

AFME consultation response

Building a Capital Markets Union

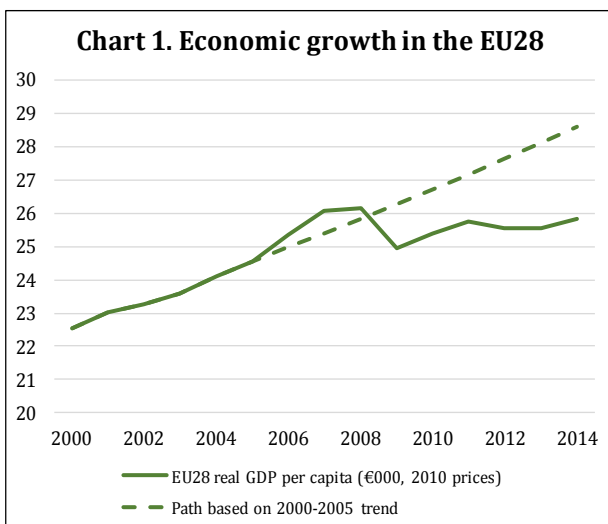
11 May 2015

HIGH-LEVEL COMMENTS ON THE COMMISSION GREEN PAPER

AFME strongly supports the capital markets union (CMU) initiative. Capital markets union is vital to secure the main aim of the new Commission: creating jobs and restarting growth and investment as well as to improve the functioning of the European financial sector. On behalf of leading participants in Europe's wholesale markets we are committed to working to help the Commission and the EU Member States build a successful capital markets union.

The economic imperative for CMU

High unemployment and weak economic growth throughout much of the European Union mean that many citizens face uncertain job and earning prospects and many businesses lack the confidence to invest in the future and pursue growth.

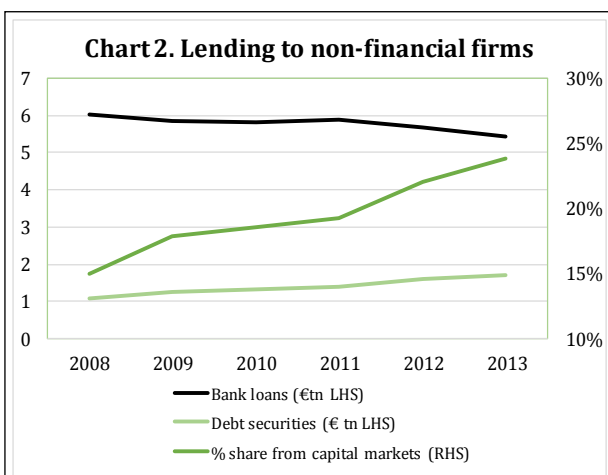


Despite a growing labour force, there are 5 million fewer EU citizens in employment than in 2008. Chart 1 shows that more than six years since the financial crisis, real GDP per head has yet to recover, and is more than 10% below the pre-crisis trend. This is largely owing to the impact of the financial crisis on the banking sector and the real economy in Europe.

Today, many businesses lack suitable funding options to support their growth – particularly risk capital and committed long-term funding. The CMU initiative should address this funding challenge by providing firms with a greater range of financing tools and ensuring access to a wider and deeper pool of potential investors.

Source: European Commission AMECO database

Chart 2 tracks the balance of banking and capital markets funding to EU companies since 2008. Between 2008 and 2013 the stock of bank loans *fell* by €600 billion, or 10% of the total stock. Meanwhile, the stock of debt securities *rose* by around €600 billion to stand at €1.7 trillion at the end of 2013.



Overall, the share of EU debt funding from the capital markets rose from 15% in 2008 to 24% by 2013. This major shift between banks and capital markets was driven by deleveraging in the banking sector.

The challenge for Europe going forward is to harness the potential of its capital markets to deliver a greater volume of funding overall to EU companies in order to support a strong and sustained recovery. The financial sector is pivotal in this process. In this way, we believe that the capital markets union initiative can help the Commission to deliver its key aims of creating new businesses, new investment and new jobs.

Source: New Financial, based on ECB and BIS data

Aims and objectives for CMU

We welcome the direction of the Commission Green Paper on CMU, including its three main objectives:

- improving access to financing for all businesses and investment projects such as infrastructure;
- increasing and diversifying the sources of funding from investors; and
- making markets more effective and efficient, both within Member States and cross-border.

We believe that a major long-term reform project focused on these objectives will be most effective if it has clear and measurable goals. The Commission should consider setting a range of 'SMART' (specific, measurable, attainable, realistic and timely) targets in order to track and demonstrate progress. These targets could take two complementary forms:

- policy milestones – covering the development and implementation of measures both in the near term and the period up to 2019; and
- market outcomes – identifying specific changes which the CMU project will promote in the size and diversity of capital markets¹ and the investor base, over a short and a longer time horizon.

Priorities for the CMU project

We endorse the early priorities for CMU that the Commission has identified: high quality securitisation; reviewing the Prospectus Directive; credit information on SMEs; private placements; and ELTIFs. In two recent AFME publications – *An agenda for capital markets union* and *Bridging the growth gap*² – we put forward a number of policy suggestions which also feature in our response to the consultation questions. For completeness, the annexes to this response provide summaries of the recommendations from our recent publications.

In addition to our detailed response below, we would emphasise five overarching priorities for the Commission to consider in taking forward the CMU initiative. These are:

1. building an equity culture, to promote entrepreneurship, business growth and new jobs;
2. improving the market ecosystem to better serve companies at different stages of growth;
3. preserving necessary market efficiency and liquidity;
4. tackling market fragmentation in Europe and internationally; and
5. supporting the Commission's 'Better Regulation' approach to produce better policy outcomes.

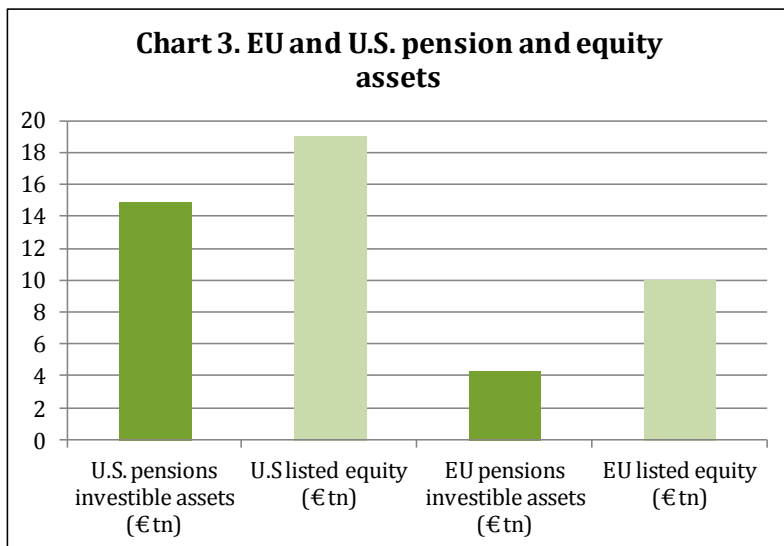
Building an equity culture in Europe to develop entrepreneurship, business growth and new jobs

We welcome the Commission's recognition in the Green Paper that "*more integrated capital markets, especially for equity, would enhance the shock-absorption capacity of the European economy and allow for more investment without increasing levels of indebtedness*". Data shows that the overall funding for SMEs in Europe is higher compared with the US, but European SMEs suffer from a lack of equity financing. This lack of equity is a key bottleneck to the provision of further overall SME funding and is holding back the growth of business and creation of new jobs.

Developing an equity culture in Europe requires change on several levels. At the aggregate level, EU equity market capitalisation of €10 trillion is around half of the U.S. level of €19 trillion despite similar levels of GDP. EU pension fund assets of €4 trillion are barely a quarter of the size of U.S. pension assets (€15 trillion). These figures are shown below in chart 3.

¹ In our paper *An agenda for capital markets union* we proposed four potential targets on equity and debt market development for the Commission to consider.

² BCG/AFME report *Bridging the growth gap: Investor views on European and US capital markets and how they drive investment and economic growth*.



Moreover, in Europe only 37% of the €4 trillion of funds managed by pension funds and fund managers are invested in equities, compared to 53% of €15 trillion in the US, which highlights the very significant lower amount of risk capital available for investment in Europe. Part of this can be explained by the predominance of government-provided pension schemes in most European countries, with two major exceptions (the Netherlands and UK).

Source: AFME/BCG [report](#) 'Bridging the growth gap'

We would encourage the Commission to look in the round at the incentives that need to be developed, both at EU and national level, to develop more of an equity culture in Europe. This should include encouraging SMEs to make greater use of equity including alternative sources of financing such as venture capital, angel investing, equity crowdfunding and family and friends. In our response to this consultation we have made a number of recommendations to help develop an equity culture.

The answers to questions 2, 5, 8, 9, 10, 15, 28, 30 and 32 should help with promoting an equity culture in Europe to develop entrepreneurship.

Improving the market ecosystem to better serve companies at different stages of growth

We share the Commission's clear message that CMU should improve access to the capital markets for small and medium-sized firms across Europe. Through CMU, policymakers and industry can take action which will improve financing options for SMEs which should help them grow their business:

- *directly* – e.g. by improving access to funding markets and strengthening incentives to issue new equity or debt and promoting alternative financing channels³; and
- *indirectly* – e.g. by promoting a greater breadth of investment research, a wider availability of SME credit data and greater issuance of SME securitisations.

However, given that according to Commission's definitions European 'SMEs' may have total assets ranging from zero to €43 million – whereas 'mid-cap' firms can have a market capitalisation of up to €1 billion – broad-brush policy solutions are likely to be limited in their effectiveness. We believe that the policy debate on funding options and solutions will benefit from clearly differentiating the market failures which affect firms of a particular size and stage or in specific sectors.

The capital markets may provide an important funding channel for larger SMEs and innovative and high-growth firms in Europe. Alongside this, however, there must be recognition that for many SMEs, the transaction costs for the SMEs themselves, for intermediaries and for investors will make conventional equity and debt funding options uneconomic for those SMEs below a certain size, particularly in the public markets. This means that Europe must think creatively about creating new networks for SMEs to access capital markets products such as bonds and equities through non-public capital markets means such as friends and family, business angels, private equity, and private sources.

We believe there is scope for industry participants to develop standardised and proportionate reporting guidelines for SME data for capital markets funding. AFME would be keen to work with experts from a range of perspectives – including issuance, lending, and rating – to help identify solutions.

³ The AFME / BCG study confirms that venture capital, angel investment and funding by friends and family play a larger role in SME financing in the U.S. than in Europe.

The answers to questions 2, 3, 4, 8, 10, 15, 16, 23, 26, 29 and 30 should help with developing solutions to channel more investor funding to the best funding opportunities that will help the economy growing.

Preserving necessary market efficiency and liquidity

In order to encourage investors to invest their money in European businesses and other financing opportunities that will help the economy growing, they need to have the confidence that markets operate efficiently and are sufficiently liquid to protect their investments. When markets are less liquid and investors do not have the ability to change investment strategies at any point in time, it is less likely that investors will decide to make the decision to invest in the first place. This means that it will be more difficult to mobilise the capital that is available and get it to where it can be most productive.

As noted in the Commission's Working Document accompanying the Green Paper on Long Term Financing of the European Economy: *"providing liquidity is an important function of secondary markets. Liquid and well-functioning secondary markets encourage activity in primary markets too, as this enables investors to sell their investments quickly and at low costs when needed."* The market maker model is vital for the real economy by providing liquidity, enabling market participants to trade smoothly in and out of positions without excessive price volatility, providing certainty of credit exposure and enabling investor flows to raise financing.

It is essential that in its policy development on CMU (and on wider markets and prudential regulation) the Commission acts to preserve and indeed enhance liquidity in Europe's capital markets. We recommend that under CMU, the Commission considers a careful calibration or review of existing major regulatory initiatives, taking into consideration the combined liquidity impact of market reform (e.g. MiFID) and prudential regulation (e.g. NSFR and FRTB).

We support an appropriate regulatory framework for market making activities that provides confidence to regulators and market participants and encourages liquidity and responsible risk management as well as investment in the real economy. In particular, we would like to point to the importance of an appropriate liquidity calibration in MIFID, which will be crucial for market makers to fulfil their role.

The answers to question 6, 8, 21 and 23 should help promote efficient and liquid secondary markets.

Tackling market fragmentation in Europe and internationally

Fragmentation discourages investments in Europe and acts as a brake on growth. Differences in information and understanding across markets, as well as national discrepancies in rules, are often mentioned as examples of fragmentation that impede investment. Closer integration of EU capital markets will not only ensure that the Single Market will be more attractive for foreign investment, but will also increasingly serve as a reference for regulatory best practice and convergence across jurisdictions and that Europe speaks with one voice in global fora. CMU represents a major opportunity to facilitate European businesses' access to global capital pools and funding opportunities. Providing better access to international capital flows would reduce capital and funding costs and foster stronger connections for the EU with other capital markets globally. Central to achieving this is the removal of frictional barriers and ensuring fair access and treatment of international investors. Conflicting regulatory policies and divergent implementation of global standards create barriers to capital flows and reduce the efficiency of Europe's capital markets. Initiatives such as the proposed Transatlantic Trade and Investment Partnership (TTIP) and the work of the [IOSCO Task Force on Cross-Border Regulation](#) can improve regulatory coordination and further integrate international capital markets.

The answers to questions 13, 16, 18, 20, 22, 26, 27 and 32 should help address the current capital market fragmentation and lead to more international competitiveness and coordination.

Supporting the Commission's 'Better Regulation' approach to produce better policy outcomes

The CMU project will be most effective if it is informed by clear market failure analysis and robust impact assessment – in line with the approach to new regulation as set out by Commissioner Frans

Timmermans in the context of the 'Better Regulation' agenda. We encourage the Commission to adopt a strategic approach to its policy programme, with a very limited number of new proposals; each of which should be chosen to deliver the maximum economic impetus to the capital markets union project. On each issue where the Commission considers that action is required, there should be detailed analysis of the appropriate form of intervention – i.e. market-led reform or regulatory reform. Also, we would urge the Commission to, in the forthcoming reviews of recently adopted legislation, keep the possible impact of regulations on the developments of capital markets in mind (we note the reviews of EMIR, CRR, ESAs framework and Shareholder Rights Directive).

Separately, we would highlight the clear risk that other regulatory proposals, currently in development but not formally part of CMU, may undermine the potential economic benefits of a capital markets union. Here we would highlight in particular:

- *Bank structural reform* – The prudential and market reforms undertaken since the crisis have already caused bank balance sheets to shrink and reduced banks' capacity to make markets, thereby reducing liquidity and increasing volatility in asset classes such as corporate bonds. A 2014 PwC study on the impact of the Commission's proposal on bank structural reform suggests that the measure would lead to a concentration amongst market makers (with an impact on competition) and further impact secondary market liquidity, leading to higher cost for borrowers. PwC estimates that corporates would be subject to a 30bps rise in their typical spread on capital markets borrowing.
- *FTT* – The proposed financial transaction tax (FTT) being developed by 11 EU Member States under enhanced cooperation would, if implemented, raise the cost of capital and fragment EU capital markets. A 2013 economic analysis by Oliver Wyman suggests that the EU11 FTT would reduce the value of future equity issuance by 6-8% and would increase the yield on corporate debt issuance by 10-20 bps. It is possible that this economic damage resulting from an FTT would outweigh the wider gains arising from CMU.

The answers to questions 7, 12, 15, 16, 20, 23 and 32 should provide suggestions for the Better Regulation agenda.

There are 5 questions in this consultation for which we have not submitted a detailed response. This is generally because the issue in question is not within our remit as a trade association and/or because we consider that other market participants (and associations) are better placed to provide an authoritative response. The questions for which we have not submitted an answer are: 11 (fund management); 14 (EuVECA and EuSEF); 17 (UCITS); 19 and 20 (retail investment); and 31 (technology).

About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME members are keen to play a leading role in providing tangible, practical input on how to implement a CMU which will support growth, particularly for SMEs and infrastructure finance. To date, AFME has developed four initiatives which to provide new insights for policymakers and practical advice to SMEs and infrastructure finance, including:

- Comparison of EU and U.S. capital markets: In February 2015, AFME and Boston Consulting Group published *Bridging the Growth Gap*. The report highlights that despite similarly sized economies, the EU has far less risk capital available for investment.
- Improving Access by SMEs to all Forms of Finance: In June, AFME members will distribute to their SME clients across Europe a practical publication, *Raising Finance for Europe's Small & Medium Sized Businesses*, in five EU languages. The guide provides insights on how bank and non-bank lenders make their credit decisions; private and public bond issuance for larger SMEs; and how to raise equity through IPOs, venture capital, private equity, business angels, friends and family, and crowd-funding/P2P lending.

- AFME-ICMA Guide to Infrastructure Finance through Bank Loans, Private Placements and Bonds. In June, AFME and ICMA will be distributing to infrastructure issuers, sponsors, procurement agencies and investors this practical guide.
- Identifying funding obstacles to EU corporates: In 2013, AFME published, together with Oliver Wyman, *Unlocking Funding for European Investment and Growth*. This report identified nearly 50 specific obstacles for SMEs, infrastructure issuers and corporates in obtaining funding.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Transparency Register, registration number 65110063986-76.

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RESPONSES TO QUESTIONS

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

We welcome the priority actions which the Commission has highlighted in the Green Paper, covering securitisation, the prospectus regime, SME credit information, private placements, and ELTIFs.

In addition to the overarching issues mentioned in the introduction to this consultation response, we would also emphasise the importance of near term action to:

- recalibrate existing capital charges for securitisation both for banks and insurers, since these are still set too high to encourage widespread investment in securitisation;
- create a new infrastructure asset class within Solvency II, so capital charges for infrastructure debt and equity provide an appropriate incentive structure for insurers to incentivise long-term investments by insurers;
- calibrate legislation in such a way that markets benefit fully from the essential role played by market makers in bringing together issuers and investors, users and providers of capital;
- maintain a broad and efficient 'ecosystem' for investment research in Europe, with a particular focus on SMEs. Work on CMU should recognise the essential requirement for good quality investment research on EU companies to support price formation, market liquidity for smaller and mid-cap companies, and a broad investor base;
- encourage Member State contributions to the investment plan for Europe, including the European Fund for Strategic Investments in order to build scale and economic impact; and
- identify possible tax incentives that Member States could introduce to promote long-term investment.

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?

Banks and non-banks often have different commercial interests in publicly available data on SMEs, the standardisation of SME definitions and of credit scoring. Any initiative will therefore need to be carefully assessed: (i) for its impact on both bank and non-bank financing; and (ii) from a 'better regulation' perspective, to ensure that the economic benefits of any reporting requirements on SMEs significantly outweigh the additional administrative costs.

Expanding the availability of credit information and credit data standardisation

The lack of credit information on SMEs is often a barrier for non-banks to provide funding to SMEs. It will in many cases not be economically viable for non-banks to conduct research on individual SMEs due to the small size of SME loans and the lack of available data. This lack of consistent and timely information often means that non-banks will not be able to lend to SMEs, in particular not cross-border.

On the other hand, because of Europe's historic reliance on bank finance, credit information is primarily retained only by these institutions as well as centralised national repositories in limited circumstances. It should be considered how credit information on SMEs could be made more widely available, not only within a country between banks and non-banks, but also on a cross-border basis in order to create more lending and investment opportunities. Standardisation, in the collection of this data could be very helpful in helping a user of the information more efficiently collect and interpret the information. Aspects that could be standardised include language, consistent accounting standards, and the format in which the information will be electronically available.

We believe there is scope for industry participants to develop standardised and proportionate reporting guidelines for SME data for capital markets funding. AFME would be keen to work with experts from a range of perspectives – including issuance, lending, and rating – to help identify solutions.

Credit scoring

Certain commercial organisations such as credit agencies (for example Experian and Creditreform) and credit ratings agencies (such as Moody's, Standard and Poors, Fitch, DBRS and others) provide scoring and ratings services for a fee. Some policymakers may ask whether all SMEs should be scored, and if so, how and by what measurement. AFME recommends that significant further research is required as to how credit scoring services could, and whether they should, be expanded and possibly be developed into a pan-European network. Making credit information on SMEs more easily accessible for non-banks does not mean that a standardised SME credit scoring is necessary. FICO scores in the US were not reliable in predicting credit defaults on subprime mortgages in the US. SME loans and equity are capital- and information-intensive, and standardised scoring – while helpful to lenders who do not have extensive credit teams – could prove counterproductive if it prompts bank and non-bank lenders who disagree with the scoring assessment not to make a loan they would otherwise have approved.

SME definitions

One of the problems with regard to getting more non-bank financing to SMEs is the inconsistent use of SME definitions across European countries which makes it more difficult to evaluate SMEs. Although there is an EU recommendation ([2003/361](#)) available on standard European definitions for SMEs, this is often not used for a variety of commercial reasons since the businesses of both bank and non-bank lenders differ across business models and institutions. Every bank currently has its own definitions, commercial and risk segmentations for marketing purposes and its own data systems integrating those definitions.

In theory, applying a single definition for SMEs across Europe would make it possible for non-banks to better categorise risk which should facilitate the SME funding process. However, requiring banks to apply commercially a standardised SME definition could lead to significant difficulties. The impact of constraining definitions on retail network practices should be carefully assessed.

SME equity growth markets

In this context, we note the SME provisions in MiFID II which are aimed at encouraging the development of SME growth markets. From the MiFID provisions currently proposed, SME MTFs enjoy no secondary trading benefits over and above ordinary MTFs. Owing to their liquidity profile, investors seek to use pre-transparency waivers (such as the Reference Price Waiver) in SME shares to avoid market impact⁴. We therefore recommend that SME Growth Markets be exempted from the pre-trade transparency requirement as healthy secondary trading in SME shares is vital to attract interest in these shares in the primary market, providing SMEs with the necessary access to capital.

As is described in the AFME SME Finance Guide, there is a very wide range of SME growth equity platforms established at the major exchanges across Europe. Since 2007, IPO issuance on the five largest EU markets ranged from a total of €71m (raised from 21 transactions) to €13.6bn (from 492 transactions). The listing requirements for these five platforms also varied significantly. In the absence of a pan-European exchange for SME equity, it would be worthwhile for policymakers to explore how some type of consolidated data platform could be developed where market participants and investors could easily see which equities are listed across all EU exchanges, research available, and which firms might provide markets in those shares upon investor request.

3. What support can be given to ELTIFs to encourage their take up?

AFME considers that the ELTIF framework has the potential to be a valuable additional investment vehicle for institutional and retail investors across Europe and can provide an important source of long-term funding for infrastructure projects; particularly giving smaller funds an opportunity to achieve

⁴ Without these pre-transparency waivers, the incentive to first invest at issuance is much reduced. SME shares will be disproportionately impacted by the double volume cap that will apply to shares under MiFID II. Analysis of the impact of the cap on the Reference Price Waiver shows that trading in a large proportion of shares is expected to be suspended for six months when MiFID II enters into force on 3rd January 2017.

sufficient scale and ability to access large-scale investments. We support ELTIFs for illiquid investments. ELTIF operators should be clear to investors as to how liquid the investment is to clarify what the investment exit opportunities are.

The ability of investors (particularly retail investors) to gain exposure to large-scale, long-term investment is currently limited by a lack of cross-border transparency and consistency. To address this, and to facilitate the development of ELTIFs, it is important for the EU authorities to provide adequate clarity on the scope, parameters and investor incentives of the regime, as well as removing, as far as possible, the barriers to investment. Specifically, the following steps should be considered:

- sufficient incentives for equity investment to make the regime attractive. For example, the capital treatment of ELTIFs under Solvency II should be calibrated to encourage investment by insurers.
- certain distribution restrictions under existing and forthcoming EU law should be examined in the light of their potential impact on the development of ELTIF markets. For example, In MiFID the automatic classification of ELTIFs as complex means that they cannot be sold on an execution-only basis;
- clarifying the scope and parameters of ELTIFs as a vehicle. In particular, (i) what investments other than infrastructure properly qualify as long-term; and (ii) what is the eligibility of both secondary market debt and equity investments?; and
- widening the scope of ELTIF-eligible investments to include high quality securitisations backed by appropriate qualifying assets (such as infrastructure project receivables). This would align with and support the CMU.

We have also identified a range of actions to enhance the basic investability of European infrastructure as an asset class (and hence to improve the case for investing in such assets through an ELTIF structure). As outlined in question 10, these actions include reducing political and regulatory risks for projects; targeting government support to address market failures; and increasing the size and consistency of the EU project pipeline.

From the pension fund industry we understand that pooled investment vehicles such as ELTIF could be attractive for pension funds, especially for smaller and medium-sized ones, but that the current capital requirements and tax treatment could limit the pension fund industry's investment in ELTIFs. We would also encourage Member States to review tax treatment of ELTIFs to attract investment.

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?

The current lack of standardisation across European Private Placement deals is considered to be one of the key issues for the development of a European private placement market. Under the umbrella of the Pan-European Private Placement (PEPP) Working Group, the industry has developed best practices, key principles and standardised documentation and will continue to work on this. The production of a private placement guide to inform investors' choice, as was launched early 2015 by ICMA with active support from AFME, Euro PP, LMA, other associations and officials, should help to make private placement investments more visible and bring them into the investment mainstream. This should help to develop the idea that the EU, besides the US, is seen as an attractive location of choice for private placement deals and would help get more funding from investors to businesses that can use it to grow.

We would welcome the Commission's and Member States' support in promoting the standards that have now been developed. We believe that the Commission should draw on this work to identify and overcome barriers to entry for new issuers and investors into the private placement market. It should review legal and regulatory impediments to invest in unlisted securities and project finance deals. Investors cite ambiguity in rating, tax and regulatory treatment – for example under Solvency II – of private placement investments as reasons for them being cautious in investing in private placements in Europe.

A current problem for the development of private placements is uncertainty over tax treatment; in particular the withholding tax treatment on returns on private placement investments, which leads to a reluctance among investors to invest in private placement deals. We believe that the standardisation of the tax treatment of private placement deals should be a priority and Member States should be encouraged to exempt private placements from withholding tax, as was recently decided to do in UK. At the very least, withholding tax reclaim procedures should be simplified significantly.

There is some ambiguity about the capital and/or regulatory treatment of European private placement bonds. In the US, the National Association of Insurance Commissioners (NAIC) provides a scoring of private placement bonds, which typically are in the investment grade equivalent category, which provides certainty on their regulatory capital treatment. It may be appropriate to consider developing an NAIC-type framework if the Solvency II framework (which comes into force early in 2016) is found not to provide a workable platform for credit investment in unlisted “crossover” companies.

The Commission could also consider developing easy-to-understand guidance about the current regulatory treatment of private placement deals which could attract a larger number of smaller investors to invest in this market. AFME is working with ICMA to develop a list of remaining buy-side obstacles across Europe which may still restrict investment in the debt of unlisted companies, including whether some type of no-action letter like those used in the US by the SEC might be helpful to investors.

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

A more coordinated availability and consistency of borrowing and investing information for SMEs should be established on a pan-European basis. This could be done by creating comprehensive ‘how to’ financing guides for SMEs to use as their source. As previously mentioned, AFME has taken a leadership role on this and will soon be publishing a guide for SMEs on how to raise finance setting out a range of financing options for different types of SME firms. The Guide includes information on how SMEs can access loans from banks and non-banks, bonds for larger SMEs and equity through various sources such as crowdfunding platforms, business angels, venture capital, private equity and public markets. The Guide will be available in five languages: English, French, German, Italian and Spanish. The Guide also provides information on SME Growth market exchanges, volumes and listing requirements for bond and equity issuances as well as case studies of SMEs in various countries. Through this Guide, SMEs may also access information on available national and pan-European support schemes, a list of various national and pan-European sources of information such as the association of exchanges as well as bond and equity listing requirements.

At the same time we believe that the Commission and Member States should develop a more coordinated approach to tackling SMEs’ financing and growth concerns, with possible improved centralised access to information on support for SME debt and equity. Most member states maintain some type of SME support agencies. Although merging initiatives along the lines of the US SBA (Small Business Administration) is probably not feasible or desirable, further coordination and information sharing could be useful to SMEs. The existing initiative of the Enterprise Europe Network could provide a base for this. The EIB and EIF already provide good access on their support programmes.

The Commission and Member States should further facilitate venture capital investing through the promotion of SME equity initiatives similar to the [US SBA-led SBIC initiative](#). Under its Small Business Investment Companies (SBIC) programme, the SBA licenses qualified VC firms to search for small businesses in need of debt or equity financing.

Finally, we would note that in the UK, recent legislation is requiring banks to refer and detail all SME credit applications that they have declined (or partially declined) on an on-line portal for other investors to consider. If successful, this initiative will promote competition with challenger banks and alternative funders, increasing the number of funding avenues available to SMEs and boosting growth.

On question 2 we provide more detail on how accessible credit information for SMEs and a consistent European definition for SMEs could enhance the channelling of funds to those who need them.

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?

We discussed the standardisation of corporate bond markets in our recent [AFME/GFMA joint response](#) to the Fair and Effective Market Review consultation from HM Treasury, the FCA and the Bank of England. There we noted that:

“Achieving optimal standardisation of market practices across market participants is desirable for the overall efficiency and effectiveness it can achieve. However, standardisation also needs to be balanced carefully against the ability to innovate and compete more effectively. Also, it is important to distinguish standardisation of disclosure and reporting (which we support and indeed have helped establish), from standardisation of issuance practices, procedures and operations, which based on feedback from corporate issuers will achieve only limited benefits and will likely result in more problems than it would solve.

Standardisation of corporate bond issuance in particular has a separate set of considerations. We are not aware that large corporate bond issuers are anything other than satisfied with the effectiveness and efficiency of the corporate bond issuance process, as a general matter. We note that standardisation will introduce the greatest challenges for small and mid-cap corporates looking to raise financing through the debt markets because smaller firms require the greatest flexibility when structuring debt. Therefore, mandating standardisation will create inconsistency with the Capital Markets Union objective of expanding access to financing through the bond markets for small and mid-cap firms.

From an issuer’s perspective, the key attributes of a successful bond issuance process are investor diversification, attracting anchor investors, cementing long-term investor relationships and minimising cost of capital. Different issuers often require specific structures, credit support and covenant flexibility, depending on the industry or business model, and it is therefore important that issuers and investors maintain the flexibility to tailor and agree each transaction to meet those requirements. Issuers are also keen to maintain flexibility over timing of issuance in order to capture the right market opportunity. For large corporate issuers the traditional bank-run allocation process helps achieve these objectives. Alternative bond issuance processes, such as auction and retention, do not offer these wide-ranging benefits and therefore, have not been widely adopted by issuers. Separately, the issuance process for credit intensive products can differ from that of more frequently issued, less credit intensive products (in terms of disclosure details) and hence, merit closer alignment.

Any moves towards standardisation, particularly around issuance practices, should therefore be undertaken on a voluntary basis. Standardisation of disclosure and reporting can always be improved. It will be helpful to leverage, refresh and update, as appropriate, existing standardised disclosure frameworks (for example, AFME’s longstanding initiatives on standardised securitisation reporting, which supported BoE/ ECB development of their standards for securitisation, AFME High Yield bond issuer reporting guidelines, the Pan-European Private Placement documentation initiative, and the EFR’s standardised infrastructure finance reporting guidelines described in the AFME ICMA Infrastructure Finance Guide).

Further comments on bond market liquidity are provided in the answer to question 23.

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?

We are supportive of the work that ICMA has led on the development of Green Bond Principles (GBP). We have noted the GBP guidance that promotes the development of a transparent green bond market. We are supportive of the self-regulatory approach taken by the stakeholder group that is led by the ICMA and would agree with their view that a flexible market-driven process is preferable to any additional regulatory norm or label.

Establishing a consistent tax framework to shelter income and capital returns in green investments from tax would increase the appeal of these investments and also align with EU environmental policy, objectives and obligations. At present, there is no economic advantage for issuers to issue Green Bonds instead of vanilla bonds and yet additional resources and effort are required of issuers to issue them.

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?

As noted in the Green Paper, accounting standards can play an important role in addressing information problems and International Financial Reporting Standards (IFRS) have “*played a key role for promoting a single accounting language in the EU, making it easier for large listed EU companies to have access to global capital markets*”. The question is raised whether a similar, though simplified, accounting standard should be developed for SMEs. Such accounting standard is already available though in the form of [IFRS for SMEs](#). Accordingly, we think that the right approach is to explore the question at international level, and to consider whether the use of IFRS for SMEs can be promoted without undermining the benefits of full IFRS. Therefore we would not recommend a separate exercise to develop a standard for application purely at EU (rather than international) level.

The IFRS for SMEs was developed to provide investors with an accessible and standard format for financial statements of SMEs that is nevertheless less extensive and detailed than for companies in public capital markets while at the same time reduce the administrative burden that a full IFRS would impose on SMEs. The use of IFRS for SMEs also has the benefit that when SMEs grow, a transition to full IFRS can be expected to be less complicated than when SMEs had been using a completely separate accounting standard.

We note that the Commission conducted a [consultation](#) on IFRS for SMEs in 2010⁵. As the summary of consultation responses notes, there is considerable support for using IFRS for SMEs and the introduction of IFRS for SMEs in the EU could in particular benefit companies seeking international finance and therefore help with further developing capital market access for SMEs. As the consultation’s response also noted, using IFRS for SMEs could lower the cost of capital and broaden the capital base. At the same time it was noted that in certain member states the application of IFRS for SMEs could be burdensome by duplicating reporting requirements due to the close link between tax, profit distribution and accounting regimes in several Member States.

In our response to the Commission’s consultation on the effects of using IFRS in the EU, we commented that we consider that IFRS has significantly increased comparability and transparency and the ability to reflect the increasing complexity of businesses. Given the potential benefits for the development of a CMU and providing better access for SMEs to a broader capital base, it is worth exploring whether the use of IFRS for SMEs can be promoted without undermining the benefits of full IFRS for listed companies or introducing undue burdens on European SMEs.

9. Are there barriers to the development of appropriately regulated crowdfunding or peer to peer platforms including on a cross border basis? If so, how should they be addressed?

Peer-to-peer (P2P) lenders (also known as “market place lenders”) and crowdfunding platforms are a small but growing source of finance. The legal and regulatory framework for P2P and crowdfunding lending varies widely from country to country within the EU. Where platforms are regulated, this will generally be by the national regulator of the country where the funds are raised. This has an impact on the credit criteria of lending platforms and on lending volumes in each country. The significant majority of platforms do not operate cross-border, although there are a few exceptions. Only 38% of financial-

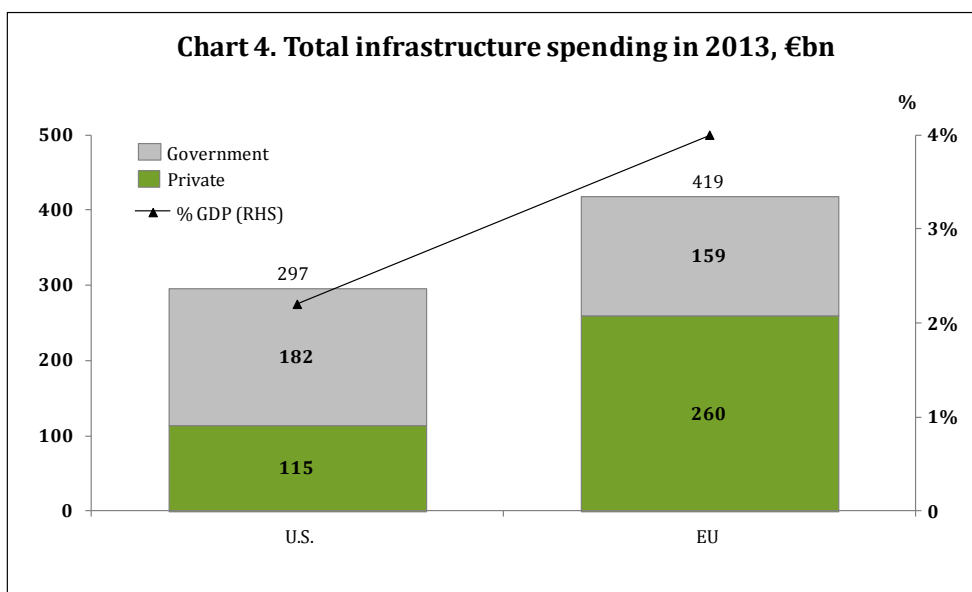
⁵ As part of the Commission’s consultation on IFRS for SMEs, the European Financial Reporting Advisory Group (EFRAG) conducted an [analysis](#) of the compatibility of IFRS for SMEs with the EU Accounting Directives. The IFRS for SMEs was assessed to be incompatible with the EU Accounting Directives and as a result, the IFRS for SME was not endorsed in the EU.

return platforms answering the 2014 Commission consultation on crowdfunding operate cross-border while almost half of them would like to extend their business to other EU Member States in the future.

Crowdfunding through debt and particularly equity could play an important role in providing risk capital in comparatively low amounts to smaller SMEs with high growth potential. It is therefore an important new stream of capital markets funding. Given that crowdfunding is a relatively new technique in Europe, we support the approach set out in the 2014 Commission Communication⁶ not to propose regulation but to continue to study the market and relevant market practices. Given the shortage of equity available to SMEs across Europe, it is important that this market sector succeeds, and grows in a manner which maintains the confidence of regulatory authorities, investors and borrowers.

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?

On infrastructure funding, the BCG / AFME report, *Bridging the Growth Gap* surveyed major institutional investors' perceptions of barriers in the European market. The report also highlighted that, as shown in Chart 4, in 2013 the total volume of infrastructure financing was considerably higher in Europe than in the U.S., and that 62% of EU infrastructure spending was privately financed, compared to 39% in the U.S.



* Source: AFME/BCG report 'Bridging the growth gap'

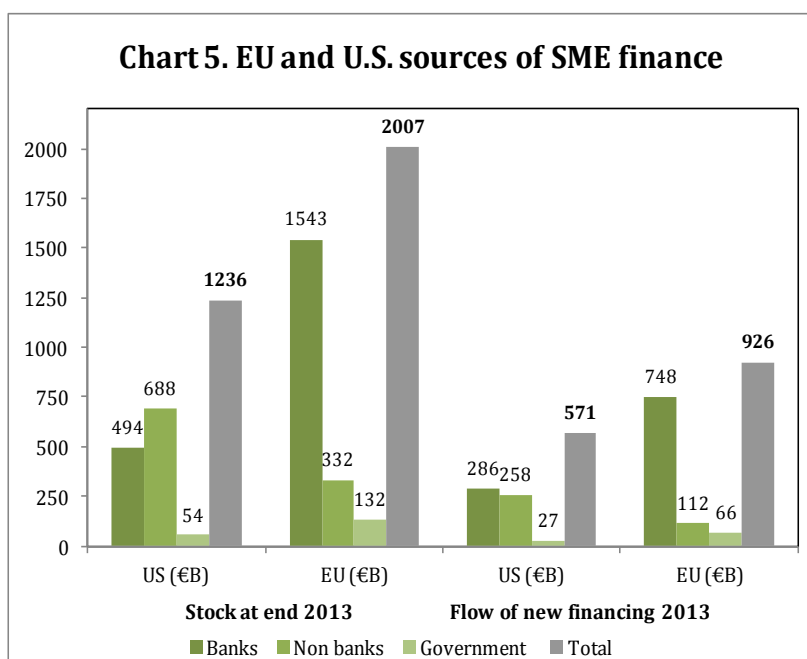
Nonetheless, the *Bridging the Growth Gap* report also identified significant barriers in Europe to the efficient funding of infrastructure investment, particularly through the capital markets. Based on that evidence, AFME believes that solutions should seek to:

- reduce political and regulatory risk associated with investing in selected European countries, especially post-closing changes in law and regulations, including tariff reductions. There are examples of European (as well as non-European) transactions where after the transaction completed the funding and legal closing process, local governments decide to lower tariffs on project revenues to such an extent that either credit and/or mark to market losses were incurred, which discourage investment. Best practices on procurement and contracting in this areas could be an idea worth exploring. Such a mechanism would facilitate greater investment in greenfield and brownfield projects;

⁶ See http://europa.eu/rapid/press-release_MEMO-14-240_en.htm

- provide targeted public sector guarantees, while not guaranteeing the success of a project per se, where the usage risks of the project (e.g. for a toll road) mean that it would not otherwise be commercially viable and financeable. In such cases, a fairly-balanced risk sharing mechanism will encourage investors who may be willing to take some risks between an agreed minimum or maximum level of usage, but are unlikely to be prepared to take all of the risk;
- encourage investment through the EU Investment Plan to be directed towards projects where burden sharing between public and private sectors is necessary, rather than displacing investment from projects which can be entirely financed from private sources;
- amend punitive accounting and capital charges associated with investing in infrastructure as an asset class;
- with regard to renewable infrastructure investment, introduce tax incentives for bond and equity investments along the lines of Green Bond Principles; and
- increase the size and consistency of the project pipeline, which we understand is already under active review by the Commission.

On SME financing, despite higher overall funding for SMEs in Europe compared to the US, European SMEs suffer from a lack of financing avenues that could provide equity. Chart 5 below shows that in the US, a significantly higher proportion of SME funding is provided by equity from private equity, business angels, and friends and family. This lack of European SME equity is a key bottleneck to the provision of further overall SME funding.



* Source: AFME/BCG report 'Bridging the growth gap'

Investors surveyed in the BCG / AFME report noted that, in order to provide long-term financing to SMEs, a number of logistical barriers need to be addressed:

- SMEs could be made more aware of the differences between, and suitability of, debt and equity finance.
- Cost and size requirements for SMEs to issue debt/equity are often too high for small firms.
- Current market conditions, as well as regulatory capital treatment of securitisation investment by insurers and others, do not make securitisation of SME loans particularly attractive.

To address these points, AFME believes that Europe should focus on increasing SME supply and demand for alternative forms of finance – particularly equity finance for small SMEs. AFME recommends that the Commission discuss with the fund, insurance and pension fund industry whether they actually invest or not in SME whole loans or SME equity, and if not, what could be done to improve incentives. In particular, secondary market liquidity for SMEs is generally weak, and further trading could be incentivised through more research. Member States should also be encouraged to share best practices with SME financing initiatives that they have taken. In this respect we welcome the initiatives already taken by the Commission and Member States in arranging events on SME financing.

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?

[No response.]

12. Should work on the tailored treatment of infrastructure investments target certain clearly identifiable sub-classes of assets? If so, which of these should the Commission prioritise in future reviews of the prudential rules such as CRDIV/CRR and Solvency II?

Infrastructure offers a truly wide range in the risk-return spectrum. Private investors require each investment to be successful financially, while policy-makers as the ultimate owners of infrastructure, may focus on the average of a large number of projects.

More specifically, investors interviewed in the BCG/AFME 'Bridging the Growth Gap' report felt that the current Solvency II capital charges fail to distinguish between long-term corporate debt and infrastructure debt, in spite of there being significant differences in default and recovery rates. (This observation is borne out in data that indicate cumulative default rates on infrastructure debt are 34% lower than the corresponding rates on corporate debt at a 10-year horizon.) It appears that the lack of a clear asset class definition for infrastructure investment is leading to disproportionate accounting regulation and capital charges for some long-term investors. EIOPA has recently completed an extensive consultation on the definition and calibration of a new infrastructure asset class, in connection with the Commission's request for EIOPA to explore this issue and make a recommendation by the summer. On 26 April, AFME and ICMA submitted a comprehensive response in which we suggested the following comprehensive definition of infrastructure: "Infrastructure" means a long term, capital intensive undertaking the purpose of which is to utilise certain assets, facilities, equipment, systems, networks or part thereof to provide services that are essential or desirable for the maintenance of societal or governmental functions, health, safety, security, economic or social well-being of the population. Banks and institutional investors like pension funds and life insurers are more and more working together to provide long term funding solutions for long-dates infrastructure projects, combining bank debt and capital markets products.

With respect to banking regulation, we recommend a review of the prudential treatment of specialised lending exposures, which includes amongst others, project finance, commodity finance and object finance. Currently, the Standardised Approach of the CRD4/CRR does not recognise the structure and collateralised nature of these transactions which have exhibited a track record of low losses over a full economic cycle. For example, historical data over the period 2008-2014 from a sample of 6 European banks shows an average default rate of 1.01% while the average loss rate is 0.21% (on exposure at default (EAD))⁷. The Basel Committee's review of the Standardised Approach for Credit Risk is an also an opportunity to consider this at international level.

13. Would the introduction of a standardised product, or removing the existing obstacles to cross-border access, strengthen the single market in pension provision?

The scale and risk profile of Europe's pool of pensions assets is a vital area to address for European economic growth. The AFME BCG Bridging the Growth Gap report highlighted that the U.S. has €15 trn of private pension assets, while Europe has only €4 trn. In the U.S., 53% of these assets are held in risk capital/equity, while in Europe only 37% of that much smaller private pension balance is invested in equities. Among European life insurers, an even lower proportion – only 15% of total assets – is allocated to equities. The growth of European private pensions and life insurance companies is essential to provide a much larger pot of investment for European risk capital.

We note the work of the Commission and EIOPA on the creation of a single market for personal pensions. The creation of a European personal pension product could facilitate cross-border activity,

⁷ See AFME's response to the BCBS consultation paper Revisions on the Standardised Approach for Credit Risk

providing investors and savers with a greater choice across a more competitive and (due to economies of scale) cheaper fund range.

The current Pillar 2 pensions market is fragmented and lacks scalability largely due to the myriad manners in which funds are taxed across 28 Member States and the fact that taxation happens *inside* the investment vehicle in many Member States through applying taxes on a bundled basis. If we can create system whereby EU Member States could create their own 'tax wrappers' *around* the fund, this would allow fund managers to market similar products across borders whilst still giving Member States the power to levy tax appropriately under national regimes. This would improve the cross-border nature and scalability of funds thus allow for more sizeable and steadier investment flows into a greater number of companies and projects.

UCITS have been highly successful in Europe and globally for several reasons: consumer protection, diversification, transparency, liquidity and sound risk management. However, UCITS are not the place for certain types of investments like infrastructure, SME loans and other as these assets tend to be less liquid longer term in nature. There needs to further thought given to how to channel retirement savings (Pillar 2 pensions) toward infrastructure and SME loans – perhaps through the creation of a 'UCITS-style' product for pension fund investment.

14. Would changes to the EuVECA and EuSEF Regulations make it easier for larger EU fund managers to run these types of funds? What other changes if any should be made to increase the number of these types of fund?

[No response.]

15. How can the EU further develop private equity and venture capital as an alternative source of finance for the economy? In particular, what measures could boost the scale of venture capital funds and enhance the exit opportunities for venture capital investors?

Private equity and venture capital are important sources of financing which can play a growing role in the EU economy. Developing these markets will also help to promote an equity culture and provide vital risk capital to companies with high growth potential. While distinguishing between private equity and venture capital as investment types, it is important to develop a supportive policy environment for the three key phases of investing activity:

- Attracting funds – funds for private equity and venture capital investment are sourced from pension funds, insurers and to a lesser extent also from banks. As a result, the prudential capital rules and risk-weights under CRD4 and Solvency 2 are a key driver (or obstacle) for private equity investment. We understand that there is concern in the private equity industry that the calibration of these prudential rules may be overly conservative. The proposed EU bank structural reforms are also expected to significantly restrict banks' ability to invest in alternative investment managers, and hence in private equity and venture capital funds;
- Fund operation and investment – fund management regulation should not discourage the development of PE/VC investments. In particular it is important to ensure that compliance requirements in AIFMD, EuVECA and MiFID are proportionate and do not undermine the efficient management of funds;
- Exit – important in the fund exit stage are the possibilities for public listing of companies that PE/VC funds have invested in. In this context the requirements to be able to do an IPO need to be proportionate and consider the cost of issuance without losing sight of the necessary protection for investors. We welcome the review of the Prospectus Directive with a focus on the regime for SME issuance. We also note the importance of competitive exchanges for the fund exit stage; and

- Adjusting the risk-return parameters: there are a range of existing EU (European Investment Bank and European Investment Fund) and nationally-backed finance initiatives. The terms of these schemes should be revisited to assess whether they are effectively meeting the segments of the market that need finance. Member States should be encouraged to consider successful national schemes, such as the Spanish FOND-ICO Global and the UK Business Growth Fund, and the extent to which they can be adapted to meet local needs. If appropriately calibrated, these initiatives can adjust the parameters of risk and return for private investors and develop businesses to go public sooner than they might otherwise.

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

Bank lending

In spite of general agreement that the regulatory reform agenda is substantially complete and that the focus must turn to capital allocation that supports growth, we are concerned that international regulators are continuing on a path of regulatory overhaul that is unlikely to be consistent with that objective. In particular, the Basel Committee is currently working on proposals to introduce a standardised capital floor. These changes are being billed as one of the last steps needed to fully complete financial reform; however, they are so fundamental that they may very well produce an entirely new basis for capital requirements, effectively reducing the role of internal models and the risk sensitivity of the capital framework.

A risk incentive framework is likely to create the wrong origination and capital allocation incentives because it incentivises banks to privilege high return, high risk assets. It will also destroy the virtuous cycle whereby improvements in risk measurement and management systems are incentivised and integrated into business decisions, which results in improved lending decisions and risk-based pricing. In our view, the case for the introduction of additional floors is not clear as the leverage ratio already provides a non-risk sensitive backstop to capital requirements. We do realise that these measures are decided on at global level as part of the work of the Basel Committee but concerns about its implementation in the EU should be carefully considered.

In order to unlock lending, mechanisms which allow for an efficient credit risk sharing between the public and private sectors should be promoted. At EU level this could be done through (i) increasing the available amounts of public guarantees; (ii) easing of European guarantees standards; (iii) reviewing the prudential calibration on some market segments, especially securitisation. The AFME SME Guide includes a section which describes the most frequently used debt and equity guarantees schemes in the largest EU countries, as well as pan-European programmes. Regarding securitisation of SME loans by banks, the Commission's push to reviving high quality securitisation is supported. The industry also supports a review of the capital charges incurred by regulated institutions for investment in all classes of securitisations. (See June 2014 AFME publication "Securitisation at a Crossroads" for further details).

Furthermore, high and rising levels of nonperforming loans (NPLs) in some EU countries continue to weigh on banks' balance sheets. The rapid rise reflects in part the prolonged recession which has worsened the creditworthiness of borrowers, particularly SMEs. At the same time, inefficient and lengthy insolvency proceedings, combined with the limited incentives to write off loans, has held back the pace of NPL resolution.

Non-bank lending

Market participants, governments and regulators can act collectively to increase institutional investor appetite for purchases of loans, including by establishing a legal framework for loan funds (similar to UCITS), removing of barriers such as banking licence restrictions on the purchase of loans, and developing loan performance benchmarks. The main challenge for non-banks is whether current yields available on SME loans are sufficiently high to encourage investment, as compared to rates available through institutions such as banks who fund with low-cost deposits. Increased availability of credit data on SME loans could also help encourage new providers to enter the market.

In addition, Basel Committee's Fundamental Review of the Trading Book, based on its current calibration of liquidity horizons, would increase the capital banks need to hold against less liquid credit products for market making purposes up to five times the current levels. Such an outcome in the final rules would significantly reduce the capacity to provide market based funding for smaller issuances and lower rated credit.

Lastly, we would note that in the UK, recent legislation is requiring banks to refer and detail all SME credit applications that they have declined (or partially declined) on an on-line portal for other investors to consider. If successful, this initiative will promote competition with challenger banks and alternative funders, increasing the number of funding avenues available to SMEs and boosting growth.

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

[No response.]

18. How can the ESAs further contribute to ensuring consumer and investor protection?

One of the key objectives of European Supervisory Authorities (ESAs) is to provide consumer and investor protection. Securities supervision in Europe requires strengthening and enhancing existing structures and processes related to the ESAs, including ESMA. We believe that making full use of the current supervisory framework to improve supervisory convergence should remain a top priority for ESMA in order to contribute to ensuring consumer and investor protection, and we note ESMA's work on MiFID in this context. Specifically, Article 9 of the ESAs' establishing Regulations empowers them to undertake cross-border product initiatives. This should be encouraged through the CMU and is contingent on the ESAs having sufficient resources to undertake this type of work.

19. What policy measures could increase retail investment? What else could be done to empower and protect EU citizens accessing capital markets?

[No response.]

20. Are there national best practices in the development of simple and transparent investment products for consumers which can be shared?

[No response.]

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

Attracting a wide range of global investors with diverse profiles and risk appetites, increasingly from emerging economies, should be a key priority in the future development of the Single Market. Closer integration of EU capital markets will ensure that the Single Market increasingly serves as a reference for regulatory best practice and convergence across jurisdictions and that Europe speaks with one voice in global fora. Initiatives such as the proposed Transatlantic Trade and Investment Partnership between EU and U.S. and the work of the IOSCO Task Force on Cross-Border Regulation can improve regulatory coordination.

We are aware that some market participants from outside the EU have expressed concern about a lack of clarity regarding the process for equivalence assessment to support third country recognition, the information available to market participants, and communication between relevant regulators. As the Commission and ESMA become more practiced in conducting these procedures we expect that the robustness of the assessment process will improve.

Advancing the EU's Better Regulation agenda would also materially assist in improving competitiveness and inward investment. A Better Regulation Board, independent of the Commission's Directorates, should be established to review the accuracy and completeness of impact assessments. The latter should also include a robust growth test to ensure that any proposal ultimately supports European economic growth, unless sufficient reasons are given for pursuing an anti-competitive measure that nonetheless achieves other objectives. Making impact assessments more 'user friendly' would also improve policymaking. For example, providing separate assessments that address the impacts on companies and those on investors, along with headline summaries, would facilitate better feedback. These changes, while incremental, would improve dialogue, mitigate unintended consequences and ultimately increase the credibility of EU policymaking.

Finally, we understand that the Commission will undertake a cumulative assessment of the impact of recent financial regulation. This assessment could consider where new EU regulation may have created additional barriers to third country investment into the European economy. Moreover, in developing further Level 2 measures we would encourage the Commission and ESMA to keep the objectives of CMU firmly in mind.

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

CMU should be seen as a major opportunity to facilitate European businesses' access to global capital pools and funding opportunities. Positioning the EU and its capital markets as one of the top global destinations for capital investment would expand international capital inflows and greatly contribute to the success of a Capital Markets Union. This would enhance capital availability, reduce capital costs and funding costs and foster stronger connections for the EU with other capital markets globally. Central to achieving this is the removal of frictional barriers and ensuring fair access and treatment of international investors.

We would emphasise the importance of strengthening the framework for global regulatory coordination. Conflicting regulatory policies and divergent implementation of global standards create barriers to capital flows and reduce market efficiency. Formal guidance should be agreed by the Commission with foreign regulators and provided to market participants on how equivalence and substituted compliance will work in practice. A pragmatic outcome-based approach for equivalence assessment, favouring regulatory dialogue and international supervisory cooperation, particularly as regards the timing of implementation of rules, should be developed, with a transparent and comparable set of criteria across all respective pieces of EU financial services legislation.

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?

The importance of market-making

Liquid and well-functioning secondary markets encourage activity in primary markets too, as this enables investors to sell their investments quickly and at low costs when needed. However, AFME research has shown that the adverse impact of a decline in liquidity tends to fall on less liquid instruments in particular, typically those related to small and medium enterprises (SMEs) and project finance – precisely the types of investment highlighted in the Green Paper.

The market maker model is vital for the real economy by providing liquidity, enabling market participants to trade smoothly in and out of positions without excessive price volatility, providing certainty of credit exposure and enabling investor flows to raise financing. For example fixed income markets have low secondary market liquidity, which is one factor that drives the need for market making. We support an appropriate regulatory framework for market making activities that provides confidence to regulators and market participants and encourages liquidity and responsible risk management as well as investment in the real economy. It is essential that in its policy development on CMU (and on wider markets and prudential regulation) the Commission acts to preserve and indeed

enhance liquidity in Europe's capital markets. There are certain current legislative proposals that risk damaging market makers ability to provide liquidity though.

Liquidity and transparency

Transparency is important for ensuring effective markets. The existing level of market transparency will be even further enhanced under MiFID, particularly through the introduction of pre- and post-trade transparency requirements in non-equity markets. However, the move to greater transparency in these markets requires careful calibration if the correct balance between contribution to price formation and ability to commit market making capital is to be maintained. We are concerned that ESMA's current draft calibration proposals do not strike the right balance in this regard. We therefore strongly recommend that under Capital Markets Union, the European Commission and ESMA take into account AFME's recommendations on liquidity calibration.

As we have noted [elsewhere](#): *"Inappropriate and excessive transparency could lead to severe unintended consequences. In particular, costs to investors (impacting pension funds and insurance companies) could increase and for instance, issuers would be disincentivised from issuing bonds, contrary to the objectives of the European Commission... We think that the pre- and post-trade transparency regimes should be appropriately calibrated to preserve liquidity."*

Prudential reforms affecting wholesale market liquidity

Across the fixed income product spectrum, dealers are trying to move from an inventory based trading strategy towards a broker or order-driven approach in order to deal with the additional costs arising from new prudential rules. This trend has been more relevant in corporate bonds where capital cost under Basel III is significantly increasing – while recognising that decisions of the Basel Committee are outside the scope of this consultation. In the US corporate bond market dealer inventories have shrunk by more than 60% from 2007 and are similar to levels last seen in 2002/2003 while the overall market has expanded since then substantially. European markets are experiencing similar trends. The reduced balance sheet usage is adding to the lack of liquidity in larger trades. At the same time corporate bond holdings have increased significantly with mutual funds leaving most of the risk (sudden shift in liquidity) with investors.

For instance, the Net Stable Funding Ratio requires the funding of short term liquid positions with long term funding is likely to significantly raise the cost of trading in securities and derivatives. In particular, the treatment of derivatives and linked transactions could have a substantial dampening effect on the liquidity of securities markets leading to less ability for customers to manage risk, increased volatility and higher operating costs/reduced returns for investors.

Proposals on bank structural reform that would require automatic separation of trading activities on the basis of size-based metrics would – if implemented – materially restrict banks' market making and hedging capacities in addition to their ability to hold inventories, securitise loans and provide a range of capital markets services to their clients. If banks are forced to structurally split market making from other core activities, the most likely outcome is that several wholesale banks will shrink their financial markets operations. Such withdrawal of capacity will impact pricing of liquidity as well as bid/offer spreads, ultimately resulting in higher financing costs for issuers and end-users.

Another regulatory drivers impacting market liquidity is the ongoing Fundamental Review of the Trading Book by the Basel Committee. Under this framework, capital will be calculated for trading activities at a desk level and will be based on stressed calibrations. The framework will also include liquidity horizons for trading risks that require significantly more capital for less liquid products. The new desk based leverage ratio will set a minimum level of capital for desks and may become a binding constraint for desks that trade in lower risk assets. As currently proposed, the FRTB's final rules may undermine the fundamental policy goal of an appropriate capital framework and have disproportionate impact on certain products and markets. While the overall capital impact of the FRTB is not yet clear, we expect, based on our analysis, that the FRTB framework will result in punitive capital increases for certain business lines. Some of the most affected products are those with the greatest significance for the wider economy, such as bond markets, SME credit, securitisations, small cap equities, and commodities and foreign exchange hedges. Impacts from the FRTB on these products will have an

adverse impact particularly on emerging European markets that depend more on cross border financing of less liquid products that typically involve FX hedging.

Higher trading book capital requirements in these markets will also further increase issuance costs and will negatively impact on secondary market liquidity that is already subdued due to the impact of other regulatory initiatives. Given such an environment, investor participation in certain markets is likely to fall further thereby negatively impacting on their depth and efficiency. Such loss of efficiency and increased costs might also be expected to discourage some current market participants from hedging their risks raising the prospect of increased market volatility and significant financial instability.

Finally, the introduction of standardised capital floors (see question 16 above) may further exacerbate the situation. In general, the wide range of capital floors planned or being envisaged (such as TLAC, the leverage ratio, the introduction of regulatory risk parameters, exposure/desk level and standardised floors), and at different levels of consolidation, makes it difficult for banks to balance regulatory compliance against the allocation of capital to individual business lines. Importantly, this limiting the risk sensitivity of the capital framework will likely have important behaviour implications on market-making, and therefore on capital market efficiency, product pricing and available liquidity for end-users.

We would also refer back to our comments made earlier in the introduction to our response with regard to the expected negative impact of an FTT on the ability of market makers to be able to continue to provide liquidity to the market.

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

Different rules across Member States stand against the objective of creating one single capital market. This may result in preventing consumers from making cross border investments.

The single rulebook currently being developed relates to banking supervisory practices. In financial markets a coherent single rule book is still missing. In addition, various national options and discretions exist in level 1 legislation. The CMU should therefore also be seen as an occasion for the development of a coherent EU capital market that is based on a joint understanding and philosophy of what a effective and well functioning financial market should be, a joint supervisory approach towards investor protection and financial oversight. The development of a single rulebook is an important element in this regard.

The Commission and ESMA should consider introducing with the single rulebook the power for regulators to issue “No Action” letters. U.S. regulators have the authority to issue “No Action” letters in response to requests from market participants for clarifications regarding proposed transactions that are originated and distributed in accordance with a described set of circumstances. More detail on this is provided in the answer to question 32.

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?

We consider that the current institutional framework for securities markets supervision in Europe is broadly fit-for-purpose. As regards structures and processes, the leadership capacity of the ESAs, including ESMA, should be enhanced by strengthening their independence – including from the European Commission and from national authorities. As we have noted [before](#), we believe that greater independence and effectiveness could be achieved by exploring thorough governance reforms, for example as regards the composition, role, tasks and powers of the Board of Supervisors and the Management Board. ESMA has been granted supervisory authority in respect of credit rating agencies and trade repositories. This could be expanded to other cross-border facilitators, notably market infrastructures and critical benchmarks. As we note below, the role of the European Systemic Risk Board should also be considered further as the EU capital market grows and becomes more integrated.

We believe the policy process should be based on the principles of clarity, efficiency, openness,

transparency and evaluation. These principles should be fully enshrined in the level 1-level 2 relationship, which in many cases since the ESAs' inception has not functioned effectively, and would benefit greatly from a more robust quality control framework. During the last years, banks have noticed increased administrative burdens due to overlapping supervisory actions and reporting requirements which result in increased costs. The ESAs could play a stronger coordinating role to avoid such unwanted consequences, to the benefit of broader CMU objectives. A necessary precondition to ensure that CMU is developed effectively and meaningfully, is that ESMA's, and more generally all ESAs' resource allocations are considerably enhanced in the coming period. More generally, more transparency at both Level 1 and Level 2 would be beneficial. For example, where the European Commission opts not to follow ESA advice, this could be disclosed, as could any legal advice that the ESAs receive from the Commission Legal Service. Full and proper consultation should be built into the legislative process. For example, delays in earlier parts of the process should not result in rushed Level 2 rule-making to meet an inflexible deadline.

European Systemic Risk Board

In its current setting, the ESRB is performing its mandate under a set of institutional constraints inherent in the EU regulation, thereby hindering its capacity to make decisions in a timely manner. The ESRB has no legal personality and is dependent on the ECB, which provides administrative, logistical, statistical and analytical support. AFME would suggest strengthening and simplifying the governance of the ESRB. We expect that the creation of the SSM will have important consequences for the macro prudential supervision framework for banking in the euro area. AFME would highlight that despite some obvious progress made towards the development of the macro prudential supervision framework, both at the national and European level, the ESRB still suffers from a lack of visibility. Furthermore, the CMU is primarily about supporting economic growth, rather than systemic risk. ESRB has a role to play in both. It should be given a genuinely counter-cyclical role to recommend relaxing as well as tightening prudential standards at the appropriate time.

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?

We would welcome EU legislation to clarify ownership of securities when trading cross-border. The certainty provided by such EU-wide legislation would provide reassurance to investors who may be trading outside of their 'home' legal jurisdiction, and in the event of adverse market conditions, find themselves unable to determine which law is applicable to a transaction with a defaulting counterparty.

We believe that, as we have expressed elsewhere before, compulsory harmonisation of member state property law and civil liability regimes may lead to unintended consequences and could increase systemic risk (if credit risk is concentrated in intermediaries) to the ultimate detriment of investor protection. Investors might be exposed to more risk if a prescriptive Securities Law Legislation makes intermediaries more susceptible to failure due to events beyond their control.

In view of these practical considerations and market realities, we propose adhering to an "operational approach" that focuses on harmonisation of operational aspects of securities accounts and transactions. The core of this approach would be that transfer of legal title would be deemed to take effect on the debiting or crediting (as applicable) of an Account Holder's securities account on the books and records of an Account Provider as the overriding principle of a new Securities Law Legislation. We believe that any effects on market practice would be offset by the benefits of a uniform, commonly understood principle underlying all securities transactions, resulting in greater confidence in customer positions in securities accounts. At the same time, an operational approach which is implemented in this way will minimise unnecessary disruption, will maintain legal certainty under the laws of the various member states, will not create impossible burdens to overcome with respect to securities held through legal systems outside the EU and will not increase systemic risk through concentration of credit exposure to intermediaries. More details on our proposals are set out [here](#). AFME also recently published "[Post-Trade Explained](#)", which explains in more detail the roles of various post trade market participants.

We would consider that priority actions are for credit and debit account entries to become legally constitutive for valid acquisition and disposition of securities, for EU law to provide for a harmonised understanding of ‘good-faith acquisition’ of securities and securities collateral, and for commercial and insolvency law to address a shortfall in securities, in particular in case of insolvency of an intermediary.

Also a proposal to harmonise, to some extent, loss sharing and compensation mechanisms is required and it is important to clarify which law has to be applied to a certain case. Therefore, the existing conflict-of-laws rule of the Financial Collateral Directive should be extended to all areas of holding, acquisition and disposition of securities.

Finally, we wish to address the Commission’s comment in the Green Paper (p.23) that *“there are risks that the same securities are being reused to support multiple transactions as was the case pre-crisis”*. It is important to distinguish between (i) uncertainty around the nature and implications of collateral re-use structures⁸ and (ii) the ability to re-use collateral per se, which does not contribute to legal, credit, market or other systemic risks, and will be a key requirement for CMU to succeed. We do not believe that the transfer of securities as collateral between multiple parties leads to “asset inflation” or confusion as to who owns what, provided that all relevant parties have a clear understanding of the nature of the relevant collateral flows, their respective rights and obligations, and that relevant operational processes and account records support the agreed nature of those collateral flows.

It is important that any party who provides collateral to another party (in order to secure the providing party’s repayment or other obligations) makes a fully informed decision as to whether to permit the collateral receiver to use that collateral, and understands what risks arise by permitting that use. The collateral provider can permit use of collateral either (a) by transferring title in the collateral to the collateral receiver at the outset, or (b) by granting the collateral receiver a right or use (also known as a right of rehypothecation) over the collateral. In relation to collateral passed by way of title transfer, or collateral which is rehypothecated (but only when the right of rehypothecation is exercised), the collateral provider has a claim for redelivery of equivalent assets from the collateral receiver, but ceases to have any ownership right in relation to the actual collateral asset. That ownership right has passed to the collateral receiver, enabling it to use that collateral (including by passing ownership on to a third party). That ability to use the collateral asset is crucial.

In the (simple) example of a cash loan from the collateral receiver to the collateral provider, the ability to use the collateral enables the collateral receiver to provide the collateral assets to secure cash borrowings from a third party, the less efficient alternative (i.e. if the ability to re-use collateral did not exist) being to use other assets, or to borrow on an uncollateralised basis (both of which would mean a higher cost of borrowing for the collateral receiver and hence the collateral provider). By granting the collateral receiver a right of use of collateral, the collateral provider is making an informed risk/reward decision, ceasing to be an owner of the collateral but having a cheaper cost of borrowing. The risks associated with that arrangement can be mitigated if the collateral provider has an enforceable right to set off obligations it owes the collateral receiver (e.g. to repay borrowed amounts) against the collateral receiver’s obligation to return equivalent collateral – a right that is typically included in collateral re-use arrangements.

We would emphasise that collateral re-use arrangements of the kind contemplated above do not have the effect of multiplying the aggregate volume of cash generated, or of artificially inflating the volume of assets in the capital markets system. Rather, the re-use of collateral enables the exchange of cash and securities between parties (and where relevant across multiple intermediaries) to allow sources of financing to be made available to asset owners. We would regard this as an efficient and effective credit generation process (essential in an effective Capital Markets Union), and not a cash/security multiplier. Risks do exist here, but not in the principle of onward use of collateral; rather, the risks exist where parties do not adequately understand the basis of collateral re-use arrangements (which as mentioned above, can be adequately mitigated through risk disclosures), or that relevant account entries do not accurately reflect the transfer of securities in collateral re-use structures (which is a theoretical issue

⁸ To the extent such uncertainty exists it should be tackled primarily by adequate disclosure between parties – as contemplated in the draft Securities Financing Transaction Regulation – and by reporting, as required under AIFMD.

that should not exist in practice, and is adequately covered by existing and future planned regulations).

AFME is planning to, in the context of the CMU project, come forward with more practical proposals that could form the first steps in the development of a more unified Securities Law Legislation.

27. What measures could be taken to improve the cross-border flow of collateral? Should work be undertaken to improve the legal enforceability of collateral and close-out netting arrangements cross-border?

Measures to improve the cross-border flow of collateral

European regulation increasingly requires additional collateral and in terms of removing barriers to cross-border collateral use it is important that there can be free flow of collateral and collateral availability across entities and across borders. Standardised forms of collateral (e.g. assets and transactions) should be developed where appropriate. It is also important that the cross-border flow of collateral is not constrained by excessive regulatory restrictions (e.g. caused by constraints on the repo markets, unnecessary requirements for segregation higher up the custody chain, margin requirements or insolvency laws).

The fluidity of collateral may be restricted and compromised by the introduction of new rules currently under discussion which would unduly penalize the activity of collateral re-use in case of title transfer financial collaterals. We are particularly concerned about constraints imposed on banks' repo activity, which is of crucial importance to support liquidity in the secondary market - and hence an important tool to support the development of EU capital markets. The appeal of repo transactions for market operators is precisely the fact that the collateral – the full ownership of which has been acquired - can be immediately reused. In particular, European legislators should avoid introducing unjustified constraints to the re-use of collateral in the context of the Securities Financing Transactions Regulation. In addition, future rules and guidelines covering segregation requirements under AIFMD and UCITS V should allow for fluidity in collateral at all levels of the custody chain, and should not unduly restrict the access of AIFs and UCITS to collateral management and securities lending services. Furthermore, the principle of the underlying securities ownership transfer in the framework of the SFT Regulation should be extended to the other types of securities transactions.

In addition, and more broadly, the Commission should consider fostering harmonisation in the access of banks to different systems of securities' settlement across the EU. The higher the level of harmonisation in the access of banks to different systems of securities' settlements, the more fluid the use of collateral throughout the EU should become.

As we have noted before, in the context of the [operational approach](#) for Securities Law Legislation which is highlighted in the answer to question 26, with regard to collateral there should be:

“A clear distinction between (1) crediting and debiting of securities accounts, as dispositive incidents of transfer of ownership, whatever the underlying consideration could be (outright sale or title transfer collateral), and (2) the means of providing collateral under a security financial collateral arrangement, which operate to vest possession and/or control of the subject securities in the collateral taker and limit an account holder's or third parties' access to those securities. In the former case, the circumstances under which an Account Holder's ownership rights would arise and cease would be clarified.

In the latter case, AFME believe this would further the twin objectives of (a) ensuring investor protection through clarity in respect of when ownership is actually transferred on the enforcement of a security interest by a collateral taker granted under a collateral arrangement and (b) clarifying that title does not transfer on the provision of securities as collateral under a security financial collateral arrangement under the Financial Collateral Directive. AFME believes that the specificities of the manner in which securities may be provided as collateral as defined by the FCD is sufficient and consequently should be considered beyond the scope of the securities law legislation.

In relation to collateral it should be made clear that an account holder's creditor may enforce its rights against an account holder only in relation to the securities held by the account holder's relevant

intermediary, and not in the books of an upper-tier account provider, including where that account provider holds the debtor's securities in segregated accounts."

Legal enforceability of collateral and close-out netting arrangements cross-border

As regards the question of measures to improve the cross-border flow of collateral and the enforceability of collateral and close-out netting arrangements, we would make the following observations:

- The cornerstone for cross-border recognition of collateral and close-out netting arrangements in Europe is the EU Collateral Directive. Unfortunately, implementation of the Collateral Directive in relevant jurisdictions has been varied and somewhat inconsistent. We believe that consideration should be given to a replacement with a Collateral Regulation, to provide a standardised pan-European framework for the recognition and enforceability of collateral arrangements.
- Alongside the Collateral Directive, existing and planned European regulations such as AIFMD, the draft SFTR, the European Markets Infrastructure Regulation (EMIR), the Settlement Finality Directive and the Central Securities Depository Regulation, provide a robust framework for the cross-border flow of collateral, and the recognition of collateral and netting arrangements. The draft SFTR includes risk disclosure and consent requirements for collateral re-use arrangements, providing a regulatory basis to support consistent market-wide understanding of the nature and implications of those arrangements. Separate to the need to ensure robust and enforceable collateral flows, however, there is the growing need to ensure efficiencies in those flows, in particular given the increased demand for collateral. While minimum qualitative and quantitative margin and collateral haircut requirements are being developed under EMIR for non-cleared OTC derivatives and are contemplated as a future requirement for securities financing transactions in the draft SFTR (and related work undertaken by the Financial Stability Board), we believe that where risk offsets exist across OTC derivatives and SFTs, it should be permitted to calculate relevant collateral requirements taking those risk offsets into account. This would support efficiencies in collateral flows without jeopardising counterparty and systemic risks.

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?

The laws and process around changing the capital structure of a company as a result of capital raisings differ among EU Member States which affects the management of contemporaneous offers in more than one Member State. There are differences in both the required steps to authorise changes in capital and the required steps to create capital in the official company record. For example in some Member States it is necessary for an designated official auditor to verify and confirm that nominal capital has been actually paid in before the new shares may be issued which may be after the funds have been paid in. Time differences and differences in public holidays may add to the complexity of managing the closure of an offering. The solution to this complexity may be in having a central EU authority deal with these issues according to a universal protocol.

Nonetheless we acknowledge that company law and corporate governance models in the EU's Member States are perhaps too diverse to harmonise easily, given historical attempts and the various vested interests involved. Rather than a top-down 'one-size-fits-all' approach, a more workable solution is to continue to work within local frameworks but underpinned by three fundamental pillars that must be rigorously enforced:

1. Comply or explain: we agree with giving companies flexibility by allowing them to adapt their corporate governance frameworks to the local market; as well as their size, stage of development, shareholding structure and sector. Embedding 'comply or explain' has been

successful where it has been adopted (notably in the UK) and should be applied more widely.

2. Transparency: in relation to corporate reporting, governance behaviors, architecture and (not least) related party transactions. This allows comparability of financial and non-financial reporting, allowing investors and the market to better assess cross-border investment risk to price it appropriately.
3. Shareholder rights: are the vital underpinning to the two principles above, giving meaningful safeguards to shareholders in the event of a corporate failure. This includes the fundamental principles of one share, one vote and the elimination or regulation of Control Enhancing Mechanisms. In addition, the right to approve related party transactions, dismantling impediments to cross-border voting and measures to ensure a level M&A playing field are important.

Without high standards of corporate governance and removal of barriers, money will not flow easily across the EU and markets will assign a discount to those stocks and Member States that do not apply appropriate or comparable standards. This would prevent the European Commission from achieving its laudable aim of building a meaningful and effective Capital Markets Union.

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

At a broad level, insolvency laws influences capital market performance because they help to determine recovery rates for creditors and timing of asset recovery and the speed and efficiency of capital reallocation from failing businesses. Currently, the widespread divergence in Member State insolvency regimes and outcomes acts as a major deterrent to cross-border investment. Insolvency reform will be a long-term project, but one which should significantly contribute to capital markets union.

We consider the following to be the most important elements in order to enhance the efficiency of European insolvency practices:

- Stay: By preventing precipitate action by creditors, such a facility is critical to the successful rescue or orderly workout of a failing business. Although in most Member States, some form of stay has been introduced, it is arguable that the precise forms of stay deployed by certain European jurisdictions do not go far enough. It is important, however, that any expansion of the stay procedure Europe-wide is cautiously assessed to make sure that it does not have any unintended or undesirable effects on relevant stakeholders, including SMEs;
- Valuation: There is currently no consistent method or platform for having stakeholders' disputes as to the basis of valuation, short of a company entering formal insolvency proceedings. A consistent and harmonised framework should be created for fast judicial resolution of valuation disputes. Any improvements in the valuation regime should, to the extent possible, include the following elements: (i) adequate information regarding valuation methods and outcomes should be made available to all stakeholders; (ii) the valuation methodology should be specified and applied consistently and (iii) the valuation should not result in any changes to the original creditor hierarchy;
- Cramdown: Creditors or shareholders with (on a proper valuation basis) no economic interest in the enterprise, should not be in a position where their "veto" could force full insolvency proceedings or delay otherwise viable restructurings. Current practice in Europe varies, however, which leads to greater uncertainty concerning stakeholders' rights and, ultimately, makes restructuring outside administration more difficult. We also note that minimum fair standards and consistent approaches to cramdowns should be implemented to avoid abuses and ensure adequate protection for affected stakeholders, and that it might be helpful to conduct impact assessments at the national level in connection with imposing such standards.
- Role of creditors: Member States should allow creditors or third parties to play a stronger role even in insolvency proceedings. Their active involvement could lead to find new solutions or

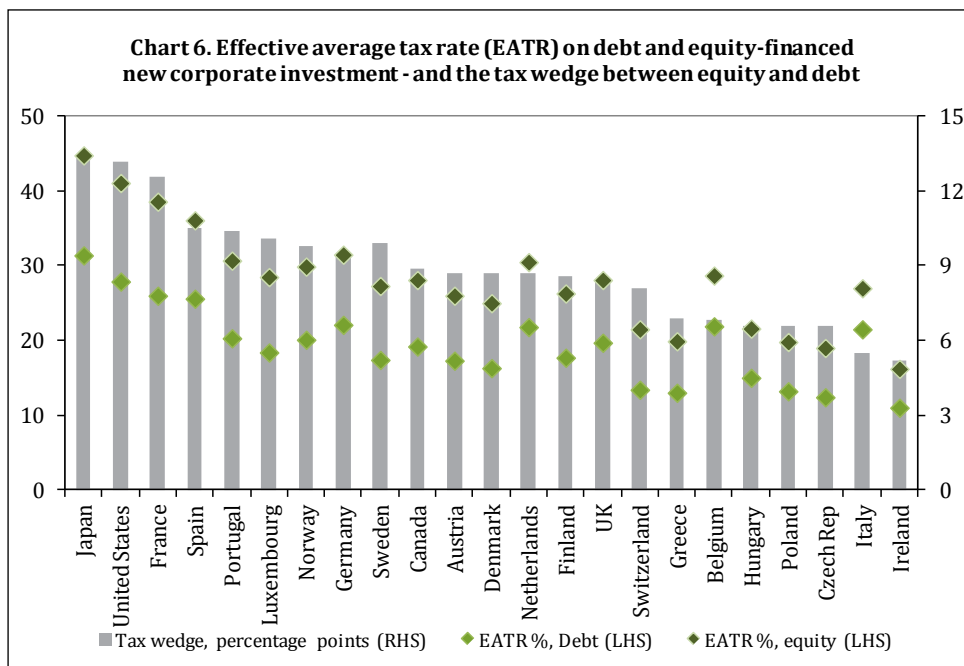
funding and make an easy distinction between companies that deserve to continue their activities and companies that need to be subject to liquidation procedures;

- **Financing:** Steps should also be taken to address the issue of ongoing funding for distressed companies, in order to ensure that a greater proportion of economically viable companies can be turned around, thereby limiting destruction of value in a restructuring. Such funding should be protected against prosecution for bankruptcy and should have priority in return in case of insolvency. Creditor approval, or in some cases court supervision of the restructuring process, would help to ensure that the terms of the interim financing (including any priority status over existing financing) are warranted and fair in the context of the particular situation.

We recognise the technical and political challenges arising from harmonisation of insolvency laws in Europe, regardless of whether a maximum or minimum harmonisation approach is pursued. AFME will therefore undertake further economic and legal analysis on this issue in order to help inform the policy debate and identify viable options for reform.

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?

Different tax treatment across Member States and between various types of financing poses an obstacle to the development of pan-European capital markets. A large majority of corporate tax systems in Europe favour financing by debt rather than equity by allowing a deduction for interest costs; there is no deduction for dividend payments in the case of equity. Chart 6 shows the effective average tax rates for debt and equity in a range of major economies, as well as the ‘wedge’ between the effective tax rate on equity and debt.



The current structure of corporate tax produces different costs of capital for raising debt and equity.⁹ It has been suggested by some that targeted deductions in respect of the equity costs of small businesses should be introduced in order to reduce the financial disincentive for small firms to increase their equity capitalisation. We would support further work in this area.

* Source: ZEW, reproduced in Bank of England Financial Stability [Paper](#) No. 33

One possibility is to see whether any lessons can be drawn from the way Italy introduced an Allowance for Corporate Equity (ACE) in 2011. The introduction of this ACE seems to have significantly reduced the cost of equity capital for firms and could stimulate the issuance of equity by SMEs. More details of the Italian ACE and its effects can be found [here](#) but the key features seem to be:

⁹ Here it should be noted such preference typically is part of a coherent approach where recipients of interest are taxed as ordinary income whereas dividend income is infrequently preferentially taxed.

- the ACE operates on an incremental and cumulative basis: the base for the ACE is equal to the net increase of equity capital;
- the ACE gives full relief for the notional return set by the Minister of Finance and can be deducted from taxable income. An excess of ACE can be carried forward indefinitely; and
- there are strict anti-avoidance provisions.

One of the downsides of an ACE that has been discussed in the literature is the loss in tax revenues. However, the specific design of the Italian ACE, which operates on an incremental basis, means that, at least for the first few years, the loss in tax revenues is in fact relatively limited. When considering the cost of capital in Italy, the introduction of an ACE has brought the cost of capital more in line with the cost of debt capital. Limiting the use of ACE to SMEs only could further reduce the potential loss in tax revenues.

A further disincentive for cross-border equity investment is the prevalence of withholding tax on dividends. The European Commission has previously consulted on various options for reform. It is appropriate, in the context of CMU, to revisit the options – including for example possibilities for simplifying the withholding tax reclaim procedures. Please also note out comments on this in response to question 32. In this context, it is also worth noting our comments on withholding taxes in the context of private placements under question 4. In addition, Member States should consider the tax treatment of certain investment vehicles which can currently, for example, not always benefit from withholding tax exemptions because they do not have a legal personality.

31. How can the EU best support the development by the market of new technologies and business models, to the benefit of integrated and efficient capital markets?

[No response.]

32. Are there other issues, not identified in this Green Paper, which in your view require action to achieve a Capital Markets Union? If so, what are they and what form could such action take?

Further integration of EU post-trade infrastructure

Integrated, low risk and low cost efficient post trade services are an indispensable part of a successful Capital Markets Union that creates growth and jobs. A comprehensive list of issues and barriers is on hand: the Giovannini Reports of 2001 and 2003¹⁰, the EGMI Report of 2011¹¹, the EPTG documentation¹² and T2S harmonization documents¹³. Both EPTG and T2S need to regularly scrutinize the resolution of issues and the effective dismantling of barriers as well as to identify new impediments.

In our assessment the following priorities should be vigorously taken at hand in the context of the CMU project:

- the successful conclusion of the process to implement private sector post trade solutions such as the Market Standards for Corporate Actions Processing¹⁴;
- the dismantling of the barriers related to withholding taxes by means of enforceable implementation of the recommendations of T-BAG¹⁵ and of the OECD Implementation Package¹⁶;

¹⁰ http://ec.europa.eu/internal_market/financial-markets/docs/clearing/first_giovannini_report_en.pdf;

http://ec.europa.eu/internal_market/financial-markets/docs/clearing/second_giovannini_report_en.pdf.

¹¹ http://ec.europa.eu/internal_market/financial-markets/docs/clearing/egmi/101011_report_en.pdf;

¹² http://ec.europa.eu/finance/financial-markets/clearing/eptg/index_en.htm;

¹³ <http://www.ecb.europa.eu/paym/t2s/governance/ag/html/hsg/index.en.html>;

¹⁴ [http://afme.eu/uploadedFiles/Content/Divisions_\(Public\)/Post-Trade/Market%20Standards%20for%20Corporate%20Actions%20Processing%20revised%202012.pdf](http://afme.eu/uploadedFiles/Content/Divisions_(Public)/Post-Trade/Market%20Standards%20for%20Corporate%20Actions%20Processing%20revised%202012.pdf);

¹⁵ http://ec.europa.eu/finance/financial-markets/docs/clearing/tbag/130524_tbag-report-2013_en.pdf;

- the removal of practical legal barriers¹⁷ as identified by our Member firms (including removal of current unintended consequences from regulation that create impediments to collateral fluidity);
- the consolidation of securities regulations by means of a single rulebook.

To deal with these priorities we recommend applying the following principles:

- to break complex issues down in smaller, prioritised parts to be resolved sequentially (e.g. securities laws, company laws, insolvency laws);
- to make use of developed solutions avoiding duplication of efforts (e.g. OECD Implementation Package for withholding tax procedures);
- to provide, where required, public sector support in favour of private sector initiatives (e.g. corporate actions processing) and vice versa (e.g. T+2, LEI).
- to test proposals wherein a 'pass' requires a significant contributions to at least two out of three of the overriding objectives:
 - improving access to financing
 - increasing investors' choice
 - augment the efficiency and effectiveness of market infrastructure, in particular cross border
 - (e.g. the proposed process for shareholder identification would not pass this test).
- to reinforce the role of EPTG in driving and coordinating the process of post trade reform.

Availability of pre- and post-trade data on a reasonable commercial basis is especially important to gain the benefits of the increased competition in the market for trading, and to contribute to an efficient Single Market for equities. Delivering a single European Consolidated Tape would, as is intended, improve the quality and consistency of post-trade data.

Promoting pan-European equity issuance and trading

We note that there is no pan-European stock exchange, which combined with the negative impact on SMEs of the contraction in equity and fixed income research, is likely to hamper growth. There could be measures developed by the Commission, together with industry input, which should make it easier for equity investors across Europe to know the location of where SMEs are listed, where summary financial data can be found, who provides research, and who will consider making markets in those shares. Also market participants could form an MTF for the purpose of trading SMEs in a specific sector from across the EU which would allow comparisons of financials and market data e.g. automobile suppliers, steel manufacturers, energy suppliers. These would entail dealing with language and currency challenges but would also represent business opportunities for the MTF operator and investment opportunities for market participants.

Possible development of an EU No Action regime

Currently there is no power at the European level similar to the facility of U.S. regulators to issue No Action letters in response to requests from market participants for relief from compliance obligations. The safe harbours created through No-Action letters may promote innovative market practices and product structures, and have produced positive developments in U.S. capital markets. The Commission should consider whether and how to incorporate such safe harbour regimes into the EU regulatory framework, and the product classes and issuer and investor categories to which they would apply. This could be particularly useful for private placements and other types of distributions.

¹⁶ http://www.oecd.org/ctp/exchange-of-tax-information/TRACE_Implementation_Package_Website.pdf;

¹⁷ The European Union still lacks a harmonised approach to readily distinguish financial instruments which belong to an investor and are held through one or more intermediaries from other financial instruments which belong to such intermediaries or other clients of them. This omission has consequences for investors, intermediaries and issuers, as the rights and obligations of each of them can vary with national laws (Barriers 3 and 13), while conflicts of laws (Barrier 15) promote uncertainty. Addressing the role of the intermediary at a Union level, as a holder of financial instruments that ultimately belong to investors, does not require the full harmonization of national property, company and insolvency rules; it can be achieved by defining a common set of outcomes in a directive. (Reference to Note on Securities Law Reform of Legal Committee, November 2014)

A broad, well functioning market for investment research

Work on capital markets union needs to recognise the essential requirement for good quality investment research on EU companies to support price formation, market liquidity and a broad investor base. The coverage of investment research in Europe should be broad and deep, across countries, sectors and company sizes, particularly for small and midcap firms.

Efficient and coherent reporting requirements

As well as considerably strengthening the regulation of banks and markets, the regulatory reform programme in Europe has introduced a wide range of reporting requirements for market participants in Europe's wholesale markets. Dealers, institutional investors and market infrastructures face a significantly increased reporting burden and in some areas supervisors do not yet have systems and practices in place to make full and effective use of the market data which is being generated. As part of the CMU initiative – or a broader review of the cumulative impact of regulation – the Commission could examine the consistency and proportionality of the new reporting requirements for the capital markets.

Annex 1: Overview of initial AFME proposals to promote CMU from AFME’s ‘An agenda for capital markets union’ (2014)

	Issuance	Investment	Market infrastructure
Industry action	<p>Securitisation: initiatives to promote securitisation, with a focus on SME loans</p> <p>Private placement: develop standard documents and practices to promote pan-EU market</p>		<p>Settlement: support implementation of T2S platform, enabling broader EU harmonisation</p>
Review existing EU measures	<p>Securitisation: streamline reporting requirements</p> <p>M&A: review implementation of the Takeovers Directive to reduce obstacles to capital flows</p> <p>Equities: review SME rules in Prospectus Directive and MiFID; reduce research blackout periods</p>	<p>Securitisation: recalibrate regulatory capital for investors (notably Solvency 2) and for bank investment; harmonise risk retention rules</p> <p>Investment research: recast MiFID proposal in order to maintain research coverage of EU firms, particularly midcaps and SMEs</p>	<p>Collateral: ensure collateral flow is not constrained by excessive restrictions (e.g. on repo markets, margin rules, insolvency laws)</p>
Action by governments or regulators	<p><i>Equities: review tax treatment of SME equity; review withholding taxes on cross-border equity</i></p> <p>Securitisation: embed and recognise a core definition of high quality securitisation</p> <p>Project finance: firm Member State support for EU Investment Plan; public sector commitment on tariffs, regulatory regime and project pipelines</p>	<p><i>Equities: review tax treatment of SME equity; withholding taxes on cross-border equity</i></p> <p>Investment research: identify incentives for brokers and research providers to widen coverage of SMEs and midcap firms</p> <p>Private placement, project finance: review legal and regulatory impediments to investment in unlisted securities and project finance deals</p>	<p>Market data: open, affordable data access from primary exchanges; develop pan-European Consolidated Tape for post-trade data</p> <p>Settlement: support implementation of T2S platform, enabling broader EU harmonisation</p>
New EU legislation	<p><i>Safe harbour regime: explore options for an EU-wide regime to develop key funding markets (e.g. private placement, loans)</i></p> <p><i>Insolvency reform: examine scope for greater harmonisation of insolvency rules in Europe</i></p>	<p><i>Safe harbour regime: explore options for an EU-wide regime to develop key funding markets (e.g. private placement, loan funds)</i></p> <p><i>Insolvency reform: examine scope for greater harmonisation of insolvency rules in Europe</i></p>	<p>Collateral: Securities Law Directive to provide certainty of cross-border share and collateral ownership</p>

Annex 2: Summary of possible actions from the AFME/BCG report 'Bridging the growth gap'

	European roadblocks	US view	Possible solution
SMEs	<ul style="list-style-type: none"> • Presence and accessibility of alternative funding avenues is underdeveloped for SMEs e.g. venture capital & angel investing • Culture of risk aversion among SMEs relative to US peers • Many European SMEs are unaware of risk assessment methodology used by lenders and their preference for more capitalised SMEs • European government funding is fragmented and difficult for SMEs to identify and access • The market for SME securitised assets is underdeveloped in Europe, with current legislation preventing increase in usage 	<ul style="list-style-type: none"> • Higher cultural risk appetite has led to better development of credible alternative funding avenues • Strong culture of utilising internal funds and personal savings/wealth for SMEs • US Small Business Association (SBA) is 'one-stop-shop' for SMEs providing access to required information in a user-friendly way • Greater consistency in definition and application process, with no data restrictions applied at across states • Established national credit rating system (FICO) • More established securitisation market 	<ul style="list-style-type: none"> • Establish a more coordinated availability and consistency of borrowing and investing information for SMEs on a pan-European basis • Increase the use of alternative financing sources e.g. VC/angel investing • Produce easy-to-understand 'how to' guides for SMEs • Better sharing and linking of information about SMEs across nations and borders • Increase awareness and incentives for SMEs to raise equity financing • Increase the size and prevalence of SME securitisation within Europe • Address tax code preference for debt over equity
Infrastructure	<ul style="list-style-type: none"> • Examples of governments having 'moved the goalposts' has increased perceived political risk and regulatory uncertainty in some European infrastructure projects • Lack of project linkages to investor demand • Public involvement and credit enhancement not perceived to focus on most needed countries/projects • Accounting and regulatory treatment of investments currently punitive to long-term infrastructure projects • Direct investing not easily accessible to smaller investors 	<ul style="list-style-type: none"> • US perceived to have high rating as a destination for infrastructure investing, based on political stability and a sound legal/insolvency regime • US municipal bond market provides access to retail investors in a tax-effective manner 	<ul style="list-style-type: none"> • Establish an EU-wide legal framework to prevent issuers from lowering tariffs after purchasers have invested • Establish a more comprehensive public review process for infrastructure to ensure planning is more strategically coordinated • Increase focus of government and Europe-wide funding to financially unviable, but socially important, projects (potentially through (partial) guarantees in order to make them viable) • Produce easy-to-understand guide to infrastructure finance through banks and capital markets • Amend accounting and regulatory treatment of infrastructure projects to increase attractiveness for investors • Increase use of structures which enable retail investors to participate better in illiquid financings

Private Placements	<ul style="list-style-type: none"> • A lack of standardisation in Private Placement deals and documentation • Rating and regulatory treatment of Private Placement deals differs across nations, reducing desire to invest via Private Placements • Poor visibility of Private Placements conducted in Europe, with many investors unaware of this option to raise funds in Europe 	<ul style="list-style-type: none"> • US Private Placement market well established and viewed globally as 'go-to' location • Standardised documentation exists in US, e.g. Model Note Purchase Agreement • Common legal framework used in assessment and application of deals with 'safe harbour' of SEC exemption through Regulation D • All deals required NAIC rating through the Securities Valuation Office (SVO) 	<ul style="list-style-type: none"> • Promote and increase awareness of Private Placements as a funding avenue, and their potential benefits • Establish standardised documentation for European Private Placement deals • Increase consistency and clarity of accounting procedures and regulatory and tax treatment of investment
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Specific SME findings:

	European roadblocks	US view	Possible actions
Evaluation / rating	<ul style="list-style-type: none"> • Lack of high-quality and easily accessible information on SMEs makes due diligence difficult • Lack of consistently applied SME definitions within and across countries and industries • Evaluation often involves qualitative factors that are not easy to explain and share • Economics of rating/scoring SMEs may be prohibitive 	<ul style="list-style-type: none"> • Limited availability of scorings and ratings for SMEs • Greater consistency in definition and application process, with no data restrictions applied across states • Established, well-regarded and national credit rating system (FICO) score • Increasing use of 'Big Data' among newer firms to include non-financial/public data to review financing applications • SBA role in providing financing enables greater linkage with other financial data 	<ul style="list-style-type: none"> • Increase use of mandatory reporting for key financial information in public records such as developed in France and Italy • Ensure greater access to, and linkage with, existing data records on file to improve general SME quality of information • Extend data sharing agreements with supra-national agencies across borders to enable higher quality assessment • Explore the use of consistent, industry-based definitions for SMEs
Locating funding avenues	<ul style="list-style-type: none"> • Alternative sources of financing such as VC and angel investing are underdeveloped in Europe • Applying to multiple lenders risks tarnishing credit record through multiple failed applications 	<ul style="list-style-type: none"> • Strong culture of internal funds and personal savings/wealth for SMEs • Significantly larger and more developed VC and angel investing market in US (vs EU) • US Small Business Association (SBA) is 'one-stop-shop' for SMEs, providing access to required information in a user-friendly way 	<ul style="list-style-type: none"> • Create comprehensive 'how to' financing guides for SMEs to use as their source • Merge existing initiatives and further develop a single European SME entity, along the lines of US SBA • Facilitate VC investing through promotion of SME equity initiatives e.g. US SBA-led SBIC initiative

		<ul style="list-style-type: none"> • Higher cultural risk appetite has led to better development of credible alternative avenues 	
SME risk	<ul style="list-style-type: none"> • SMEs have strong preference for debt over equity • High debt ratios are potentially unattractive to lenders • SMEs unaware of decision process and need for more equity • SMEs receive insufficient feedback on their application in the event that it is unsuccessful • Limited risk taking across borders 	<ul style="list-style-type: none"> • Culture of personal savings/ wealth makes for more attractive capital structure • Higher equity on balance sheet / use of VC funds • More information readily available on loan decisions • SBA provides significant information resources to SMEs 	<ul style="list-style-type: none"> • Promote a culture of greater equity involvement through use of personal savings / wealth • Provide feedback to SMEs through better application of CRR 431 (4) • Explore ways to incentivise sharing of internal rating systems towards harmonisation profitable to banks
Government support	<ul style="list-style-type: none"> • Government support programmes often difficult to find/hard to obtain and regularly require use of (state) bank to apply for 	<ul style="list-style-type: none"> • SBA plays a prominent role as gatekeeper to government subsidies and guarantees • Many subsidies/loans provided without need for bank 	<ul style="list-style-type: none"> • Mandate a single entity as the gatekeeper of European subsidies / guarantees • Explore alternative to banks as provider of subsidies / guarantees
Use of securitisation	<ul style="list-style-type: none"> • Originate-to-distribute model of financing is less prevalent in Europe • Solvency II applies an unduly high capital charge for securitised assets, dissuading investment 	<ul style="list-style-type: none"> • Originate-to-distribute model more established in US • Better capabilities among non-bank investors to assess risk 	<ul style="list-style-type: none"> • Further develop securitisation market regulatory framework • Promote partnerships between banks and investors with former conducting diligence and co-investing with latter

Specific Infrastructure findings:

	European roadblocks	US view	Possible actions
Political and legal risk	<ul style="list-style-type: none"> • Governments have ‘moved the goal posts’ on commitments made with investors, amending project terms retrospectively • Investors are uncertain of the security of assets/potential recovery 	<ul style="list-style-type: none"> • US perceived to be an attractive destination for infrastructure investing, based on political stability and a sound legal/insolvency regime 	<ul style="list-style-type: none"> • Establish clear rules on contractual agreements to ensure all parties agree on the nature of the deal • Establish EU legal framework to ‘grandfather’ investments already made (reduce policy and rules volatility)
Credit enhancements & viability	<ul style="list-style-type: none"> • Necessary, but less financially attractive projects not being funded • 70% of investors focus more on risk-averse opportunities, i.e. brownfield/operational/refi 	<ul style="list-style-type: none"> • Local and state funding contribute c.75% of infrastructure spending • Cuts in state budgets have seen falls in spending over past years • Limited but growing use of 	<ul style="list-style-type: none"> • Focus efforts on turning important, but less viable projects into viable projects; to be achieved via guarantees or first lien loss cover

	<p>ancing stages</p> <ul style="list-style-type: none"> • 75% of EIB funding concentrated in six countries • Projects not viable due to unsuitable economics are not funded, e.g. no demand risk taken by government 	<p>PPP (P3) initiatives to better involve private sector funds</p>	
Accounting and regulation	<ul style="list-style-type: none"> • Poor definition of infrastructure as an asset class, leading to disproportionate regulatory treatment • Fair value accounting treatment (IFRS 4 and 9) creating excessive volatility on insurers' books • Capital charges under Solvency II punitive given infrastructure risk/return profile 	<ul style="list-style-type: none"> • US insurance companies are not subject to the same regulations as their EU counterparts 	<ul style="list-style-type: none"> • Develop pan-European definition of infrastructure as an asset class, reflecting its unique risk/return features and distinguishing it from other asset classes • Amend IFRS accounting rules for treatment of specific long-term infrastructure investments • Ensure Solvency II treats infrastructure as a separate asset class; ensure capital charges reflect risk/return
Demand linkages	<ul style="list-style-type: none"> • Lack of project linkages to demand and growth framework • Europe has a significant infrastructure spending gap varying by country and project type • Investors lack a visible project pipeline, making it difficult to plan for long-term investments • Heterogeneity in procurement process across countries creates unpredictability 	<ul style="list-style-type: none"> • Limited visible project pipeline • Less private involvement in projects reduces pressure for high-quality and easily available market data 	<ul style="list-style-type: none"> • Provide a consistent, detailed and visible project pipeline at national and EU level • Establish a more comprehensive infrastructure framework • Leverage best-in-class examples, e.g. UK National Infrastructure Planning portal, Netherlands Investment Institution (NII)
Investor access	<ul style="list-style-type: none"> • Direct investment not possible for smaller funds/individuals due to sophisticated and local knowledge requirement and large ticket size • Limited usage to date of Project 2020 Bond 	<ul style="list-style-type: none"> • US municipal bond market provides access to retail investors in a tax effective manner and accounts for majority of US spend • PPP funds offer alternative to state and local funding and are rising in prominence 	<ul style="list-style-type: none"> • Facilitate pooled investments by pension funds at pan-European level to achieve scale and reduce costs