European Securities and Markets Authority

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ESMA Financial Innovation Day

Overview of the Four Panel Discussions

Panel 1 - Crowdfunding

ESMA has been working on investment-based crowdfunding since 2012 and the Commission has restated its interest in crowdfunding as a source of funding particularly for start-ups and small and medium-sized enterprises (SMEs) in the recent Capital Markets Union Action Plan.

The regulatory landscape for crowdfunding is complex, partly because of the wide range of structures used. While many platforms fall within the scope of MiFID in some way, others may be operating alternative investment funds (AIFs), and still others may be outside both of these regimes. Some Member States have developed special national regulatory regimes within the MiFID Article 3 optional exemption. In addition, the Prospectus Directive, or in some cases national rules on prospectuses, may apply to the offer of securities.

In our Opinion[1] to national competent authorities (NCAs) and Advice[2] to EU institutions published in December 2014, we identified a number of challenges for the crowdfunding sector as it moves out of the 'start-up' phase and find its place as a sustainable part of the business financing ecosystem.

In particular, we considered:

- That there were challenges for sustainability arising from business models which rely primarily on success fees from new capital raising (a common business model);
- That access to projects and investors cross-border and the emergence of a pan-EU crowdfunding sector would be needed for the sector to meet its full potential and that for some platforms this was clearly an important part of their business model;
- That to become a 'mainstream' choice for retail investors, some shorter-term exit mechanism such as provided by secondary markets was likely to be needed.

Since then we in ESMA and some of the national authorities in our crowdfunding supervisory forum have seen some of the firms they regulate dealing with these practical challenges.

[1] https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1378_opinion_on_investment-based_crowdfunding.pdf

[2] https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1560_advice_on_investment-based_crowdfunding.pdf

The aim of this Panel was to hear from market participants whether the challenges we identified are still relevant and how they and regulators are working to reduce or overcome them.

Panel 2 – Trading innovations in corporate bond markets

In the years following the financial crisis, market participants have voiced growing concerns over the illiquidity of the corporate bond market. For decades, trading in this market was characterised by over-the-counter (OTC) quote-driven trading, where dealers (e.g. banks) act as principal to the trades and remunerate themselves through the bid/ask spread. It relies on banks' balance sheets to provide liquidity, the banks themselves holding vast inventories of bonds in order to make markets as and when their clients want. However, this model is under increasing strain as buyers struggle to find sellers when they need them and vice versa.

Another change seen in the corporate bond market is the rise in outstanding debt (from approximately 0.8trillion to 1.1trillion EUR between 2010 and 2015) which has led to the growth of buy-side players coupled with a significant reduction in trading. In order to re-introduce liquidity into these markets, banks, buy-side firms and technology providers are looking at innovative ways to bring together potential buyers and sellers. Initiatives to develop new trading technologies and electronic platforms are multiplying and include:

- Removing or reducing the role of the middleman, i.e. the bank, between the buyer and seller, given the buy-side holds up to 99% of inventory according to some market estimates;
- Different trading protocols, for example, looking at trading methods used for equities, in a market which is driven by voice trading; and
- Improving the quality and breadth of pre-trade information made available to investors to help connect buyers and sellers.

These developments deserve ongoing scrutiny given the importance of this market in funding companies and the new challenges they may create for regulators. In this Panel, experts with a wide range of experience provided their insights into the corporate bond market, the challenges it faces and the spate of recent innovations they are seeing which aim to help close the liquidity gap.

Panel 3 - The Distributed Ledger Technology

Distributed ledgers - sometimes known as 'blockchains' in the case of cryptocurrencies - are essentially a record, or ledger, of electronic transactions, very similar to accounting ledgers.

Their uniqueness lies in the fact that they are maintained by a shared or 'distributed' network of computers (so-called "nodes") and not by a centralised entity.

In November 2008, Satoshi Nakamoto, a pseudonym for one or several individuals, was the first to provide a description of a peer-to-peer network that would be used to timestamp and validate transactions. Although Nakamoto did not use the term 'distributed ledger' at the time, he referred to the same concept, i.e., a system where trust would rest on a network of peers and not a centralised third party. The idea behind Nakamoto's peer-to-peer network is that two parties should be able to transact directly with one another without going through a financial institution. However, for this to happen, participants need to trust that the system is reliable and secure. While financial institutions typically provide that trust, an alternative mechanism is needed when those financial institutions are removed. The distributed ledger and the network of peers provide that alternative 'trust' mechanism. Importantly, distributed ledgers rely on the extensive use of cryptography, i.e. computer-based encryption techniques, and consensus algorithms to store assets and to validate transactions.

Nakamoto's paper gave rise to Bitcoin and until today the most widely known application of the Distributed Ledger Technology (DLT) is the public ledger of transactions for cryptocurrencies, such as Bitcoin. However, more recently, the idea has spread that the DLT could be used in financial services outside the scope of virtual currencies. A myriad of FinTech firms are effectively developing systems using the distributed ledger technology with the aim to use them to issue and transact financial securities. Meanwhile, some of the biggest names in finance have started to put resources into exploring a technology.

Possible benefits that the distributed technology could bring to markets and market participants include lower costs and faster and more efficient clearing and settlement of transactions. The technology could also streamline asset servicing and the record of asset ownership, including through the use of so-called 'smart' contracts. Furthermore, it could bring more transparency and security to the system. Yet, the technology is not exempt from risks and challenges. Some of those risks and challenges are not unique to the technology but may be exacerbated in the case of distributed ledgers. These include the risk of fraud or errors, the ability to handle large volumes of transactions and, considering the distributed nature of the information, potential privacy issues. Furthermore, the technology may raise a number of governance and regulatory issues. This in turn will drive how the technology may replace/interact with the existing infrastructure and service providers.

The Panel discussed:

- The unique features of distributed ledgers and what makes them relevant for financial services now.
- The segments of the securities markets/investment services where the technology is likely to bring the most value.
- Possible shortcomings of the technology and new risks that may arise from it.
- The interactions with the existing market infrastructure and the potential implications for incumbent service providers and regulators.

Panel 4 - Leveraged Loan Funds

Recent years have seen the increased presence of loan origination and participation fund vehicles across a number of countries in Europe. For the greater part, those activities are taking place within institutional separate accounts or within the Alternative Investment Fund Managers (AIFM) platform targeting professional investors.

In the US, over the past 25 years, the senior secured bank loan market has evolved from a fairly illiquid market, where the underlying vehicle was closed-end, to a market that is today considerably more liquid, and where the product can be found even in ETF form.

The European senior secured bank loan market is not identical to the more mature market that exists in the US. In fact, certain risks that we have identified in the US may exist to a greater degree in Europe, such as settlement risk and transparency of deal information. Yet if the European senior secured bank loan market were to mature to a greater degree, the market may probably have comparable developments in terms of its risk profile to that of the US senior secured bank loan market. If this were the case, the asset class could provide an appealing investment choice for certain investor profiles.

In this Panel, market practitioners and regulators discussed differences between the European and US markets, the risk/return profile of the asset class, impediments to growth and the development of loan origination funds in Europe.