideration also needs to be given to whether the current arrangements for investor compensation schemes are adequate, and the €20,000 required coverage sufficient. Given existing concerns about the cost and value for money of retail investment funds, care will need to be taken to ensure that any initiatives focus on direct retail investment offer good value for money to investors in comparison to potential alternatives, such as contributions to pension schemes able to invest at scale.

Table 1. The Euro Area: Capital Markets Union - Main Recommendations¹				
#	Recommendation	Addressee	Priority	Timeframe
Supervision and Supervisory Convergence				
1.	ESMA should articulate the appropriate risk tolerance and resources to attach to its direct supervision work.	ESMA	H	I
2.	ESMA should maximize the use of remediation tools without the need for formal investigations or the imposition of sanctions.	ESMA	H	ST
3.	ESMA should further elaborate on intervention strategies and the choice of appropriate tools in its internal supervisory manual.	ESMA	H	ST
4.	For CCP supervision: ESMA should reinforce the connection between its risk analysis work and its supervisory response.	ESMA	H	ST
5.	Supervisory convergence work should focus on ensuring that a core capability in fundamentals of supervision is in place across all NCAs at different stages of market development.	ESMA	H	MT
6.	ESMA should continue to develop its RBS Principles for use in supervisory convergence as regards use of intervention tools and escalation approach.	ESMA	M	MT
Powers, Governance and Resources				
7.	ESMA should have a wider 'default' set of supervisory tools established by ESMAR, which it is able to use to reduce risk without proof of a specific breach.	EC	H	ST
8.	ESMA should have a stable funding framework set out in ESMAR, including: (i) the ability to spend on the EU budget for preparatory work before it is able to charge fees to the relevant entities; (ii) powers to hold reserves, (iii) the ability to set fees.	EC	H	ST

Table 1. The Euro Area: Capital Markets Union - Main Recommendations (Concluded)

#	Recommendation	Addressee	Priority	Timeframe
9.	The EU should consider a reduction in the share of the budget contribution to ESMA from NCAs.	EC	H	ST
10.	ESMA's governance arrangements should be revised to allow for fully efficient and independent decision making. New arrangements should ensure independence from individual MS interests.	EC	H	ST
11.	The authorities should self-assess against IOSCO's Objectives and Principles for Securities Regulation before the next ESA review, with particular regard to Principles 1-4 and ESMA's supervisory mandate.	EC, ESMA	H	ST
Transition Planning				
12.	Authorities should ensure thorough, funded transition planning for the transfer of any additional mandates to ESMA to ensure that existing capabilities are maintained and enhanced.	EC, ESMA	H	ST
13.	For any transition of CCPs supervision: ensure appropriate arrangements for co-operation with central banks and, if the need arises, National Resolution Authorities.	EC, ESMA	H	N/A
Scope and Focus of CMU Initiative				
14.	Authorities should ensure the framework for investor protection continues to be fit for purpose, including the minimum coverage threshold under the Investor Compensation Schemes Directive.	EC	M	MT

¹ In terms of priorities, H, M, and L stand for high, medium and low. In terms of time frame, I, ST, and MT stand for immediate (within one year), short-term (within 1–2 years), and medium-term (within 3–5 years).

INTRODUCTION

1. The Capital Markets Union (CMU) is an initiative to grow and deepen the European Union's (EU's) capital markets and, with the Banking Union, contribute to a Savings and Investment Union. Building on earlier efforts to identify and address barriers to the growth and consolidation of the EU's capital markets, the European Commission was expected at the time of the mission to announce a range of initiatives to help the Union reduce its reliance on bank funding and enhance the attractiveness and efficiency of EU capital markets, including to retail investors.²

2. The mission considered how to effectively mitigate potential financial stability risks in pursuing the CMU. The purpose of the mission was not to examine the individual initiatives which will comprise the latest package of measures under consideration to achieve the CMU, but to consider what institutional, regulatory and supervisory arrangements the EA would need to have in place to effectively mitigate risk if an enlarged capital market with increased retail participation were to be achieved. Arrangements for regulation and supervision at national level have been considered within FSAPs of relevant EA countries, so this mission has focused on the arrangements at the EA level, in particular the supervisory and supervisory convergence roles of ESMA³. It's important to bear in mind, however, that the scope of the CMU project is very broad and success in its completion is complex and not guaranteed by addressing the institutional and supervisory arrangements identified in this note, which are simply one leg of the initiative. Many other aspects of the CMU, including addressing fundamental legal barriers like those relating to corporate, insolvency, tax and securities laws will be key to the success of the initiative, but are not discussed in this note. Also, because legal reforms must be a central part of the CMU efforts, a subsequent, substantially different legal framework may call for a deeper reflection on necessary changes to the institutional and supervisory structure down the line. The mission's primary focus was on the EA. However, as the CMU is an EU-wide initiative and there is not a distinct regulatory or supervisory architecture for EA capital markets within the EU, there may not always be a distinction from the EU as a whole.

3. The mission benefited from input from the authorities and a range of stakeholders. The authorities completed a targeted questionnaire and met with the mission team during an on-site in February-March 2025. During the on-site visit, the team had access to information about a limited range of supervisory action taken in relation to two entities. The mission team also met EU (EA and non-EA) and non-EU NCAs, regulated entities, industry and public interest representatives, and academics.

² The Commission's intentions were set out before the mission in its January 2025 communication "A Competitiveness Compass for the EU" COM (2025) 30 final. Shortly after the mission, in March 2025, the Commission published a further communication, "Savings and Investments Union: A Strategy to Foster Citizen's Wealth and Economic Competitiveness in the EU" COM (2025) 124 final. As anticipated, this committed to a range of legislative and non-legislative measures, including in relation to enhancing supervisory convergence and transferring some supervision to the European level.

³ Implications for financial stability of individual member states, therefore, have not been considered in this note.

4. The rest of the note is divided into three sections. The first describes the market and institutional context for the CMU initiative and the elements that we have considered most relevant for financial stability and the potential evolution of the regulatory and supervisory arrangements. The second sets out the current arrangements for supervision of capital markets entities and assesses the current status of those for which responsibility lies at the EA rather than national level, principally with ESMA, to complement work on arrangements at the national level carried out in individual country FSAPs. Together, these provide a baseline for the consideration of the potential future evolution of regulation and supervision to be “fit for purpose” in the context of a successful expansion of the EU’s capital markets, which is set out in the third section.

THE CMU INITIATIVE AND ITS CONTEXT

A. EU and EA Capital Markets

5. Data published by the authorities shows a wide range of variation in member states’ capital markets, with considerable scope for further deepening of capital markets overall. The most recent compilation of data on indicators at the time of the mission⁴ suggests that there is no clear pattern distinguishing EA from non-EA member states in this regard. The Association for Financial Markets in Europe (AFME) also publishes CMU key performance indicators for the EU and, where data is available, for the UK, and also finds evidence of wide variation between member states.⁵

6. While the EU contains some of the most developed capital markets in the world, others are classified as ‘emerging’, ‘frontier’ or even ‘standalone’ markets. This assessment affects the extent to which securities issued in these markets are included in indexes and attract investment through funds. It is also an indicator of the widely differing levels of maturity still coexisting within the EU, though again there is no evident pattern distinguishing EA countries from non-EA countries.

B. The Institutional Framework for Regulation and Supervision

7. Capital markets regulation is mainly at the EU level, through a multi-layered system. Regulation is through primary legislation (so-called ‘Level 1’), proposed by the European Commission and then negotiated by the ‘co-legislators’, the Council (consisting of the EU’s 27 member states) and the European Parliament. This primary legislation is supplemented by technical rules in three types of secondary legislation⁶ (‘Level 2’) and by ‘guidelines’ (‘Level 3’) addressed to competent authorities and/or market participants. ESMA develops the majority of the Level 2 and

⁴ Commission Staff Working Document SWD (2021)544 ‘Monitoring progress towards a CMU: a toolkit of indicators’, [Overview of CMU Indicators 2024 Update](#), 19 July 2024.

⁵ AFME, [CMU KPIs, Seventh Edition](#), November 2024.

⁶ Delegated acts, devised by the Commission; and regulatory technical standards and implementing technical standards developed by the relevant ESA (ESMA, EBA and IOPA, as relevant) and adopted, with or without amendment, by the Commission following input from the co-legislator.

Level 3 measures for capital markets, but some are developed by the European Banking Authority (such as in relation to the prudential regime for investment firms) and some by ESMA in collaboration with the ECB (such as in relation to financial market infrastructures). Like the other European Supervisory Authorities (ESAs), ESMA can only draft Level 2 measures where it receives a specific mandate empowering it to do so through a Level 1 measure and these must be adopted (and can be changed) by the Commission and co-legislator. It has no autonomous regulatory power,⁷ though it can initiate Level 3 measures with which national competent authorities must either 'comply or explain'.⁸

Table 2. The Euro Area: MSCI Classification of EU Member State Equity Markets, March 2025

Developed	Emerging	Frontier	Standalone
Austria Belgium Denmark Finland France Germany Ireland Italy Netherlands Portugal Spain Sweden	Czech Republic Greece Hungary Poland	Croatia Estonia Latvia Lithuania Romania Slovenia	Bulgaria ¹ Malta
Sources: MSCI Market Classification . ¹ Consultation underway at the time of the mission on possible reclassification as 'frontier'. For classification criteria, see MSCI Market Classification Framework, June 2024 . Cyprus, Luxembourg and Slovakia are not classified.			

8. Nevertheless, important dependencies on national laws and rules remain in some areas. Corporate laws, securities laws, and insolvency laws are generally unharmonized, with a few exceptions where specific EU-wide arrangements have been put in place, for example to ensure settlement finality or certainty around the treatment of financial collateral in insolvency⁹. As a result, the arrangements for certain core aspects of, for example, securities issuance depend on national laws. While EU-wide principles exist in relation to the protection of client assets by investment firms,

⁷ ESMAR, Article 10.

⁸ ESMAR, Article 16(3).

⁹ In December 2022, the European Commission tabled a proposal for a directive harmonizing certain aspects of insolvency law. The initiative is part of the Commission's priority objective of strengthening the CMU.

the specificities of asset safeguarding and segregation, particularly outside the context of a collective investment scheme, are determined at the national level.

9. Supervision for some types of entity is now carried out at EU rather than national level, but there is no distinct architecture for the euro zone as there is in the banking sector.

ESMA was the only one of the three ESAs given a direct supervisory mandate at its creation, in relation to Credit Rating Agencies (CRAs). Since then, it has been given supervisory responsibility for a range of other types of entities, and additional responsibilities are also envisaged in the coming years as discussed further below. However, many of the key actors in capital markets including most investment firms, asset managers, and distributors/advisors, are authorized and regulated at national level. Collective investment schemes (funds) are also authorized at national level. Some of the largest and most systemically significant investment firms are treated prudentially in the same way as banks, and where such firms are within the EA, or a country that has opted into the single supervisory mechanism (SSM) arrangements, they are subject to prudential supervision by the SSM,¹⁰ with conduct supervision remaining at national level.¹¹

Table 3. The Euro Area: Class 1 Investment Firms Prudentially Supervised by the SSM	
Entity	Country
KBC Securities NV	Belgium
Citigroup Global Markets Europe AG	Germany
Morgan Stanley Europe SE	Germany
BNP Paribas Financial Markets	France
Portzamparc	France
BofA Securities Europe SA	France
Pro Capital	France
CI-B SG Option Europe	France
Source: SSM List of supervised entities, cut-off January 2025	

10. The EU-level and national authorities also co-operate through various mechanisms to promote a common supervisory culture and “supervisory convergence”. This is an obligation placed on all three ESAs in their founding regulations. Some supervisory convergence measures are then required or permitted under specific pieces of legislation, for example the requirements under EMIR and the Regulation on Central Securities Depositories to convene supervisory colleges in

¹⁰ The Investment Firm Regulation and Directive—in force since June 2021—introduced a multi-tiered regulatory regime for investment firms. They require that the largest and more systemic investment firms (above EUR 30 billion at solo- or group-level) and engaging in specific activities (dealing on own account or underwriting or placing financial instruments on a firm commitment basis) are authorized as credit institutions and, if the criteria for significance are met, fall under the direct supervision of the ECB.

¹¹ ESMA plays no role in the direct supervision of systemically significant investment firms.

specific formations, or the empowerments for ESMA to use its binding mediation¹² tool in certain situations under EMIR. However, in many cases the choice of tool, or the situations in which it should most effectively be deployed, is not prescribed. The use of these tools in practice is discussed further in Section H below.

11. Regulation is now in place governing recovery and resolution for CCPs as well as for banks and the largest investment firms, and implementation is underway. The largest investment firms are subject to the capital requirements applicable to banks, and by virtue of that are within scope of the banking resolution regime including, where applicable, the Single Resolution Board (SRB). A specific regime for CCP recovery and resolution has been adopted ('CCPRRR'). Supervisory colleges are assessing CCPs' preparation of appropriate recovery plans. National resolution authorities (NRAs) have been appointed, which are drafting resolution plans, and resolution colleges established. Within ESMA, a team distinct from the supervisory team has been tasked with the related coordination and convergence work.

ESMA's Powers, Governance, and Funding

12. ESMA's general powers and governance are set out in its founding regulation, with its direct supervisory powers separately specified in sectoral legislation. The powers contained in Article 8 of ESMA's founding regulation (ESMAR) mostly refer to ESMA's mediation and coordination role among NCAs, as well as its supervisory convergence function. Sectoral legislation whereby ESMA is granted a direct supervision mandate specifies how this is to be carried out, including procedures for requesting information, carrying out on-site visits, investigations and enforcement actions. These sectoral provisions are quite prescriptive and provide very little regular supervisory powers outside of formal "investigation" and enforcement processes, e.g., the ability to carry out an onsite inspection of a CRA is subject to a prior decision to open an investigation, article 23(c) of the CRA Regulation. This, in practice, means ESMA needs to rely on moral suasion to effect any needed change in supervised entities in a timely fashion, or otherwise deploy burdensome approval processes to send stronger messages or initiate enforcement actions (e.g. monetary penalties). The sectoral approach to establishing supervisory powers and processes also creates inefficiencies and inconsistencies across ESMA's mandates.

13. ESMAR further provides for the use of "no-action letters", but these are in practice a very limited tool. Article 9a provides for a process to follow in exceptional circumstances, when ESMA considers that the application of a legislative act can raise significant issues due to the lack of developing regulation or guidance, or where it directly conflicts with another act. In practice, ESMA's power under this article is limited to submitting an opinion to the NCAs and the Commission, explaining the issue and the urgency. It has no power to indicate what measures NCAs or market actors should take and can only wait until regulatory or legislative action is taken to remedy the

¹² Article 19(3) of ESMAR provides for ESMA to carry out mediation between NCAs in case of disagreement, and for the result to be binding.

problem. This hampers ESMA's ability to react with agility and provide adequate response in exceptional circumstances.

14. The two governing bodies of ESMA are the Board of Supervisors (BoS) and the Management Board.

- a. The BoS guides the work of ESMA and has the decision-making responsibility on a broad range of matters, including the adoption of draft technical standards and guidelines, as well as opinions, reports, and advice to EU institutions. It is supported by a number of standing committees and working groups that deal with technical issues. In addition to the ESMA Chair, the BoS is composed of the heads of the NCAs in the EU and the European Economic Area responsible for securities regulation and supervision with non-voting representatives from the EC, the European Systemic Risk Board, the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Free Trade Association Surveillance Authority.
- b. The Management Board ensures that ESMA carries out its mission and performs the tasks assigned to it under ESMAR. In particular, it focuses on the management aspects, such as the development and implementation of the multi-annual work program, as well as budget and staff resource matters. In addition to the Chair, the Management Board is composed of six members selected from the BoS by its members. The Executive Director, and a representative from the Commission attend as non-voting participants (except on budget matters where the Commission has a vote).

15. The adequacy of these governance arrangements may merit consideration as regards their capacity for efficient and independent decision making. While evidence gathered by the mission points to increased common efforts towards convergence in decision making at the BoS and wider use of delegation (where permitted by mandates), it has long been perceived by stakeholders that the size and composition of the Board could impair its ability to act independently in the interest of the EA (as opposed to individual member states). Furthermore, as a supervisory authority it also needs to be able to demonstrate independence from the EC and that all supervisory decisions and resourcing decisions are made without the potential for political interference by the EC, so the EC's participation in management bodies also needs to be reconsidered in future. While there are already some safeguards in place (e.g. the EC does not participate in supervisory discussions regarding individual market participants unless there is an explicit legislative mandate to do so)¹³, it would be wise to explore other avenues for accountability that do not involve the EC being part of the BoS and the management body and having a vote on budget matters, as this can endanger the perceived independence of the authority. While this issue will gain relevance as ESMA's mandate continues to expand, the adequacy of the governance structure should be reviewed irrespective of specific advancements of the CMU project.

¹³ Further to ESMAR Art 44 "The non-voting members and the observers, with the exception of the Executive Director, shall not attend any discussions within the Board of Supervisors relating to individual financial market participants, unless otherwise provided for in Article 75(3) or in the legislative acts referred to in Article 1(2)."

16. ESMA is funded through a growing combination of sources and oversees an increasingly complex budget. Given the mandate to directly supervise certain firms, ESMA is partially funded by fees from those market participants, as well as by a combination of contributions from NCAs and a general contribution from the EU Budget.¹⁴ The fee funding model is specified separately for each mandate in Level 2 regulation. The calculation, timeline and types of fees are currently set in eight separate Commission implementing regulations. According to these, fees operate under a full cost recovery principle for each individual mandate, creating an overly rigid framework that does not allow ESMA to respond effectively to unforeseen circumstances or urgent needs. The process to adopt the budget is complex as it has to align both ESMA's internal procedures and the Parliament and Council's process to approve ESMA's level of EU subsidy based on a proposal from the European Commission. Furthermore, ESMA operates within an annually determined budget that is framed by the seven-year Multi-annual Financial Framework, which means total allocation of EU subsidies is capped for the relevant period.

17. The need to cover preparatory work for new mandates from ESMA's running budget has resulted in constant reprioritization of ESMA's work. Unless the relevant legislation introducing new mandates for direct supervision by ESMA specifically includes a Legislative Financial Statement procuring EU funding for implementation, the preparatory work has to be financed from ESMA's running budget. This can prove challenging, particularly given that some of that preparatory work can include not only major policy development projects and building of supervisory capacity, but also the need to develop or scale up IT systems and operational capacity. As additional supervisory mandates are added in future, there will be a need to procure resources and technical expertise that is not available in-house.

C. The CMU Initiative and Its Predecessors

18. A number of initiatives have, over the years, analyzed the development and integration of securities markets in Europe. The start of the journey towards free capital movement in the EU can be traced back to the Treaty of Rome in 1957 and began to gain further interest with the introduction of the Euro in 1999, as that gave rise to increased investor demand for foreign securities. The Financial Services Action Plan, issued by the EC in 1999 presented the first roadmap aiming at harmonization of the regulatory framework for financial services within EU. Costs and inefficiencies tied to cross-border financial transactions were especially evident in the clearing and settlement of securities, which primarily relied on domestic frameworks. This was one of the key findings of the Lamfalussy Group, which highlighted the need for authorities to take a more decisive approach to speeding up the process of harmonization of clearing and settlement systems. The work of this group also identified lack of harmonization of rules in a number of areas, as well as differing implementation across member states, the slowness of the legislature, differences in national legal and tax systems, and cultural barriers, as main obstacles to further integration. Two of the recommendations of the Lamfalussy report are now key staples of the institutional framework for securities regulation in Europe: the introduction of the different levels in the legislative and

¹⁴ Further to Recital 68 of ESMA's Regulation, the costs for core activities that do not entail direct supervision are split between NCAs and the EU Budget on a 60/40 ratio.

regulatory process, as well as the creation of the European Securities Regulators Committee, ESMA's predecessor. The Giovannini reports further looked into the obstacles to efficient functioning and development of cross-border clearing and settlement. This work identified 15 barriers across 3 categories, barriers relating to: national differences in technical requirements/market practice; taxation; and legal certainty. The reports highlighted the special nature of legal barriers pertaining to securities laws and the potential ramifications of any changes to these, across many different parts of member states' legal systems, making them a particularly complex area to tackle.

19. Since the Lamfalussy report, there has been numerous of regulatory initiatives spearheaded by the Commission towards establishing a unified European capital market. A few examples relating to trading and infrastructure are the Markets in Financial Instruments Directive (MiFID II), which aligned the regulation of a wider range of trading venues and established EU-wide authorization standards and procedures for investment firms and trading venue operators, and the European Market Infrastructure Regulation (EMIR) establishing a framework for the functioning of central counterparties (CCPs) and facilitating their cross-border operations. Additionally, the Regulation on Central Securities Depositories fostered competition among depositories and bolstered their cross-border activities, and the Settlement Finality Directive, enhanced legal clarity concerning settlements and mitigated systemic risk. Numerous other examples could be given of regulatory initiatives for investment funds, issuers, and intermediaries, that have worked towards the harmonization of the regulatory framework and the creation of the single rulebook.

20. Progress in core legal areas has been much more limited. While there have been several working groups and initiatives aiming to tackle some of the legal barriers identified by the Lamfalussy and Giovannini groups e.g., the Fiscal Compliance Experts' Group for taxation and the Legal Certainty Group (for addressing issues involving legal certainty around securities clearing and settlement), the work has made limited headway. The interconnections of many of these areas with different parts of member states' legal systems, as well as the necessary involvement of numerous government counterparts, help to explain the lack of progress.

21. Partly driven by the ambition of moving away from the bank-bias in the EU financial sector, the Capital Markets Union (CMU) initiative was launched in 2015, to develop and further integrate capital markets across the EU. Its objectives include (i) diversifying the financing sources available to EU enterprises, with a particular focus on small and medium enterprises, and (ii) offering savers enhanced long-term investment opportunities while improving the connection between savings and productive investments across the Union. The CMU also aims to safeguard financial stability and strengthen the resilience of the EU economy by promoting geographical diversification of funding sources, enhancing private risk-sharing mechanisms, and reducing dependence on bank financing, which in the past has resulted in a concentration of risks on bank balance sheets.

22. The initial CMU Action Plan outlined 33 actions covering a broad range of topics. Initiatives included measures to relaunch securitization, facilitate the cross-border distribution of investment funds, optimize prudential calibrations for capital market activities, and simplify

prospectuses, but also to address key insolvency barriers, tackle uncertainty around securities ownership and address bias in the tax system. After a mid-term review of the plan, the Commission proposed a new set of measures in 2017. These measures aimed to address additional objectives, such as strengthening the powers of the ESAs, fostering fintech development, promoting sustainable finance, introducing a Pan-European Pension Product framework, and supporting the growth of local capital markets.

23. Despite significant advancements in the legislative framework further to the action plans, stakeholders generally felt that much work remained to fully develop and integrate EU capital markets. Several flagship items from the 2015 and 2017 plans were achieved, like the introduction of the Prospectus Regulation, the Securitization Regulation and the amendment of the Venture Capital Regulation. The ESAs Review in 2019 also strengthened ESMA's supervisory convergence tools and tasked it with direct supervision of some market actors. Finally, the review of EMIR that came into force in 2020 strengthened ESMA's powers over both EU and third-country CCPs, including mandating the direct supervision of systemically important third country CCPs to ESMA. There was, however, widespread concern that the CMU's initiatives were not sufficient to promote growth and integration of EU markets, and that implementation was too slow to address the EU's increasing financing needs. In response, the Commission established a High-Level Forum to propose recommendations for revitalizing the CMU.

24. The recommendations of the High-Level Forum were integrated in the subsequent 2020 Action Plan, across four key areas: the financing of EU businesses, market infrastructure, retail investment, and the internal market. Key initiatives under the 2020 Plan include the setting up of a Single Access Point to information on EU companies, which is in the process of being implemented, the enhancement of the European Long Term Investment Fund Regulation, the Listing Act, the Directive on Alternative Investment Fund Managers frameworks and the review of MiFID II (legislative initiatives entered into force in 2024). The Investment Firms Directive and Regulation introduced in 2021 a risk-based approach to the supervision of investment firms, including transferring supervisory responsibility of the most systemically relevant to the SSM.

25. The appointment of a new Commission in 2024 has brought renewed attention to the CMU and a new Plan was released shortly after the mission. While much has advanced in the regulatory harmonization of securities markets in the EU, integration of markets and infrastructure remains elusive, as does a reduction in the banking bias for the funding of investments. This has prompted calls for renewing the approach to CMU, with a number of reports published in the months prior to the FSAP mission. Particularly, reports by Christian Noyer, Mario Draghi and Enrico Letta have suggested different approaches to capital markets supervision in the EU going forward. At one end of the spectrum, the Letta report suggests the most integrated market or significant players could be supervised by ESMA, while less significant entities would remain at the national level. At the other end, the Draghi report argues ESMA should become the single EU supervisor for capital markets. The Noyer report proposes a third option for gradually moving towards more centralized supervision, via an opt-in regime for entities to transfer into ESMA supervision. At the time of the mission, the EC was expected to launch a new plan focused on increasing retail

participation in investments and access of firms to the market as well as on making the regulatory framework more effective and strengthening supervision, including by continuing to harmonize approaches and provide more weight to ESMA's mandate.¹⁵ This was happening in the context of a commitment by the EC to rationalize reporting obligations and reduce such burdens by 25 percent, as announced under the regulatory fitness and performance program, which was part of the Better Regulation initiative by the Commission.

D. CMU and Risks to Financial Stability

26. Deeper, larger capital markets can help support the stability of the wider financial sector. Financial stability is a foundational pillar of the CMU, while its importance is balanced with other key and complementary objectives such as market efficiency, investor protection, and economic growth. Progress towards CMU could enhance private risk-sharing across the EA, helping stabilize growth when countries are hit by local shocks to which monetary policy cannot respond. A more integrated and diversified financial system could also potentially help reduce fragmentation and ensure better spreading of financial risks across the EA. EU policymakers also see financial stability benefits in reducing the bloc's dependence on bank financing.

27. However, it is important to ensure that risks occurring within capital markets are given sufficient attention alongside efforts to grow and deepen them. It is important that the Commission, co-legislators and relevant ESAs have sufficient capacity to monitor and address emerging risk areas, such as those discussed in the Targeted Consultation assessing the adequacy of macroprudential policies for Non-Bank Financial Intermediation (NBFIs) and, potentially, in the growth of less transparent and regulated private markets.

28. Larger capital markets are likely to result in more complex frameworks that require adequately strengthened supervision. The existing supervisory ecosystem is complex and may lead to potential risks being overlooked, in particular, in relation to the emergence of cross-border risks which may not be fully internalized by national authorities. In this sense, the diversity in type and materiality of frameworks and actors across member states in the EA brings in particular challenges, and underscores the importance of retaining and leveraging expertise at the individual member state level, while working towards a more unified approach to supervision across countries. Nevertheless, it is important to recognize that centralizing supervision will not of itself create the CMU, and that risk from a poorly planned or implemented transition could be material. In particular it is important that centralizing supervision is carefully sequenced to ensure that the capacity and resources from day-to-day supervision are not diverted. The difficulties of striking the right balance on distribution of supervisory responsibilities and ensuring that adequate levels of expertise and resources are available where most needed to effectively manage risks should not be underestimated. There is also a risk that in focusing on centralizing supervision which may appear a more achievable goal, political capital is expended that could be deployed on addressing other barriers to integration or risk areas.

¹⁵ See footnote 2 for details of the communication published shortly after the mission.

29. Preparation is also needed to ensure robust protection of retail investors in areas that might be more fully tested in a successful CMU. If the CMU is successful, new and inexperienced investors will enter the market, including some who have previously saved through bank deposits covered by extensive deposit guarantee schemes and may not appreciate the lack of such a safety net in relation to investments. New firms may enter the market, and those already operating will continue to be subject to a wide range of operational risks that need to be effectively managed in order to ensure that client assets are safeguarded from cyber-attacks, fraud and potential unavailability in insolvency due to segregation or safeguarding failings. The supervision of investment firms' client asset segregation and safeguarding has not historically been a focus for supervisory convergence work because although common minimum requirements are set at EU level, there are national legal specificities. Despite these differences, it is important to ensure that supervisory capability is robust and consistent across the EU in preparation for the likelihood that the adequacy of current arrangements will be more fully tested in a successful CMU. Additionally, the framework for investor compensation schemes is harmonized further to a directive that dates back to 1997 and has not been revised, including its €20,000 floor for protection.^{16 17}

THE SUPERVISORY BASELINE FOR CMU

A. Current Supervisory Arrangements

30. Licensing and supervision of most types of entity is carried out at national level. At the same time, the European System of Financial Supervision is a multi-layered system of micro- and macro-prudential authorities that aims to ensure consistent and coherent financial supervision in the EU. It includes the European Systemic Risk Board, the three European Supervisory Authorities (EBA, ESMA and EIOPA) and the national supervisors. The European Central Bank (ECB) as part of the Single Supervisory Mechanism (SSM) is the banking supervisor for the largest banks. Exchanges and other trading venues are licensed and supervised at national level, as are CSDs.¹⁸ "Investment firms" carrying out broker-dealer activities, portfolio management (i.e., asset management through mechanisms other than collective investment schemes) and/or providing financial advice are authorized/supervised at national level unless they are so prudentially significant that they are treated as banks within the mandate of the SSM.¹⁹ Banks carrying out investment activities, and investment firms treated as banks but not large enough to be supervised by the SSM, are licensed

¹⁶ For non-EA member states the requirement is an equivalent amount in local currency.

¹⁷ There was an attempt by the European Commission to update the Investor Compensation Schemes Directive in 2010, following concerns about how the directive was being applied (e.g., lengthy processes to access compensation in some member states). The proposal, which included raising the level of compensation to €50,000, was dropped.

¹⁸ Licensing of exchanges and other trading venues is addressed under MiFID II, and for CSDs under the Regulation for Central Securities Depositories.

¹⁹ MiFID II contains the licensing regime for 'investment firms' and regulates specified investment activities carried out by such firms or by banks. The prudential regime for investment firms, including the conditions under which they are subject to the prudential regime for banks, is set out in the Investment Firms Directive and Regulation.

and supervised at the national level. Managers of collective investment schemes (which may also be MiFID II asset managers) are licensed at the national level under either the UCITS or AIFM legislation, or both. Each UCITS fund is also required to be authorized at the national level and AIFs to be registered also at national level. Custodians and depositaries, who ensure that client assets are safeguarded appropriately, may be banks or licensed under national regimes.

31. An entity licensed in one EU member state may “passport” its services across the EU, without the need for a physical presence in other countries. While some firms do establish branches in other countries, many operate without a branch. This is particularly the case for trading venues which do not have the legacy of being the “national exchange” and for CCPs. For asset managers and investment firms there are examples of both models, including some investment firms which have established in one country while primarily providing services to customers elsewhere. The authorization/registration of funds (collective investment schemes) is concentrated in a few jurisdictions, though the asset manager is often located elsewhere.

32. In some cases, size or materiality thresholds determine whether supervision is carried out at national or EU level. Data reporting service providers (DRSPs)²⁰ were originally all licensed and supervised at national level, but on 1 January 2022 this changed, with the default then becoming that DRSPs should be authorised and supervised by ESMA unless they fall under specified size thresholds. ESMA has also been responsible to date for the supervision of EU-based administrators of benchmarks deemed critical to the EU, with NCAs responsible for other EU administrators, though the scope of benchmarks subject to regulation and supervision is set to change following the agreement early in 2025 of changes to the underlying regulations.

33. In other cases, ESMA has been given responsibility for all entities of a given type. From inception, ESMA was responsible for the licensing and supervision of credit rating agencies, under a then newly-established regulatory regime. It was also given responsibility for derivatives and securities financing transactions ‘trade repositories’ and later for securitization repositories. It has also recently been given responsibility for green bond reviewers, ESG ratings providers and will be the supervisor for all consolidated tape providers (CTPs), a form of DRSPs envisaged since inception but likely to be first established in 2025/2026.²¹

34. For some types of entity, ESMA has responsibilities regarding those located outside the EU (‘third country’ entities), while supervision of those located within the EU rests with national authorities. This is the case for CCPs, where NCAs are responsible for the licensing and supervision of those established within the EU, while ESMA is responsible for CCPs outside the EU which seek recognition to provide clearing services to EU trading venues or which accept EU

²⁰ DRSPs are market data infrastructure providers regulated under MiFID II. Approved Reporting Mechanisms provide mechanisms for market participants to fulfil obligations in relation to transaction reporting to authorities for the purposes of market abuse monitoring. Approved Publication Arrangements provide mechanisms for the publication of data to the market.

²¹ Tenders are underway for the appointment of a third type of DRSP for different asset classes, a CTPs, which will aggregate market data across markets for each asset class and will be licensed and supervised by ESMA.

counterparties as clearing members (see Section G below for more detail). Furthermore, under the revised benchmark regulation agreed in early 2025, ESMA will also become responsible for the supervision of all in-scope third-country benchmark administrators.

35. EU legislation requires member states to nominate competent authorities, but generally the objectives, powers, resources and administrative arrangements for such authorities are determined at national level. There is a wide range of variation within member states about the objectives such bodies have. For example, many of the NCAs on the ESMA BoS do not have responsibilities in relation to financial stability. Their structures (e.g., some have integrated responsibilities for banking and insurance and other financial services, while others regulate capital markets only) and their regulatory/supervisory mandates (for example, some have separate authorities for prudential and conduct matters) vary significantly. In some cases, responsibilities are devolved within a country, with a notable example being state-level responsibility for the regulation of exchanges in Germany. Some EU-level regulation (such as MiFID II) defines minimum powers which NCAs must have in relation to that specific regime, but this is not the case for all regimes. The MiFID II powers were introduced following realization that many authorities lacked the necessary powers for supervision and the imposition of adequate sanctions.

36. Where legislation gives ESMA direct supervisory responsibility, its powers are determined in relation to that specific regime and there appear to be some gaps and inconsistencies in comparison to the minimum powers specified in comparable legislation for NCAs. While ESMA has many of the powers listed, and some of the other powers are less relevant for the types of entity ESMA supervises than for investment firms, one example of a gap is the lack of ability to remove a natural person from the management board of a supervised entity, which NCAs currently have further to Article 69 (2)(u) of MiFID II. Additionally, as mentioned earlier, for the powers that ESMA does have under sectoral legislation, these are mostly subject to the deployment of an investigation or pre-enforcement activity.

37. Although ESMA has a remit to promote supervisory convergence, its remit does not deliver a full overview of the system for capital markets supervision, akin to that available in the banking sector. ESMA does not systematically collect data on the supervisory frameworks and powers employed by NCAs, on the resources available and how they are deployed, and on detailed national programs for supervision, so it is hard to form a view of the baseline across the EA. There is a risk that the fragmented approach to the allocation of supervisory mandates and the limitation of ESMA's coordinating role to areas of topical interest at the EU level gives rise to a mismatch between the allocation of system-wide resource and the areas of greatest risk.

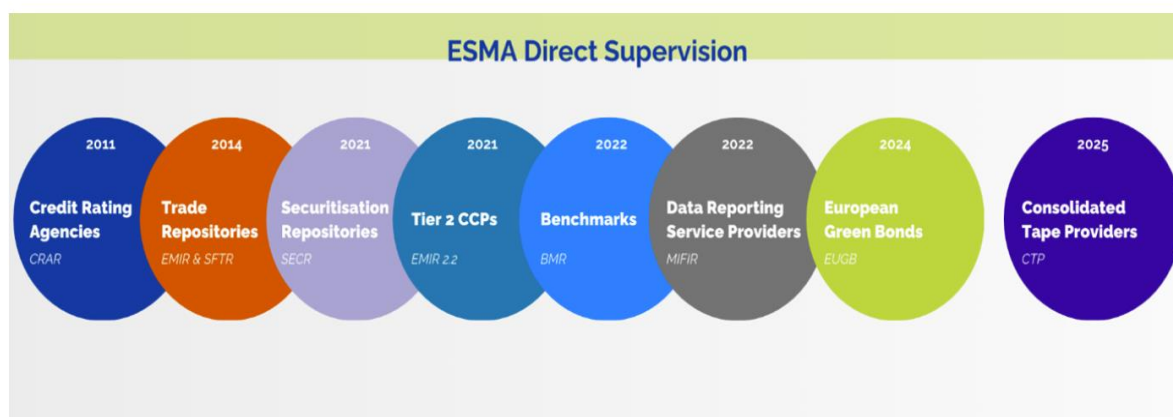
B. ESMA's Direct Supervision

38. ESMA's direct supervisory mandates have been established under individual pieces of Level 1 legislation, rather than through its founding legislation, the ESMAR. Its responsibilities have been added incrementally, with distinct powers and responsibilities assigned under each mandate. In most cases, the types of entity ESMA has been given responsibility for, have not previously been licensed or supervised within the EU, with the exception being the DRSPs and

certain benchmarks administrators (i.e. EU critical and recognized third-country administrators) which were initially licensed and supervised by NCAs.

39. ESMA is now responsible for the direct supervision of various types of market data infrastructure providers, building on the original mandate for CRA supervision given at inception.²² At the time of the mission it was responsible for the supervision of 23 CRAs, 11 Benchmark Administrators (out of which only one is an EU-based critical benchmark provider and 10 are third-country administrators recognized in the EU, one of which provides significant benchmarks), 17 market transparency infrastructures (comprising 8 DRSPs, 4 trade repositories under EMIR, three Trade repositories under SFTR and two securitization repositories). This population is expected to expand, with the addition of CTPs and external reviewers of EU Green Bonds due to take effect in 2026, and ESG Rating Providers in 2027, and for which preparatory work is well underway.

Figure 1. The Euro Area: ESMA's Direct Supervision Scope



Source: ESMA

40. For the types of entity ESMA supervises, conduct rather than prudential matters are the main source of risk to investors, market integrity and the wider financial system. ESMA has restructured to bring these directly-supervised entities within a single Conduct Supervision Department, which encompasses the licensing, supervision and investigation functions in relation to these entities and the associated policy work, such as Level 3 guidelines. It has grouped together supervision of the various market transparency infrastructures ('MTIs'), where the key risks relate to digital operational resilience and the quality and availability of the relevant data; and considered distinctly both CRAs where the key risks relate to the integrity of the rating methodology (for example freedom from conflicts of interest) and administration of critical benchmarks. The risks to the latter pertain to the integrity of the benchmark and its constituent parts, and the steps needed to prevent or manage any wider financial stability shocks arising from potential non-availability of

²² Its responsibilities in relation to CCP, under distinct legislation and governance arrangements, are discussed separately in the following section.

systemically-significant benchmarks, such as those used widely to provide reference rates in financial instruments or mortgages.

41. As for any supervisory authority taking on new mandates, ESMA has faced a learning curve in understanding the business models, risk drivers and appropriate calibration of supervisory response. Even where authorities are long-established as supervisors, it is quite common and prudent that more supervisory effort and engagement is needed in the early years of a new mandate until further understanding of business models and individual entities' specificities has been built; a body of relevant data compiled and analyzed; and effective relationships with those entities established. That has also been ESMA's approach.

42. Lessons should be learned from the transfer of DRSP supervision from NCAs to ESMA for any future transition of responsibilities. Because of the loss of synergies between trading venue supervision and DRSP supervision—with DRSPs often being an ancillary business activity connected to the operation of a trading venue— and ESMA's full cost recovery funding model, fees determined by ESMA for supervision of these entities were significantly greater than what had been charged by NCAs. This resulted in material unplanned price increases for clients and led some DRSPs to reflect carefully on whether to continue operation. It also took some time before the entities understood what ESMA was seeking to achieve from its supervision and from their perspective they were subject to a surprisingly intensive supervisory regime initially without fully understanding the aims. By the time of the mission this relationship and understanding had matured and ESMA's efforts in this regard were appreciated by stakeholders. With any future transfer of mandates, particularly of entities that have established supervisory arrangements, it will be important to avoid sudden significant changes in fees, and to ensure that ESMA is able to articulate its initial priorities and expectations early in the regime, and perhaps set expectations that there may be more intensive engagement at the start of the mandate than will be needed in the medium term. Reflecting on the experience of the DRSP supervision transfer might also be helpful to assess the advantages and disadvantages of any future potential splitting of the supervision of closely related or integrated services between ESMA and NCAs.

43. ESMA's supervisory approach appears to have matured over time. By the time of the mission, ESMA had well-articulated a framework for its risk-based approach to supervision; and identified common elements across mandates, such as in relation to governance, internal controls, and management of outsourcing and other 'third-party risks', as well as those idiosyncratic to specific mandates.²³ ESMA is using this approach to support internal efficiencies, as well as consistency and effectiveness. We saw evidence during the mission of this approach being applied and of ESMA reflecting regularly on lessons learned to refine its approach, and a number of

²³ For example, at the time of the mission ESMA was consulting on [Guidelines for Internal Controls of Benchmark Administrators, Credit Rating Agencies and Market Transparency Infrastructures](#), ESMA80-1286971524-661. This followed consultations in 2024 on guidelines for the same types of entity on [regulatory reporting](#), (ESMA84-2037069784-2169) and on [supervisory expectations for the management body](#) (ESMA84-2037069784-2168), with the latter were also applicable to Tier 2 third-country CCPs.

stakeholders indicated that they had seen an increased maturity in terms of consistency, predictability and effectiveness relative to the early days of supervision by ESMA.

C. Central Counterparties (CCPs)

44. ESMA recognizes CCPs located outside the EU that accept EU clearing participants or provide services to EU trading venues and directly supervises those deemed systemically important to the EU. ESMA assesses the systemic significance of ‘third-country’ CCPs according to a formula specified in EMIR and is responsible for the recognition and oversight of such systemically-important CCPs where the Commission has determined that the regulatory regime in the relevant jurisdiction is ‘equivalent’. Of the 37 third-country CCPs recognized at the time of the mission, two were categorized as Tier 2 CCPs equating to the higher level of systemic significance, with the remainder classified as Tier 1.

45. EMIR defines supervisory process for third country CCPs which leaves less room for supervisory deference and risk-based resourcing than is possible under some other jurisdictions’ regimes for CCP supervision. For example, for Tier 2 CCPs, ESMA is required to validate significant model changes and submit them to stress tests, even where these are undertaken by the lead supervisory authority. Furthermore, while these processes are clearly designed to address situations where there is an increase in the risk profile of the entity, they appear to have been enacted in a way which requires the deployment of a similar amount of resources even where the action of a CCP is risk-reducing. Fine-tuning and streamlining these processes where possible would enable more efficient deployment of analytical and supervisory resources.

46. Under EMIR 3, ESMA will play an enhanced role in the supervision of the 14 EU CCPs, while NCAs will remain the lead supervisor. For example, ESMA will co-chair with the relevant NCA the supervisory colleges established under EMIR with specific powers in relation to decisions about authorization and supervision made by the relevant NCA (e.g., an NCA may not authorize a CCP if the other college members adopt a unanimous opinion that it should not do so). ESMA also has expanded powers to issue opinions on proposals before decisions are made by the NCAs.

47. Assessing the effectiveness of the supervision of EU CCPs was beyond the scope of this mission, but there would appear to be scope for simplification of the institutional arrangements. Conducting oversight via such a complex system of checks and balances through, for example, the EMIR colleges and validation by the NCAs and ESMA, effectively leads to two levels of validation by authorities for model changes which seems resource-intensive and potentially duplicative. Consideration should be given to the potential efficiency and effectiveness benefits of consolidating responsibility for supervision of EU CCPs in ESMA. This might initially be done on an “opt-in” basis, and potentially with a phased transition allowing ESMA time to prepare before taking over the most complex entities. Consideration would need to be given to how best to achieve any such transfer in a way that allowed for effective consolidated supervision of the financial groups which include CCPs (including, for example, related trading venues) and also ensuring that there are appropriate arrangements in place to ensure co-ordination with the ECB and NCBs, NCAs responsible for the supervision of clearing members and NRAs. Consideration should also be given

to whether the mandatory EMIR requirements for annual on-sites of each CCP and an annual peer review of CCP supervision by ESMA constitute the most effective use of the available resources, and whether supervisory practices could more effectively be determined through Level 2 or Level 3 measures in future.

D. Supervisory Convergence

48. ESMA has a mandate to foster effective supervision by NCAs and ensure a convergent application of EU rules. Further to Article 29 of ESMAR, it is mandated to play an active role in building a common supervisory culture and consistent supervisory practices, as well as in ensuring uniform procedures and consistent approaches. Article 29 details a minimum set of activities—including issuing opinions, defining Union strategic supervisory priorities, reviewing application of Regulatory Technical Standards (RTS) and Implementing Technical Standards (ITS) and promoting effective exchange of information – for ESMA to implement this mandate. Further, ESMAR mandates it with carrying out periodic peer reviews of some or all of the activities of NCAs. Also, sectoral legislation sets out specific supervisory convergence tools, like ESMA’s Opinion to the Commission as requested by the Short Selling Regulation, or ESMA coordinated colleges of EU CCPs under EMIR.

49. Beyond the tools established in ESMAR, a broader supervisory convergence kit has been developed over time. Article 29 of ESMAR provides also ESMA with the ability to develop new practical instruments and convergence tools to promote common supervisory approaches and practices. Accordingly, the toolkit has been evolving over time, based on the experience gained and the risks and requirements at hand. New tools like Common Supervisory Actions, whereby a specific supervisory activity is deployed simultaneously across NCAs, have proven useful in bridging supervisory approaches and identifying good practices. The level of depth in published outcomes of supervisory convergence tools has also evolved over time, progressively including more detail on the findings and background of exercises.

50. Steering of convergence work happens via the Senior Supervisors Forum (SSF) alongside ESMA Standing Committees. The SSF, a permanent ESMA group, provides a forum to share expertise on common supervisory issues and address horizontal convergence issues. It includes through its alternating sectoral configurations (Markets, Investment Firms, Investment Management), the NCAs’ heads of supervision from the relevant areas and recently expanded to an enforcement configuration with the participation of heads of enforcement across NCAs. An active discussion of priorities and risks across NCAs through the SSF culminates with the production of the annual risk assessment exercise, where the more prominent risks are defined and ranked. The exercise influences not only areas for supervisory convergence but also supervisory priorities at the NCAs and it is a valued tool across the membership. Similarly, the SSF works towards the determination of Union Strategic Supervisory Priorities—generally transversal encompassing work in different sectors—with the aim of providing a structured and comprehensive response to address key market risks across the EU.

51. There is a risk that priorities identified for convergence tend to focus on areas relevant for more advanced markets. While all NCAs participate in the risk assessment exercise and USSP

process, and through the relevant work of the standing committees on the actual decision and deployment of convergence tools, smaller NCAs may play a more limited role due to the materiality of their markets and the resource constraints to participate in the most intensive exercises (e.g., in peer review committees) or may find it harder to persuade colleagues with more advanced markets that their issues are of wider relevance. These NCAs value the outcomes of these exercises and use them to guide their work, but also struggle with core supervisory topics that are not covered, or to get timely answers to specific implementation questions.

52. Initiatives like the development of the Principles on Risk Based Supervision (RBS) are very welcome to bridge that core supervision gap and foster a common supervisory culture. A recent focus of the convergence team has been the development of RBS Principles, another exercise that has been carried out within the SSF, and that aims to set a common framework for RBS across NCAs, as well as ESMA. Now the initial principles have been approved by the BoS, the plan is to work on their practical implementation – including through the development of risk-specific methodologies as needed, and continue to work on refining the framework.²⁴ This type of work can be very valuable to ensure minimum supervisory principles and frameworks are in place across NCAs, as well as to identify further core supervisory work on specific areas.

CONCLUSIONS: MANAGING RISK UNDER AN ENHANCED CMU

A. Firm Foundations for CMU

53. Renewed efforts should be made to address underlying uncertainties and conflicts in securities, corporate and insolvency laws. The Commission has made a range of proposals in the past to address areas where there is uncertainty and potential conflict about the national rules applicable, and the extent of protection for financial assets in insolvency, but has been unable to gain agreement from the co-legislator and specifically member states in some fronts. It is important that renewed efforts are made, particularly in relation to the predictability of choice of law and protection of investor rights in relation to securities and other financial instruments in insolvency.

54. Efforts to ensure the appropriate awareness of financial risks and protection for an expanded retail investor base, are important to underpin the credibility of the CMU initiatives. It is important to consider here the profile of consumers who may choose to invest for the first time if the CMU initiatives are successful. At one end of the spectrum, investors who may otherwise be drawn to crypto or other high-risk investments where incidence of fraud, scams and operational loss is high and protection limited, entering into mainstream investing is likely to reduce the risk to which they are exposed. However, for those whose assets are currently held in deposit accounts where capital is not at risk (though its value may be eroded by inflation) and there is deposit protection up to €100,000, the situation is different. For such savers it is important that they understand the different risk/reward profile of investing and are not “mis-sold”, for example as a

²⁴ ESMA plans to publish a high-level version of the Principles by year-end 2025.

result of distributor incentives. Increased supervisory focus at European and national level will be needed on this issue, particularly in member states which permit the payment of inducements and whose firms may solicit investments from across the EU. These new investors will be exposed to additional operational risk relating to the segregation and safekeeping of assets. The adequacy of client asset controls should be a focus for supervisory convergence work even in the absence of a fully harmonized framework: work to understand and, where necessary, reinforce current practice should be undertaken notwithstanding that there remain differences in the details of national rules implementing the framework specified in MiFID II and UCITS. It would be helpful if, through its convergence work, ESMA prepared a supervisory briefing on key elements of client asset supervision and a “playbook” for dealing with an investment firm holding client assets that is failing or where there is suspicion of serious loss or theft of client assets²⁵. In addition, a review of the investor compensation scheme framework should be considered, including not only an increase of the minimum investor compensation scheme coverage across the EU (currently at €20,000), but a deeper discussion of what risks such schemes should cover and whether protection against fraud and error are warranted.

B. Preparing for an Enlarged ESMA Mandate

55. ESMA is better prepared than it was a few years ago for a potential expansion of its supervisory mandate. It has introduced a more structured framework governing supervision, with appropriate consistency underpinning its approach to its different mandates alongside specificity where needed. It is building capability to make full and effective use of its supervisory powers, such that investigations can be used in a more targeted way, and enforcement used in cases where a sanction and deterrent are needed, but not as the first port of call to bring about behavior change in regulated firms.

Enhanced Approach to Risk-Based Supervision

56. Going forward, ESMA should reflect on and articulate the appropriate risk tolerance and resources to attach to its direct supervision work. To ensure an appropriate calibration of risk across the whole supervisory system, ESMA should consider whether the intensity of supervision for its firms is appropriate relative to that in place for the types of entity regulated at national level. In addition, as a risk-based supervisor ESMA should prepare to set expectations among stakeholders that no supervisory regime delivers ‘zero-failure’ and take structured decisions internally about the inevitable trade-offs between risk and resources.

57. ESMA would benefit from maximising its potential to use remediation tools without the need for formal investigations or the imposition of sanctions. Developing a supervisory relationship where ESMA sets out its expectations and holds firms accountable for finding solutions to deliver them is a key part of changing behaviour in a way that reduces risk. This can often be done in a more timely, less intrusive way that makes better use of both the authority’s resource and

²⁵ Any such exercise, however, should bear in mind the existence of diverging national insolvency regimes, over which ESMA has no convergence powers.

that of the supervised entity than where formal investigations and consideration of sanctions is used, important though these are in establishing an effective deterrent. ESMA has made progress in this regard, particularly in its longer-established mandates, and should look to apply the approach more confidently and consistently across its portfolio. Likewise, it should continue to elaborate on the choice of tools in its internal supervisory manual. It should also ensure that there is a strong and timely linkage on the CCP side between risk analysis work, such as stress tests, and supervisory follow-up and that supervisory techniques are informed by, and where appropriate aligned to, practice in relation to ESMA's other mandates. ESMA's efforts to become less prescriptive about how firms should achieve the required supervisory outcome are bearing fruit and should be reinforced. Going forward, it will be important to ensure that appropriate responsibility is placed on senior management and control functions of regulated entities to devise and implement effective and proportionate solutions. Senior managers of regulated entities should be incentivized to take ownership and empower and wherever possible, place reliance on the entity's own control functions.

Strengthened the Supervisory Toolkit

58. However, to further mature in its existing mandates and take on additional responsibilities, ESMA needs a wider range of tools that it can use in carrying out direct supervision. ESMA has shown that it can use enforcement tools effectively to impose sanctions. However, as ESMA recognizes, this is neither the most efficient nor effective means in many situations to address risk and reduce harm in the short term given that it is resource-intensive and time consuming to use and must be linked to specific regulatory breaches rather than clear indicators of risk. For its direct supervisory mandate, ESMA will need a wider, "default" set of supervisory tools in its founding regulation, in addition to those it already has, which it would be able to use in pursuit of achieving supervisory objectives without the need to prove a specific breach before doing so. Such tools should include: (i) the ability to require the firm to nominate, remove or replace a member of the board or senior management; (ii) the ability to direct the firm to take, cease or desist from taking a specified action; (iii) the power to appoint an external skilled person at the expense of the firm to carry out an assessment and report to the authority, with the choice of skilled person to be approved by ESMA and the brief determined by it. These could be supplemented if needed by mandate-specific powers in the relevant legislation. If ESMA were to be given any responsibility in relation to crypto asset service providers, investment firms or asset managers it is likely that these powers would need to be supplemented by powers to freeze assets, obtain injunctions and other measures necessary to safeguard client assets. Clarity would also be needed on how ESMA would collaborate with relevant authorities in cases where criminal investigation may be contemplated. Additionally, ESMA's current power in relation to no-action letters should be revised, to ensure it can expediently act in changing market circumstances or crisis situations, and provide adequate guidance and relief, as needed, to NCAs and industry.

Sustainable Funding and Enhanced Governance

59. ESMA's funding model also needs to be put on a sustainable basis. ESMA's entitlement to funds from the EU budget, including for supervisory purposes, should be consolidated in its founding regulation and include specific provision for spending on preparatory work before it is

able to charge fees to the relevant entities. ESMA should be given powers to hold reserves, given the strong likelihood of it being given additional tasks by the co-legislator that are not envisaged in the financial *fiche* prepared at the time of the original Commission proposals, and to allow it to be responsive to emerging risk within the seven-year budgetary period. The share of the budget contribution from NCAs should be reduced as this otherwise provides an unhelpful disincentive to further consolidation of supervisory tasks at ESMA, and to ensure that the reinforced supervisory capability at national and potentially European level, that will also be required for investor protection under an enhanced CMU can be delivered. ESMA should also be given the power, and responsibility, to set its own fees to enable greater agility than is possible through the mechanism of delegated acts. This would also enable a future transition to increased dependence on fees within the funding model, should direct supervisory mandates expand.

60. ESMA's governance arrangements should be revisited to ensure that it is able to take timely and independent decisions in relation to supervision and supervisory convergence.

Consideration should be given to adding independent non-executive directors to the existing BoS or management board or a newly-constituted board configuration, and formalizing the delegation or transfer of decisions in relation to ESMA's direct supervision to a smaller group than the BoS, consisting predominantly of senior ESMA staff. In the meantime, ESMA should continue to make full use of delegations from the BoS to the ESMA Chair, and where legally permissible to ESMA staff. Care also needs to be taken to ensure that there is appropriate operational independence from the European Commission and co-legislator, as well as from any national interest.

Transition Planning and Risk Prioritization

61. Thorough, funded transition planning is needed for the transfer of any additional mandates to ESMA. The types of entity currently under discussion (trading venues, large asset managers, CCPs, CSDs) are much more complex than those ESMA currently supervises, and the potential impact of crystallized risk greater. The experience and expertise that has been accumulated in NCAs will need to be transferred to ESMA with care, to ensure that capability is at least as strong from "day one" of any new arrangements. Within ESMA, expertise would need to be built in relation to microprudential supervision, and the balance of risk and resourcing between prudential and conduct supervision considered. Entities themselves need clarity about what supervision will look like, and the attached costs. Careful consideration needs to be given to the potential implication of splitting financial groups between supervisory authorities to ensure appropriate coordination and a consolidated view is available where appropriate. For any transition of EU CCP supervision, careful consideration will be needed to ensure appropriate arrangements for co-operation with central banks²⁶ and, if the need arises, NRAs. For any entity type where only a sub-set might transfer to ESMA (for example, as raised by some commentators, in relation to asset managers), consideration would need to be given to how to ensure appropriate benchmarking and consistency with the risk assessment and supervisory approach in relation to those that remain at national level. Given these factors, it is important that lead times for transition are sufficiently long to enable effective

²⁶ Similar considerations would arise if responsibility for CSD supervision were to be transferred to ESMA.

preparation and supported by funded transition plans. Temporary arrangements, like grace periods for shared responsibilities during transition, could also be considered.

62. As its supervisory mandate expands, ESMA will need to make an increased effort to have regard to the risks in the overall market including in areas where supervision is undertaken elsewhere. While the prudential oversight of investment firms identified so far as systemically-significant is under the SSM, conduct supervision, which may be an important driver or facilitator of prudential instability, is likely to remain at national level, as will both prudential and conduct oversight of the remaining investment firms, many asset managers (including fund managers), custodians/depositaries and others, as well as the licensing or registration of individual funds. These types of entities raise different types of risk and ESMA will need to ensure that enough focus is given to those when determining convergence work on supervisory frameworks and risk prioritization, including through further development of the Principles of Risk Based Supervision and similar initiatives. Given that a number of individual member states currently host “emerging” or “frontier” capital markets, weight should also be attached to ensuring that baseline supervisory capabilities in those areas are in place in all member states. This is particularly important to ensure that the benefits of CMU/SIU accrue across the EA, and not only to investors in those countries that already have highly-developed capital markets. Examples of the kind of tools that should be pursued include a supervisory briefing or similar guide on how to assess the safekeeping and segregation of client assets held outside of a fund structure, or a supervisory playbook for situations where urgent action is needed to protect client assets, for example where a firm is close to financial failure; has experienced an operational incident compromising access to client asset; financial fraud is suspected; significant failings are found in asset segregation or other relevant internal controls. Continuing to gather data on member states’ approach to supervision would assist ESMA in further determining areas of focus, as well as to identify jurisdictions that may benefit from more targeted work on fundamentals.

Benchmarking

63. With the prospect of an enlarged mandate in the future, ESMA’s institutional arrangements and supervisory practices need to be in line with international standards.

IOSCO’s Principles for Securities Regulation, particularly Principles 1-4 set standards for financial and operational independence, powers, and clarity in relation to the entity’s remit and transparency and consistency in its operating procedures. The changes described above are necessary components of bringing ESMA’s institutional framework into line with these principles. It is also important in this regard that ESMA’s supervisory role and powers are fully reflected and empowered in its founding regulation. ESMA itself should further enhance the transparency of its supervisory approach, continue its recent practice of taking part in supervisory convergence exercises such as peer reviews alongside NCAs where relevant, and look for opportunities to benchmark against other peer authorities or to seek external input, as the SSM has done in relation to the SREP. The authorities should self-assess against the IOSCO Principles and use them to benchmark any new institutional mandate for ESMA proposed by the co-legislators.