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ESMA – Issues and Priorities

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Ladies and Gentlemen,

I am very pleased to have the opportunity to speak at your conference today. EFAMA deserves praise for the organisation of the event and for putting together such a distinguished line-up of speakers and panellists to exchange views on the key issues for the fund management industry.

I would like to take advantage of my presence here today to give you an overview of ESMA's work in the area of investment funds. This will allow me to expand on our recent guidelines on ETFs and other UCITS issues, as well as their interaction with the broader shadow banking debate. I will also speak about a number of ongoing work streams in the context of the Alternative Investment Fund Managers Directive (AIFMD).

Turning first to the ETF guidelines, ESMA has been working on this issue since the summer of 2010. At an early stage we saw a need to intervene in this area to address a number of limitations in the existing regulatory framework. The problems were varied, covering both investor protection and transparency concerns, as well as more general systemic risk issues.

The first point I would like to make about these guidelines is that they take a comprehensive approach to the issues identified. By this I mean that, rather than setting out provisions applying to ETFs only, we considered that it made more sense from a regulatory perspective to tackle certain activities in a holistic way. So, while some of the

new provisions are very relevant to ETFs, targeting only ETFs would have led to the risk of regulatory arbitrage and an uneven playing field.

Let us take securities lending as an example. This activity is clearly an important part of the operations of ETFs that use physical replication. However, we felt it appropriate to introduce new rules with respect to securities lending by any UCITS. These rules include additional disclosure to investors on the extent of this practice and the impact this could have on the risk profile of the fund. In the interests of safeguarding the liquidity of the fund, and the investor's right to redeem on demand, there is also an obligation on the UCITS to ensure that it is able to recall any asset lent out at any time.

Another example would be the new rules applying to index-tracking funds. Originally, we had intended to target index-tracking ETFs only, but on reflection, and taking into account the valuable feedback we received from external stakeholders, our final guidelines cover all index-tracking UCITS. This recognises the fact that the issues that arise when a fund tracks an index are not limited to index-tracking ETFs. We feel the additional disclosure required by the guidelines, particularly on the method of replication used by the fund, will help investors to make a more informed choice.

As you will have seen, certain elements of the guidelines nevertheless apply specifically to ETFs. This includes the need to use an identifier in the name of the fund, and the treatment of secondary market investors. On this issue, we felt that it was important for potential investors to know that the subscription and redemption of the shares or units works in a different way for an ETF. We also wanted to introduce safeguards so that secondary market investors have the possibility to sell their shares directly back to the ETF provider, such as in situations of market stress. This approach is in line with the principle in the UCITS Directive that allows investors to redeem on demand.

Moving on to a topic that has attracted significant attention following publication of the guidelines, I would like to clarify our position on the issue of fee-sharing arrangements for securities lending. The guidelines require that all the revenues arising from

securities lending, **net** of direct and indirect operational costs, should be returned to the UCITS. This does **not** mean that securities lending agents cannot charge a fee for their services, nor does this provision seek to reduce the scope for UCITS to engage in securities lending, which can be a valuable source of additional revenue. Rather, we take the view that the benefits arising from the use of the fund's assets should accrue to the investors in the fund, not to the management company.

Since investors would be the ones to suffer should problems arise from the securities lending activity, it seems reasonable that the profits generated by this practice should go to those same investors. Nevertheless, the formulation used in the guidelines leaves scope for the payment of fees to securities lending agents. With a view to ensuring a proper implementation of the guidelines at national level, it will be important to verify that the concept of ***direct and indirect operational costs*** is being applied in a way that is consistent with the underlying intention of this provision.

This brings me to a wider point that I would like to make that is relevant to ESMA's work more generally – with a provision of this nature it will always be possible to find a way to circumvent the rule. However, I would urge the industry to bear in mind that it is in a firm's interests to serve its investors, and that this new rule on revenues from securities lending has been designed with that in mind. Efforts should therefore be focused on complying both with the letter and the spirit of the requirement rather than on identifying potential loopholes or grey areas that could be exploited.

Before I move on to other issues, I will touch briefly on process. As you are no doubt aware, the document that contained the final guidelines published in July also included a consultation on the appropriate treatment of repo and reverse repo transactions. Purely coincidentally, that consultation is closing today so I hope that everyone in this room who wishes to contribute has submitted a response! In terms of next steps, as we explained in July, our intention is to come to a final position on repo and reverse repo and integrate that into the rest of the guidelines, which we will then formally issue as a single package by the end of the year.

There are a couple of further issues that I would like to touch on which have some connection with the ETF guidelines – complex products and shadow banking.

Regarding complex products first of all, I would like to clarify – in case there is any doubt on this matter – that ESMA is not against complexity per se. Indeed, there will be cases where a more complex structure will render a product more suitable for an investor, such as via the inclusion of capital protection. However, it is equally clear that there are circumstances in which retail investors struggle to understand the complexity of a particular investment product, whether it be the internal workings of the product or the risk and reward profile. ESMA has several initiatives in place in relation to complex products.

For example, within the framework of the existing MiFID conduct of business requirements, we are working on proposals to improve implementation standards of those existing MiFID rules (on information to clients, suitability and appropriateness – in particular). This is partly in response to the *retailisation* of complex products which increases the risk that retail investors do not understand the risks attached to their investments and/or the drivers of risks and returns.

It is an important investor protection area in which we can improve supervisory convergence (by reinforcing MiFID conduct rules) especially in an era of:

(i) growing complexity in financial instruments; and
(ii) increasing use of the internet (both by providers to approach investors, and by investors to access products).

In this regard, it seems likely that we will need to remind both supervisors and firms about selling practices, and ESMA's expectations, to be observed when selling complex products, including, for example, the sale of structured products to retail investors, and platforms giving access to complex products. We are currently developing an investor

communication explaining the risks of investing in complex products, for example, structured products, CFDs, structured bonds and notes. This will be a complement to the investor warning ESMA issued earlier this month regarding the pitfalls facing investors when using the internet for investment purposes.

On the distribution of complex products, we are continuing to map the various national initiatives to get a better understanding of the rationale for those initiatives, and to identify existing problems and issues. The aim is to consider what we could do at European level to improve investor protection in relation to the distribution of complex structured products, by establishing common ground where possible for distribution frameworks of complex structured products across the Union.

With regard to the MiFID review, I would also like to mention that inducements provided to advisers are an important factor leading to unsuitable products being recommended to clients. I firmly believe that the problem cannot be solved by yet more transparency alone. I fully support the proposal to ban inducements in certain situations as included in the proposal by the Commission for MiFID 2. Disclosure of inducements is simply not sufficient. At a minimum we need to ban inducements in the case of discretionary portfolio management and when an advisor wants to use the *independent* label.

Moving on to shadow banking, this sector has come to be recognised as an important part of the financial system, and as a significant source of intermediated funding for the financial and non-financial sector alike. After all, it is estimated at 11 trillion Euros in the Euro-area, hence about one-third of the conventional banking sector. The problem in shadow banking, of course, is the shadow. As important as its intermediation function may have become, the sector has retained a tainted image, owing to its role in the crisis, its inherent complexity, and the many critical risks involved. These risks still need to be better understood, and there is no doubt that the sector will continue to have the full attention of regulators and supervisors. However, I would like to emphasise that, in the

EU and the U.S. alike, regulators have taken important steps in the past years not only to cast light on this segment of the financial market, but also to make it a safer place.

Due to those efforts today most shadow banking activities are already addressed by existing regulations. In addition, multiple regulations are in the process of implementation. The focus of regulators shifts now to the optimisation of that regulatory framework. We need to ensure that shadow bank activities and traditional banks are not exposed to incentives for regulatory arbitrage between the two sectors. Rather, shadow and traditional banking, and also their regulation, should complement each other.

In terms of practical regulatory progress, ESMA has recently submitted a response to the European Commission's consultation, and I would like to highlight some of the key messages of that submission.

In particular I would highlight that we felt it was important to make clear, both to the Commission and other stakeholders, that ESMA has already been active on a number of topics that are relevant to shadow banking.

Perhaps the best example of this is the ETF guidelines that I talked about earlier. The increased safeguards we have introduced on the use of efficient portfolio management techniques such as securities lending, as well as on the management of collateral received both in the context of those techniques and for the purposes of OTC derivative transactions, are clearly relevant to the shadow banking debate. Looking further back in time, there are guidelines of 2010 on a common definition of European money market funds that were issued by ESMA's predecessor CESR. Those guidelines address certain of the risks arising from money market funds by prescribing in some detail the credit quality of eligible investments, the maturity of the instruments and the additional disclosures that have to be made to investors.

This is not to say that all the possible challenges posed by money market funds or activities such as securities lending are addressed by the aforementioned guidelines, and indeed there is scope for further work by ESMA in this area; rather, the key point is that shadow banking is not a vacuum in terms of regulatory action and any new initiatives should take full account of what has already been done.

I would now like to devote some time to explaining the latest developments on ESMA's work in the context of the Alternative Investment Fund Managers Directive (AIFMD). While the Level 2 measures are being finalised by the European Commission, we have continued to make progress on three main work streams.

First, I would like to mention our guidelines on remuneration of AIFMs. We published our consultation paper in June and responses are due to reach us by this Thursday, 27 September. Indeed, as I speak there is an open hearing taking place in Paris on this very issue.

The proposed guidelines are broad and cover issues such as the AIFM's internal governance, the types of remuneration within scope and the awarding of bonuses. I would also flag for your attention the consultation on remuneration guidelines under MiFID that we published on 17 September, since I know that many asset managers will also provide certain MiFID investment services. Here it is important to bear in mind that the guidelines under MiFID are being developed from a different starting point, in the sense that the CEBS guidelines on remuneration already apply to MiFID firms. Whereas the CEBS guidelines are focused mainly on remuneration policies and practices from a prudential perspective, the ESMA guidelines are focused on remuneration from an investor protection perspective and we are satisfied that they can co-exist with the CEBS guidelines. We look forward to receiving your feedback on our proposals, including on the interaction with the AIFMD guidelines.

Secondly, another significant work stream under the AIFMD is the negotiation of the co-operation agreements with non-EU authorities, which have to be in place by July 2013.

It is worth reiterating here that ESMA is leading the negotiations on behalf of the EU competent authorities. This makes sense both in terms of efficiency and in helping achieve a consistent result across jurisdictions. A common text has been agreed on the EU side and we are now negotiating with our non-EU counterparts on the basis of that text. We recognise the importance of having the agreements in place in a timely manner and will look to make progress as quickly as possible, of course bearing in mind the need to have robust arrangements that deliver what is required by the AIFMD.

Finally, I should mention our follow-up work on the discussion paper on key concepts of the AIFMD and types of AIFM that we published at the beginning of the year. We are aware that the outcome of this work, and in particular the technical standards required by Article 4(4) of the Directive, will be an important element of the future AIFMD framework and we are close to finalising a consultation paper for publication in the coming months.

In the time that remains I will touch on two other topics that are likely to be of interest to this audience. The first is the Packaged Retail Investment Products (PRIPs) initiative. By its very nature this is an issue that calls for a cross-sectoral approach, so we are addressing it under the auspices of the Joint Committee of the European Supervisory Authorities. From an ESMA perspective, it will be especially important to build on the extensive work done on the Key Investor Information Document for UCITS. We will be working closely with the European Commission on this project, particularly in view of the consumer testing exercise that will be used in order to check the effectiveness of different approaches to disclosure.

The second initiative I would like to mention relates to the powers for ESMA under Article 17 of the ESMA Regulation. This article gives ESMA the powers to investigate breaches of Union law by national competent authorities. This is a very valuable tool that we now have at our disposal in order to promote supervisory convergence within the EU. Indeed, it will almost certainly continue to require more of our time and resources as the number of potential breaches increases. Although the use of these powers may

result in tensions between us and national securities regulators, I think this is a natural consequence of ESMA's independence and our objective to achieve proper and consistent application of EU law. This is needed to esnure the single market.

I have spoken today about some of the key initiatives that ESMA is focusing on in the area of investment management. I have tried to highlight the interactions between them and the diversity of issues with which we – and therefore you – are faced on a daily basis. I look forward to overcoming those challenges with the benefit of constructive engagement from the asset management industry.

Thank you for your attention.