

# ESMA Brief - 2020

## *Review of Principles and Compliance Areas: Market Ethics, Governance, and Information Sharing (Topic: governance)*

The code under discussion covers crucial principles and areas like ethics, governance, transparency, and information sharing in markets. It addresses issues such as market manipulation and compliance risks, and aims to prevent behavior that could disrupt market functioning or distort price discovery. It lays out stringent requirements for administrators of benchmarks, including governance, conflict of interest, record keeping, input data, methodology, and code of conduct requirements. The code applies sanctions for each infringement, including non-compliance with the code of conduct and breaches of governance and control requirements. Respondents acknowledge the complexity of precise information identification in areas like internal or external investigations, board changes, key contract disputes, declining financial performance, and more. Despite favoring the proposed code, most respondents highlight the need to provide high-level obligations, giving the issuer the choice of consistent arrangements and procedures. Issues such as market abuse, short-selling, auditing, and corporate governance are also relevant. The report highlights the importance of open and transparent standards with a strong governance framework for reporting, with most respondents agreeing with the utilization of the ISO standard. Furthermore, the product identifier used in derivatives reporting should meet several conditions, including appropriate governance framework, accessibility, reliability, and neutrality.

## *Complex Information Identification and Sustainability Priorities in the Finance Industry (Topic: esg)*

Several sectors where information identification is particularly difficult include internal and external investigations, board changes, declining financial performance outside insolvency, and transactions like mergers and acquisitions or joint ventures. Guidelines are being written on outsourcing to the cloud by a task force reporting to the financial innovation standing committee. The European Securities and Markets Authority (ESMA) is working to integrate Environmental, Social, and Governance (ESG) factors and sustainability into its activities. Actions recommended include the disclosure of ESG factors by issuers and harmonization of ESG disclosure from credit rating agencies (CRAs). This should increase the transparency of the impact ESG considerations have on credit ratings. ESMA has also set up a new subgroup to develop standards for ESG disclosures due to requirements set out by the Sustainable Finance Disclosures Regulation (SFDR). There is a highlighted need for moving towards a more sustainable economy, and tackling ESG-related risks. Various workshops focusing on market data issues, cyber/cloud computing, investors' ESG disclosures, and high-frequency trading have been arranged. Asset classes like Environmental, Social, and Governance (ESG)-oriented equity indices and funds have outperformed counterparts not focusing on ESG. The importance of ESG factors for investors saw net inflows in money markets even when equities suffered net outflows.

## *Summary on Article Inclusions, Disclosure Delays, Reporting Formats, and Environmental Considerations in Financial Frameworks (Topic: environment)*

The summarized content centers around financial and legal considerations in areas such as auditing, taxation, and bankruptcy laws. A significant portion of responders were against the inclusion of auditors and notaries, among others, in the scope of the article's MAR. Questions were raised about measures to manage behavior in permitted environments, with specific regard to delaying disclosure in public-related issues. Additionally, concerns were raised about adding reporting formats that could impact the performance of low latency environments. A lack of adequate monitoring was identified as a red flag that should have been noticed, while questions were also raised about the ESMA's application in the Distributed Ledger Technology (DLT) environment. The document further included a comprehensive classification of commodities and the relevant standards and sub-standards. Lastly, environmental factors and sustainability were given significant importance, with a focus on non-financial reporting and embedding ESG factors into operative frameworks. The above aspects hint at key considerations to improve practices within the financial industry, thus fostering a competitive and sustainable environment.

***Analysis of Administrative Sanctions and Measures Imposed under Market Abuse Regulation in European Union (Topic: sustainability)***

The document studies the imposition of administrative sanctions and measures related to insider dealing and market manipulation among EU member states, focusing on Greece and unidentified location, where respectively ten and four such sanctions were put to effect. The offenders comprise both natural and legal persons. There is an emphasis on easing the administrative burden concerning insider lists, alongside deliberations on establishing common norms for all member states. The text also outlines the necessity for a report to be presented by the European Commission (EC) to the EU Parliament and Council, addressing topics such as the definition of inside information, efficiency of trading prohibitions for persons discharging managerial responsibilities, and feasibility of a universal cross-market order book surveillance framework. Conclusions on insider lists, provisions for administrative sanctions for insider dealing and market manipulation, as well as cross-border law enforcement and benchmark provisions are also to be discussed. A specific mention is also made of tackling multiple withholding tax reclaim schemes to prevent large-scale tax frauds, the latter also known as cum/ex schemes.

***Evaluation of Regulatory Measures and Their Implementation in Detecting Tax Frauds and Market Abuses (Topic: fraud)***

ESMA conducted an analysis to identify if there are adequate measures under the Market Abuse Regulation to address tax frauds, like the Cum/Ex schemes and fraudulent withholding tax schemes reported in certain EU states. While the UCITS directive and AIFMD are believed to already address such offenses, introducing preventive measures and enhancing cooperation and information sharing between National Competent Authorities and other law enforcement could yield more efficient results. There was a corresponding examination of the roles and actions of BAFIN and FREP in the case of alleged fraud at Wirecard, focusing on their respective obligations to report suspicions of criminal activities related to financial reporting. Challenges include the lack of power to conduct or order a forensic examination into frauds and the reliance of public prosecutors on BAFIN and FREP for notifications of potential fraudulent activities. The PRC does not expect financial reporting supervisors to actively seek out fraud unless there are indications of such activity. Assessments of the effectiveness of the supervisory system highlighted weaknesses in financial fraud reporting, cooperation among authorities, information flow within BAFIN, and compliance with guidelines.

### ***Confidentiality Practices and Challenges in Emission Allowances Regulations (Topic: confidentiality)***

The Market Abuse Regulation (MAR) has broadened the definition of inside information to include details about emission allowances and equivalent products. This only applies in situations where the information meets the necessary confidentiality, precision, and significant market impact standards. However, keeping this information confidential has been difficult, with many challenges rising, like assessing 'legitimate interest', determining whether delays in information disclosure are misleading, and confidentiality requirements causing interpretations issues in case of rumors. There have been suggestions to extend obligations towards those who perform tasks for the issuer to ensure the confidentiality of information. Furthermore, given the ambiguity, respondents suggest that the phrase, 'ensuring the confidentiality of inside information', should be properly defined or amended. Some respondents have also highlighted potential additional administrative burdens and possible confusion with the obligation to notify the delay of disclosure of inside information when it loses its insider nature. Lastly, due to stringent confidentiality rules, efficient exchange of information between authorities has been inhibited, hindering the enforcement of financial reporting requirements.

### ***Overview of International Financial and Tech Regulations (Topic: technology)***

The text focuses on the international auditing, assurance standards, securities identification, interest rates, market abuse directives and regulations, and financial instruments directives. It explains the role technology plays in market liquidity due to the migration of the price-making function in the spot segment away from traditional EU banks to specialist tech firms. The text highlights the need for a consistent cross-border approach. It outlines how recording tech can lead to reliable audit trails. The impact of tech firms on the payment industry and distributed ledger technology are touched upon. It also covers the implementation of MiFID II/MiFIR regulation, data requirements, and action plans for both capital markets and financial technology. The text covers supervisory convergence, risk analysis, and regulatory IT projects. An overview of the licensing regimes for fintech firms and the trials in distinguishing between fintech and traditional business models during authorization and licensing activities is presented. It ends with detailing Esma's ict activity and efforts towards a paperless office through video-conferencing. The text implies a positive outlook for the tech and health sectors amidst the crisis.

### ***Examination of Wirecard Business Model and Related Allegations (Topic: business model)***

There are concerns about business models requiring extensive IT investments leading to additional operational burdens and undermining cost-efficiency. Wirecard's business model is under scrutiny due to concerns about its transparency. These doubts are intensified when considering the whistle-blower's allegations and supposed inconsistencies within the company's operations. Wirecard's business model is centered on secure transaction processing between customers and retailers. Questions have been raised about Wirecard's process of growth through acquisitions and its incomprehensible business model. The whistle-blower's submission, though not based on accounting knowledge, further complicates the understanding of Wirecard's business model. The PRC, the enforcement body, and the Ministry of Finance are aware of these controversies and are seeking to better understand Wirecard's business approaches. Additionally, concerns about the expected useful life of customer relationships have been raised considering Wirecard's acquisition-focused strategies. Going forward, focus should be on understanding the business model and addressing areas of significant risk rather than minor to non-relevant areas.

### ***Enhancing Fintech Innovation and Consumer Protection (Topic: innovation)***

The majority view of the company was distinctly positive due to its prominence as a leader of German fintech innovation. A new subgroup focusing on ESG disclosures was established to develop draft technical standards, taking advantage of the positive climate toward innovation in fintech. The European Forum for Innovation Facilitators (EFIF) was also set up to provide a platform for supervisors to share experiences, technological expertise and common approaches to innovative financial products, services, and business models. This in turn promotes fintech scaling across the single market. New committees in areas of innovation and consumer protection were established, with an emphasis on technological innovation, sustainable finance, and proportionality. ESMA, EBA, and EIOPA play a crucial role in enhancing consumer protection, monitoring financial innovation and cybersecurity, and combating money laundering and terrorist financing.

### ***Investigation and Evaluation of Wirecard Financial Inconsistencies and Fintech Industry Trends (Topic: fintech)***

In the months leading up to ESMA's decision to conduct the FTPR, various media outlets highlighted recurring issues & emphasized inconsistencies in the accounting practices of Wirecard, a prominent fintech company in the German DAX index. Although no indication of incorrect accounting was detected, a critical report by Zatarra Research raised questions on Wirecard's oversight and controls designed to prevent fraud, leading to a fall in its shares. The market perception of fintech companies, Wirecard included, was generally positive. ESMA conducted surveys examining the licensing regimes for fintech companies across the EU, confirming that National Competent Authorities (NCAs) do not differentiate between traditional and fintech business models in their authorization processes. Steps were taken to increase the cooperation between innovation facilitators to support the rise of fintech in the single market. However, despite their business potential, the report identifies risks like cyber threats, high market concentrations among data service providers, and vulnerabilities in the fintech sector. The 2020 COVID-19 crisis has led to a decrease in funding for fintech as investors' risk aversion emerges, significantly impacting smaller or early-stage fintech companies. While digital transformation rises during the crisis, innovation in other sectors is likely to decline as resources are being shifted to manage the pandemic's impact.

### ***Understanding the Pros, Cons and Impact of ESG Ratings on Investment Funds (Topic: esg ratings)***

ESG ratings enable a more transparent comparison of funds' sustainability credentials, through objective third-party assessments. However, they mainly rely on quantitative criteria, excluding qualitative aspects like fund management's stakeholder interaction, and often displaying inconsistency due to possible biases against non-rated companies. Moreover, research revealed a low correlation among ratings from different ESG rating providers, signifying a lack of comparability. Despite such limitations, ESG rated funds have seen higher traction and better resilience during crises. These funds have also performed better than their non-rated counterparts. However, it's essential to consider sectoral factors when analysing performance based on ESG ratings. The limitations in ESG ratings could potentially result in the rejection of sustainability-driven investment principles, undervaluation of environmental risks and suboptimal resource allocation. Despite these risks, fund ESG ratings remain superior to complete information absence. Higher-rated ESG equity funds have seen more net inflows over the past two years. Approximately 50% of ESG rated funds in the EU claimed to use sustainable strategies and were rated above average on Morningstar's ESG scale.

### ***Climate Change Impacts and Transition Risks in Financial Sectors with Focus on Investments in Virtual Currencies and Renewable Energy (Topic: climate change)***

The report underscores the European Securities and Markets Authority's (ESMA) concern regarding retail investors' interests in virtual currencies and the associated risks. It also stresses the need for greater awareness of climate-related risks due to economic transitions towards a low-carbon economy, which have resulted in decreased energy demand and global CO<sub>2</sub> emissions. Investors are encouraged to focus on long-term strategies in sectors like education, housing, infrastructure, renewable energy, and climate change mitigation. The article discusses two main financial risks from climate change: physical risks from weather-related events, and transition risks associated with adjustments towards a more sustainable economy. It emphasizes the competencies of the EU Emissions Trading System (EU ETS) and discusses the ESMA's focus on cryptoassets because of their risk factors. ESMA also highlights the influence of climate change on various ESG (Environmental, Social, and Governance) issues. Finally, the report considers the impacts of biodiversity loss due to climate change on industries like agriculture, construction, and fisheries and the need for better climate-related risk models for strategic investment decisions.

### ***ESMA's Accountability Measures and Strategic Planning for Enhancing Organization Structure and Compliance (Topic: accountability)***

The annual report detailed ESMA's activities for improving accountability, which is a key element of its objectives and work program. Significant steps include optimization of communication, stakeholder relation activities, strategic planning, reporting, and assurance. ESMA collaborated consistently with EU institutions to ensure accountability in developing implementing measures. Essential aspects include reviewing, evaluating, and validating trading systems, governance, accountability framework, business continuity arrangement, and overall compliance according to the complexity and scale of the business. Benchmark administrators were urged to establish clear decision-making procedures, reporting lines, and accountability measures for all decisions related to benchmarking. Careful review and reporting of compliance with benchmark methodology are vital, especially when opting out of an accountability framework requirement. It was emphasized that cloud service providers (CSPs) should retain full accountability and responsibility for sub-outsourced services. There is growing interest in standardized reporting tools and blockchain technology to enhance transparency and accountability in sustainable finance. Also, the governance arrangements should clearly outline the individuals accountable for significant decisions, conflict of interest disclosure, and establishment of internal control procedures.

### ***Enhanced ESG Disclosure: Importance, Improvements, and Challenges (Topic: esg disclosure)***

The report emphasizes the need for action in areas such as issuing companies' ESG (Environmental, Social, Governance) factors disclosure and inclusion of non-financial statements in annual financial reports. It mentions initiatives such as the Single Set of International ESG Disclosure Standards and the Sustainable Finance Disclosure requirements for financial markets. ESMA (European Securities and Markets Authority) has begun working to promote ESG disclosure and has conducted multiple roundtables and workshops in this regard. Notably, the report highlights the role of ESG disclosure in impacting long-term investment decisions and improving market environments. However, it also recognizes the hurdles in implementing effective mandatory ESG disclosure including standardization issues and assurance concerns. Lastly, the report suggests enhancing the quality of ESG disclosure and increasing institutional investor engagement to facilitate longer-term investment decisions and

stress on the need for comparable, reliable, and relevant disclosures.

***Adherence and Interactions with GDPR in Credit Institutions and Investment Firms (Topic: gdpr)***

The content primarily revolves around the General Data Protection Regulation (GDPR) requirements and its application in credit institutions and investment firms. Discussions range from amendments for reducing sensitive information required to gaining clarification on GDPR's overlap with other directives and guidelines in the Information and Communications Technology (ICT) security sector. The concern about complying with GDPR and maintaining resources, as well as the relief for trading venues from carrying sensitive GDPR data, were addressed. Another significant point is addressing the transfer of data to third countries under the GDPR, highlighting potential legal risks and compliance issues. Likewise, the text touches on outsourcing functions and data storage, data protection laws, and the implementation of various technological measures to safeguard data and ensure robust information security. Lastly, the extraterritorial impact of GDPR on data collection and processing is mentioned.

***Governance, Ethics and Compliance in Market Execution (Topic: ethics)***

The text emphasizes adherence to principles of ethics, transparency, governance and information sharing for transactions in financial markets. Two entities named Bafin and Frep are underlined as being independent from issuers and auditors both at a board and staff level. This is ensured through codes of ethics, composition of their boards, and ensuring personnel do not have conflicts of interest from relationships with issuers or the audit firm involved. The guidelines dictate that manipulation of market prices is prohibited and that all transactions must be carried out for legitimate reasons. Additionally, in the Wirecard enforcement context, systems are in place to prevent undue governmental influence and to maintain the established composition of the board unless exceptional circumstances necessitate changes. The text additionally highlights the importance of managing conflicts of interest, implementing anti-fraud measures and promoting organizational values among staff. A code of good administrative behavior and a policy on staff conflict of interest is established to guide professional conduct and dealings with public and stakeholders. Climate change is also identified as a prominent aspect of environmental, social and governance factors to be considered.

***Fraud Detection and Disclosure in Accounting Practices (Topic: accounting estimates)***

When instances of accounting fraud occur in a company or a subsidiary, it is common for the company, along with an audit firm, to investigate the extent of fraudulent actions and then correct the errors in financial statements as per International Accounting Standards (IAS). Examples of such adjustments can be seen with the axis of a table that determines the relations of domain members and line items. A unique member represents assets, liabilities, and periodic consumption of an asset. Adjustments also apply when estimating changes in accounting values is impractical. Further, changes in accounting estimates having effects currently or in future are also reported. Disclosure of such issues, changes in accounting estimates, and errors form a major portion of the accounting policies and practices of a company.

***Importance of Internal Controls and Corporate Governance in Risk Management and Compliance (Topic: internal controls)***

The document discusses the significance of maintaining strong internal controls and proper corporate governance structure within organizations. This is underscored by instances of

negative press coverage and reports related to money laundering, round-tripping revenues, and financial opacity, attributed to weak internal controls and faulty corporate governance. Fitch Credit Rating Agencies (CRAs) were found to infringe on conflict of interest requirements due to inadequate internal control mechanisms. To mitigate such issues, ESMA released proposed guidelines on the requirements of internal controls for CRAs and initiated consultations to provide clarity and promote consistent internal control practices. Important elements of this internal control system includes error detection, managing weakness, and handling significant risks. Furthermore, the guideline extends to the management of significant reputational risks and risks arising from outsourcing of the compliance function. Finally, companies are expected to provide assurance that adequate and effective internal control systems are in place to ensure the accuracy, integrity, and monitoring of operational activities.

***ESMA's alignment with International Standards and Maturity Date Definition Modification (Topic: international standards)***

The European Securities and Markets Authority (ESMA) is proposing to adjust the name and definition of 'maturity date' in compliance with international standards. This proposal includes reference to confirmation. ESMA strives to align its standards with the highest international standards, such as those identified by the Committee of Sponsoring Organisations of the Treadway Commission (COSO) framework, supplementing financial regulations and other applicable rules. Highlighted were the 'emphases of matter' paragraphs within international standards on auditing, crucial for user comprehension of financial statements. The proposal also suggests a need to refer explicitly to the international standards that the Central Security Depository (CSD) should implement. Firms are also encouraged to use internationally-based certifications for due diligence support. The importance of new reporting requirements compatibility with existing international standards and ensuring clear definitions and calculation methodologies was emphasized.

***Scrutiny in Working capital and 'Going Concern' Statements (Topic: going concern)***

The respondents stated that working capital statements receive more detailed analysis than 'going concern' statements which could be misinterpreted per the draft guideline. Changes were requested to guideline drafts to be specific to qualifications and emphases of going concern matters. ESMA then revised the drafts, clarifying their application. Working capital statements offer a forward-looking perspective about a business's 'going concern' status. When there are discrepancies between auditor 'going concern' statements and clean working capital statements, explanations are required in the prospectus. Disclosures on IFRS E and IFRS are about uncertainties on the entity's ability to continue as a going concern, while IAS provides explanations on why financial statements were not prepared on a going concern basis. Some investors withdrew from equity funds due to ongoing economic growth and global trade uncertainties.

***Cybersecurity in Financial Services: Risks, Innovations, and Regulatory Focus (Topic: cybersecurity)***

ESMA, along with EBA and EIOPA, has published advice on cybersecurity, underlining the crucial need for clear ICT governance requirements for related entities. A cyber-resilience testing framework is recognized as beneficial, despite differences in cybersecurity maturity across financial sectors. Progress continues on cross-sector issues like consumer protection, financial innovation monitoring, cybersecurity, and anti-money laundering. ESMA, acknowledging the escalating importance of cybersecurity in EU market structures, is exploring enhancements in the notification process for IT incidents. The year emphasized constant actions

regarding cybersecurity surveillance and intelligence. Cybersecurity incidents in various economic sectors could directly impact financial firms with significant cross-sector presence. Large-scale resources invested in technology and cybersecurity expertise, while beneficial, could make financial services an attractive target for cyberattacks, and potentially elevate the risks during a data breach.

### ***The Role and Objectives of Peer Review in Supervision and Regulation (Topic: objectivity)***

Peer reviews focus on two primary aspects: one being the supervision, which aims to ensure investor protection, orderly markets, and financial stability via convergence. This requires the PRC to consider jurisdictional and market differences, justifying limited scope reviews of NCAs. The second focus is the legal framework, which requires uniform implementation and enforcement of the Union Law throughout the EEA. Ensuring the transparency, objectivity, and accuracy of work contributes to its effectiveness. Moreover, ESMA requires market data providers to establish and explain the criteria distinguishing data usage types, enhancing objectivity and narrowing down client categories. Lastly, the CCP should have transparent, fair, and accessible rules for handling complaints promptly.

### ***Supervisory and Enforcement Tools in Foreign Exchange Trading and Central Counterparty Risk Evaluation (Topic: interviews)***

The individuals of interest are spot forex traders and salespersons, those in supervisory roles up to senior management level, and the staff members of BAFIN, FREP, and NCAs. The methods used for investigating and continuous oversight include interviewing these figures along with accessing enforcement files and demonstrating the carried-out work. Important documents to consider are those involving marketing communications such as advertisements, press releases, electronic information, and other types of messages for UCITS or AIF. The evaluation of Central Counterparty (CCP) risk includes the collection of self-assessments, updates from the CCP, performance analysis of risk models, records of meetings, and documents prepared by the CCP for the risk committee, among other details. The FREP president, vice president and managing director participate as guests in the selection process and nominations committee meetings, but they don't hold voting rights.

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