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ESMA Brief - 2014

Investment Firms' Governance & Risk Management in Algorithmic Trading and Product Manufacturing (governance)

The text primarily discusses the complexity, nature, and degree of intricacy involved in the operations of investment firms, particularly concerning trading activities and product governance arrangements. Key points of interest include the firm's regulatory status, roles in the market, automation of trading, types of instruments traded, strategies employed, and the level of outsourcing of key functions. Emphasis is also placed on managing operational risks associated with algorithmic trading through sound governance and internal controls. There is a call for regular reviews of trading systems, algorithms, and associated governance structures. The text also highlights the importance of due diligence in dealing with Direct Electronic Access (DEA) clients and the need for transparent governance structure. Furthermore, it provides insights into product governance arrangements to ensure investor protection and compliance with regulatory requirements.

Financial Regulations and Their Impact on Administrative Burdens within the European Union. (nist)

The presented report encompasses the directives and regulations related to financial markets within the European Union. Key points include the necessity for financial institutions to strengthen their own credit risk assessments and not depend solely on external credit ratings, as part of the new rules aimed at reduced dependency on external ratings by the European supervisory authorities. Regulations around intra-group transactions, transactions in derivatives and commodity derivatives are examined, which are stipulated in articles under MIFID II. The discussions further elaborate on which actions should be excluded from reporting obligations to limit unnecessary administrative burdens. A recurring theme throughout is the impact of these regulations on administrative burden and costs for market participants, with an emphasis on achieving proportionality. Observations are also included about the increase in costs due to disaggregation of data for venues. Lastly, the report handles the consultation of stakeholders on various draft technical standards under MIFID II and MIFIR directives.

Overview of Financial Instrument Trading and ESMA Guidelines (environment)

This piece focuses on the various categories of derivative contracts involved in trading, particularly those centered on interest rates, foreign exchange, equity, commodities, credits, and others. The document allocates considerable detail to subcategories of these instruments, discussing specific types like exotic options, swaps, and futures, as well as elements related to contract value and quantity. It discusses the European Securities and Markets Authority's (ESMA) preference for using existing guidelines for automated trading environments. These guidelines are intended to ensure orderly trading. ESMA recognises the need for non-live testing for investment firms in trading venues to prevent disorderly trading. Member firms as well as those via Direct Electronic Access (DEA) need to test individual market-specific algorithms and trading strategies in non-live environments. They should conduct their tests conscientiously and cautiously to prevent disorderly trading. Specifically, they should limit factors such as the number of financial instruments traded, order value, number of orders, strategy positions, and number of target markets. This process should include review and sign off by a responsible party within the investment firm.

Algorithmic Trading and Technology Risk Mitigation Measures under MiFID II (technology)

MiFID II places shared responsibility on trading firms and trading venue operators to mitigate risks arising from technological use, with real-time monitoring occuring with minimal time delays. Complexity is acknowledged in relation to types of instruments traded, diversity in trading models, structure of trading venues, technological and geographic setups, and changes in trading models or systems.

Algorithmic trading faces risks such as malfunctions potentially causing market disorder. Regulatory requirements insist on adequate technology systems to manage the complexity and ensure security, integrity, and confidentiality. Changes in the technical fundamentals of data feeds should be disclosed to trading venues or CCPs before implementation.

Although ESMA recognises technological evolution could overcome current constraints, the identified current rules do not adequately accommodate future technology standards. Despite legal risks and potential outages due to unreliable services, ESMA does not intend to prescribe specific clocks synchronisation technology, providing technology-neutral rules instead.

Furthermore, the regulation requires that record-keeping systems meet several conditions for accessibility, amendability, transparency, and security, regardless of the technology used.

Overall, the changing technology landscape suggests a need for more extensive and future-proof regulations and strategies.

Confidentiality and Security in Financial Services (confidentiality)

The key interest is positioned at the intersection of confidentiality and security within financial and investment industries, particularly regarding data handling, IT systems, and licensing. Industry players are vested in the process of setting and adapting regulatory standards for data security and confidentiality, focusing particularly on nonpublic and commercially sensitive information. Investment firms are advised to develop and implement comprehensive security measures and maintain robust information technology (IT) systems. Such initiatives aim to protect the integrity, authenticity, and confidentiality of data, and minimize hacking risks. Directive requirements for CCPs highlight the need to match the strength of IT systems with the complexity and variety of services they offer. Other interest areas include regulatory technical standards for access conditions to financial instruments during their development phase, confidentiality of provided information, and non-discriminatory and transparent benchmark licensing procedures. In reporting positions, ensuring trader anonymity and data protection is imperative. Confidentiality statements in emails and less prescriptive vendor requirements have been proposed. Legal risks also present interest, particularly when a CCP is unable to enforce its rules or manage risks arising from disparate trade acceptance models.

Impact of ESMA Policies on Business Models and Market Practices (business model)

The ESMA is considering preparing a non-exhaustive list of quoting parameters to allow trading venues to deploy suitable market making agreements based on their specific business and trading models. There is a recognition of the need for investment firms to produce monitoring that caters to their specific business models, client information needs, and market activities. ESMA's proposals are evaluated in terms of their impact on business models, implementation costs, and transparency. Concerns surround the possible negative impacts on investments in innovation, risk monitoring costs and the potential for circumvention. A proposed two-step policy intervention aims to reduce high data fees and opaque market practices, while still ensuring flexibility towards diverse business models. While there are advantages such as transparency and comparability, there are also noteworthy disadvantages and implementation risks. Finally, attention is drawn to the diversity of financial market participants and their varying data needs, emphasizing the necessity for business models to align with client needs and objectives.

Innovation and Competition in Financial Trading (innovation)

The discussed financial trading policies encourage competitive and innovative commercial solutions while also considering intellectual property rights protection. A balance between providing market access and securing businesses' innovative rights is achieved by postpone licensing new benchmarks for a month period. By removing barriers and discriminatory practices, competition for clearing and trading of financial instruments increases, thereby lowering investment costs and fostering market innovation. It is advised that future measures should focus on principle-based descriptions of order types in order for businesses to self-assess their compliance, thereby promoting innovation. There are concerns that mandatory synchronization to a common reference clock may restrict innovation and market development, and create monopolistic positions, hence detailed elements on the matter are suggested. The recovery of joint production costs is identified as beneficial for trading venues, while also restraining suppliers' market power. A two-step policy intervention is recommended to control high data fees and improve market practices.

Enhanced Regulations for Fraud and Misconduct Prevention in Financial Markets and Trading Venues (fraud)

The revised MiFID directive has highlighted fraudulent activities within spot secondary markets in emission allowances, thus instigating a distrust in emissions trading schemes. To counter these fraudulent activities, aspects such as fraud, misconduct in financial markets, misuse of information, and the handling of illicit funds are being closely scrutinized. Harmonizing client identification on trading platforms will also aid National Competent Authorities (NCAs) in identifying potential fraud. Additional measures have been put in place to ensure market resilience against high-risk activities. Regulatory schemes also require data reporting service providers to submit comprehensive information, including any criminal offences or disciplinary proceedings related to each member of senior management. Similarly, the authorization process for a Central Securities Depository (CSD) involves an analysis of each senior member's history regarding financial misconduct or fraud. This includes any connections to undertakings that have faced insolvency, liquidation or refusals for registration by regulatory bodies. Data protection from fraud, poor administration, inadequate record keeping and negligence, among others, is emphasized. Lastly, the potential for fraud within new financial sectors - such as crowdfunding platforms - is also recognized, even though minimal fraudulent activity has been reported so far.

Periodic Review and Accountability of Trading Systems in Investment Firms (accountability)

Investment firms have an obligation to routinely evaluate their trading systems, algorithms, governance procedures, along with business continuity arrangements. This should occur at least twice a year, and should also include a review of performance, risk and compliance considerations. Clear lines of accountability, including development approvals and problem resolution, should be established within the firm. ESMA guidelines require trading venues to perform similar reviews, and to act upon any identified deficiencies. Both investment firms and trading venues need to remain compliant with legal obligations, embedding risk management principles into their operations. An annual validation process should be conducted by the investment firm for these reviews. This approach helps to maintain transparency, enhance accountability, and enable prompt reaction to system disruptions. Data reporting services providers are also required to implement periodic reviews of their technical infrastructures to ensure continual, effective service provision.

ESMA's Efforts on Professional Ethical Conduct and Regulatory Compliance (ethics)

The article revolves around how the European Securities and Markets Authority (ESMA) is enforcing ethical guidelines and practices to foster integrity within their ranks. It identifies how investment services provided online must follow regulatory legislation and uphold ethical conduct. ESMA has established two designated staff members to handle ethical issues, and has created a dedicated intranet page for 'ethics and integrity' to guide its staff regarding potential conflicts of interest. Regular ethics training is held to curb misbehaviour and ensure compliance with confidentiality and integrity requirements. It also outlines the various mandatory tasks and activities undertaken by ESMA for market integrity, data protection, internal control and organisational support. The article also discusses the organization's effort towards increased transparency with the implementation of new regulation on conflict of interest policy, protection data framework, and anti-fraud strategy. ESMA places high-value emphasis on a mandatory legal, cooperation, and convergence while executing their operational set up. The various tasks, deliverables, and deadlines for these activities are listed in detail.

Comprehensive Qualitative and Quantitative Assessment through Stakeholder Engagement and Research (interviews)

The key interests involve conducting comprehensive research involving interviews with investment firms, trade associations, and national authorities. It is supplemented with desk-based research and online questionnaire. Along with the objective of cost-based analysis, a qualitative assessment will be carried out using feedback to discussion papers, as well as responses received from interviews. Open access arrangements for equities already meet most draft requirements according to firms. Various mediums like meetings, road shows, or audio/video conference, as well as media, are explored for non-written recommendations. Analyst Kurt Salmon evaluated the cost/benefit aspects of EEAP options for investors, OAMS, and ESMA, including direct, substantive compliance costs. Data was obtained using multiple methods: desk research, interviews, workshops, and online questionnaires. It's implied that ESMA officials and OAMS would also share their viewpoint to determine the cost of establishing EEAP.

Changes and Developments in Indian Accounting Standards (Ind AS) and International Accounting Standards (IAS) (accounting estimates)

The report emphasizes the amendment of Indian Accounting Standards (Ind AS) providing management the flexibility to resort to the latest International Accounting Standards Board (IASB) pronouncements. The report covers various aspects including lists of changes required in Ind AS based on IFRS for SMEs, differences between existing accounting standards (AS) and Ind AS, and an impact analysis conducted by the Institute of Chartered Accountants of India (ICAI). It clarifies that a company cannot arbitrarily change its accounting policies according to the requirements of Ind AS on Accounting Policies, Changes in Accounting Estimates, and Errors. Specifically highlighting Ind AS and IAS on Accounting Policies, Changes in Accounting Estimates, and Errors, the report explains the goal is to prescribe criteria for selecting and changing accounting policies along with the accounting treatment and disclosure of changes in policies, accounting estimates, and corrections of errors. The document also underlines the difference between Ind AS and IAS by discussing differences in the presentation of income and expense items, the definition of accounting policies, and the distinction between a change in an accounting policy, accounting estimate, and a correction of an error.

Enhancing Risk Management in Algorithmic Trading and CSDs (internal controls)

The included information highlights the necessity for investment firms to increase their oversight of operational risks in algorithmic trading. This includes the integration of governance measures, internal controls, and reporting systems, which align with CEBS/EBA operational risk guidelines. Greater emphasis is placed on the quality of internal controls and governance structures, specifically for Central Securities Depositories (CSDs) seeking authorization. Guidance highlights the use of insurance to cover financial risks as an added measure where internal controls are insufficient. There is an emphasis on rigorous audit and compliance procedures. CSDs are expected to address risks internally and employ insurance for risk coverage where necessary. The document also recommends robust accounting, security procedures and internal controls for third party financial institutions. Lastly, efficient record-keeping and active measures to prevent conflicts of interest are pivotal.

ESMA's Draft Regulatory Technical Standards on Clock Synchronisation and International Securities Identification (international standards)

This overview discusses the European Securities and Markets Authority (ESMA)'s role in developing the draft Regulatory Technical Standards (RTS) on clock synchronisation. The specific standards ensure harmony across countries in relation to clocks' accuracy, mirroring international benchmarks. The drafted RTS aims to establish a common accuracy level for clock synchronisation across all EEA trading venues and their members, aligned to international regulations.
Furthermore, the discourse examines how the International Securities Identification Number (ISIN) is assigned to various note classes or tranches following the International Standards Organisation (ISO)'s set regulations, or other security codes determined by exchanges or other bodies. This compliance promotes consistency in regulatory requirements related to derivatives markets and post-trading market infrastructures.
Lastly, ESMA's advocacy for the importance of excellent quality audit work is revealed, emphasizing the need for high-quality International Standards of Auditing (ISA) to remain relevant and effective in the changing landscape. This includes both an internal auditing function compliant with suitable international standards and a cost-effective, internally developed audit capability.

Enhancing Objectivity and Independence in Investment Research through Conflict of Interest Regulation (objectivity)

Individuals responsible for regulatory compliance should not perform activities they are tasked to monitor. Their remuneration should not impact their objectivity. ESMA advises on managing conflicts of interest. Concerns are raised over the objectivity and independence of financial analysis in investment research due to potential conflicts of interest and unclear terms in the regulations. This suggests a need for clearer definitions in the regulatory language. Resistance was expressed towards a pure equivalence test in trading, as it could decrease objectivity. However, ESMA advocates for such adjustments to increase objectivity. The disclosure of significant financial interests and conflict of interests are crucial to ensuring the impartiality and reliability of investment recommendations. To enforce this, ESMA proposes stricter disclosure regulations.

Impact of Going Concern Principle on Fair Value Accounting and Audit Practices (going concern)

The principle of going concern holds paramount significance in determining the fair value of assets, like land. A company's valuation should reflect its current use of the land and its future outlook rather than possible disposal scenarios. Indian Accounting Standards (Ind AS) indicate that if post-reporting date events prove that the going concern assumption is no longer valid, a fundamental shift in accounting practices is required. The classification and disclosure of items in financial statements are also governed by existing AS for uniform preparation and presentation. The potential negative fallout of loss-sharing arrangements on the financial health and going concern assumption of a Central Securities Depository (CSD) owning a Central Counterparty (CCP) is acknowledged. The European Securities and Markets Authority (ESMA) proposes further cooperation with the International Accounting Standards Board (IASB) to provide more comprehensive guidance on going concern issues. Increased guidance on materiality determination and audit sampling in high volume data environments is also recommended. Concerns persist around the use of an internal audit function for external auditors.
