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# Discours de Robert Ophèle, Président de l'AMF - 'From Brexit to financial innovations, new challenges for financial regulation', OMFIF - Official Monetary and Financial Institutions Forum - 15 mars 2018 (en anglais uniquement)

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Good morning,

Many thanks to the OMFIF for inviting me this morning to present some thoughts on the current challenges for financial regulation. Allow me to be modest in these remarks, after all, after a career spent at the French central bank devoted to monetary policy and banking supervision, I joined the financial markets regulatory circle just a few months ago and it would be most presumptuous of me to lecture such an audience on financial regulation; at this juncture, I am more inclined to offer you some sort of "discovery report".

I will structure it via two complementary angles of the challenges we face with regard to financial regulation in the EU: first how to improve the way financial regulation is designed and institutionally set up and second how to organize balanced relationships with third countries.

Let me start with the obvious; when comparing the three main fields of financial activities, banking, insurance and financial markets operations, one is confronted with three very different stages of regulatory/supervisory harmonization; this is true at both the international and at the EU level.

- The level of Harmonization is at a fairly advanced stage for banking activities. The BCBS has elaborated a broad set of precise supervisory rules for banks which are implemented in all major jurisdictions; and the regulatory journey is probably largely over with the conclusion of the Basel3 saga. In the Euro zone, there is a fully-fledged banking union well under way, with almost no residual national fields of competence; this reflects the highly systemic nature of banking activities;

- Conversely, when turning to insurance activities the level of harmonization is quite low. The IAIS has great difficulty finding a consensus in order to elaborate the so-called ComFrame for the Supervision of Internationally Active Insurance Groups and with the adoption of a risk-based Insurance Capital Standard. In the EU, while there is a set of common rules with Solvency 2, there is no union-wide insurance supervision and no strong need for that. It reflects the fact that there are actually no significant cross-border insurance activities;

- Financial market activities are at an intermediate stage with a growing set of international principles, especially in the field of CCPs and derivatives. However there are still fields that lack a common international approach: take extra-financial reporting or crypto-assets, to name a few. In the EU, there are numerous financial regulations, but EU-wide capital markets supervision remains extremely limited furthermore, supervisory convergence is still in its infancy despite the importance and extent of cross-border activities.

In an area where financial entities benefit from the freedom of establishment (i.e. the right to establish a branch) and from the freedom to provide services and where they use these freedoms extensively, it is not sufficient to have common regulations; it is necessary to implement and enforce them coherently in all member states. Probably in order to facilitate that, European co-legislators have developed a rather detailed set of rules which are complemented by a flurry of Level 2 regulations. Based on such granular regulations, one would imagine that national authorities have little room to adapt their supervisory stance. However, this is unfortunately not the case and MIFID2 provides a good example of the difficulties encountered.

- The Lamfalussy report recommended using Level 1 regulation only for setting out framework principles. Let us take the example of the Double Volume Cap rule which is now implemented; MIFIR defines rightfully the mechanism but it also foresees that "ESMA shall publish (the detailed calculation) within five working days of the end of each calendar month" (MIFIR art 5-4). These five working days are most challenging and maybe impossible to observe; by drilling down to this degree of detail, the co-legislators are obviously far from sticking to framework principles.

- Turning to the tick size regime, Level 1 has indeed provided the basic principles but Level 2, actually RTS 1 and RTS 11, has failed to properly address the case of dual listed securities and the case of Systematic Internalizers. A lack of homogeneity in the tick size implementation (between the EU and third countries or between trading venues inside the EU) obviously distorts the price discovery process and, in the absence of a level playing field, gives a competitive advantage to the trading venues with the smallest tick sizes. This would clearly deserve swift and consistent adjustment.

- Coming now to the actual implementation of the rules, which are supposed to follow Level 3 guidance, we can already observe some differences between EU countries, for example in the scope of the prohibition for OTFs to trade in equity–instruments, which is not understood the same way in all countries when it comes to packaged transactions; Direct Electronic Access requirements are another example of different approaches inside the EU.

Obviously, we would prefer a more principle based regulation (i.e. less Level 1 and Level 2 rules) and a single European-wide interpretation with a degree of leeway to adapt the European supervisory stance rapidly and homogeneously (more effective level 3 and more binding Level 3).

Having nearly finalized the single rule book and made every effort to promote supervisory convergence with existing tools, it is time to move towards a more unified supervision.

At a bare minimum, European authorities need the legal tools to avoid the deadlock which may occur when Level 1 or Level 2 texts are in practice unenforceable or require international coordination; no-action letters such as those used in the United States or similar types of acts would provide targeted and legally sound responses in those specific instances, where, for objective reasons, it appears that a legislative requirement cannot be complied with, or when action from the authorities is required to promote a coordinated approach with third country authorities.

These are illustrations of the limits of the current institutional setting in the EU; they are also a warning vis-à-vis any system of general mutual recognition with third countries. There is an urgent need to rethink the EU regulatory framework, improve it and ensure it is appropriate for the EU27 before accepting to largely open our financial markets. In any event, it is clear that neither the freedom of establishment nor the freedom to provide services can be extended automatically to third country entities.

Let me now turn to the challenges around defining a balanced approach vis-à-vis third countries. There are basically two types of approaches: one can either rely on a national regime under which a third country entity is allowed to establish a branch in one EU Member

State and, subject to specific requirements, is allowed to provide financial services through this branch, but without the ability to passport them into other EU countries. Alternatively one may benefit from an equivalence decision from the EU Commission, which allows a third country entity to provide services to all EEA customers.

The equivalence regime is of course the favored avenue but it has a very different meaning depending on the regulation to which it applies; regarding financial services, let me mention two fields of activity which have recently been the subject of intense discussions:

- the recognition that CCPs established in some third countries deemed "equivalent" are qualified to provide clearing services to clearing members or trading venues established in the Union and therefore can be used to fulfill the regulatory "clearing obligation" imposed on certain financial derivatives by EMIR;
- the recognition that trading venues established in third countries deemed "equivalent" are eligible for European investment firms to fulfill the "trading obligation" for shares and derivatives imposed on them by MIFID II.

In many other fields, equivalence regimes are provided by EU regulations but have not yet been activated. One of the most sensitive equivalence regimes relates to investment firms under MiFIR and is designed to allow third country firms to provide EU-wide services to EU professional clients and eligible counterparties. One should also bear in mind that in certain areas, there is no equivalence regime: the UCITS regime is an example of an EEA-only product regulation (a UCITS fund may only be registered in the EEA and managed by a management company incorporated in the EEA).

In the EU, equivalence decisions are the prerogative of the Commission, which adopts an implementing act subject to the assessment of an appropriate "regulatory committee" composed of representatives of Member States. In order to assess the equivalence of the legal framework of any given third country, the Commission can seek the technical advice from the appropriate ESA[(1)]
The Commission's legislative proposal on the review of the ESAs, published on 20 September 2017, amends Art. 33 of the ESMA Regulation to provide that ESMA "shall assist the Commission in preparing equivalence decisions pertaining to regulatory and supervisory regimes in third countries following a specific request for advice from the Commission (…)" (COM(2017) 536 final).
. However the involvement of the ESAs remains very limited, both in terms of preparation and in terms of follow-up after a positive equivalence decision has been taken.

Actually the Commission has considerable leeway to determine the scope, duration and conditions of a possible equivalence. It also has full discretion in its decision-making process

in order to take into account the promotion of the internal market for financial services and the protection of financial stability.

Obviously these last two components of the equivalence assessment will become all the more relevant when discussing possible equivalence with the UK. When the main financial center of the EU is about to leave the Union, it is clear that the European third country regimes as previously defined can no longer be appropriate and hence deserve to be revisited. On the one hand, on the day Brexit occurs, the UK should have the same rulebook as the EU27, but, on the other hand, it raises specific questions linked to the possible dependence on financial services provided by firms located outside the Union.

Let us take a closer look at the issues at stake in this debate.

There is currently a school of thought that advocates that, provided certain conditions are met, such as equivalence of regulations, supervisory cooperation, level playing field and reciprocity, the freedom to provide financial services should be granted. The main rationale behind this is the cost efficiency of a large, almost worldwide, single financial market where operations are centralized in one or a handful of locations, thus allowing a large pool of capital, liquidity and human expertise to build up.

If one supports this line of thought, basically Brexit should change nothing in relation to the current situation; except perhaps in some areas on the direct marketing of financial products to retail customers, where a number investor protection concerns may be raised.

I am of a slightly different view.

In elaborating the framework for the EU27's relationship with third countries, the right balance needs to be found: yes indeed, to foster, financial efficiency - but without compromising our own regulatory and supervisory remit, and taking financial stability issues into account. For a large economic Union such as the EU, which has the ambition to build up its own financial capabilities under a fully-fledged capital markets union, this means that a large set of its own financial operations should effectively take place inside the EU and not be outsourced to third countries. For those remaining operations that will however be delivered from third countries, it is important to fine-tune the right approach with a possible dose of extraterritoriality of EU rules, but without imposing a full double set of rules and supervision for conducting business in two different jurisdictions.

Let me elaborate on these two sets of issues: no general liberalization of international trade in financial services, but rather a carefully managed mutual recognition.

The global financial crisis has clearly highlighted both the vulnerabilities of various financial systems and the interconnectedness of financial markets. The G20's response has lived up to the gravity of the crisis, establishing a vast set of strengthened regulations to be implemented consistently across jurisdictions and especially targeting systemically important financial institutions or infrastructures. Coordination between authorities has also been enhanced through various colleges and crisis management groups.

Nevertheless, despite this coordinated push and the advantages of having all operations centralized in one single center (economies of scale, increased liquidity, capital optimization, reduced encumbered collateral etc.), no major jurisdiction has consequently dismantled regulatory barriers to providing cross border financial services. The rationale is very simple; public authorities cannot fulfill their duties (financial stability, monetary policy, investor protection…) appropriately where a vast majority of financial services are provided from third countries. From a global perspective, one would be foolish to think that the "too big to fail" and the "too interconnected to fail" issues could be solved without any possible State or Central bank intervention; just as it would be foolish to ignore political risks associated to any over-centralized location. As a consequence one obviously needs both to develop a strong financial base in one's constituency and to forge fruitful relationships with the most critical third country jurisdictions, targeting specific types of financial services.

These agreements take various forms and names; mutual recognition, equivalence regime, substituted compliance approach; some would be similar to a passport, others would imply location with favorable treatment.

Before discussing the possible post-Brexit EU stance, let us have a closer look at the US supervisory stance vis-à-vis third countries.

The traditional US approach vis-à-vis foreign entities and products is national treatment; meaning, if you want to provide financial services to a US person, you need to apply the full set of US regulations, whether you are located in the US or in a third country. After a failed attempt by the SEC in 2008 to enter into a mutual recognition agreement with Australia concerning trading venues and Investment firms, the "substituted compliance approach" has been developed in some cases, with the CFTC fine-tuning this approach when dealing with the CCP case.

Substituted compliance does not mean automatic recognition and relinquishment of all extra-territorial powers. It streamlines the registration process for third country CCPs applying for CFTC registration and maintains direct access of US regulators to an extensive set of the CCP data, with a right to conduct on-site inspections.

However there is the specific situation of the EU, which is not a fully- fledged single jurisdiction since there is no single EU supervisor. Let me quote Howell Jackson from Harvard in a 2015 paper[(2)]
Howell E. Jackson, Substituted Compliance: The Emergence, Challenges, and Evolutions of a New Regulatory Paradigm, Journal of Financial Regulation (2015).
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"Another unique set of concerns arise when mutual recognition procedures are extended into regional confederations, such as the EU, which are themselves built on inter-connected systems of mutual recognition among member states. (…) On almost any plausible metric of objective performance, regulatory resources, enforcement efforts, objective indicia of market performance or presence of foreign investors, the distance between the better developed and less developed European markets is substantial. The variation in supervisory and market quality militates in favor of a focus on individual member states as a preferable point of contact, starting for example with the UK or perhaps Germany as likely partners for initial European linkages. But the problems of regional confederation do not fully disappear. The genius of the EU internal market is the free flow of goods and services, which permits issuers located in one jurisdiction to list their securities in another member-state markets and allows financial services firms to branch across the region's boundaries. Thus, even if the Commission were to conclude that market oversight within a single EU jurisdiction was comparable to that of the USA, concerns would still arise whether products sold in that countries market and all firms doing business in that market were fully subject to the member states oversight."

Apologies for this rather long quote but as the EU financial market regulation landscape is currently fragmented across 28 NCAs plus a pan-European regulator (ESMA), I can fully understand why our US counterparts may sometimes feel a little nervous about granting exemptive relief to EU regulated entities.

To me, the solution to this is clear: we need a stronger ESMA; we need ESMA to supervise a larger part/share of EU regulated activities directly, and we need ESMA to be credible when it speaks to the US supervisors on behalf of the 28 (tomorrow 27) NCAs.

Let me now take the European perspective, with a new third country emerging on the EU border, the UK, which also happens to be a dominant financial center. This immediately triggers a brand new set of issues regarding equivalence; level playing field issues, which are completely different when the third country is in a distant time zone or when it is your next door neighbor; sovereignty and financial stability issues when the vast majority of financial services provided to EU clients could be delivered from an equivalent third country. This explains why we are in a process of reviewing some of our key equivalence regimes; primarily EMIR for CCPs, MIFIR for investment firms and more generally the role of ESMA in

the equivalence process.

The CCP case is well known and I will be short. It has triggered a passionate debate on the appropriateness of a possible active location policy which, if not carefully managed, could fragment the liquidity of the market, increase the amount of collateral encumbered and be possibly counterproductive for the EU. There are two reasons why one should regulate and supervise very closely large CCPs, which, by definition, concentrate risks: firstly because clearing members are at risk (margins and default fund contribution), and one should be most concerned when one's major credit institutions are among such CCPs' clearing members; second when a CCP clears a financial instrument denominated in your currency, any malfunctioning could have adverse consequences on the currency's stability and could affect the conduct of monetary policy (repo clearing is a classic example). In both cases, a default would trigger a highly detrimental financial crisis. Equivalence deserves a very granular approach which is precisely what the EMIR2 proposal of the Commission intends to achieve.

Allow me to dwell slightly longer on MIFIR.

As I mentioned, the MiFIR third country regime for the provision of investment services to EU wholesale clients by third country firms is based on a possible equivalence decision by the Commission. Although this regime has yet to be activated, in light of Brexit, it is legitimate to question whether it is properly calibrated and we actually welcome the Commission's initiative last December to issue proposals to amend the regime, although I believe we could afford to be more ambitious in the reform of the MiFID third country regime.

In the particular case of MiFID, when deciding the conditions under which third country firms may access the EU Single Market to provide investment services to European clients (e.g. executing trades, managing portfolios or operating an OTF), we must ensure that third-country firms are not treated more favorably than EU investment firms and that such firms comply with the same high standards of investor protection and market integrity that we impose on our EU firms, through MiFID II.

In my opinion, this can only be ensured by mandating that a subset of MiFID II and MiFIR rules (e.g. on transaction reporting, transparency, mandatory trading of shares and derivatives on platforms) is applied to third country firms operating in the EU. This is not extra-territoriality; this is ensuring a proper level playing field in Europe, when European clients are involved.

In such a MiFIR third country regime, the Commission's equivalence assessment would be a precondition, targeting the authorization procedure of firms by their third country supervisor. The Commission would look at the third country requirements regarding minimum own funds, management's fitness and properness of management, qualifying holdings and certain organizational requirements and verify whether their outcome is equivalent to the corresponding MiFID II rules. In the case of a positive conclusion, firms from that third country would simply be required to register with ESMA.
Subsequently, these third country firms, when operating in the EU, would however be required to apply certain rules of MiFID II/MiFIR in those areas where, I believe, the EU cannot defer to the rules of third countries. I have in mind specifically:

- MiFID II rules dealing with investor protection (e.g. product governance, safeguarding of clients' assets, pre-contractual information on costs and charges, best execution). Although similar rules may be in place in third countries and may apply to a third country entity in its relationship with third country clients, there can be no assurance that they will apply likewise where the same third country entity deals with EU clients in the EU, let alone that such rules can be effectively enforced by the third country supervisor in case of a breach in the EU;

- and MiFIR rules aimed at ensuring market transparency and integrity (e.g. transaction reporting, pre & post trade transparency, mandatory trading of shares and derivatives on platforms). We need to apply these rules to third country firms because we must ensure that the flow of information entailed (e.g. trade reporting) goes directly to EU NCAs in order to allow them to perform their duty of surveillance of EU markets.

Going a step further, if we impose a subset of our own rules to third country firms authorized in their third country, where they operate in the EU, compliance with such rules should be ensured on an ongoing basis. This requires some form of supervision of these firms in the EU. In the context of the ongoing ESAs review, here I see a fully legitimate role for ESMA to play, which by the way should logically entail investigation and sanctioning powers. Registration with ESMA, as currently provided by MiFIR, is a concept that may be kept, but which should come with a true supervisory role for ESMA, which is not currently the case. Such supervisory activities would of course need to be part of a cooperation agreement to be signed with the corresponding third country authority.

I will stop elaborating on how MiFID II should treat third country firms wishing to provide services in the EU, but you have certainly understood that it lies somewhere halfway between the plain equivalence that is currently provided in the text of MiFIR and the full imposition of EU rules that characterizes other EU financial legislations, such as for instance, the third country regime in AIFMD.

Let me conclude on the time needed for the EU27 and the UK to implement the appropriate balance in their mutual relationships regarding financial market services. While in many areas the so-called cliff effects are overdone and the private sector is perfectly able to manage them; in other areas, public authorities should provide the adequate legal support: the continuity of contracts, for insurance and derivatives, should be secured, possibly through provisions in the Withdrawal Agreement; in case of "Hard Brexit", some transitory equivalence should be granted in order to maintain the good functioning of key market infrastructures, giving us the time to reach the appropriate balance; the EU should stand strong, remain attractive and open to the rest of the world, and durably so – the City of London could help us to achieve that aim.

**Mots clés** EVOLUTION RÉGLEMENTATION

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