SMSG Advice on the Commission’s Green Paper “Building a Capital Markets Union”

Joint meeting
ESMA BOS and SMSG
25 June 2015

SMSG priorities for a Capital Market Union

1. **Focus on retail investors –** Restore trust through better protection and better information, ensure that advisors understand the products the market; adopt a framework that supports cross-border investments; create a pan-European pension product.
2. **Develop an effective ecosystem -** focus on the right incentives to invest both into equity and debt issued by companies of all sizes.
3. **Align past and recent legislation with the objectives of CMU -** The priority should be regulatory reconciliation. Important regulatory initiatives (e. g. CRD IV/CRR, MiFID II/MiFIR, EMIR, CSDR, AIFMD, UCITS V, SRD, PRIIPs, etc.) need to be integrated under the umbrella of the Capital Markets Union because legal certainty is an important prerequisite for companies.
4. **Boost long-term investment taking into account the growing institutionalization of people's savings** through pension funds, insurance schemes and mutual funds. Today CRD III and Solvency II provide disincentives from investing into equities , private equity, venture capital funds and other illiquid long term assets.

How member states can play their part in CMU

1. Capital markets vary significantly across Member States because of different legal and consumer protection frameworks, especially in relation to company and insolvency law. The SMSG points to the following barriers to an effective CMU include:
   - The lack of an EU definition of shareholder (or the end-investor) at least for listed companies
   - • Weaknesses in the Transparency Directive that mean cross-border institutional investors do not have common detailed rules on disclosing major shareholdings
   - • 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
2. Member States can help overcoming these obstacles, either by responding positively to EU level initiatives to tackle them, or cooperating more effectively amongst themselves.

How ESMA can play its part in the CMU

- **Investor protection** - ESAs should make full use of their existing powers (including data collection, analysis of returns and prices, product intervention and the ban of toxic products.
- **Consistent supervision-** through peer reviews and their consistent application
- **Consistent enforcement** - there are constraints on what further developments can pragmatically be achieved.
- **Better coordination –** across the three ESAs when they share competences
- **Role at level 1** – ESAs should contribute their views to inform the formulation of new Level 1 EU legislation.
- **Flexibility** - No-action Letter type of reliefs could be envisaged subject to approval from the Commission and a process for reporting and oversight by the co-legislators.
- **Budget** – The Group considers that ESMA's resources need to grow. The EU needs to resolve the debate about ESAs resources.

Low hanging fruit… Part I of the Green Paper identifies 5 short term priorities

1. Review of the prospectus regime
2. Improve credit information on SME
3. Build sustainable securitisation and corporate debt markets
4. Boost long-term investment & ELTIFS
5. Develop European private placement schemes

1. The Prospectus regime

- There is a need to find a balance between ensuring an appropriate regulatory framework for issuers whilst still ensuring investor confidence.
- This is why the group is <u>not</u> in favour of reducing the disclosure requirements for SME under the prospectus directive.
- The group makes the following suggestions:
  - Enhance the value of the Prospectus for investors & reduce burdens for SMEs
  - Speed up approval for SME prospectus as window for going public is short
  - Encourage Pre-IPO registration
  - Don't extend International Financial Reporting Standards (IFRS) IFRS to MTFs
  - Make IFRS optional for SMEs
  - Delete need to publish full prospectus in the national language
  - Increase the maximum number of investors allowed to be targeted by private placement to 500.
- There is a strong opposition from some members regarding the creation of a two-tier market

2. SME credit scoring - widening the investor base

SMSG supports credit scoring

- Reduce information asymmetries to reduce the risk premium demanded on loans to SMEs
- Provide data on a voluntary and not a mandatory basis
- Make existing information available to a wide set of potential investors
- The use of standardized languages - like XBRL - should be encouraged
- Alert investors to additional risks they are incurring with these types of investments.

Research on SMEs is costly…

- Bear in mind the low level of standardization in the SME market, it seems rather unlikely that this could be done at an adequate price taking into account the transaction size.
- Preserve the fragile equilibrium of the financing of securities research
- Reduce costs by allowing ECB to accept these assets as collateral in liquidity-providing operations to banks by the ECB
- Make ratings by smaller rating agencies available in Central Rating Repository

3. Securitisation

Securitisation could play a greater role but the group is <u>not</u> very optimistic:

- Pre-2008, SME loan securitisation was limited & dominated by MBS
- The relative overall costs involved of a bond issue for smaller amounts can be uneconomic compared to the amount being financed.

The SMSG's suggestions

- concentrate on securitisation of more homogenous assets, e.g. mortgages and which would provide capital release for SME bank loans
- support the use of asset backed securities and securitisation in the form of Prime Collateralised Securities (PCS) a label which aims to "enhance and promote quality, transparency, simplicity and standardisation throughout the asset-backed market.
- develop placements of debt securities for SMEs through shared SPVs

But…

- Progress remains highly dependent on central bank and official sector credit enhancement.

3. Corporate debt markets for SMEs

- There have been market driven efforts to open up bond markets (Initial Bond Offering by NYSE Euronext, German Bond M Stuttgart and LSE ORB market)
- There have also been initiatives to develop placements of debt securities for SMEs through shared SPVs (e.g. in France, the Micado France 2018 vehicle). These have however not been replicated on any significant scale.
- The channelling of market finance, aimed at medium sized rather than small companies, can also happen directly through ongoing new initiatives - with the most recent and tangible being perhaps the ongoing drive to establish a pan-European Private Placement Market.

But…

- Debt markets need increased standardisation.
- However Standardisation would make it harder for borrowers to achieve consistent borrowing on the best terms and could work against smaller issuers
- Debt markets need ratings and would benefit from increased competition between ratings agencies.

4. Long-term Investments / ELTIFS

Regarding ELTIFs – the Group suggests the following:

- Eliminate the plethora of existing long term fund categories
- Grant the "most favoured nation" clause to ELTIFs for its tax treatment in Member States
- Apply the product disclosure rules of UCITS funds
- Make listed small cap equity an eligible asset class
- Allow for closed-end listed ELTIFs to address the liquidity issue
- Reconsider mark to market accounting treatment at banks and insurance companies
- Provide tax incentives and remove fiscal or administrative barriers

Who should invest?

- ELTIFs should be "advised" only to qualified and financially literate investors
- Retails investors argue that the same ELTIFs should be sold to all investors but other members propose separate types of ELTIFS (for institutional investors and retail investors)
- Additional effort should be made to attract Small pension funds plans and local associations

5. Developing a European Private Placement scheme

The SMSG welcomes the Commission's proposal:

- There is no pan-European private placement market; mid-sized European companies have accessed the US Private Placement market
- A Private Placement market would benefit medium-sized and unrated companies by providing access to long-term debt finance

SMSG suggests

- To consider the German Schuldscheindarlehen Market as reference;
- To review the obstacles created by implementation of the AIFMD which has implied a tightening of the rules governing private placements;
- To increase the number of investors to 500 as a maximum number for what constitutes a private placement
- To review risk capital weightings in the Solvency II Delegated Act
- to supporting market-led standards

Part II of the Green Paper

1. A common EU level accounting standard for SME growth markets?

- There are arguments both in favour and against the introduction of a common accounting standard for SMEs listed on MTFs.
- The benefits of facilitating financial market access through common EU level accounting standards needs to be balanced against the regulatory burdens imposed.
- The SMSG suggests the Commission reviews the subject further before deciding to develop a common EU level accounting standard for SMEs listed on MTF.
- If the EU were to move, the IFRS for SMEs published by IASB in 2009 should be expanded to the SMEs listed on MTF
- IFRS for SMEs would be a direct (and “ready to apply”) means to help the listed SMEs by simplifying the preparation of the notes to financial statements and making them less costly to produce and easier to read, while remaining comparable with listed firms applying full IFRS and compliant with EU regulations.

2. Crowdfunding

ESMA‘s Advice on Crowdfunding.

- SMSG welcomes ESMA‘s Advice on Crowdfunding. It assists NCA´s and promotes regulatory and supervisory convergence.

Is there a need for legislation?

- The lack of a passport could also make it harder for platforms to achieve the scalability they need.
- The harmonisation of financial crowdfunding would enable the development of a Pan-European market.
- Members support the development of proposals in the context of the Capital market Union.

SMSG advicce

- Keep the situation under review!
- Consider legislation to harmonise consumer protection measures as a divergence of approaches emerge

3. How to strengthen the single market in pension provision?

- The SMSG favours a European standardised personal pension product would facilitate cross-border activity
- The European personal pension should not aim at harmonising all types of existing personal pensions.
- Instead, the aim should be to create an EU-wide personal pension product that could be offered to EU citizens
- A standardised personal pension would allow providers to offer the same product in different member states and hence favour cross-border activity
- Increased cross-border activity of providers should also convince leading providers to ensure the cross-border portability of their European personal pension products, thus facilitating the mobility of EU citizens

4. Boosting the scale of venture capital funds and enhancing the exit opportunities for venture capital investors

- Avoid restrictive capital requirement, not reflective of the actual risks, on the different types of institutional investors typically investing in the asset class
- Adapt the MIFID definition of professional investor to better suit traditional investors into VC funds (business angels, entrepreneurs, family offices, HNIs etc)
- Introduce a harmonized definition of semi-professional investor
- Use public capital to leverage private capital especially in the earlier and more risky stages of SME funding to ensure there are funds catering for the different stages of a company's development before it is mature enough to list/do an IPO *(many start-ups manage to find funding for the seed and incubator stage only too often do they later run into the "valley of death"…)*

5. How can cross border retail participation in UCITS be increased?

- **Retail participation is high:** i.e. about 80 % of their total savings are long term if property is taken into account. What individual investors do not like it high risk – low return offerings !
- **Our core recommendation is = focus on retail investors and restore trust** through better protection and better information, ensure that advisors understand the products the market; adopt a framework that supports cross-border investments; create a pan-European pension product.
- **A new cost-effective and simple European Personal Pension product** with high consumer protection standards could capture the much needed consumer trust. The creation of a single market for personal pensions should therefore be seen as a building block of a Capital Markets Union.
- **The SMSG is against continuous and further changes to the UCITS framework.** UCITs are much more cross-border than AIFs. One way to increase cross-border distribution of funds in the EU is to reduce the number of retail AIFs .

11 measures that could increase retail investment

1. Review of categorisation of high net worth individuals/business angel type investors as ‘retail’
2. Tax reforms to encourage more long-term holdings
3. Remove factual double taxation of dividends and interest in case of cross-border investments
4. Repeal barriers to cross-border shareholder engagement, e.g. by facilitating the exercise of shareholders’ voting rights cross-border
5. Improve of financial education
6. Development of a collective redress mechanism (similar to the Dutch collective settlement procedure/collective action)

11 measures that could increase retail investment

7) The PRIIPs Regulation should include shares, bonds and pension funds in its scope to further standardise and simplify pre-contractual investor information, and reintroduce past performance disclosure
8) Introduce a UK ‘simple financial products’ reform
9) At least, the Prospectus, Insurance Mediation and IORP Directives should be amended in order to make their summary documents more standardised
10) The Shareholders Rights Directive should be amended to facilitate the exercise of voting rights cross-border
11) Introduce a simple and cost effective Pan European Personal pension plan

Attracting non-EU investments

- The topic of third-country recognition is important
- A fair balance needs to be found to allow non-EU companies to provide their services in Europe
- Global standards should be carefully considered when drafting regulation in order to avoid regulatory arbitrage
- A "race to the bottom" should be avoided
- It is important that European companies are allowed to enter third country markets
- EU needs to continue to ensure "reciprocity", i.e. not to discriminate against non-EU based managers
- Potentially lower standards from third countries should not be introduced via recognition

Improving the investment chain

Other issues to consider:

- MiFID has posed serious challenges to the bank and broker intermediation chain potentially harming local funding ecosystems
- Transaction costs should be lowered towards the US level
- The Shareholders Rights Directive should be amended to facilitate the exercise of voting rights cross-border
- SME Market Segments such as Deutsche Börse's Entry Standard and the Elite programme, which was started in 2012 by Borsa Italiana (part of the London Stock Exchange Group) could be a partial solution to the lack of support from the local intermediation chain.