European Commission's Green Paper 'Building a Capital Markets Union'

Eumedion's online response dated 11 May 2015

1. Beyond the five priority areas identified for short term action, what other areas should be prioritised?

Cross-border investment is hampered by 'gold plating' and the numerous Member State options in EU Directives, e.g. the Transparency Directive. Therefore, institutional investors with a pan European focus have to take into account 28 different regulatory regimes when investing in listed companies which have their statutory seat in one the 28 EU Member States. Detailed Regulations – instead of Directives – without Member States options in the areas of financial services and company law would be an important step towards the creation of a really integrated EU capital market and should as such be considered on the short term. Before the proposal for a Regulation is published, the European Commission should launch a public consultation on the draft text that is accompanied by a thorough impact assessment in order to get better regulations. The Regulations should be complemented by a harmonised supervision and enforcement.

2. What further steps around the availability and standardisation of SME credit information could support a deeper market in SME and start-up finance and a wider investor base?

There is significant room for improvement in the ease of access to credit information. A requirement to file statutory financial reports without any delay in a single, freely accessible and easily usable European database would help investors and trade counterparties to look beyond their national barriers. The scope for widening the investor base beyond trade creditors, banks and private equity is highly related to the availability of high quality IFRS financial reports.

Another significant barrier we see is the lack of publicly available historical data on the profits and losses of SME loans. In order for these assets to be investible for institutional investors, the historic Probability of Default (PD) and Loss Given Default (LGD) data needs to be available. We support the initiative for European Data Warehouse and would like this initiative to be rolled out for other asset classes. Finally, the availability of credit rating models for SMEs will be important.

4. Is any action by the EU needed to support the development of private placement markets other than supporting market-led efforts to agree common standards?

A major hurdle for corporate debt investors in the European Union, both private placement and other debt securities, is that bankruptcy laws differ per member state. In many member states it is very difficult in practice to force the financial stakeholders to agree on a financial restructuring plan. This often results in lengthy and costly situations. The UK is one of the few countries where the legal environment supports so-called prepackaged bankruptcies which helps to limit damage to the economy as a whole. The costs associated with a lengthy restructuring process also increases the chances that a company is forced to liquidate, where it may otherwise have survived. Improvements in this area would result in an improved investor climate and lower cost of funding for all companies.

Some European investors experience near prohibitive regulatory restrictions on investing in debt securities that have no daily pricing, for example insurance companies, whereas insurance companies typically are investors that are inclined to buy and hold on to such securities. The regulatory bodies could evaluate whether the existing restrictions on private placements currently are too stringent.

Similar to our answer under 2), there also is significant room for improvement in the ease of access to credit information. A requirement to file statutory financial reports without any delay in a single, freely accessible and easily usable European database would help investors in investing in European private placements.

Where private placements by their very nature are hardly tradable, the equally underdeveloped syndicated loan market (or 'leveraged loan market') is a more standardised and tradable version of private placement market. Still, trading syndicated loans is rather cumbersome as each trade requires a legal document (a 'Cession of Rights'), especially compared to listed bonds which can be traded via 'Straight Through Processing' without approval of the issuing entity. Legal barriers that prevent STP when trading syndicated loans need to be identified and should be lifted, reducing the often prohibitive administrative burden for investors.

There is also a need for standardisation of loan documentation.

5. What further measures could help to increase access to funding and channeling of funds to those who need them?

The covered bond market has grown substantially since the start of the financial crisis. Similar to the successfully introduced transparency on Residential Mortgage Backed Securities, a requirement could be introduced for banks that have covered bonds outstanding to provide more insight on the characteristics of the available collateral for these bonds. Such improved transparency will further strengthen this important source of funding for the especially the weaker banks, especially in times when funding is needed most. As such, this transparency may prove to be an additional source of financial stability.

Sometimes, national laws only allow banks to be or become the lender of a loan to a corporate. Italy is one Member State that our participants have identified as having such a restriction.

Sometimes, national laws only allow banks to originate a loan. Banks are allowed to subsequently pass on the loan to a non-bank institutional investor. Still, this exclusive right of a bank does pose a major barrier for the much desired disintermediation by the European Commission. Examples of Member States that pose such restrictions are Germany and France.

Sometimes, national laws only allow banks to set certain covenants. For example in France, only banks are allowed to negotiate a so-called 'Dailly assignment'. Even though institutional investors can subsequently buy those loans from banks, this exclusive right of a bank also poses a major barrier for disintermediation. Spain is an example of a Member State that forbids non-banks to obtain a mortgage pledge on an asset.

On the positive side, there are examples of Member States where there are no limitations on providing credit to professional counterparties: e.g. Ireland, UK and the Netherlands. Eumedion supports the removal of limitations on providing capital in the form of loans to professional counterparties, insofar this limitation is based on the nature of the institutional investor, for example the above mentioned exclusive rights for banks.

Eumedion would strongly support the EU to develop new initiatives that would help lift legal barriers in all Member States for non-bank institutional investors that aim to provide loans to corporates.

6. Should measures be taken to promote greater liquidity in corporate bond markets, such as standardisation? If so, which measures are needed and can these be achieved by the market, or is regulatory action required?

Banks that are active as brokers in the secondary corporate bond market are experiencing too stringent criteria for netting positions. These restrictive rules have significantly reduced liquidity in the market. This reduced liquidity affects all market participants. Reduced liquidity actually resonates in more volatility and higher costs for all stakeholders involved. Standardisation of issuer markets – e.g. via larger bond issues, more us of fungibles, standard maturities, plain vanilla structures, standardised documentation, standard use of governing law and courts, etc. – could help, but will likely better be achieved via market initiatives than via regulatory action.

We would like to note that we expect credit rating agencies to play an important role for investors in corporate debt. Their analysis can be regarded as a standardised approach to assessing risks of an issuer. The efforts of credit rating agencies help investors identify attractive investment opportunities.

7. Is any action by the EU needed to facilitate the development of standardised, transparent and accountable ESG (Environment, Social and Governance) investment, including green bonds, other than supporting the development of guidelines by the market?

No.

Institutional investors are increasingly looking for investment opportunities that combine financial return with positive social and environmental impact. This development is reflected in the recent growth of the market for green bonds. This growth however comes with a challenge: issuers need to ensure the quality of green bonds to gain and maintain trust from investors.

This requires standardisation of guidelines regarding transparency and disclosure on green bonds, including guidance for evaluating and reporting on the environmental impact. This process of standardisation is currently driven by the market itself. The Green Bond Principles (GBP), initiated by the International Capital Market Association and supported by, amongst others, the World Bank and the European Investment Bank, provide issuers with a framework promoting clear definitions and transparency.

The Climate Bond Initiative (CBI) currently works on a reporting framework to provide buyers of green bonds with clear information on the content of the bond, and related environmental effects. This could eventually lead to a system of certifications indicating the level of environmental impact associated with

the bond. And specifically for the project finance market a standard ESG policy already exists globally in the form of the Equator Principles, which have been adopted by over 80 financial institutions.

Since the GBP, as well as the CBI and the Equator Principles, are currently developing and increasingly gaining support in the market, Eumedion currently recommends not to put any efforts in developing (additional) guidelines regarding ESG investment or green bonds.

8. Is there value in developing a common EU level accounting standard for small and medium-sized companies listed on MTFs? Should such a standard become a feature of SME Growth Markets? If so, under which conditions?

The EU should concentrate its intellectual effort on improving IFRS and should therefore not develop an accounting framework for SME listed companies on MTFs. Financial reporting frameworks by nature are complex and are difficult to learn to report under for preparers and difficult to learn to interpret for investors. A (new) framework that is significantly more easy to report under will undoubtedly result in reporting that is even more difficult to interpret for investors. If there are improvements to be made in financial reporting in terms of efficiency in reporting, these improvements should be incorporated in IFRS. A 'light' financial reporting framework for SMEs will be considered with skepticism and lack of trust by investors. Even for those securities that 'only' are traded on a Multilateral Trading Facility (MTF), the EU should still safeguard that the investor community needs to be able to form a reasonable basis for an investment opinion. Eumedion would like to enhance the objective of the Green Paper to 'improve access to funding' into 'improve justified access to funding'. The European economy as a whole would not benefit if capital is allocated to investment opportunities that only appear attractive. A Capital Markets Union should therefore serve both access to capital for companies, and efficient capital allocation decisions by providing the investor community with sufficient information that allows for a reasonable basis to invest. A 'light' framework for any listed company, irrespective of whether it is listed on a regulated market or on an MTF, is not the right way forward.

Allowing SMEs to raise capital from investors based on local financial reporting frameworks would also not contribute to a European Capital Markets Union, as hardly any corporate bond market investor today is familiar or can be expected to keep up to date with any of these local frameworks.

10. What policy measures could incentivise institutional investors to raise and invest larger amounts and in a broader range of assets, in particular long-term projects, SMEs and innovative and high growth start-ups?

We would like to caution for putting too much pressure on institutional investors to invest in a broader range of assets. Investors primarily have a fiduciary duty to generate sufficient return given the risk. Too much pressure could result in allocation of funds to investments that are just not attractive enough.

In line with our answer to question 4: Some European investors experience near prohibitive regulatory restrictions on investing in debt securities that have no daily pricing, for example insurance companies. Whereas insurance companies typically are investors that are inclined to buy and hold on to such securities. The regulatory bodies could evaluate the existing restrictions to see whether liquidity in the listed corporate bond market which generally has an observable market price really is so much better, or that investment in private placements currently is too restricted. This is in sharp contrast with the treatment of government bonds under Solvency II.

11. What steps could be taken to reduce the costs to fund managers of setting up and marketing funds across the EU? What barriers are there to funds benefiting from economies of scale?

We see two main problems:

1. The small average fund size in Europe.

2. Diverging local marketing rules.

Small average fund size

In the EU funds are on average 1/10th the size of US funds. This has three causes:

(i) National / home selection bias. This should ease over time;

(ii) Tax laws. Local funds sometimes get preferential tax treatment and some fund domiciles have a better tax treaty network. Tax laws should not discriminate between different fund domiciles and the EU should develop a harmonised tax treaty network for funds;

(iii) Fund mergers can cause capital gains tax. Therefore mergers can be detrimental from the tax perspective for clients even though leading to economies of scale.

Marketing rules

We believe marketing rules should be eased and made compatible with current practices. It should be noted that many marketing rules are still based on the introduction of the UCITS framework in 1985.

We suggest the following:

(i) Full harmonisation of EU marketing rules for UCITS funds. Asset managers spend significant amounts of money on tweaking their marketing material to meet diverging national marketing requirements. Most of those diverging marketing requirements are not justified by the different characteristics of the markets or consumers, but rather are caused by the fact that each Member State retains discretion over marketing rules;

(ii) Delete the requirement to have a local representative (paying agent);

(iii) Delete the notification requirement. It is costly, time consuming and does not add any real value for the regulator or consumer. Perhaps an ESMA register of all funds marketed in the European Union would be more useful;

(iv) Make sure that the distribution of investment funds by MiFID firms is qualified as transmission of orders in all EU Member States. Currently some countries continue to qualify this as placing, which requires a different MiFID license and leads to unjustified high requirements under CRD IV.

v) The exemption under the E-commerce directive for the marketing of UCITS should be deleted (see the Annex of Directive 2000/31 EC).

vi) Various member states have preferential tax treatment for some non-UCITS fund forms. We believe that UCITS and/or ELTIFs should as a general rule always receive the same treatment, unless there is a strong reason to deviate. Otherwise this leads to an unnecessary compartmentalisation of national markets.

16. Are there impediments to increasing both bank and non-bank direct lending safely to companies that need finance?

It should be very attractive for a bank to advise corporates on issuing a syndicated loan directly to investors (i.e. 'disintermediation'): the bank gets an attractive arrangement fee and the bank retains no exposure to the underlying credit, as a consequence the bank needs less capital. Still, we unfortunately experience limited sense of urgency with European banks to actively develop the market for syndicated loans in Europe. Maybe because there are legal difficulties with trading these securities, maybe because

they are less equipped than their well-known US competitors to advise on such transactions, or maybe because a well-developed non-bank direct lending market is seen as a source of more competition that could affect the spreads that banks can charge corporations in their 'core' bank direct lending market. In some jurisdictions, the core lending market for banks is even protected by legal barriers against the much desired non-bank lending, i.e. against disintermediation. Eumedion would strongly support new initiatives by the EU that would help lift legal barriers in all member states for non-bank institutional investors that aim to provide capital to corporates. Our answer to question 5 provides a number of examples of legal barriers that the participants of Eumedion encounter.

21. Are there additional actions in the field of financial services regulation that could be taken to ensure that the EU is internationally competitive and an attractive place in which to invest?

If the European Commission is serious in creating a fully functioning Capital Markets Union by 2019, the European Commission should abolish a number of Member State options in financial services Directives, a.o.:

- A further revision of the Transparency Directive:
    - Harmonisation of the thresholds to notify major holdings in listed companies – currently some investors have to look into the articles of association of a company to find out what the first notification threshold is. Also the methods of calculation, language and ways of notification should be fully harmonised.
    - The notifications on major shareholdings should be collected in a European central register. This would facilitate a more rapid analysis of the shareholder structure for potential investors in a European listed company.
    - More clarity on what constitutes 'acting in concert' in order to stimulate coordination of governance efforts by shareholders.
- A revision of the Take-Over Bids Directive:
    - Harmonisation of the mandatory bid threshold and of the treatment of anti-takeover devices in order to achieve clearness on the protection of minority shareholders in public bid situations.
    - More clarity on what constitutes 'acting in concert' in order to stimulate coordination of governance efforts by shareholders.

- The introduction of a minimum acceptance threshold for voluntary offers at “50% plus one” of the company’s voting rights.

- Full endorsement of new and of amendments to existing international financial reporting standards (IFRS) – so without carve-outs and harmonisation of the IFRS enforcement by transferring the supervision by national supervisory authorities to a pan-European authority, e.g. ESMA.

- A revision of the Accounting Directive:

  - Support the wider adoption of ‘Integrated Reporting’. Corporate reporting is of the utmost importance for investors. Long-term investors are already well known to look beyond the financial facts and figures only. The increased relevance of all material information for institutional investors required a reporting framework that results in a concise communication about how a business’ governance, performance, strategy and prospects lead to value creation over the short, medium and long term. In December 2013, the International Integrated Reporting Council (IIRC) presented a reporting framework that enables companies to combine all information that is relevant for analysing the long term development of the company in a single, integrated report. Eumedion believes that integrated reporting is a logical and necessary next step in corporate reporting, as environmental, social and governance information already is critical for assessing the performance and prospects of companies, and for the important stewardship role that investors both want and need to exercise. Currently, finding all the relevant information is very time consuming and makes good research very expensive for each investor. The IIRC’s integrated reporting framework draws an accurate picture of what long-term investors need for their investment analysis and their engagement activities. We expect integrated reporting to be very helpful for both investors and preparers. Therefore, we would encourage the European Commission to consider requiring listed companies to draft its annual report in accordance with the IIRC reporting framework.

- A further harmonisation of the European Statutory Audit Directive:

  - Full harmonisation of the maximum term to rotate the external auditor.

  - Full harmonisation of the prohibition to grant any non-audit service to an audit client.

  - The introduction of pan-European, harmonised supervision on the largest (‘Big 4’) audit firms.

- A further revision of the Solvency Directive:

    - Efforts should be made to bring about amendments to Solvency II, so that long-term investment in the shares of listed companies becomes more attractive again for insurers. Capital requirements for specific asset classes imposed by Solvency II has already limited the amount of capital available for long-term investment.

22. What measures can be taken to facilitate the access of EU firms to investors and capital markets in third countries?

- The European Commission should liaise with especially the SEC and other relevant US authorities (e.g. the PCAOB) with respect to transparency and financial services regulation, in order to see if equivalence is maintained and the international level playing field remains intact. Equivalent reporting and financial services rules would bring wider benefits to all companies and stakeholders and would fulfil the objective of achieving common global standards in the area of financial services.

- The European Commission should also liaise with the US authorities in order to allow US companies voluntarily reporting according to the IFRS reporting framework.

- Application of the reciprocity principle or signing memoranda of understanding between the European Union and third countries. This would add to the objective of better access of investors and European companies to third countries' capital markets.

23) Are there mechanisms to improve the functioning and efficiency of markets not covered in this paper, particularly in the areas of equity and bond market functioning and liquidity?

Following the evaluation of the IAS 1 regulation, sufficient evidence has serviced for the significant benefits of a uniform financial reporting language. In line with this evidence, the EU could help the functioning and efficiency of markets by endorsing all IFRSs. Of course, the EU needs to engage with the IASB, as it does, to make sure its views are taken into account during the drafting of new standards, but ultimately the EU should safeguard that the IFRS as applied in the EU does not materially differ from IFRS as issued by the IASB.

24. In your view, are there areas where the single rulebook remains insufficiently developed?

Reference is made to our answer to question 21. Especially a uniform interpretation of what constitutes ‘acting in concert’ should be added to the single rulebook.

25. Do you think that the powers of the ESAs to ensure consistent supervision are sufficient? What additional measures relating to EU level supervision would materially contribute to developing a Capital Markets Union?

Since 2011, the European Securities and Markets Authority (ESMA) has been coordinating national enforcers' operational activities concerning compliance with IFRS in the EU. However, coordination of European efforts on enforcement may not be enough. In a real European Capital Markets Union, real European enforcement, instead of a European coordination, is likely to better safeguard consistent enforcement IFRS of high quality across the EU. We would regard entrusting this responsibility to ESMA as a logical next step. The same applies to the supervision on the largest audit firms – the so-called Big 4. As these audit firms are global networks and as listed companies which have cross-border activities intensively use these networks and as the audit firms use international auditing standards, these standards should be consistently enforced. From an investor perspective, this would be best safeguarded if a European supervisor – ESMA – would act as the pan-European enforcer.

26. Taking into account past experience, are there targeted changes to securities ownership rules that could contribute to more integrated capital markets within the EU?

X Yes

No

Comments on question 26:

Reference is made to our remarks on the European Transparency and Take-Over Bids Directive in our answer to question 21.

28. What are the main obstacles to integrated capital markets arising from company law, including corporate governance? Are there targeted measures which could contribute to overcoming them?

One of the main obstacles to a real integrated European Capital Markets Union is the absence of an effective set of EU rules for minority shareholder protection. A minimum, pan-European set of rights for shareholders to hold boards of companies accountable to shareholders is required. This minimum set of rights should comprise at least – in addition to the current set of rights encompassed by the Shareholder Rights Directive:

1. The right for shareholders to appoint, nominate and remove company directors.
2. The right for shareholders to approve fundamental corporate changes, initiated by the board, e.g. large acquisitions. Numerous studies show that many acquisitions destroy value for acquirer shareholders and that the losses from the worst performing deals are very large, also to society at large. Shareholder approval can block undesirable acquisitions, deter executives from initiating them, and give executives leverage to negotiate better acquisitions.
3. Shareholder approval of the use of anti-takeover devices that can be used by the company to frustrate or to block a hostile takeover attempt.

Moreover, shareholders who decided not to tender their shares in a public bid situation should be offered a higher level of protection in post offering restructurings – e.g. a delisting, a legal merger, a triangular merger, an asset sale, etc.

And last but not least we recommend – as the High Level Group of Company Law Experts already did in 2002 – the introduction of an EU framework rule on special investigation rights for minority shareholders. A shareholder or a group of shareholders, representing a specific amount of the company's share capital, should be given the right to apply to a court or appropriate administrative body to order a special investigation when there is a serious suspicion of improper behaviour by the company's board. This could be an effective instrument for minority shareholders for holding board members to account for possible mismanagement, especially in the circumstance that a company is controlled by a controlling shareholder who is also a company's related party. Moreover, we would also be in favour of a European mechanism for collective redress by shareholders as a concluding piece of engaged share-ownership.

29. What specific aspects of insolvency laws would need to be harmonised in order to support the emergence of a pan-European capital market?

We concur with the analysis of the Commission that discrepancies between the insolvency laws of Member States and inflexibilities in these laws form an impediment for cross-border investments within the EU. These discrepancies lead to serious uncertainties in the case of credit financing transactions and can also lead to severe price fluctuations, in particular in an (upcoming) default situation. We would therefore be in favour of a European regulatory proposal with respect to the insolvency procedure.

With respect to the status of securitisation vehicles (SPVs) legislation would be welcome to ensure that such SPV is bankruptcy remote – i.e. independent from originator. Also, there should be a true sale of the underlying loans to the SPV. Some jurisdictions require notification to the borrowers. This is often not desirable. It would be helpful if EU legislation arranges for the possibility of true sale without notification requirements where the sale is done to an SPV. A common bankruptcy regime would be really beneficial and ease investment across borders.

30. What barriers are there around taxation that should be looked at as a matter of priority to contribute to more integrated capital markets within the EU and a more robust funding structure at company level and through which instruments?

On an EU level there can be many ways to simplify the actual investment world and reduce existing barriers. One point to mention is the diversity regarding withholding taxes and possibilities and procedures to mitigate those taxes (based on existing double tax treaties). Each country has its own system and forms and it depends on the legislation of the investment country whether an investor can apply for relief at source and/or for reclaim of the taxes withheld. The EU can play a role in harmonizing the procedures and measures/forms. It would be very beneficial for all investors if they can apply for relief at source instead of reclaim in all European countries with similar measures/forms, instead of each country having its own measures/form.

Another tax barrier for institutional investors could be any (proposed) Financial Transaction Tax (FTT). At present, some European countries already have a FTT in place. This is not beneficial to cross-border investments. And any proposal that directly and indirectly negatively affects the results of institutional investors and therefore also their beneficiaries and clients would not add to the competitive position of any European Capital Markets Union.

A more robust funding structure could be achieved by better balancing the tax treatment of debt finance (interest payments are deductible) in relation to equity capital, which offers no similar tax relief.