Overarching response

A contribution to the Green Paper "Building a Capital Markets Union" (CMU)

In October 2012, the Securities Markets Stakeholder Group (SMSG) presented its views on the impact of regulation on Small and Medium Size Enterprises' (SME) ability to access funding. The objective of the group was to give advice on how EU regulatory proposals impact the ability of small and medium sized companies to have access to funding (through both the private markets represented by e.g. private equity and venture capital funds, as well as through the public markets by listing on an exchange) and how EU regulatory proposals impact investors' ability to invest in these companies. The advice of the group was targeted at ESMA but might also be relevant for other European Supervisory Authorities (ESAs). This paper is a contribution from the SMSG to the current discussion on the CMU and is partly based on the initial advice of the group.

Introductory comments

In its initial advice, the SMSG stressed that expanding capital markets can bring many advantages to all companies, especially SMEs,[1] including the diversification of potential investors and access to additional equity capital. The Group rightly feared that banks would be facing additional restrictions in the amounts of credit and liquidity they would be able to provide (in light of Basel III, measures to facilitate the resilience and resolvability of banks, and forthcoming structural reform initiatives) and which in turn would make it increasingly more difficult for them to extend loans to SMEs. The development of the Capital Markets Union, if well designed and executed, can help promote alternative funding sources (equity and debt), though both the private and public capital markets, and if part of an effort to foster a stable, positive economic environment, could help facilitate innovation and the growth for non-financial companies, necessary for Europe's recovery.

To achieve this vision, the SMSG considers that the EU needs to take a holistic approach to the functioning of capital markets, and ensure that the regulatory environment is best able to support the provision of capital from savers and investors to companies of all sizes. We identify six objectives in particular that the EU and its Member States should aim to bring about:

First, the development of **an effective advisory ecosystem to support companies and investors:**

There is a need to focus on how to provide each category of capital suppliers, i.e. direct or indirect investors, the right incentives to invest not only in equity but also in debt issued by companies of all sizes. An efficient, transparent and competitive capital market, be it public or private, providing investors with multiple investment options (both short-term as well as long-term) will be a key component in offering investors the desirable liquidity they need for their investments.

[1] See IFAC (2006), Micro-Entity Financial Reporting: Perspectives of Preparers and Users, Information Paper (pages 7 & 8) for a working definition of SMEs.

The EU needs to take a holistic approach, bringing both sides together. The CMU needs to be a catalyst for the development of an effective advisory ecosystem to support companies. We need vibrant communities of entrepreneurs, business leaders, advisers, analysts, investors of all sizes (national, pan-European, and from outside the EU), technology transfer bodies, public sector agencies and academics, to support exciting businesses as they grow for the long term. Such communities can help tackle the difficult cultural changes required, through practical measures on the ground.

Second, **align past and recent legislation with the objectives of CMU and widening the investor base for SME and improving credit information on SME:**

In its 2012 report, the SMSG concluded that regulatory initiatives often have a combined negative impact on the ability of SMEs to access funding. It had singled out a number of problems including both the access of companies to capital markets as well as the difficulties for investors to invest into SMEs. The SMSG welcomes the fact that the Commission's Green Paper shares our analysis and has considered carefully the funding needs of SMEs. Three years later, there now appears to be an increasing need to review post-crisis regulation for any misalignment with the overall objectives of CMU.

In some areas there is a need for less EU regulation, in others to correct flaws caused by the EU regulation. For example, it is difficult to reduce SMEs dependence on bank financing by facilitating their trading on MTFs given the recent Market Abuse Regulation's extension to all listed companies' of reporting requirements (price sensitive information, managers transactions and insider lists.) Similarly, MiFID and CSDR settlement discipline impedes SME and other markets, making it difficult to reach investors in other Member States. Meanwhile, it is difficult to incentivise cross-border raising of capital if equity issuers depend on NCAs because the home Member State is where the legal seat is, meaning not all companies are able to relocate to more competitive EU countries. This review process should be an important aspect of the CMU project.

Third, **boosting long-term investment:**

Complementing the development of an advisory environment bringing investors and companies of all sizes together, it is important - in view of the growing institutionalization of people's savings through pension funds, insurance schemes, mutual funds etc. - that investments made by institutions, both directly through the public markets as well as indirectly through intermediaries active in the private markets, are not compromised by aggregated or unfit for purpose regulatory initiatives. As part of the review process discussed above, the EU needs to overcome institutional constraints and post-crisis de-risking of financial services to allow long-term investment. As stressed in its 2012 advice, the SMSG considers that the implementation of CRD III and Solvency II have already generated a decrease in investment flows from banks and insurance companies into equities as well as to private equity and venture capital funds and other illiquid long term assets. If pension funds covered by IORPD5 IORPD2 would also have to comply with Solvency II type of risk weightings, they will be required to hold additional liquid assets. This would not only have a negative impact on pension funds' ability to invest into equity and other long-term assets, but may could over time lead to companies being faced with increased costs for pension benefits, as pension funds would find it difficult to generate the necessary long-term returns to match their long-term liabilities.

Fourth, **facilitate the access to capital markets of retail investors:**

These initiatives need to be complemented by measures that enable individual retail investors to invest more directly into capital markets, as an effective capital markets union will not function without involving and attracting individual investors. According to the European Commission's Financial Services User Group, the proportion of equity owned by households has reduced by two-thirds since the mid-1970s to just 11 per cent. Risk aversion is high, and tens of billions of euros languish in savings accounts. Investing directly into SMEs or infrastructure projects generally is, for liquidity and risk diversification reasons, not the most likely allocation of retail funds, nor should it be. But comparisons with the US show there is more that can be achieved in this area, see for instance Bruegel's recent paper 'Capital Markets: A Long-Term Vision,' which shows that EU households have more than 40% of their financial wealth in the form of deposits compared to less than 15% in the case of US households. The point also underscores the need to enable retail investors to save more in capital markets instruments.

To achieve this, it is essential to restore investor trust and confidence. Only well-informed and well-protected investors will make responsible investment decisions from the range of capital markets products available, directly or indirectly, across the Member States. Equally important is to ensure that advisors advising these investors adequately understand the products marketed to different investors, and the suitability of these for each category. It is also necessary to keep in mind that investors do not act within national boundaries and that a supportive framework is needed to facilitate cross-border investment. From this perspective, the creation of a European pension product offers the potential to increase the volume of retirement savings invested on a cross border basis. A fair and simple taxation and reporting system for long-term individual investor-savers who directly invest in capital markets would make a real positive change on the capital supply side.

Fifth, **to complement EU level action, the Member States need to do their bit:**

The state of development of capital markets, the structure of the corporate sectors and institutions, as well as cultural attitudes to investment, all vary significantly across Member States. This is reflected in the different legal and consumer protection frameworks, especially in relation to company and insolvency law. It is obvious that these differences place strong limits on how far an integration of capital markets can proceed within the EU. But while these differences have to be taken into account, and regardless of any action to be initiated by the Commission, they should not be used as an excuse for national authorities and market participants to shield themselves from the disciplines of a potentially more dynamic pan-European market place, connecting different categories of investors with investment opportunities in SMEs, other corporates and infrastructure projects across the EU's 28 Member States and beyond.

In order to achieve more integration, institutional and retail shareholders should be able to invest easily across borders with similar rights and duties. Member States need to play their role in overcoming these obstacles, either by responding positively to EU level initiatives to tackle them, or cooperating more effectively amongst themselves. This is by no means an exhaustive list, but by way of example, such barriers to an effective CMU include:

- the lack of an EU definition of shareholder (or the end-investor) at least for listed companies,
- the concept of differential/enhanced voting rights, introduced in some Member States and considered by the European Parliament in the Revision of the Shareholders' Rights Directive, could impact cross-border investment flows, one of the key objectives of a Capital Markets Union. It

would favour majority shareholders, often domestic entities over minority shareholders, generally cross-border large and individual shareholders;

- Weaknesses in the Transparency Directive that mean cross-border institutional investors do not have common detailed rules on disclosing major shareholdings; and
- Finally more transparency for listed companies is needed at the EU level instead of (or at least before) intrusive EU intervention in the corporate governance of companies. For example, in order to give full information to actual and potential shareholders and to clients of investment funds, the full minutes of General Meetings must be published by issuers so that all the votes cast by retail and institutional investors are public.

Finally, a sixth objective should be **a rebalancing of the powers between Member States' authorities and ESMA:**

Some members of the SMSG believe that ESMA should be conferred with a wider range of direct supervisory powers where such a transfer of function brings material supervisory efficiencies. For instance, ESMA could be conferred with supervisory competence with respect to systemically important financial institutions (SIFIs) where a clear case has been made, e.g. market infrastructures such as trading platforms, central securities depositories or index providers.

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There is a consensus view that, as a matter of priority, the ESAs should make full use of their existing powers in terms of data collection, analysis, and publication, in particular in the areas of returns and prices (fees, article 9.1 of the ESAs Regulations) and of product intervention (article 9.5) to ban toxic products that bring negative value to investors. They should also better enforce existing investor protection rules. For all this they need their resources to grow, not to be cut.
The implementation of the ESAs guidelines through peer reviews and their consistent application across the 28 Member States is the most crucial element in ensuring consistent supervision as well as their contribution to consumer and investor protection.

Also, the importance of a level playing field for financial product services regulated by the three ESAs would require better coordination between all three agencies.

The Group questions whether the current governance structure is optimal to ensure that e.g. ESMA has the necessary powers to drive regulatory convergence and to allow to “crack-down” on national CAs who go further than what has been envisaged under certain Directives.

So we should consider how more can be done, and indeed is being done, to ensure consistent supervision within the existing framework, and recognise that there are constraints on how further developments can pragmatically be achieved.

One evident factor is going to have to be a resolution to the debate regarding the ESAs funding, as they are evidently stretched at the moment. This should involve resolution of the debate about how the ESAs are funded.

Indeed, there are some respects in which the ESMA and other ESAs could, given the budget, go even further than they have thus far planned. In particular it makes sense that they should be able to play a fuller role in contributing their views to inform the formulation of new Level 1 EU legislation. This would help to ensure that requirements which then come to be handed to them for subsequent Level 2 work are fully understood, have an adequate amount of time for their orderly adoption, and are more likely to be framed in a way which leads to effective regulation,. Where new regulations are brought into force and problems then become evident, consideration should also be given to allowing the ESMA to promptly propose No-action Letter type of reliefs, subject to approval from the Commission and a process for reporting and oversight designed to properly respect the authority of the co-legislators.