ESMA: A Securities regulator for Europe?
Supervisory powers and the challenge of the Capital Markets Union

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ESMA – Growing an Oak from a peppercorn

- ESMA is part of of the first institutional or “supervisory architecture” package, so-called European System of Financial Supervision. A curiosity arises from the fact that all of these institutions now enacted into EU law are grounded in Article 114 TFEU as their legal base. Article 114 TFEU was and is the

- A curiosity arises from the fact that all of these institutions now enacted into EU law are grounded in Article 114 TFEU as their legal base.

- Article 114 TFEU has been employed again recently as the central legal basis to resolve Europe’s institutional and regulatory shortcomings. Yet there is no precedent for the institutional design on the scale enacted arising from this slender legal base.

- Article 114 TFEU. The Court famously held there that Article 114 TFEU did not constitute a “generalised” competence clause for the legislature.
ESMA’s Mission

- Assessing risks to investors, markets and financial stability in the latter case complementing the work of NCAs, SSM, and ESRB – it can issue warnings to investors
- Completing a single rulebook for EU financial markets – mostly completing delegated tasks, e.g. developing technical standards – that her first task upon inception
- Promotes supervisory convergence through peer and thematic reviews (not just by means of a single rulebook) to ensure a level playing field
- Directly supervises specific financial infrastructure entities, namely Credit rating Agencies (CRAs) and Trade Repositories (TRs) and participates in supervisory colleges for central counterparties (CCPs)
- The purpose of completing a single rulebook for EU financial markets is to enhance the EU Single Market by creating a ESMA is the direct supervisor of specific financial entities: Credit Rating Agencies (CRAs) and Trade Repositories (TRs). These entities form essential parts of the EU’s market infrastructure.
- ESMA’s four activities complement each other
Supervision – definition(i)

- According to the Board of the US Federal Reserve System that acts as the chief microprudential regulator of the most important US banks:
- Bank supervision involves the monitoring, inspecting, and examining of banking organizations to assess their condition and their compliance with relevant laws and regulations. Bank regulation entails issuing specific regulations and guidelines governing the operations, activities, and acquisitions of banking organizations.
- Also San Francisco Federal Bank, part of the US Federal Reserve System, specifies that “supervision” in this context is described as involving the examination “of the financial condition of individual banks and evaluate[on] [of] their compliance with laws and regulations.” On the other hand, according to the same institution, “bank regulation involves setting rules and guidelines for the banking system.”
A. Bailey:

“[S]upervision” and “regulation” as terms are used interchangeably. That’s wrong. . . . Supervision is about how we use [regulation] in practice. For me, two critical elements of supervision are that it is forward-looking, and it requires the use of judgement. . . . Supervision is therefore a skill – in fact it’s quite a few skills. The essence of the job is to understand risks in firms, and where necessary to step in . . .
Conceptual confusion: ESMA Supervisory powers extend beyond direct supervision

- They include risk assessment:
  - E.g., Monitoring risks in the global OTC markets
  - Conducting Equivalence assessments for 3\textsuperscript{rd} country for CCPs
- AND
- They include ESMA’s work in the field of supervisory convergence
ESMA direct supervision: CRAs (i)

- Licensing-registration authority applying a prudential regime (e.g., corporate governance, systems and controls etc.)
- Technical Standards
- Scrutiny of credit ratings verification techniques
- Enforcement for breaches - fines
- Market share calculation of EU registered CRAs and publication of the calculations on annual basis under Article 8d of the CRA Regulation to assess the state of competition in the market and stimulate competition in the credit rating industry by encouraging issuers and related third parties to appoint smaller CRAs.
- The market share calculation is designed to increase awareness of the different types of credit ratings offered by each registered CRA and to help issuers
- Certification or endorsements of a non-EU CRA ratings if they their ratings to be used for regulatory purposes in the EU
CRA Supervision (ii) – ESMA areas of priority

- CRAs’ governance, risk management and internal decision making processes.
- CRAs’ business development processes.
- Uniformity of the information being reported by CRAs and on creating new frameworks for the internal monitoring and assessment of this information.
- Establishment of ESMA Credit Ratings Data Reporting system (RADAR) for the collection of data from CRAs.
ESMA Direct Supervision TRs

- Registration authority for EMIR TRs
- counterparties have been required to report details of their exchange traded or over-the-counter derivative contracts to a registered TR or a TR recognised under EMIR. There are currently six TRs evolve, which suggests that the dynamics of the markets for trade reporting are changing.
- Since their registration in 2013, five of the six TRs have been offering trade reporting services for all five asset classes of derivatives trades reported under EMIR: commodity derivatives, credit derivatives, equity derivatives, interest rate derivatives and foreign exchange derivatives
- supervisory priorities: Testing data reporting systems and quality of data
- By the end of 2015 almost 27 billion reports had been received by TRs, with an average of around 330 million trade reports submitted per week. Increasing interest in the TR business and is currently assessing two applications for registration.
- Registered TRs are looking to expand their businesses into new areas, for example by offering other reporting services.
- Approved reporting: Some TRs might decide to become Approved Reporting Mechanisms for the purposes of the Markets in Financial Instruments Directive and Regulation24 (MiFID II/MiFIR) by extend their registration as TRs in order to receive reports of securities financing transactions. Other TRs may establish joint ventures with such providers in the future in order to offer packages of complementary reporting solutions to clients.
Short sales- Emergency powers –

- In exceptional circumstances, ESMA has been given the role to co-ordinate the scope and implementation of any proposed emergency measures by NCAs:
- The NCA notifies ESMA of its intention to take emergency measures, setting out the reasons for such measures.
- Within 24 hours ESMA issues an opinion on whether the measures and time duration are appropriate and proportionate to address the threat, and publishes such opinion.
- If a NCA takes measures despite a negative ESMA opinion it must publish an explanation for doing so, within 24 hours of such opinion.
- ESMA will regularly review emergency measures taken under the Regulation, at least every 3 months.
Short sales- A cross-border authority?

ESMA has the power to coordinate the actions within NCAs by assessing the emergency measures one NCA is proposing to take and considering whether it should be expanded to other jurisdictions.

In exceptional circumstances ESMA can also decide to use its intervention powers directly and prohibit or put conditions on short sales or other transaction in a financial instrument that confers a financial advantage in case of decrease in value of another financial instrument (does not apply to sovereign debt and sovereign CDS).
Innovation: regulator, supervisor enforcer

- ESMA’s duties in the field of financial are four-fold:
  - ESMA’s Financial Innovation Standing Committee of ESMA (founded by Art. 9 of ESMA Regulation) monitors innovations and their market behaviour to feedback knowledge and assessments of risks to investors, financial stability and/or market integrity and possible utility of such innovations to national supervisors and EU policy makers and market participants.
  - Currently engaged with four major innovations: crowd-funding, block-chain currencies, loan participation funds, and structured retail products.
Product intervention

MiFIR will give ESMA and national competent authorities the power to prohibit or restrict the marketing, distribution or sale of financial instruments if there is a significant risk to investor protection, market integrity or financial stability.
Supervisory convergence: regulator and enforcer

- Thematic reviews, e.g., the most recent is a review of regulatory compliance with the market marker exemption under the Short-Selling Regulation (SSR) covering five national competent authorities (NCAs)
- IFRS SUPERVISORY CONVERGENCE
- ESMA’s main role is to promote the consistent application of International Financial Reporting Standards (IFRS) and foster convergence of enforcement practices across Europe. With this aim, ESMA makes use of a number of tools for the enforcement of financial information and the consistent application of financial reporting standards.
Evaluation

ESMA’s effectiveness
Operating model and incentives, what constitutes success?
Is it adequately staffed?
ESMA as an agency and the Meroni effect?
Evaluation: Continuous reinforcement of competences and status

- Today ESMA holds a virtually monopolistic position in four overlapping but crucial parts of capital market functions and regulation:
  - Knowledge processor for the purpose of rule supply: standard setting and regulatory convergence
  - Regulator and supervisor of key parts of financial infrastructure
  - Credit ratings gatekeeper
  - Market entry gatekeeper and overseer through product prohibition competences and the new product governance regime
- Is its portfolio of responsibilities disparate?
- Is there room for regulatory innovation and experimentation?
Evaluation: Areas of marked improvement but is the approach mechanical? (i)

- ESMA's key achievements include the registration of three new CRAs and the imposition of the first fine against a CRA for failure to comply with the requirements of the CRA Regulation (ESMA Report 2015).
- The CRA Regulation has helped to improve CRAs' corporate governance inter alia, by requiring all CRAs to put in place an administrative or supervisory board & encouraging appointment independent directors.
- The use of EU boards has helped to increase accountability for action taken and has had a positive impact on CRAs’ decision-making processes - particularly beneficial for CRAs which operate as part of larger groups consisting of diverse businesses, or for CRAs with parent companies established in third countries.
- During its 2015 investigation, ESMA identified concerns about the process of issuing credit ratings, esp. vis-à-vis issue ratings, the process of changing methodologies and the involvement of the CRA's internal control functions.
- BUT have ratings actually improved? Only time will tell.
Evaluation: Areas of marked improvement, but is the approach mechanical? (ii)

- Progress in validation of Trade Reporting process to make them compliant
- SMA conducted an extensive review of the inter-TR reconciliation process in 2015 - the exercise has shown that there is a large number of trades that are not reconciled because of unshared Unique Trade Identifier (UTI) values between the counterparties. This potentially accounts for up to 50% of the all unreconciled trades.
- So without ESMA’s interventions, e.g., if monitoring of trade reporting and reconciliation had been entrusted to a private entity the system would’ve probably collapsed
- Competitions issues in Trade Reporting?
The Capital Markets Union (CMU)

- EU has to diversify away from the banking system that still enjoys very low profitability and is loaded with NPLs towards capital markets funding, as the EUs an over-banked region
- unlock more investment for all companies, especially SMEs, and for infrastructure projects;
- attract more investment into the EU from the rest of the world; and
- make the financial system more stable by opening up a wider range of funding sources.
# EU investment expenditure

## Table 1: Investment needs for R&D

<table>
<thead>
<tr>
<th>Investment needs/objective</th>
<th>Required 2</th>
<th>Current 3</th>
<th>Gap</th>
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<tbody>
<tr>
<td><strong>Achieving 3% GDP target for annual R&amp;D investment:</strong>&lt;sup&gt;1&lt;/sup&gt;</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Private sector:</td>
<td>370</td>
<td>240</td>
<td>130</td>
</tr>
<tr>
<td>Public sector:</td>
<td>200</td>
<td>130</td>
<td>70</td>
</tr>
<tr>
<td><strong>Private/public R&amp;D investment by key strategic sectors:</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Transport equipment</td>
<td>55</td>
<td>30</td>
<td>25</td>
</tr>
<tr>
<td>Machinery and equipment, including ICT and electronics</td>
<td>75</td>
<td>40</td>
<td>35</td>
</tr>
<tr>
<td>Life sciences/pharmaceuticals</td>
<td>40</td>
<td>15</td>
<td>25</td>
</tr>
<tr>
<td>Renewable energy and eco-innovation</td>
<td></td>
<td></td>
<td>20</td>
</tr>
<tr>
<td>Other sectors</td>
<td></td>
<td></td>
<td>25</td>
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<tr>
<td><strong>Total:</strong></td>
<td></td>
<td></td>
<td>EUR 130bn</td>
</tr>
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1 Split based on comparing actual public and private R&D intensities with OECD average composition
2 EIB calculations based on Eurostat data.
Figure 22: Percentage of firms identifying access to finance as their most pressing problem

Source: European Commission and ECB Survey on SME Finance
Source: World Bank, Global Financial Development Database
Note: 2008-2013 average. EU represents EU27 GDP weighted average. Due to lack of data availability, EU does not include BG, DK, CZ, HU, LT, LV, PL, SE in the figure of Private credit to deposit money.
Figure 1: Bank loans to GDP in US, Japan, and Europe

Source: Schularick and Taylor (2012). Notes: Bank loans refers to resident banks’ loans to the domestic private sector (households and non-financial corporations). The data therefore exclude foreign (and foreign currency) loans; and loans to the financial and public sectors. Europe represents an average (weighted by GDP) of DK, DE, ES, FR, IT, NL, SE and the UK.
CMU Tools (not enough) and obstacles

- High quality securitisations to free up bank balance sheets to lend: standardisation, but local bankruptcy law might remain an issue making the matter for SME debt fragmented.
- Review the Prospectus Directive to make it easier for firms, particularly smaller ones, to raise funding and reach investors cross border; How when the goal has remained straitjacket maximum harmonisation?
- Put into place a pan European private placement regime to encourage direct investment into smaller businesses: how without forstering/developing lots of start up finance and risk capital in general.
- Lower the barriers for start up/venture capital firms (AIFMD?) as well as for platforms that will trade those funds shares, debentures or units.
CMU Tools (not enough) and obstacles

- full liberalisation for investment offers to professionals or qualifying individuals or corporates/partnerships and let regulatory competition to flourish
- support the new European long term investment funds to channel investment in infrastructure and other long term projects: how? Tax incentives!
- availability of credit information on SMEs so that it is easier for investors to invest in them: but is it necessary? Are private data banks expensive?
AN EU SEC?

- EU has no Listing Authority
- Has no single securities supervisor/enforcer
- Yet a single conduct regime by 2017 (MIFID II, MAD II) and a capable knowledge manager

- Do we need an EU SEC?
  - Is it essential?
  - Is it feasible?
  - Battling capture
Expanding ESMA & the CMU

- Legal status
- resources?
- Single Point of Entry for IPOs and SEOs?
- local discretion ought not be squeezed
- Regulatory experimentation
- Liberalise exemptions, waivers, requirements for SME risk or growth capital if products sold to professional investors EU capital markets, esp. for high growth and risk capital are underdeveloped &
- The value of disclosure overstated
- Safe harbours for risk capital funds -
- Sunset clauses (Roberta Romano (2012 & 2014))
How to build an EU-LA?

- Distinction on the basis of turnover and cross-border activity mirroring the EBU/SSM about which institutions are directly regulated by the ECB and which not.
- Encourage regulatory experimentation in the context of smaller player/issuers facilitating market access – for such issuers subsidiarity (the local regulator knows best) should be the rule.
- Give local regulators room for manoeuvre in this case giving more room for equivalence to ameliorate straitjackets without affecting the passport – but what happens with the convergence mandate?
But an EU SEC?

- In a sense ESMA already is de facto when it comes to product intervention and short sales.
- But is an EU conduct regulator necessary?
- It could just consolidate market abuse detection data.
- Can it impose criminal penalties?
- Would it be constitutional?
- Finally given present duties (CRA,s TRs, CCPs) and their disparate nature, as capital markets supervisor and enforcer of conduct/market abuse infractions would be too unwieldy and probably slow and bureaucratic or perennially under-resourced.