

Keynote Address

CMU, Brexit and ESA review – What's next?

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Ladies and Gentlemen,

I am delighted to be here in Brussels at this important event and I would like to thank Thomas Richter and the BVI for the kind invitation to speak this evening.

Before arriving here, today I had a quick look online at what Musée Belvue in Brussels offers. I learned that seven themes are addressed in various rooms: democracy, prosperity, solidarity, pluralism, migration, language and Europe. In order to let you tune in before the guided tour, which starts shortly after this speech, I would like to reflect on three of those themes, namely: migration, prosperity, and Europe. However, given my area of expertise, I will use loosely related synonyms for these themes from the world of finance: delegation, cost and charges to retail clients and Capital Markets Union.

Delegation

Of all the work produced by ESMA over the past year, I think the one that has generated the most comment, at least from the investment fund community, are our opinions on supervisory convergence in the context of Brexit. Clearly, the greatest focus, within those opinions, has been on what we said about delegation. I would like to spend a few minutes explaining why we decided to address this issue in the opinions.

Whatever your views of the UK's decision to withdraw from the European Union, I am sure you

would agree that this development presents very particular challenges to ESMA's objectives.

ESMA's mission statement is instructive here: we contribute to safeguarding the stability of the European Union's financial system by enhancing the protection of investors and promoting stable and orderly financial markets. The decision of the UK to leave not only the EU but, as stated by the UK Government, also the Single Market, has led to a situation in which there is the potential for a significant shift of entities and activities from the UK to the EU27.

It does not take a great leap of imagination to see how this activity could present risks to ESMA's objectives. The EU passporting system, while being far from perfect, is a valuable tool in allowing firms to serve clients across the Member States and it is only natural - indeed, from an investor perspective I would say it is even desirable – that firms started to look at ways to ensure they could continue to serve clients across the EU.

This triggered concerns about the risk of regulatory arbitrage between the EU27 Member States seeking to attract this business. I am realistic enough to know that such competition for business will always be with us. What we as ESMA felt very strongly was that in the contingency plans that businesses were drawing up, regulatory or supervisory arbitrage should not be a factor.

In other words, financial centres in the EU27 should be free to compete based on the particular strengths they can offer relocating firms, like speed and efficiency, but in all cases the EU rulebook should be consistently applied. Otherwise, there could be insufficient substance in the EU27, which may pose risks to ESMA achieving its stability and investor protection mandates.

It was with this in mind that we started to develop first a general Opinion, published in May last year, then three sector-specific ones in July for investment firms, secondary markets and asset management. A key area tackled by these opinions was outsourcing and delegation to third countries.

I admit that I have been surprised by the amount of commentary generated by these opinions. Reading some of the media coverage and listening to stakeholders, you could easily get the impression that we had suddenly decided to prohibit delegation overnight.

As I have repeatedly clarified, we are not looking to question, undermine or put in doubt the delegation model. We know that this is a key feature of the investment funds industry and that

the flexibility to organise centres of excellence in different jurisdictions has contributed to the industry's success. To put it more bluntly, to us delegation is not a dirty word.

What our opinions are seeking to address is the risk of letterbox entities. I hope you would all agree that it is in no-one's interest to allow the creation of such entities. Both the UCITS Directive and the AIFMD explicitly require there to be enough substance in the entity established in the home Member State.

Our opinions simply clarified what this means in practice and what factors have to be taken into account when assessing whether there is sufficient substance. Some have said that our opinions went beyond the Level 1 and Level 2 requirements – I would respond that a supervisory convergence tool would add little value if it simply repeated existing legal requirements.

Experience showed us that national regulators had been interpreting these requirements differently. That experience, coupled with the specific risks generated by Brexit, convinced us that it was necessary to take action. The opinions are not changing the legal requirements; rather they describe the practical application of the legal requirements to support a common understanding across EU27 authorities when supervising delegation arrangements.

The opinions themselves were an important step towards mitigating risks to supervisory convergence from Brexit. However, we felt that it was important not to assume that these instruments on their own would be sufficient to achieve our objectives. Instead, we believed it was necessary to make the opinions “live” – which is why we created the Supervisory Coordination Network (SCN).

This network, chaired by Verena Ross, ESMA's Executive Director, brings together experts from a broad range of competent authorities who table actual cases that they are facing involving UK entities looking to move to the EU27. All the information provided is on an anonymised basis. While the national regulators ultimately retain full responsibility for authorisation decisions, the new forum is an important means of information sharing and promotion of convergent practices. The discussion of live relocation-cases is a new ESMA activity; however, we already have extensive experience with this convergence instrument. For example, in the area of the application of IFRS by EU issuers, we have been discussing live cases for many years to ensure consistent application and it has achieved good results.

Costs and charges

I would now like to turn to the topic of costs and charges, with a specific focus on MiFID II and PRIIPs.

The first thing I want to say is that I believe the changes to cost transparency introduced by these two pieces of legislation are already having a positive impact. I have said before that in order to increase investors' confidence in financial markets, they need to have greater trust in the entities producing and distributing investment products. An important step towards achieving that goal lies in greater transparency about the products themselves and the service provided.

Let us take the example of unbundling. Under MiFID II, inducements are banned for independent advice and portfolio management. For other services, inducements are permitted if they, among other things, improve services provided to individual clients.

In relation to research, the legislation clarifies that the receipt of research by portfolio managers from any third-party entities, and brokers in particular, would not constitute an inducement provided that portfolio managers pay for research in one of two ways. They can either pay directly from their own resources, or from a separate research payment account controlled by the portfolio manager and funded by a specific research charge to the client.

We believe that the new model of payments for research gives strong incentives to portfolio managers to identify more clearly the research they need and the value it adds in informing their investment decisions. In the months leading up to the start of MiFID II we already saw that portfolio managers initiated the deliberate evaluation of the costs and benefits of the research they use, which was, and is, a positive development.

This should help ensure better use of the research budget instead of firms, and ultimately their clients, paying for low quality, duplicative research. Managers will thus be able to use the funds allocated to research more efficiently. The new rules should also provide better opportunities for independent research providers to compete on the quality of the research provided and prompt portfolio managers to acquire research from a wider variety of research providers.

Moving away from MiFID II, I believe that the new PRIIPs framework represents another important milestone towards improved cost disclosure. Thanks to the PRIIPs KID, investors now have a complete picture of the costs of the investment product they are buying. There has been much debate about the specific issue of transaction costs; first on whether such costs should be included in the disclosure, and subsequently on how to calculate them.

On the question of whether to include disclosure of transaction costs, I think it is only fair that investors are fully informed about something that can have a material impact on their returns, especially when the impact can vary significantly across different products. Indeed, I would go so far as to say that we will look back on this debate in a few years' time and wonder how it could ever have been so controversial. PRIIPs and MiFID II have really embedded the idea that no cost, whether explicit or implicit, should escape disclosure.

On the methodology for calculation, we are aware of the vocal reactions of stakeholders and the extensive coverage in the media of supposed flaws. What I would say to you is that we are ready and willing to look at this issue but that we need to see concrete evidence to assess whether these flaws are real. In the absence of any such evidence, we maintain our view that the methodology is sound and that negative transaction cost figures should be extremely rare.

I would also like to point out that flexibility is not a one-way street – stakeholders often ask us to allow for flexibility in the way that certain requirements are applied, but the whole point here is to have harmonised and consistent documents that investors can use to compare products. The methodology for cost disclosure has been designed with that goal in mind.

More generally on PRIIPs, I would stress that we are willing to discuss the issues that may arise. Indeed, you will have seen that the ESAs have already published an extensive set of Q&As on PRIIPs, which were based on issues raised with us either directly by industry or indirectly via the national regulators, and we are working on further guidance, on performance scenarios-related issues in particular, that we hope to issue in the near future.

CMU/ESAs review

Let me now move to my final theme for this evening: Europe – and more specifically the Capital Markets Union, or “CMU” as we all know it. Later this week the European Council will take stock of progress in delivering, inter alia, the CMU Action Plan, and over the last fortnight the European Commission launched another set of measures aiming at supporting the creation of the CMU, including on cross-border distribution of investment funds.

I believe I do not have to convince anyone here that deep and integrated capital markets in Europe will foster cross-border private risk sharing, thereby boosting the productive and innovative use of private capital, and diversifying the sources of funding to the real economy. ESMA, and I include myself in that, is a strong supporter of the CMU, and we have been working on eliminating certain barriers hampering the Single Market within our remit, in

particular through supervisory convergence measures, even before the CMU title was invented and became a political priority.

As envisaged in the CMU Action Plan, but also emphasised by the European Parliament Resolution in July 2015 [on building a capital markets union], the *“legal and supervisory frameworks play a fundamental role in avoiding excessive risk taking in financial markets, and [therefore] a strong CMU project needs to be accompanied by strong EU-wide and national supervision”*.

I would like to underline that the Commission’s legislative proposal on the ESAs review from September last year clearly delivers on these expectations. However, as it quickly emerged after the publication of the proposal, a number of Member States in the Council have not shared my excitement at seeing this comprehensive set of amendments to the current frameworks of ESMA, EBA and EIOPA.

Now having the opportunity to speak at such an event in Brussels, I would like to share some thoughts on a few critical aspects of this proposal, in particular those of interest for the asset management community.

Starting with – again – delegation and the potential role for ESMA in this area, much has been said about the supposedly unworkable regime that the Commission has proposed, the extra time that it would add to the decision-making process and the legal uncertainty.

However, to those who see only additional complications and burdens from a strengthened role for ESMA on delegation, I would point out that the Supervisory Coordination Network (SCN) has been doing similar work over the past six months without creating any of the disruption that has been warned about. In addition, I would like to highlight that the tools we would be empowered to use under the Commission’s proposal – namely opinions – are a very standard convergence tool that we have used hundreds of times already on a range of different topics, including under MIFID I and MiFID II.

For example, we have used the opinion tool to ensure consistency in the granting of so-called pre-trade transparency waivers to trading venues. Like delegation, this is an area where there is a high risk of regulatory arbitrage and where there is a common interest in maintaining a level playing field. The experience we have with opinions in other ESMA areas gives me the confidence that we would be able to deploy the new convergence powers on delegation arrangements in an efficient and proportionate way. This is all without even mentioning the

benefits that it would bring in terms of supervisory convergence and consistency across the EU.

Another point some Member States and parts of the industry have been critical about is the new funding model. I and my colleagues at ESMA looked at these numbers, and the shift to the industry-funded budget for indirect supervision, as proposed by the Commission, would *inter alia* impact about 2,500 investment management companies across the EU. Their yearly contribution, however, based on ESMA's 2018 budget and the proposed distribution key would mean an average of €650 per entity annually. I cannot imagine that this level of burden could significantly impact the profitability of the BVI's membership.

At the same time I predict that with a more independent funding base, ESMA would be able to expand its supervisory convergence activities, which ultimately benefits the CMU project, and both consumers and the financial industry. Finally, I think it is important to keep in mind that ESMA's Board of Supervisors would retain the budget approval powers, and the Member States would continue to co-decide the general EU Multi-Annual Financial Framework which also applies to ESMA.

The last aspect I want to mention in the context of the ESAs review are ESMA's level 3 measures. People say "*don't fix what is not broken*" and this in my opinion applies to the process governing our guidelines and Q&As. These supervisory convergence tools have been used by ESMA mostly "*per request*" of individual national regulators and industry stakeholders seeking more guidance.

While we consult extensively on draft guidelines, the Q&As are reserved for more technical issues and clearly better suited for providing faster responses. In my view there is no need to change the governance principles around these supervisory convergence tools, however, it does not mean that we should not explore ways to improve our stakeholder management. For this reason, last month, we launched a dedicated stakeholder relations survey, which will remain open until the end of March. I would appreciate receiving your feedback on this important matter.

Ladies and Gentlemen, it just remains for me to thank the BVI for their invitation tonight, and I look forward to further dialogue with you in the future.