

**European Union: Publication of Financial Sector Assessment Program
Documentation—Technical Note on European Securities and Markets Authority**

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EUROPEAN SECURITIES AND MARKETS AUTHORITY

TECHNICAL NOTE

MARCH 2013

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT

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GLOSSARY

AIFMD	Alternative Investment Fund Managers Directive
BoS	Board of Supervisors
CCP	Central Counterparties
CEREP	Central Repository
CESR	Committee of European Securities Regulators
CRAs	Credit Rating Agencies
EC	European Commission
ECA	European Court of Auditors
ED	Executive Director
EMIR	European Market Infrastructure Regulation
EP	European Parliament
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
JC	Joint Committee
MAD	Market Abuse Directive
MB	Management Board
MiFID	Markets in Financial Instruments Directive
MoUs	Multilateral Memorandum of Understanding
NCAAs	National Competent Authorities
IOSCO	International Organization of Securities Commissions
PRIPs	Packaged Retail Investment Products
TN	Technical Note
UCITs	Undertakings for Collective Investment in Transferable Securities

I. SUMMARY¹

1. **Within its resource envelope, the European Securities and Markets Authority (ESMA) has performed well during its first two years of operation, especially in connection with the single rulebook and credit rating agency (CRA) supervision.** A significant number of technical standards, advice to the European Commission (EC), and opinions were developed. ESMA has also been able to build its expertise in connection with Credit Rating Agencies (CRAs) and has worked on the development of a risk framework to anchor its supervisory program. Results are more modest in connection with other functions. To a large extent this prioritization was driven by the financial sector regulatory agenda, which imposed regulatory obligations on ESMA, under tight deadlines, and required it to assume the supervision of CRAs, which until then had not been supervised in Europe.

2. **As it acknowledged, ESMA needs to step up its role in other areas and in particular on supervisory convergence.** The institution has set up strategic directions for each area and in many cases has developed concrete actions to take these priorities forward.

- *Supervisory convergence.* Work on reengineering and strengthening peer reviews is essential to achieve convergence, as direct use of breach of laws and mediation procedures would be fit for only few cases. The two objectives of the reengineering should be: (a) making reviews more rigorous by relying more on onsite work, and (b) sharpening their outcomes such as by linking the reports to the development of best practices and/or guidelines, the implementation of which can be monitored and followed up. If necessary, stronger actions (such as a breach of law) could then be taken. These changes might also require a stronger role for ESMA in the peer review groups and in the review panel. It is important that NCAs take the steps necessary to ensure the enforceability of ESMA's opinions and guidelines in their respective jurisdictions.
- *Risk identification and crisis management.* Projects under way will allow ESMA to make a qualitative jump in its contribution to financial stability and crisis management. However, it is critical that ESMA has access to data with the granularity and timeliness necessary to conduct in-depth analysis, including stress testing in connection with entities that could pose systemic risk. In this regard, requiring a vote from the Board of Supervisors (BoS) to provide data for particular studies that ESMA wants to undertake may hinder ESMA's ability to be timely in its work. In addition, the BoS should take a more active responsibility in this area. Thus, risk identification should remain a recurrent point in the agenda of the BoS, and not only in times of crisis. In the second case, in addition to developing a framework for

¹ Prepared by Ana Carvajal (MCM).

each scenario identified, the mission recommends that ESMA coordinates simulation exercises.

- *Investor protection.* The emphasis on product monitoring is warranted, and the consumer trends data project would be key to make a qualitative jump in this area. Effective monitoring of financial innovation should also have a positive effect on financial stability. Thus, as ESMA staff indicated, these two units should work closely. The granting of product intervention powers to ESMA is welcome, but such powers should be exercised cautiously as ESMA is not a direct supervisor.
3. **Having sufficient expert resources will be key to delivering results.** The approved additional staff for 2013 will not be enough to ensure that these other functions are sufficiently covered. Furthermore, as explained in the Technical Note (TN) on Central Counterparties (CCPs), the European Market Infrastructure Regulation (EMIR) will assign additional functions to ESMA for which resources will be critical. Expanded functions will also arise from other initiatives to be implemented in the upcoming years such as the third reform of the CRA regulation (CRA3) and Markets in Financial Instruments Directive 2 (MiFID2). Thus, the current austerity concerns should not undermine ESMA's efforts.
4. **Finally, reviewing governance arrangements to strengthen ESMA's independence vis-à-vis the National Competent Authorities (NCAs) is advised.** Current governance arrangements might negatively affect ESMA's performance of its functions, in particular supervisory convergence. In addition, ESMA staff should continue to play a stronger role in the standing committees.

II. INTRODUCTION

5. **The objective of this Note is to review the role performed by ESMA in the regulation and supervision of securities markets in Europe, and determine whether there are areas for improvement.**² This review has been conducted by Ana Carvajal, MCM. Particular emphasis has been given to functions related to financial stability. The analysis looked into current governance, financial and organizational arrangements as institutional issues can have a significant impact on ESMA's ability to carry out its mandate. Issues related to financial market infrastructure as defined by the CPSS-IOSCO are outside of the scope of this Note.
6. **This analysis is based on a questionnaire answered by ESMA, as well as public information in its website, including its annual report for 2011 and its work**

² The IOSCO Principles for Securities Regulation, particularly the Principles for the Regulator and the Principles for CRAs, were used as a reference for this review. However, it is important to note that except for the supervision of CRAs ESMA does not have direct supervisory authority.

program for 2013. It also benefited from discussions with ESMA, the European Commission (EC), a sample of NCAs and a sample of market participants.

III. SECURITIES MARKETS: BRIEF DESCRIPTION OF MARKET STRUCTURE

7. **The EU financial systems are mostly bank-based.** However, especially in certain EU countries, equity and bond markets are well developed, although less liquid than the U.S. markets. As of 2012Q2 there were 6,654 issuers admitted to trading in regulated markets (RMs) or multilateral trading facilities (MTFs) in Europe, and market capitalization of EU RMs amounted to US\$11,076 billion. The collective investment schemes (CIS) industry is the second largest in the world, with assets under management of US\$11,172 billion as of March 2012 out of which US\$7,965 billion were AUM by undertakings for collective investment in transferable securities (UCITs). As of January 2012, AUM by hedge funds amounted to US\$550.94 million.

8. **There is high degree of integration of securities markets.** Although additional work still needs to be done, the passport system³ which is available for issuers, UCITS and investment firms, has helped to integrate securities markets in EU, in terms of the ability for “passport” issuers and UCITs to tap investors from the EU and of “passport” investment firms to trade and sell “passport” products across the EU.

9. **There has been a proliferation of trading venues with the implementation of MiFID.** As of 2012 Q2 there were 92 RMs and 138 MTFs licensed to provide services in EU. While RMs remain the main trading venues, MTFs have gained an important share of market volumes. Roughly 35 percent of the total volumes were transacted in MTFs. However, fragmentation differs significantly across countries, with some countries—such as Spain and Italy—where there is still a high concentration of trading through the exchanges.

10. **As in other markets, the EU markets face challenges in connection with price transparency.** While the data is scarce, it is estimated that dark pools represent around two percent of all trading in Europe. If over the counter (OTC) trading is included, around 45 percent of trading in the European Economic Area (EEA) is not subject to pre-trade transparency. Also there is significant difference across countries in regard to the percentage of trades that are conducted OTC.

11. **Also, as in other markets, high frequency trading is growing.** There is no comprehensive data on high frequency trading (HFT), but information from surveys sent by ESMA to selected trading platforms indicate that HFT firms account for between 40 and

³ The single passport allows financial intermediaries legally established in one member state of the EU to establish/provide their services in the other member states without further authorization requirements. A similar effect has the passport system for issuers and UCITS, whereby the authorization for public offering given in one member state allows the issuer to do public offering in other member states without requirements.

70 percent of the total index trading volumes in 2010 Q4 on individual trading platforms. In the futures market HFT firms accounted for between 10 and 60 percent of total equity index futures trading volumes on individual trading platforms over the same period and HFT firms accounted for up to 95 percent of all orders sent and 97 percent of all orders cancelled for one trading platform.

IV. ESMA: INSTITUTIONAL ARRANGEMENTS

A. Mandate and Powers

12. **ESMA was created in 2011⁴, as part of the new European System of Financial Supervision.** This system consists of the European Systemic Risk Board (ESRB) and the three European Supervisory Authorities (ESAs), ESMA based in Paris, the European Banking Authority (EBA) based in London, and the European Insurance and Occupational Pensions Authority (EIOPA) based in Frankfurt. While new in its current structure and nature, it builds on the work of its predecessor, the Committee of European Securities Regulators (CESR). Pursuant to Article 5 of ESMA Regulation, ESMA is a legal body of the Union, with legal personality.

13. **Pursuant to Article 1 of ESMA Regulation, ESMA’s mission is to enhance the protection of investors and reinforce stable and well functioning financial markets in the EU.** To achieve such objectives several tasks are allocated to ESMA in Article 8 of ESMA Regulation, along with the powers to undertake them. Such tasks and powers can be grouped in the following themes:

- *Regulatory work.* ESMA has a key role in contributing to the development of a single rule book via (i) the development of technical standards, (ii) the development of guidelines, and (iii) the provision of advice to the EC on secondary legislation.
- *Supervisory convergence.* ESMA has a role in supporting convergence of supervisory culture and practices mainly by (i) issuing opinions, (ii) conducting peer reviews, and as a last resort (iii) making use of powers to investigate and remedy breaches of Union laws.⁵ Pursuant to ESMA’s Regulation other means to foster supervisory convergence include the development by ESMA of sectoral and cross sectoral training. Furthermore Article 17

⁴ Regulation 1095/2010 of the European Parliament and of the Council of November 24, 2010 establishing a European Supervisory Authority (European Securities and Markets Authority)

⁵ Article 17 of the ESMA Regulation provides ESMA with the power to investigate possible breaches of EU acts by national competent authorities (NCAs)—either because they have failed to implement such acts or have implemented them in a way which appears to be a breach of law. After the investigation, ESMA may address a recommendation to the NCA concerned setting out the action necessary to comply with Union law.

of ESMA Regulation empowers ESMA to develop new practical instruments to foster convergence.

- *Financial Stability and crisis management.* ESMA's obligations include contributing to the assessment of risk and financial stability. To this end (i) it carries out its own analysis, (ii) contributes to the work of the Joint Committee, which was created to enhance cooperation and ensure cross sectoral consistency, and (iii) cooperates with the ESRB. On crisis management ESMA's role is fundamentally one of coordination, except in connection with short-selling where recent regulation has also given it direct powers to intervene.
- *Investor Protection.* ESMA contributes to strengthen the framework of investor protection through different tools, including (i) issuing guidelines and (ii) the power to issue warnings in the event that a financial activity poses a threat to investors.
- *Supervision.* ESMA's direct supervisory role currently focuses on CRAs. Since July 2011 ESMA is responsible for the registration and supervision of CRAs in the European Union.

B. Governance

14. **ESMA's governance structure is established in Article 6 of ESMA Regulation.** The Regulation confers specific roles to (i) a board of supervisors, (ii) a management board, (iii) a chairperson, (iv) an executive director, and (v) a board of appeals.

15. **ESMA is governed by a Board of Supervisors composed of the heads of the 27 NCAs for the supervision of financial markets in each member state.** In addition, there are observers from the European Commission (EC), ESRB, EBA, and EIOPA. Norway, Iceland, and Liechtenstein also attend as permanent observers.

16. **The BoS is the decision making body of ESMA.** The Chair of ESMA is responsible for preparing the work of the BoS and participates in its meetings without voting rights. The Regulation requires board members to act independently and objectively and in the sole interest of the Union as a whole, and therefore should not take instructions from any European body or domestic authority. Pursuant to ESMA's Regulation, most decisions are taken by a majority of votes, where each member has one vote. However the adoption of technical standards and guidelines requires a qualified majority. Under the qualified majority voting process, voting rights are weighted by population to ensure demographic representativeness. Stakeholders interviewed indicated that this represents a fundamental change from CESR's way of operating as its decisions were taken by consensus—which in some cases meant agreeing to the lowest denominator. Yet, the qualified majority required for technical standards and guidelines means in practice that blocking minorities could stall the work or force compromises that can affect the quality of standards. However,

stakeholders interviewed consider that the requirement for a qualified majority has not prevented ESMA from being able to agree on the technical standards required by law, without detriment to the quality of such standards. Nevertheless, there is concern that the current composition of the BoS, as a college of peers, can hinder the performance of other functions, in particular supervisory convergence, where the institution has not developed yet a robust approach for the identification of divergent practices and appropriate follow up, as will be further described below.

17. **The BoS has met regularly.** In 2011, it met seven times. As indicated by the BoS procedures, in the majority of the cases the NCAs sent their head to the meetings; and when not possible a high-level alternate was sent.

18. **Standing committees—made up of staff from the NCAs—do the preparatory work for ESMA’s decisions.** There are currently 11 standing committees (SCs). Ad-hoc task forces are also constituted from time to time. NCAs lead the work of the SCs, i.e., chair them and in some cases “hold the pen,” while ESMA staff act as the rapporteurs. There was consensus among the stakeholders interviewed that over time ESMA staff is becoming more active in the discussions. ESMA staff highlighted that when consensus on a topic has not been reached, more often now reports explicitly state ESMA’s position in addition to highlighting the different alternatives. In addition, at BoS meeting, the Chair presents the position of the institution.

19. **ESMA also has a Management Board (MB), which is composed of six members selected from the BoS by its members.** ESMA’s Chair is a member and chairs the MB. The Executive Director (ED) of ESMA prepares the work of the MB. The EC representative is a non-voting participant but votes on budget matters. The MB focuses on management aspects of the Authority, such as the development of the annual work program, the budget and resources.

20. **ESMA’s Chair and the ED are appointed by the BoS, following an open selection procedure based on merits, skill, knowledge, experience relevant to financial sector regulation and supervision, and managerial experience.** Both are required to act independently and are prohibited from taking instructions from any European body or domestic authority. Both are appointed for five year terms with the possibility of reappointment for one more term. Before the Chair takes up his/her duties, the European Parliament (EP) may object to the designation. The Chair may only be removed by the EP following a decision of the BoS. The ED is appointed by the BoS after confirmation of the EP. The ED may be removed by decision of the BoS. ESMA Regulation does not require the existence of “due cause” for the early removal of the Chair or the ED.

21. **There is one Appeal Board for the three ESAs composed of two experts from each sector (and their alternates).** Decisions of the Appeal Board can be appealed to the European Court of Justice.

22. **The Regulation also establishes a Securities and Markets Stakeholder Group to facilitate consultation with stakeholders in areas relevant to ESMA’s tasks.** It has 30 members appointed by ESMA for a period of two and a half years following an open call for candidates. In practice this group is active and has its own work program. The Group has periodic meetings with the BoS, for which an agenda is set up in advance. ESMA officials indicated that the Group is vocal in raising issues of concern to ESMA. Thus, as stated in the corresponding section below, they expect this group to be a source of valuable information for the purpose of supervisory convergence.

23. **ESMA operates under a high level of transparency.** A significant amount of information can be found in ESMA’s website, including the minutes of the meetings of the BoS, ESMA’s annual work program, its budget and its annual report. The reports of the different standing committees can also be found in the website. Proposals for technical standards and guidelines can also be found in the website.

24. **In addition, mechanisms of accountability exist vis-à-vis the EP and the Council of the EU.** By regulation, the EP and Council can summon ESMA at any time, and can require opinions from it. In practice accountability has been made operational in two ways. First, via an annual joint hearing at the EP for the three ESAs. Second, ad-hoc hearings (of a more technical nature) take place with the EP and Council.

Conclusions and recommendations

25. **In the context of the upcoming review to be conducted by the EC⁶, governance arrangements should be evaluated and if necessary further enhanced.** It must be acknowledged that ESMA represents a significant evolution from its predecessor (CESR), not only from a legal perspective, but also from an operational perspective. In this regard, most of the stakeholders indicated that the presence of the Chair in the discussions of the BoS ensures that ESMA’s positions are heard. However, the conversations with stakeholders and examples given by them lead to the conclusion that decisions are still dominated by “domestic” views. Furthermore, the mission concurs that ESMA's governance structure could be particularly troublesome in the context of supervisory convergence. The fact that there does not appear to be strong follow up of the conclusions of peer reviews—as will be further explained below—might be in part explained by the current composition of the BoS. Therefore, the mission recommends that this issue be further analyzed during the review of the ESAs, with a view to enhancing ESMA’s independence Executive Director the NCAs, while keeping a framework of high accountability to the European authorities. Different alternatives can be considered: from adding more independent members to the board, to

⁶ Article 81 of ESMA Regulation requires the EC to conduct a review of the performance of the Authority by January 2, 2014 and every three years thereafter. The same obligation exists in connection with EBA and EIOPA.

moving to a fully full time board, to delegating more functions to the MB. In addition, the rules for removal of the Chair and the ED should be strengthened by requiring removal only with due cause. Finally ESMA staff should continue to play a stronger role in the standing committees.

26. **From a transparency perspective, more engagement with the stakeholders group in connection with the work plan can be explored.** ESMA already works under a high degree of transparency to the public and stakeholders. One aspect where more engagement could be advisable is in relation to the development of the work plan. ESMA could engage with the Stakeholders Group early on in the process to get their views on priorities.

C. Funding and Budget Issues

27. **Pursuant to Article 62 of ESMA Regulation, ESMA has three sources of funding: a subsidy from the EC⁷, a contribution from the NCAs, and a fee levied on registered firms under its direct supervision.** Currently only CRAs are subject to this levy, but with the approval of EMIR, trade repositories would also have to contribute to ESMA's funding. Thus, its funding differs from the other ESAs, where 60 percent of their funding comes from the EU and 40 percent from the NCAs. For 2013, ESMA's budget will amount to €28.3 million, of which the EC contribution would represent roughly 46 percent, the NCAs' contribution 30 percent, the CRAs' contribution 20 percent and the trade repositories' 4 percent. It was indicated that the contribution of the largest NCAs do not represent a significant proportion of ESMA's budget.

28. **There are procedures in place for the development of the budget proposal by ESMA.** ESMA has linked the development of the budget to the work plan. Thus, its annual work program has an estimate of the resources that would need to be allocated to each major area, for it to be able to deliver on the priorities established in such plan. The preparation of the proposal is a responsibility of the ED (in close collaboration with all divisions and units), who submits it for the consideration of the MB. In turn the MB submits it for the approval of the BoS.

29. **The EC decides on the budget proposal to be sent to the EP.** The budget proposal approved by the BoS must be submitted to the EC in a template developed by the EC, which includes three line items (staff, administrative and projects) and a justification from ESMA for the amounts proposed. The EC can make changes to ESMA's proposal, and the EP and Council in turn can make changes to the EC proposal. In practice during the two years of existence of ESMA, the EC has only made minor changes to ESMA's proposal. In this regard its situation differs from the other ESAs, since in their cases the EC has in fact proposed cuts to the initial proposals of the ESAs.

⁷ Entered in the general budget of the EU (Commission section).

30. **There are internal mechanisms to oversee budget execution.** There is monthly reporting to the ED and quarterly reports on progress in the execution of the budget to the MB. ESMA is currently working on the development of performance indicators for 2013.

31. **In addition, there are mechanisms in place for budget accountability.** ESMA's accounts and use of resources are audited on an annual basis by the European Court of Auditors (ECA). Twice a year the ECA sends a team of three inspectors, which spends roughly two weeks reviewing ESMA's use of resources. In addition ESMA has an Internal Control Officer and, as is the practice for many other EU agencies, an internal audit of ESMA is carried out by the EC, which sends a team also on an annual basis to check use of resources focusing on efficiency.

Conclusions and recommendations

32. **It would be useful to review the funding structure and more generally the budget process.** In the medium term, the current funding structure could become a problem. First this funding structure could create conflicts of interest vis-à-vis the NCAs—as in some cases there might be a bias against letting ESMA grow in light of views toward centralizations of functions. Second, as ESMA grows, the contribution from the NCAs could become a heavy burden for the smaller jurisdictions, and a risk of non-payment could arise. This opens the question of what would be the ideal source of funding. The mission concurs with the opinion of the Committee on Economic and Monetary Affairs of the EP⁸ that additional funding models should be explored, including industry fees, and in fact part of ESMA's budget is already funded this way. However, it may be difficult in the short term, to expand such type of funding mechanisms beyond CRAs. On one hand, there would be resistance from market participants to a system of “double” charge (to fund the domestic authority and to fund ESMA), while on the other a system where the levy charged domestically would be offset to compensate for a levy charged at ESMA level could negatively impact the operation of the domestic regulator. From a strictly technical perspective, the functions assigned to ESMA are not identical to those of the NCAs; furthermore in many ways they benefit market participants, including for example by ensuring the existence of a level playing field across the EU. Thus, a system of dual charge could very well be implemented. In addition, given the large number of regulated participants in EU, the levy on each could be relatively small. An alternative would be to be funded entirely by the EU or to increase its share of funding.

33. **In this context, it would be important to review also the current role in the EC in the approval of the ESAs' budget.** The experience is that in times of austerity the EC could be under pressure to reduce the budgets of the ESAs, using a mechanistical reduction scheme

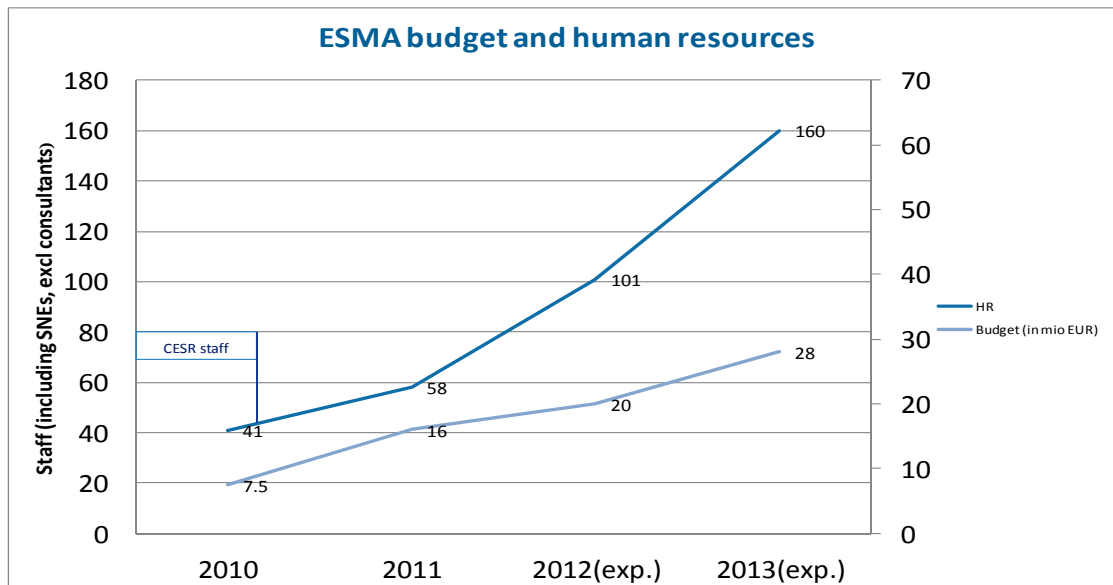
⁸ Committee on Economic and Monetary Affairs, EP, Opinion, for the Committee on Budgets, on the General Budget of the European Union for the financial year 2013-all sections, 2012/2092

across the board, without any differentiation for the ESAs vis-à-vis other public agencies.⁹ It is worth exploring, whether ESMA should present and justify its budget directly to the EP and Council.

D. Organizational Structure and Resources

34. **During its two years of existence ESMA’s management has worked on the development of its organizational structure and procedures for operation.** ESMA currently has three divisions (Markets, Investment and Reporting and Operations) and three units (Credit Rating Agencies Unit, Economic Research and Financial Stability Unit, and Legal Cooperation and Convergence). ESMA is bound by the same administrative rules that apply to other public agencies of the EU, for purposes of recruitment and procurement.

35. **ESMA’s human resources are growing.** It started with 35 staff (from CESR). As of November of 2012, it had 85 professionals on post, 16 percent less than the 101 included in the budget plans end 2012. ESMA’s officials explained that as per recruitment procedures it takes an average of six months until the person arrives. ESMA’s Chair also highlighted that the institution has “taken the time” to fill key positions to ensure that people with the right skills are selected. Furthermore, all key positions at ESMA (heads of division or unit) were subject to an open selection process. Finally, ESMA’s officials also indicated that the rapid growth of the institution is a key challenge from a managerial perspective, as staff needs to familiarize with the different procedures of the institution, and more generally with the specific functions assigned to them.



⁹ See Idem.

36. **There is a mix of 75 percent staff and 25 percent secondees from NCAs and contractors.** Staff is hired under a three year contract, with the possibility of renewal for another three years, and then can be offered an “indefinite” position. ESMA’s officials indicated that salaries have not hindered recruitment of qualified experts as EC salaries—which apply also to ESMA—are reasonably high. However they recognized that there are significant differences in salaries across Europe; and that hiring experts from “the north” is more challenging, as their salaries are relatively higher

	2012 Current	2012 Planned	2013 Planned
Staff	68	75	121
Secondees	9	16	25
Contractual	8	10	14
Total	85	101	160

37. **ESMA provides training on securities market issues and on cross-sectoral issues together with EBA and EIOPA.** Training programs are developed in cooperation with the NCAs and part of the training is delivered by the NCAs. Eleven seminars were organized in 2011. In 2011, two training sessions were targeted to ESMA staff. Nine sessions are planned for 2012. In addition ESMA staff has access to the training programs of the EC.

38. **Several IT projects are key to ESMA’s mandate.** ESMA developed a data depository to assist it in its CRA supervision. CRA3 requires the expansion of such data base, as “live” information must now be stored and made publicly available. MiFID2 might also lead to the need for further IT developments. There are also IT needs connected to the risk identification function, which will be explained below. Finally, there are also several on-going IT initiatives, including IT developments in connection with registers of issuers (notifications of prospectus approval) and investment firms (consolidation of information on registered firms from EU member states).

Conclusion and recommendations

39. **ESMA is building a strong institution with adequate expertise.** This has been confirmed by the meetings with both ESMA staff and stakeholders. In this regard, there is consensus that ESMA staff is becoming more active in the standing committees and making its views heard which over time can act as a counterbalance to the “domestic” positions of NCAs. Ideally this evolution should lead to ESMA staff chairing standing committees to foster EU wide interests being fully incorporated into the work plans and different reports of the standing committees. To achieve this it is critical that ESMA keeps a high ratio of expert staff versus secondees.

40. **However, ESMA needs more resources to carry out all its functions effectively.** The budget envelope for 2013 would not be enough to allow for the implementation of the

different initiatives mentioned in this TN, which are critical for ESMA to take a more active role in functions beyond the single rulebook and the supervision of CRAs. Furthermore, initiatives in the pipeline such as EMIR, CRA3 and MiFID2 will create new responsibilities for it or expand existing ones.

41. **Finally recruitment policies should be monitored to determine whether they pose any risk to ESMA's ability to attract and retain qualified staff.** The mission acknowledges that at this stage recruitment policies, in particular the six year term to provide an indefinite position to staff, might work to the advantage of ESMA, as indicated by the Chair. However, at the outset the six year policy does not seem conducive to the stability of the organization, which should be a long term objective of recruitment policies. It is early to make a definitive judgment; thus this is an issue to keep under monitoring.

V. ESMA'S ROLE IN FINANCIAL STABILITY

A. Direct Supervision of CRAs

42. **ESMA has a dedicated unit for the supervision of CRAs.** Currently this unit has 16 staff (15 officers and the head of unit), with a mix of policy, market and supervisory experience. The unit is expected to grow to 26 people by 2013. With the approval of CRA3 ESMA will receive funding to hire 15 more staff. Not all of them would be assigned to this unit, as other divisions provide supporting services and therefore also require an increase in resources.

43. **Since July 2011 all registration and supervisory responsibilities concerning CRAs were transferred from the NCAs to this unit.** There is a Technical Committee chaired by the ED, composed of NCAs and observers of the EC, EBA and EIOPA, which provides advice to the unit on its policy work and international cooperation. This and the IT Committee are the only Committees currently chaired by ESMA.

44. **Since its operation, the CRA Unit has conducted significant supervisory work.** This work included:

- *Registration and certification.* It provided advice and assistance to NCAs with the application process. Since July 2011 it has taken charge of the assessment of new applications, with one new CRA being registered upon application received directly by ESMA. There are currently 18 registered CRAs and one certified CRA. There are five applications pending.
- *Perimeter.* ESMA contacted around 30 companies the activities of which prima facie could be considered to fall under the CRA Regulation and requested explanations. It is currently preparing guidance on the scope of the CRA Regulation to be published in 2013.

- *On-going supervision.* ESMA is taking a multidimensional approach, which includes desk reviews—based on notifications of changes, complaints and other periodic data—and on-site inspections, both horizontal (thematic) and vertical (on individual entities). Last year, ESMA conducted on-site inspections of three global CRAs with a view to better understanding their business models and operations and gaining expertise. As a result of such inspections, ESMA sent individual reports to each CRA with a request for changes and a plan for implementation, which ESMA is monitoring. In addition, it published a report summarizing main findings, which is available on ESMA’s website. Based on the findings from these inspections it is currently conducting a review of banking rating methodologies. In addition, based on its risk analysis it decided to conduct a vertical individual on-site inspection on the internal controls of another CRA. As per the CRA Regulation, the CRA Unit must conduct inspections on all CRAs by 2014. Conducting these inspections is in the work plan of the Unit.
- *Development of a central repository (CEREP).* Pursuant to the obligations established in the CRA Regulation, ESMA developed CEREP, which is a data repository that makes available information on past performance of ratings (six months lag) via the ESMA webpage. CRA3 will require such data to be available in real time. Another IT tool, SOCRAT will facilitate the processing of ratings data in a standard and automatic manner to support ESMA’s supervisory activities and would provide the Unit more input for its risk assessment framework.

45. **In addition, the Unit has made progress in the development of a CRA Risk Assessment Framework, as the basis to support its supervisory program.** Overall the work program will be risk-based. The risk factors included in the framework are: environmental risk, operational risk, business model risk and governance risk. The Unit developed criteria/alerts for each type of risk, in order to foster a consistent view of risk by the officers. It is estimated that roughly 70 percent of the supervisory resources would be spent on the large CRAs; however the approach of the Unit is that there should be at least some engagement with all CRAs, even the small ones. In this regard, each CRA has been assigned a relationship manager in charge of continuous monitoring of such CRA. Feedback from the relationship managers would be one of the inputs for the risk assessment framework. Such minimum engagement would include also periodic (annual) meetings with the compliance officers of the CRAs. Once the inspections on all CRAs are concluded, it is estimated that on an on-going basis the Unit will conduct two thematic reviews and two vertical reviews per year, in addition to other supervisory work (registrations, handling of complaints, etc).

46. **ESMA has been active ensuring coordination with non-EU regulators.** ESMA has finalized MoUs with a number of jurisdictions including the United States, Canada, Australia, Hong Kong, Japan, Brazil, Singapore, Mexico and Argentina. In addition, ESMA has been actively involved in IOSCO’s consultation on the establishment of a global

“college” for CRAs. The expectation is that regulators would not only share information, but also that they would be able to conduct joint inspections.

47. With the approval of secondary legislation on the amount of fines and the procedures for their imposition, all enforcement tools can now be used by ESMA.

Pursuant to the CRA Regulation, ESMA has the power to withdraw a firm's license, if licensing requirements are no longer met. In addition, in the case of infringements to certain provisions of the Regulation, ESMA can (i) temporarily prohibit the CRA from issuing ratings with effect in the EU, (ii) suspend the use for regulatory purposes of ratings with effect in the EU, (iii) require a CRA to bring the infringement to an end, (iv) issue notices, and (v) impose fines. Recently, through secondary legislation, the EC established the amount of the fines that can be imposed. In each case the regulation establishes a minimum and a maximum fine that can be imposed for each type of infringement.¹⁰ Overall, the maximum fine that could be imposed is €750,000 for a first time infringement. Sanctions can be appealed to the Appeal Board. Finally, decisions of the Appeal Board can be appealed to the European Court of Justice.

48. A system of internal oversight has been developed. Medium term objectives are prepared by staff and discussed and approved at BoS level. This process also applies to the annual work plan and the risk based supervisory approach. There is monitoring of implementation of the work plan via reporting to the MB and major changes to the objectives are to be reported to the BoS during the course of the year where necessary.

49. Mechanisms for public accountability are also in place. In particular, ESMA will make available to the public a public version of the work program, an annual report, and reports following thematic reviews, such as the one published in March 2012.

Conclusions and recommendations

50. Over the next couple years, ESMA needs to finalize the implementation of its risk-based supervisory approach for CRAs. Overall, the approach developed by the Unit is comparable to approaches taken by other regulators. The mission agrees that a risk-based supervisory approach is a sound way to go, provided that at least a minimum engagement is kept with the small CRAs, since they can be important in a domestic context. This is already envisioned by ESMA. Furthermore, the mission believes it is important that after the initial on-site inspections required by regulation for all CRAs, small CRAs are at least included from time to time in the samples for thematic on-site inspections. This would be in addition

¹⁰ Infringements are grouped in categories, and a minimum and maximum fine is assigned to each category. For example, the “lowest” category contemplates sanctions ranging from €10,000 to €50,000 and the “highest” category from 500,000 to 750,000. Aggravating and mitigating factors triggered increases or decreases respectively which amounts are also specifically prescribed in the regulation.

to the basic level of engagement via the relationship managers and the meetings with compliance officers. In addition, meetings with senior management of the CRAs should also be considered. A key challenge in supervision would continue to be striking a right balance between the need to supervise that the methodologies used by the CRAs are “rigorous, systematic, continuous and subject to validation, without interfering with their content, as required by the Regulation.

51. **It is important also that ESMA keeps close coordination with the NCAs.** Due to their functions –in particular concerning market surveillance and monitoring of issuers’— they could provide valuable information to feed ESMA’s risk-based approach.

52. **Oversight mechanisms have struck the right balance on the role that the BoS should play in connection with CRA supervision.** CRA is the first case where an ESA has direct supervisory powers. Therefore, it is critical that the exercise of this role is structured well from the start. Furthermore, as ESMA will get supervisory powers in connection with trade repositories, current oversight arrangements for CRAs should also serve as a blueprint. In this regard, the mission believes that that monitoring of specific and supervisory work should remain at the level of the MB whilst the role of the BoS should be one of oversight. This oversight should be exercised through the discussion and approval of the work plan and the risk based supervisory approach that the CRA unit is developing, as well as through periodic reporting on the accomplishment of the working plan, as appears to be currently the case. Engagement in connection with individual supervisory work (for example, conduct of individual on-site inspections) should remain at management level, without intervention from the BoS.

53. **As part of the review of the ESAs to be conducted by the EC, the mission recommends that the enforcement framework for CRAs be reviewed.** The mission considers positive the fact that the framework requires disclosure of the sanctions after their imposition by the BoS. However, the sanctions that ESMA can actually impose appeared rigid as the approach appears very mechanistic and, depending on the size of the CRA, in practice could be too low to have a deterrent effect –although it is early to predict whether the publication of the sanction would suffice to alter behavior. The mission acknowledges that pecuniary sanctions are only one tool to influence behavior.

B. Identification and Monitoring of Risks

54. **Risk identification and monitoring is the responsibility of the Economic Research and Stability Unit.** As of November of 2012, this Unit was composed of 6 staff. It is expected to grow to 11 staff by 2013. In addition, there is a Standing Committee for Economics and Market Analysis (CEMA).

55. **Risk identification is mainly based on the continuous monitoring of a set of indicators, which then feeds into two periodic reports¹¹ that must be approved by the BoS.** Currently this analysis is done based on publicly available data.

- *A quarterly risk dashboard.* ESMA has produced seven risk dashboards. This publication is a market trends analysis divided in four categories (risk overview, liquidity risk, market risk, contagion risk, and credit risk). The content of these reports is similar to reports produced by central banks. ESMA acknowledges that a key challenge is to adjust the categories/indicators in the risk dashboards to securities markets. A recent improvement, for example, was the inclusion in the most recent report (Q2 2012) of an indicator of stress in securities markets. A second challenge, already in the working plan of the unit, is to develop a set of early warning indicators, based on risks that originate in securities markets (for example, related to hedge funds).
- *Bi annual report of Trends, Risks and Vulnerabilities.* This report is mandated by ESMA's Regulation. ESMA produced its first report last year. The first section aims at providing a systematic analysis of markets; the second is a replica of the dashboard(s) and the third contains a thematic analysis of risks that ESMA believes deserve attention. ESMA acknowledges the need to further improve this Report, by having a more systemic analysis of the markets within its remit, which requires also improvements in the indicators to be followed, as discussed above.

56. **Such periodic reports are complemented with thematic work.** Two reports have been completed on: (i) the risks associated with the current industry trends toward structured and complex retail products; and (ii) an assessment of the size of shadow banking. On-going thematic work includes the following analyses: (i) credit default swaps market, (ii) contribution of the hedge fund sector to systemic risk, (iii) high frequency trading in European equity markets, and (iv) bank funding issues and securities financing transactions (the latter coordinated by the ESRB).

57. **In addition, the Unit is currently working on developing techniques for stress testing of securities firms.** In this regard ESMA considers important to do work in connection with three types of firms: trading venues, hedge funds and CCPs. However, at least in the first case, its informal request for data from the NCAs met with opposition and the NCAs requested a strategic discussion at the BoS level on ESMA's stress testing strategy. At the time of this review such discussion had not taken place.

58. **Finally the Unit believes it is important to work on building a full set of relevant data.** A data warehouse would incorporate publicly available data as well as the incoming

¹¹ There is also weekly Financial Monitor.

regulatory data. In addition to the operational challenges described above, there are areas where data is not collected at the NCA level and these gaps will need to be filled. Incomplete data hampers complete and accurate analysis.

Conclusions and recommendations

59. **Projects under way will allow ESMA to make a qualitative jump in its contribution to financial stability and crisis management, provided that it has access to data.**¹² The mission found the work-plan to be very reasonable and on-point. However, it is critical that ESMA has access to data with the granularity necessary to conduct in-depth analysis, including stress testing. Article 35 of the Regulation provides ESMA with the power to request information to the NCAs as long as such information is necessary to fulfill its mandate.¹³ However the recent experience of ESMA indicates the existence of practical challenges. In this regard, requiring a vote from the BoS to provide data for particular studies that ESMA wants to implement might hinder ESMA's ability to be timely in its work.

60. **It is important that the BoS takes a more active responsibility in risk identification and monitoring.** The mission acknowledges that the BoS has had discussions on risk in the context of the current crisis. What is key is that risk identification remains a recurrent agenda item for all meetings of the BoS, and not only in times of crisis, and that input from those discussions be given to the corresponding Unit (Economic Research and Financial Stability). The same applies to CEMA.

C. Crisis Management

61. **ESMA's role and powers in crisis management generally focus on coordination.** Pursuant to its Regulation, ESMA only has direct powers where sectoral legislation provides it with such power—which is the case in the short-selling regulation—or when an emergency has been declared by the European Council.

62. **The short-selling regulation provides ESMA with direct, but exceptional intervention powers.** The regulation grants temporary intervention powers to NCAs. Measures available include (i) increased transparency requirements, (ii) prohibiting or restricting natural and legal persons from engaging in short sales on a trading venue, or

¹² Contributing to financial stability is for many regulators a new focus, and therefore many of them are also at an early stage of implementation of tools and arrangements to identify systemic risk. Furthermore, IOSCO recently reviewed its Principles and Objectives of Securities Regulation and introduced a new principle on systemic risk, which requires securities regulators to have in place a process, or contribute to a process to identify systemic risk. In addition, a new principle was also added on perimeter of regulation, which requires securities regulators to have in place similar type of arrangements to review the perimeter of regulation.

¹³ Only when the information is not made available in a timely fashion and after following certain steps, ESMA can request it directly to market participants.

otherwise limit transactions on a specific financial instrument in such trading venue for a maximum of three days in certain circumstances, (iii) an outright prohibition on short-selling for a period of time, or (iv) imposition of conditions on a short sale or transactions that indirectly create short positions. If a NCA intervenes it is required to notify ESMA, which has to issue an opinion within 24 hours on whether it considers the measure necessary to address the exceptional circumstance faced by the NCA. If ESMA considers that there is a threat to financial stability that is not adequately addressed by the NCA's actions, it has the power to take any of the measures available to NCAs.

63. **ESMA has not yet made use of such powers.** In November of 2012, two NCAs issued bans on short-selling. There were concerns in the market that the two bans were not identical, creating challenges for their implementation. ESMA did not use its direct intervention powers in this case, but was required to issue an opinion on the measures of the NCAs. Recently, the United Kingdom brought a suit against the European Parliament and the Council of the European Union for granting such powers to ESMA. The suit is pending (C-70/12).

64. **In its coordination role, ESMA has recently started work on crisis management, with the goal of identifying the potential crisis scenarios where it would need to be involved and establish a framework to deal with such events.** The starting point was the development of a definition of “crisis” for securities markets (i.e., one that seriously affects orderly trading or financial stability, with cross border implications and an urgency element). Such definition led to the identification of six types of events that would fit into it: (i) EU wide trading suspension, (ii) EU wide ban on short selling, (iii) EU wide suspensions of redemptions of units in UCITs, (iv) settlement fails on a pan-European basis, (v) EU wide product intervention measures, and (vi) failure of clearing members and CCPs.

65. **The development of a framework to deal with each scenario is ongoing.** A first output from such work is a protocol for exchange of information in connection with CCPs. The protocol (i) identifies the potential emergency situations faced by a CCP, (ii) establishes principles for the exchange of information, (iii) sets mechanisms for such exchange, and (iv) identifies the information to be exchanged.

Conclusions and recommendations

66. **The mission is concerned with the use of direct powers on short-selling.** While it could be argued that in the short term a restriction in short selling can slow down a downward spiral, in the medium term restrictions on short-selling affect liquidity and price formation. Second, if such measures are to be used by NCAs, it is critical that NCAs aimed at implementing non-conflicting and preferably identical measures, unless differences in domestic market structures do warrant the differences.

67. **Work on developing a framework for crisis scenarios appears to be shaping up well.** Starting with CCPs is a reasonable approach. In addition to developing a framework for

each type of “crisis” identified, the mission recommends that ESMA coordinates simulation exercises.

VI. OTHER FUNCTIONS

A. Single Rulebook

68. **ESMA’s role in the single rule book is bound by a framework of transparency.** ESMA is required to conduct a public consultation process both in cases where it develops implementing technical standards as well as when it provides technical advice to the EC on secondary legislation. It is also required to consult the Securities and Markets Stakeholders Group. Technical standards must be endorsed by the EC. ESMA officials stated that so far, the EC has not made changes to the standards proposed by ESMA.

69. **During its first two years of operation ESMA has dedicated a significant amount of resources to the single rulebook.** Several pieces of legislation require ESMA to either develop technical standards or to provide advice to the EC for it to develop secondary legislation (level 2). The following is a summary of the policy work conducted by ESMA:

- Forty technical standards were developed, involving significant work for the implementation of EMIR.
- Four technical standards were developed for the new CRA supervisory regime.
- Seven technical standards were developed for the new short-selling and credit defaults swap regime.
- Five pieces of advice were provided to the EC on secondary legislation in areas such as prospectuses, UCITs, alternative investment funds (AIFs) and short-selling.
- Six sets of detailed guidance and recommendations for market regulators and participants were developed in areas such as automated trading, AIF managers (AIFMs), exchange traded funds (ETFs), suitability of advice and the investment firm compliance function.

70. **ESMA has had to deliver some of the technical standards under very tight deadlines.** As a result, in some cases consultation processes have been squeezed. Many stakeholders expressed concern about such a situation, as market participants did not have the time to conduct thorough analysis of the proposals, nor ESMA to actively engage with them to discuss their concerns. As a result neither industry, nor ESMA had a comprehensive view of the costs and impact of the proposals.

71. **Work on the single rulebook is not likely to slow down in the short to medium term.** Several important and complex pieces of legislation are in the pipeline and will require

either technical standards or advice. Such initiatives include: MiFID2/MiFIR, MAD/MAR, CRA3, the Transparency Directive, and UCITs VI.¹⁴

Conclusions and recommendations

72. **Prima facie, EC’s authority to make changes to the technical standards could be troublesome; however, the procedure is subject to high transparency.** As ESMA is the technical authority, it is critical that any “intervention” from the EC via its “endorsement” process be motivated and grounded on technical reasons. The process devised in the regulation ensures that cases where the EC deviates from ESMA’s proposal are visible. Furthermore, there do not appear to be major problems with this process at this time.

73. **Going forward, it is important that ESMA be given sufficient time to deliver on its regulatory obligations.** It is important that regulations be cost-effective. The tight deadlines can create an important reputational risk for ESMA and may have a potential negative impact on the market.

B. Supervisory Convergence

74. **ESMA has several tools to foster supervisory convergence.** Pursuant to its Regulation ESMA can issue guidelines and opinions, conduct peer reviews and training, as well as develop new practical instruments and convergence tools to promote common supervisory approaches and practices. In particular, a peer review involves an assessment or comparison of provisions or practices. They are conducted by the review panel, which is a standing committee established for the purposes of fostering supervisory convergence.

75. **The review panel is the main standing committee involved in supervisory convergence work.** In addition, all the standing committees play a role, as in many cases they conduct mapping exercises and develop opinions and guidelines in connection with sectoral legislation within their remits. Staff from the Legal, Cooperation and Convergence Unit support this work. Currently this unit has two staff directly dedicated to convergence work and three more lawyers that support all of ESMA’s work, including the standing committees. The Unit is recruiting four more staff members in 2013 (including additional lawyers).

76. **ESMA approved a methodology to conduct peer reviews in January 2012.** Peer reviews are conducted by a team of experts from NCAs, although the methodology allows hiring external experts. A questionnaire is sent to the NCAs, which must answer it and provide evidence to support their responses. The team compares the answers against the evidence provided and provides a conclusion. Reports of the teams are discussed in the

¹⁴ A selected view of key initiatives is included as an Annex.

review panel, and then send to the BoS. The procedures state that the implementation of measures agreed by the authorities should be monitored by the review panel and reported to the BoS according to an agreed timetable. The review panel should make recommendations to the BoS as to how to deal with delays in implementation.

77. Since 2011, ESMA has conducted four peer reviews; two of them have been finalized.

- Review of the use of sanctions under the Market Abuse Directive (MAD): this review showed significant differences in the type, amount and use of sanctions by NCAs.
- Prospectus approval: The review found that the majority of countries were in full compliance with prospectus approval requirements. Based on the evidence received the report developed best practices for prospectus approval.

78. ESMA has also issued opinions to foster supervisory convergence. Two important cases are (i) an opinion on the treatment of sovereign debt under International Financial Reporting Standards and (ii) opinions on consistency with MiFID a large number of pre-trade transparency waivers.

79. Some stakeholders expressed concerns that in some countries opinions and guidelines of ESMA are not being incorporated into the national framework, which creates uncertainty for them. Opinions and guidelines of the ESAs do not have the status of enforceable EU law. However, it is expected that NCAs transpose them in national law so that they become legally enforceable in national courts. There might be valid reasons why a member state does not integrate guidelines and opinions into their national legal framework. However in such case the member state must ensure that the domestic provisions do not breach the relevant EU legislation (Level 1 and level 2).

80. ESMA has not made used of its powers in connection with mediation and breach of laws procedures. In the first case, no case has been filed by a NCA, which is a requirement of the Regulation. As to the latter, part of the reason is that there is no culture of filing complaints by firms or by the NCAs. However, ESMA acknowledged that it could start a procedure at its own initiative and it stated that its involvement with the stakeholders group as well as having more staff will allow it to take a more proactive stance. There has only been one case brought by an NCA regarding the application of one provision in the UCITs framework. In such case, the BoS opted to issue an opinion on how such provision should be interpreted. While this could be considered a “softer” measure, ESMA officials highlighted that opinions carry weight and that their implementation could be followed up by ESMA. The UCITs case is very recent so no follow up actions have been taken so far.

81. ESMA acknowledges that supervisory convergence has been one of the most challenging areas of its mandate. Work by CESR focused more on mapping than assessments. When assessments were done, they were desk-based which did not allow for

thorough contestation of the responses provided by the NCAs. Thus, most countries usually rated fully compliant. Finally, even when countries were found to be partially compliant, there was no systematic follow up, nor any action attached to such non-compliance, beyond the publication of the report. ESMA Chair expressed the intention to revamp peer reviews to make them more rigorous and their outcomes sharper. It also intends to conduct more peer reviews. Three reviews are already planned for 2012 and 2013: (i) a review of the money market guidelines developed by ESMA, (ii) a review of MAD supervisory practices, and (iii) a review of MiFID requirements for fair, clear and not misleading information.

82. ESMA is starting to play an important role in global convergence. ESMA maintains an active dialogue with non EU jurisdictions. In particular in the context of the implementation of the third country regime envisioned by the AIMFD ESMA is playing a role on reviewing non-EU regimes for the purposes of determining that they are of sufficient equivalence. It is also entering into MoUs for the purpose of facilitating exchange of information and cooperation in supervision of these entities.

Conclusions and recommendations

83. As indicated above, the mission concurs with the Chair that supervisory convergence is the area where ESMA's efforts must be intensified. Within the ideal of a single market, ensuring consistent transposition of laws—in which the EC plays a role—and convergence in supervisory practices is critical to minimize the risk of regulatory arbitrage and unlevel playing field. The experience from FSAPs, as well as conversations held with different stakeholders during this FSAP, lead to the conclusion that the risk of regulatory arbitrage arising from inconsistent supervisory practices and/or interpretations of current regulations must not be overlooked.

84. Reengineering and strengthening peer reviews would be essential to step up work on supervisory convergence. Breaches of laws and mediation procedures only would be fit for a limited set of cases. This leaves peer reviews as a key mechanism to foster convergence. The mission concurs with ESMA officials that the main two objectives of the reengineering should be: (i) making reviews more rigorous by, for example, relying more on onsite work, and (ii) sharpening their outcomes, by for example, linking the reports to the development of best practices and/or guidelines which implementation can later on be monitored and followed up in a systematic manner, and if necessary, stronger actions (such as a breach of law) can then be taken. The mission understands that the regulations already allow these types of outcomes; the issue is to make a more systematic use of them, and to link them with already agreed mechanisms for follow up, as well as already agreed measures that would come up as a result of such follow up. Achieving these objectives might also require a stronger role of ESMA in the peer review groups as well as in the review panels. The mission encourages the Authority to draw a comprehensive strategy in this area. Finally, as supervisory convergence cuts across the whole organization, the development of the annual plan of peer reviews should consider input from all the standing committees.

85. **As a principle, it is also important that NCAs take the necessary steps to ensure that ESMA's opinions and guidelines are enforceable in their respective jurisdictions.** This is an issue that needs to be addressed, if necessary via changes to the domestic legal frameworks, as appropriate.

C. Investor Protection

86. **Investor protection issues are within the remit of the Investment and Reporting Unit.** This unit currently has 17 staff, but it covers a wide array of issues in addition to investor protection. In addition, the Financial Innovation Standing Committee was recently established to assist ESMA in fulfilling its investor protection responsibilities. Its main function is to identify risk to investor protection and to financial stability in the financial innovation area and then to produce a risk mitigation strategy. There is also an Investor Protection and Financial Intermediaries Standing Committee.

87. **While still at an early stage, monitoring of products is one of the key initiatives of ESMA in the area investor protection.** The objective is to monitor products that are sold to retail investors mainly to determine whether appropriate disclosure exists. Currently, the main tool for monitoring is market intelligence, through a network of regulators but also industry participants, and data from private vendors. Through the Joint Committee, the ESAs have embarked in a project to determine the type of information that is critical for the authorities to make risk assessments (including for example complaints and information on products sold) and the format for it.

88. **Currently the main tools at ESMA's disposal to address risks to investor protection are warnings.** ESMA has issued two warnings to the public: one on forex and the other on internet trading. Both warnings can be found in ESMA's website. ESMA has a flexible framework to determine when to intervene via warnings. Essentially the criterion that it is currently using is that the problem with a particular product exists in multiple member states; otherwise the problem is domestic and should be addressed by the NCAs. It is expected that MiFID 2 will give it product intervention powers—although certain reforms seek to extend it also to product pre-approval.

89. **A second workstream is product distribution and suitability obligations.** Here ESMA's actions have mainly translated into guidelines in relation to the process to assess the needs of clients and suitability.

90. **A third workstream is on investor education.** The goal is to coordinate investor education programs. The starting point will be a mapping of the work presently done by NCAs. ESMA is looking at the work of the OECD in this area to see how it can build on it. The second part would be an impact assessment.

Conclusions and recommendations

91. **The emphasis on product monitoring is warranted and the consumer trends data project would be key to make a qualitative jump in this area.** Effective monitoring of financial innovation could also have a positive effect on financial stability. Thus, as ESMA staff indicated, these two units should work closely.

92. **Finally, the mission considers that the granting of product intervention powers to ESMA is a good development.** However, it is critical that such powers be exercised cautiously as ESMA is not a direct supervisor. If such powers are granted to ESMA, then a clear and transparent protocol for their exercise should be developed. On the other hand, the mission considers that the proposal to provide it also with pre-approval powers should be carefully evaluated, as it does seem to pose more risk than benefits. Such risks include slowing down innovation and the potential moral hazard brought by the early approval given by a supervisory body.

VII. CROSS SECTORAL ARRANGEMENTS

A. The Joint Committee

93. **According to ESMA Regulation, the Joint Committee (JC) serves as a forum for cooperation and exchange of information among the ESAs, as well as to foster cross sectoral consistency.** The Chairs of the three ESAs sit on it. In addition, the EDs, a representative from the EC and the ESRB, and the chairs of any of the subcommittees of the JC participate as observers. The JC does not have a permanent secretariat, but each ESA has committed one staff to it (the rapporteurs). The chairperson rotates on an annual basis. Each year the *rapporteur* from the ESA that is chairing the JC takes the lead on producing the different documents for the JC, including setting the agenda for the meetings. The agenda for the JC meetings is set up taking into consideration requests from the three ESAs. A work plan is developed on an annual basis also based on feedback from the three ESAs. The bulk of the technical work is conducted via subcommittees, composed of staff of the ESAs, which then report to the JC. There are currently four subcommittees.

94. **The authorities acknowledge that the JC had a slow start.** During its first year of operation, the JC focused on setting up working procedures. However, the subcommittees have started to work on important projects as per their 2012 plan.

- The Risk SC is the forum to exchange information and data on risks. This results in the development of the Report on Risks and Vulnerabilities in the EU System, which is produced twice a year. The report is shared with the ESRB and the Economic and Financial Committee (EFC). ESMA officials acknowledge that the work of this SC has proven challenging, in particular identifying value added beyond what each ESA produces individually. Selection of topics is currently done via a “brainstorming,” and

having the respective risks reports from the ESAs as key background information. One case where the ESAs decided to do ad-hoc work was on reference rate indices.

- The Consumer Protection and Financial Innovation SC is focusing on product oversight and on key measures proposed by the EU in relation to Packaged Retail Investment Products (PRIPs):
 - Cross selling and complaints handling are priorities. The SC is currently reviewing whether principles developed for complaints in the insurance sector can be applied in securities and banking. In addition, the JC will consider improvements on, and consistency between, the ESAs templates for collecting, analyzing and reporting on consumer trends based on lessons learned from the first data collection rounds from NCAs.
 - Product oversight and governance: the SC is considering the development of high level principles for a product approval process based on results of a September 2012 mapping exercise.
 - PRIPs: a subgroup has initiated work on the development of draft technical standards in the areas envisaged by the PRIPs legislative proposal.
- The Financial Conglomerates SC has focused on developing its response to the EC call for advice on the review of the financial conglomerates directive.
- The Anti-Money Laundering SC has assessed the application of the Third Anti-Money Laundering Directive (AMLD) in the EU countries. This has resulted in two reports to support the review process of the Third AMLD. In addition, the SC published a protocol on cooperation between home and host supervisors to facilitate AML supervision of agents and branches of payment institutions in host member states in accordance with the Payment Services Directive.

B. Cooperation with the ESRB

95. ESMA cooperates with the ESRB in the identification of systemic risk through different mechanisms.

- ESMA's Chair is a permanent member of the ESRB General board and a member of the Steering Committee. Therefore, ESMA participates in all decisions of the ESRB during meetings and written procedures. The general board meets at least four times a year.
- ESMA's Head of the Economic Research Unit is a permanent member of the ESRB Advisory Technical Committee and therefore participates on all analyses and policy

recommendations put forward to the General Board. The Advisory Technical Committee meets at least four times a year.

- ESMA economists participate on an ongoing basis in ESRB research activities, including its Instruments Working Group (WG), the Analysis WG, the Money Markets Funds Expert Group, the CDS Expert Group, the shadow banking group and the bank funding group. Each group meets at least four times a year.
- Data exchange: ESMA sends data on number of shares and trading venues in the EEA on a quarterly basis to the ESRB.
- Ad-hoc contributions: ESMA also contributes on ad-hoc basis via (i) comments to document (for example to the ESRB Risk Dashboard), (ii) ad-hoc meetings (ESRB Dashboard dry-run discussion), and (iii) joint projects: CDS markets and systemic risks.

Conclusions and recommendations

96. **The JC needs to adapt to the changing role of the different ESAs.** As the authorities acknowledge, the JC had a slow start, as the first year was devoted to setting up the rules of engagement. The mission does observe that many of the “new” subcommittees are starting to work in important projects, such as PRIPs and harmonization of data on consumer trends, and encourages the authorities to continue to commit resources for this cross-sectoral work. The establishment of a single website for the JC should add transparency to its work.

97. **Cross sectoral work on risk assessment has proven challenging.** To some extent this is reasonable, as for some of the ESAs (including ESMA) risk identification is a new focus. It is key that this work be closely coordinated with the ESRB, to avoid overlap.

C. Looking Ahead

98. **It is important that the authorities develop a framework for ECB cooperation with ESMA in the context of the proposed banking union and the ECB’s new supervisory role.** The banking union will primarily affect the authorities involved in the prudential supervision of banks, but it will have an influence on ESMA’s work. National banking supervisors and securities supervisors presently cooperate extensively on a day to day basis regarding the supervision of specific banks. An important question is how day to day coordination will be arranged when the prudential supervision of banks moves to the ECB. The current proposal already includes the duty of the ECB to cooperate with the ESAs, but the scope of such operations would need to be defined.

99. **As stated in the TN on CCPs, ESMA needs to build its expertise in the new functions assigned to it by EMIR.** In particular, in connection with CCPs, ESMA will

benefit from the experience of the other ESAs regarding its role and working of colleges of supervisors.

100. The mission agrees with ESMA’s Chair that in the short term is not desirable to assign additional direct supervisory functions to ESMA beyond those already in EMIR. The institution needs first to acquire certain stability in connection with its current mandate and deliver in the areas mentioned above.

101. In the medium term, it would be worth exploring whether further centralization of supervisory functions in ESMA is desirable. There are a few areas where such centralization would be desirable (below). However the mission acknowledges that in many of the cases listed there are challenges (fiscal, legal, and/or operational) that would need to be addressed first.

- *Facilitating cooperation in connection with third country regimes.* Given the global nature of financial services, global regulatory convergence is key. Regulatory convergence does not necessarily mean that all countries should have the same regulation rather more and more the trend is to go toward mutual reliance. In this context, ESMA could play a role in helping to set up these systems of mutual reliance (for example, through the determination whether the frameworks are “equivalent” enough or facilitating the execution of MoUs).
- *Direct supervisory activities where “domestic” presence is not critical, and/or where synergies and expertise would benefit from a centralized approach.* This category could include (i) supervisory responsibilities in connection with issuers’ information, from the approval of the prospectus, to the review of all the periodic and ongoing information that issuers are required to submit, and (ii) market surveillance.
- *Direct supervisory responsibilities in connection with firms with pan European reach or where a home regulator is not clear.* The list here could include (i) CCPs (for which EMIR already provides ESMA with some role), (ii) trading venues, and potentially (iii) auditors.

VIII. TABLE OF RECOMMENDATIONS

Action	Authority	Importance	Time
Review governance arrangements of ESMA with a view to make it more independent from NCAs.	EA	High	Short to medium term
Review budget funding structure.	EA	High	Medium Term
Review role of the EC in ESMA's budget proposal.	EA	High	Medium Term
Provide more resources to ESMA.	EA	High	Short Term
Finalize implementation of a risk based supervisory approach for CRAs that ensures an appropriate level of engagement for all CRAs.	ESMA	High	Short to Medium Term
Review the enforcement framework for CRAs.	EA	Medium	Medium
Implement projects to enhance financial stability role, including improving risk reports and developing stress testing and data warehousing.	ESMA	High	Short-to Medium Term
Ensure that ESMA has easy access to complete data with sufficient granularity.	BoS of ESMA	High	Ongoing
Finalize development of frameworks for crisis scenarios, including simulation exercises.	ESMA	High	Short-to Medium Term
Ensure that ESMA has sufficient time to conduct public consultation on technical standards and advice to the EC.	EA	High	Ongoing
Reengineer the peer reviews, by making them more rigorous and follow up in their outcomes in a systematic manner.	ESMA	High	Short to Medium Term
Clarify the enforceability of opinions and guidelines issued by ESMA in each relevant jurisdiction.	ESMA	High	Short to Medium Term
Continue to provide priority to product monitoring, including via the development of a framework for data collection on consumer trends.	ESMA	High	Short to Medium Term
Continue to commit resources to the JC.	ESAs	High	On-going
Review whether further centralization of functions in ESMA is desirable.	EC	Medium	Medium

ANNEX I. FINANCIAL SECTOR REFORM AGENDA-SELECTED ISSUES

102. **The approval of MiFID2 and reforms to MAD will be key to fostering market resilience and market integrity.** In most cases the current texts still require adjustments. However, overall MiFID2 seem to address challenges brought by market fragmentation and technological innovations, and the reforms to MAD will foster market integrity. Of particular importance are provisions in the following areas:

- *Definition of Organized Trading Facilities (OTFs) and definition of OTC markets.* The mission supports the general objective of fostering trading in organized facilities, as well as transparent and open markets.
- *Obligations on markets to have arrangements in place to manage volatility.* These provisions should foster market resilience.
- *Enforcement framework (MiFID2 and MAD).* The mission supports further harmonization of sanctions available to deal with infractions to MiFID and MAD, in line with ESMA's recent peer review; as well as the extension of the market abuse provisions to MTFs
- *High frequency trading.* The mission supports the introduction of obligations for high frequency traders to set up strong risk controls. Other requirements should be analyzed further in order to get better insight on the costs and benefits that they might bring.
- *Framework to report data on market transactions, impose client identification, develop a consolidated tape, and ensure access by NCAs to order book data.* These provisions should help NCAs to strengthen their market surveillance arrangements and the consolidated tape should allow for better supervision of best execution obligations.
- *An enhanced framework for commodities derivatives markets.* The provisions require registration of commodities derivatives firms. They will also provide the NCAs with powers to manage positions, an important tool both from market resilience as well as from a market integrity perspective.

103. **Priority should also continue to be given to initiatives that seek to address risks from shadow banking.** Considerable work has already been done. Provisions to encourage work by the authorities on reducing reliance on ratings are part of CRA3, the implementation of EMIR would impose post-trade transparency on OTC derivatives transactions, and the implementation of the AIFMD should bring further transparency to the hedge fund industry. Vis-à-vis the Financial Stability Board (FSB) work there are two areas where further work is warranted: (i) money market funds and ETFs, and (ii) securities lending and repos. In the

former, the mission acknowledges that ESMA has issued guidelines—including in connection with their use of securities lending and repos—which should be the starting point for the reforms to be incorporated in UCITSVI. Feedback from the consultation on the EU green paper should provide further input on other areas where additional work is warranted.

104. Finally the mission emphasizes the importance that consumer protection issues get sufficient priority in the financial sector reform agenda.

- *Cross sectoral harmonization.* The mission support initiatives to level the playing field for investment-like products. In this regard, PRIPs would address disclosure requirements, and MIFID2 and Insurance Mediation Directive (IMD) would address selling practices. In the first case, it is important that the text provides sufficient flexibility to address differences in disclosure for certain insurance products. Concerning the latter, it is critical that the reforms remain consistent.
- *Inducements in MiFID2.* The mission highlights the importance that the ban on inducements not be dropped.
- *Product intervention powers for the NCAs and ESMA in MIFID2/MiFIR.* In light of the lessons from the crisis, the mission believes that these powers should exist, but emphasizes that they must be used cautiously. On the other hand, the reforms to provide these institutions with product pre-approval powers should be reevaluated, as they seem to bring more drawbacks than potential benefits.