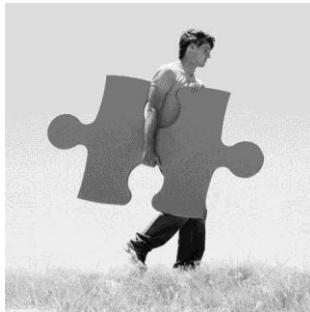


Client Alert

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The Rise of the ESAs: EU Proposals to Extend Direct Supervision of Financial Markets

On 20 September 2017, the European Commission published a package of measures designed to increase the powers of the three European Supervisory Authorities (ESAs), primarily by transferring certain powers of regulation and supervision from national competent authorities to the ESAs.

The proposals are significant in relation to a number of aspects of financial services and capital markets activity. We highlight below some of the key features of the proposals.

Background

The ESAs comprise the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). The ESAs were established in 2010 as part of the creation of a Single Rulebook for financial regulation in the EU to take over the functions of previous committees of EU supervisors and regulators. The ESAs were granted more direct powers to coordinate the work of competent authorities of member states, providing technical advice to the EU Commission on specified matters and producing draft technical standards and guidelines to supplement provisions of EU regulations and directives.

The precise framework of regulation, supervision and enforcement in relation to each piece of EU financial regulation varies on a case by case basis. Generally, however, the primary role of supervision and enforcement in each member state is the responsibility of the relevant competent authority or authorities in that member state. One or more of the ESAs will usually have a role in coordinating work of competent authorities and may have specific powers to approve certain actions by competent authorities. On the whole, however, the ESAs do not perform the primary function of regulation and supervision under relevant legislation. There are, however, already some exceptions. For example, ESMA has the role of authorising and supervising non-EU central counterparties and all trade repositories under the European Market Infrastructure Regulation and is the single supervisor of credit rating agencies within the EU.

In addition to the three ESAs, the European Systemic Risk Board (ESRB) was also established in 2010 with the function of overseeing the EU financial system as a whole and coordinating EU policies for financial stability.

In recent years, the EU has sought to move towards a more integrated system of supervision of financial markets. In September 2015, the EU Commission launched its Capital Markets Union (CMU) Action Plan¹ to seek to strengthen and deepen capital markets across the EU with the aim of having a fully functioning CMU by 2019. The mid-term review of CMU in May 2017 highlighted the need for more integrated financial markets. In the

¹ "Action Plan on Building a Capital Markets Union," <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0468&from=EN>.

“Five Presidents Report” in June 2015², it was concluded that there would in due course be the need for a single EU capital markets supervisor.

Proposals to further centralise powers within the ESAs will not be without political controversy. Individual financial markets vary greatly among member states and many are likely to argue that primary responsibility for the bulk of financial regulation should remain with individual competent authorities. Although the EU Commission will be likely to argue that the proposals do not undermine this principle, the proposals will inevitably lead to a significant change in the balance of power towards the ESAs.

What Is Proposed?

The specific proposals comprise:

- a draft Omnibus Regulation which contains amendments to various EU financial regulations including the Markets in Financial Instruments Regulation (MiFIR), the Benchmarks Regulation and the new Prospectus Regulation³;
- a draft Omnibus Directive which contains amendments to the recast Markets in Financial Instruments Directive (“MiFID II”) and the Solvency II Directive⁴;
- a draft Regulation amending the ESRB Regulation⁵; and
- an amendment to the EU Commission’s June 2017 proposed Regulation amending EMIR (referred to generally as “EMIR II”)⁶.

Some of the key features of the proposals include:

Prospectuses. At present under the Prospectus Directive and the new Prospectus Regulation (which is due to come into effect from July 2019), all prospectuses are required to be approved by the competent authority of the issuer’s home member state. For non-EU issuers the home member state is determined by reference to specified criteria.

Under the proposals, all non-EU issuers required to prepare a prospectus under the Prospectus Regulation will have to file the prospectus with ESMA and ESMA will take over the role of the home competent authority in approving such prospectus. In addition, ESMA will take over the role of competent authority for any prospectus drawn up:

- relating to the admission for trading of non-equity securities which are to be traded on a regulated market, or a specific segment thereof, to which only qualified investors can have access for the purpose of trading such securities;
- relating to asset-backed securities;
- by property companies, mineral companies, scientific research-based companies and shipping companies.

These proposals will give rise to a significant role for ESMA in directly authorising securities prospectuses. It is worth noting that after the UK leaves the EU following Brexit, the proposals will mean that all prospectuses relating to securities issued by UK entities and offered to the public in the EU will be subject to approval by ESMA. The proposal does, however, fix the solution as to what authority would be the home member state for such prospectuses after Brexit. Assuming this proposal eventually comes into force, it is to be hoped that transitional arrangements in relation to Brexit will allow the UK FCA to continue to approve such prospectuses up to the date

² “Completing Europe’s Economic and Monetary Union,” https://ec.europa.eu/commission/sites/beta-political/files/5-presidents-report_en.pdf.

³ <http://ec.europa.eu/transparency/regdoc/rep/1/2017/EN/COM-2017-536-F1-EN-MAIN-PART-1.PDF>.

⁴ <http://ec.europa.eu/transparency/regdoc/rep/1/2017/EN/COM-2017-537-F1-EN-MAIN-PART-1.PDF>.

⁵ <http://ec.europa.eu/transparency/regdoc/rep/1/2017/EN/COM-2017-538-F1-EN-MAIN-PART-1.PDF>.

⁶ <http://ec.europa.eu/transparency/regdoc/rep/1/2017/EN/COM-2017-539-F1-EN-MAIN-PART-1.PDF>.

the new rules become effective. Otherwise, there will be an interim period where a new home member state has to be appointed by such issuer. Similarly non-EU issuers that currently have the UK as their home member state in relation to securities prospectuses (as with all non-EU issuers) will be required to seek approval from ESMA in relation to their prospectuses for securities offered to the public in the EU.

Financial Benchmarks. The Benchmark Regulation will come into effect from 1 January 2018 and, subject to transitional arrangements, will require EU-based administrators of financial benchmarks within the scope of the regulation to be authorised in respect of the administration of such benchmarks with their relevant EU competent authority. For non-EU benchmark administrators whose benchmark is used in the EU, the benchmark can be registered with ESMA subject to certain conditions.

Under the proposals, ESMA will take over the role of the relevant national competent authority for authorising and supervising all EU administrators of critical benchmarks. The definition of “critical benchmark” includes a benchmark that is used as a reference for financial instruments/contracts or for measuring the performance of investment funds, having a total value of at least €500 billion. Where the relevant value is at least €400 billion, the benchmark will also be critical if it has no, or very few, appropriate market-led substitutes and if, in circumstances where the benchmark is no longer provided, its absence would have a significant and adverse impact on market integrity, financial stability, consumers, the real economy or the financing of households and businesses. A benchmark is also regarded as critical if it is based on submissions by contributors, the majority of which are located in one member state, and is recognised as being critical by the relevant competent authority in accordance with specified criteria. At present, the only benchmarks that have been designated as critical benchmarks are EURIBOR and EONIA but others are expected to be so designated shortly, including LIBOR.

In the context of Brexit, LIBOR is currently administered by ICE Benchmark Administration (IBA) and regulated by the Financial Conduct Authority (FCA) in the UK (although the FCA has recently announced that it does not intend to exercise its powers to require firms to contribute to LIBOR after 2021). Assuming that LIBOR is designated as a critical benchmark then, but for Brexit, the effect of the EU’s proposals would be that ESMA would take over the role of regulator of LIBOR from the FCA. However, assuming that LIBOR continues to be administered by IBA, it will be regarded as a non-EU benchmark following Brexit. The FCA would therefore likely continue to be the regulator for LIBOR even if the new proposals come into effect, although the IBA would also be required to be registered with ESMA under the Benchmark Regulation.

Data Reporting Services. Data reporting service providers under MiFID II/MiFIR (which comes into effect from January 2018) will be required to be authorised and supervised by their relevant competent authority and to provide relevant information to such competent authority. The proposals would transfer the authorisation and supervision of data reporting service providers to ESMA. The EU Commission argues that this will allow for centrally managed authorisation and oversight and avoid market participants having to provide multiple competent authorities with data which is then provided to ESMA. The proposals will also give ESMA the power to conduct investigations and on-site inspections and to impose sanctions for non-compliance.

EMIR. The draft Regulation published by the EU Commission in June 2017 includes provisions to establish a CCP Executive Session within ESMA which will be responsible for aspects of the regulation and supervision of CCPs. These powers are expanded under the new proposal.

Solvency II Directive. The EU Commission proposes to make amendments to the Solvency II Directive. The proposed changes include enhancing the role of EIOPA in relation to insurance and reinsurance undertakings and groups using internal models for the solvency capital requirement calculation. EIOPA will have additional powers in relation to cooperation and information sharing in this regard.

ESRB. The EU Commission believes that the move towards CMU and the establishment of the Banking Union through the Single Supervisory Mechanism (SSM) requires some changes to the ESRB’s governance. It proposes that representatives of the SSM and the Single Resolution Board (SRB) become voting members of the ESRB General Board. It is also proposed that the ECB should be included as a potential addressee of ESRB warnings

and recommendations. It is also proposed that the European Central Bank president be given the permanent role of acting as chairman of the ESRB.

Governance of ESAs. It is proposed that the ESAs will each have new Executive Boards which will prepare the relevant ESA's work programme and budget. Each Executive Board will have powers in specified areas to prepare decisions for adoption by the Board of Supervisors. Each Executive Board will comprise a chairperson and three full-time members (five for ESMA).

The enhanced roles of the ESAs will inevitably lead to further staffing needs and additional costs. The current fixed distribution of funding between national authorities and the EU budget is to be amended. It is intended that less of the funding for the ESAs will come from the public sector and more will be met by industry and market participants.

Next Steps

The legislative proposals will now need to be considered by the European Parliament and the EU Council of Ministers. The EU Commission is pushing for the legislation to be finalised by 2019 in the current legislative term. The EU Commission has also invited public/industry feedback by 15 November 2017.

Some Thoughts

The proposals, although significant, do not, on the whole, represent a huge change in the balance of power between the ESAs and national competent authorities who will continue to maintain much of their current role in relation to financial regulation and supervision. The changes, however, do continue a slow but steady rise in the powers and responsibilities of the ESAs since they were established in June 2010 and it will be surprising if this does not continue to be the direction of travel in the future. The balance of power shift is most acute in relation to the new Prospectus Regulation. Effectively designating ESMA as the competent authority for all non-EU issuers in terms of approving prospectuses in respect of securities to be offered to the public in the EU and all issuers in respect of non-equity securities to be admitted to trading on a regulated market is likely to result in it being asked to consider the approval of a very significant number of prospectuses.

A number of member states, most notably the UK, have fought hard to maintain the role and independence of national competent authorities. It is therefore perhaps not surprising that with the UK on the verge of leaving the EU, the move towards centralisation of powers within the ESAs seems to be accelerating. There is perhaps some irony in the fact that, once the UK leaves the EU, one of the most significant consequences of the proposals is that all prospectuses prepared by UK issuers of securities to be offered to the public in an EU member state will need to be authorised by ESMA.

The extra burden on ESMA as a result of this new role is not to be underestimated. Even with the UK within the EU, a significant number of non-EU entities issue securities to the public within the EU. It is to be expected that UK issuers will continue to actively seek investors in the EU. This role itself is therefore likely to add considerably to ESMA's workload and staffing requirements and is likely to need some preparation by ESMA to be able to fulfil this role. Also, with the likely increase in the designation of critical benchmarks under the Benchmark Regulation, ESMA's role as competent authority in relation to such benchmarks is also likely to be material. It is therefore likely that ESMA, in particular, will need significant new resources and staff to be able to fulfil its new role.

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