Finance for Europe

Association for Financial Markets in Europe

AFME Questionnaire Response

Next CMU High-Level Group

August 2019

AFME thanks the Next CMU HLG for its engagement with stakeholders and the opportunity to provide written feedback on the next phase of the CMU project.

We have sought to provide succinct responses to the questions raised. In the answer to question 9, we have taken the opportunity to summarise our main views and the recommendations for CMU discussed in this submission. We therefore draw the HLG's attention to question 9 as a summary of the response to the questionnaire.

AFME stands ready to continue to engage with the HLG and provide further feedback on our views.

1. **Could you provide us with an analysis of deep trends and developments (such as digital and artificial intelligence transformation, aging, climate change, UK's decision to leave the EU) relevant for the future of the Capital Markets Union? What is the impact of these trends on capital markets in Europe, its products and services? (Please provide data).**

We believe the following broad trends and long-term challenges are relevant to the EU economy and future evolution of the CMU project:

1) the need to support long-term growth and productivity in view of the challenges noted below and growing competition from other jurisdictions;
2) the need to continue to support financial stability and the resilience of the EU financial system to avoid a future crisis in the EU/euro area of the scale and magnitude of the latest crisis;
3) the need to prepare the EU financial system to meet a demographic challenge which has the potential to affect pension systems and growth prospects[1];
4) the need to manage a transition to a low-carbon economy and close a yearly investment gap of almost EUR 180 billion to achieve EU climate and energy targets by 2030[2];
5) the need to remain at the cutting edge of technological innovation, embrace the opportunities digitalisation can bring to the single market and prepare EU economies for an environment where new technologies will drive changes across society and the workforce, introducing varying levels of disruption and increasing competition between countries;
6) the need to manage the implications of the United Kingdom's prospective withdrawal from the EU, potentially resulting in the EU's largest wholesale financial centre becoming a third country jurisdiction outside the single market.

[1] As stated by Vice-President Dombrovskis in April 2019: "The EU's demographic challenge can be summed up in one simple statistic: today there's one pensioner for every four people of working age. But in 50 years, this ratio will be about one to two." https://ec.europa.eu/commission/commissioners/2014-2019/dombrovskis/announcements/capital-market-union-keynote-speech-impact-pepp-eu-capital-markets-and-sustainable-pensions-income_en

[2] European Commission Sustainable Finance Action Plan, March 2018.

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We consider the CMU project to be vital to contributing to addressing these long-term trends and challenges by:

1) promoting the availability of diverse and efficient financing mechanisms for businesses of all sizes, with particular focus on enterprises with high growth potential, through capital market ecosystems;
2) supporting European integration and financial stability by providing diversification, shock-absorption and risk-sharing channels through the capital markets;
3) providing citizens and organisations with a diversity of assets for investment and saving, contributing to wealth creation and the provision of retirement income;
4) financing the transition to a more sustainable economy through a strong and diversified financial system with the capacity to support sustainable investments;
5) providing financing for higher risk investments and frontier technologies as these types of investments are essential to support future economic growth and job creation;
6) In response to Brexit, continuing to develop the size, capacity and connectivity of the EU27 financial system to provide long-term investment and financing to the economy through the capital markets, while maintaining continued close connectivity with international markets and two-way capital flows.

In relation to the HLG's request for data, we would like to draw to the attention of the HLG the following publications:

- AFME's report *Capital Markets Union – Measuring Progress and Planning for Success* (September 2018), a joint publication with nine trade associations and international organisations, which tracks progress on the development of EU capital markets and provides detailed data on the above trends and specific products and services. The report includes the first country-by-country comparison of individual EU Member State progress against the CMU's objectives. The report is available here. A second edition will be published in October 2019.
- The AFME and New Financial report *The Benefits of Capital Markets to High Potential EU Economies* (November 2016) which features a comprehensive analysis of capital markets in the Central and Eastern Europe (CEE) Member States. The report argues that deeper capital markets in the CEE region could unlock more than €200 billion in long-term capital, deliver more than €40 billion a year in extra funding for companies and boost growth across the region. The report is available here.
- AFME and the Boston Consulting Group's report "Bridging to Brexit: Insights from European SMEs, Corporates and Investors" (July 2017), which provides survey-related data and research on the impact to real economy users as well as financial institutions, as highlighted in the Executive Summary and table on page 30. The report is available here.

We refer to other AFME publications which contain analysis and data on EU capital markets in other sections of this submission.

2. **From a forward-looking perspective, how do you view strengths and weaknesses of the Capital Market Union in its current state and when made of 27 Member States? From the perspective of companies (all sizes and at each stage of their growth), consumers, (wholesale and retail) investors and other market players? How do you view the role of EU's and national supervisors? How does Brexit change the prospect for a financial integration in the EU?**

EU 27 CMU Strengths

1) The single market with its significant potential to deliver competition, choice and economies of scale in products and services that enable capital markets to thrive: however, it has not been utilised to its full potential in the field of financial services. Capital markets in the EU remain fragmented and under-sized. Roughly 70% of funding for EU non-financial counterparties (NFCs) is in the form of bank loans with the remaining 30% from market finance. In the US this is reversed and around 70% of finance for NFCs has come from capital markets instruments and the remainder has been lending.
2) EU support for sustainable finance and the transition to a low-carbon economy, which has contributed to the EU's global leadership position in this area.
3) Large pools of household savings in many Member States; however, these are often invested in conservative instruments like deposits and not deployed in the capital markets. The average EU household accumulates savings at a higher rate than in other jurisdictions (net savings rate of c. 6%, compared with 3.3% in the US, and 2.6% in Japan), but invests 35% of those savings in conservative instruments like cash or deposits, while in the US households allocate only 15% in such instruments[3].
4) The Economic and Monetary Union (EMU): though not all Member States participate in the euro, the existence of a common currency in several large EU 27 financial centres is a CMU strength, the potential of which could be further developed;
5) Presence of global financial market infrastructure; the EU27 has world-leading market infrastructure companies, including SWIFT and the two international central securities depositories;
6) Availability of technical skills, knowledge and expertise;
7) Diversity across the EU27, when properly managed, is a major strength, as it creates the possibility for new and innovative business models, as well as stronger and richer ecosystems.

EU 27 CMU Weaknesses

1) Fragmentation: despite progress in removing barriers in the single market, there remain many instances of harmful regulatory and structural fragmentation that undermine the development of EU capital markets. Notable examples include: national ring-fencing requirements in the banking sector that inhibit the free flow of capital and liquidity[4], barriers in securities markets and the post trade area[5] and divergent insolvency frameworks[6]. Undue national discretions in various regulations (MIFID/R, prudential regimes and others) undermine the achievement of a single EU capital market;
2) Regulatory frameworks that result in inefficiencies and undue complexity in the EU's securities market structure (discussed in question 8) and sectoral frameworks. The new framework for simple, transparent and standardised (STS) securitisation is a case in point: it features 100 separate requirements to meet the STS standard, continuing conservative prudential treatment for both credit

[3] See AFME "Capital Markets Union – Measuring progress and planning for success", September 2018, p. 14.
[4] See the following AFME publications: *The European Banking System: Tackling the Challenges, Realising the Opportunities - Achievements and Next Steps for the New EU Legislative Cycle* (July 2019) here and *Creating an Integrated Financing Union for the EU – The important role of Banking and Capital Markets Unions* (May 2019) here. The "ring-fencing" approach, which requires cross-border banks to hold minimum amounts of local capital and liquidity, imposes considerable costs on the economy and weakens financial stability.
[5] See AFME's report *A Roadmap for Integrated, Safe and Efficient Post Trade Services in Europe - An essential part of successful and sustainable European Capital Markets* (May 2018). Available here.
[6] See AFME's report *Potential economic gains from reforming insolvency law in Europe* (February 2016). Available here.

institutions (under CRR) and insurance companies (under Solvency II), complex and challenging new reporting and due diligence requirements. The current framework risks entrenching disincentives to securitise and undermining the distribution of assets to end investors and the ability of credit institutions to fund and manage their balance sheets;

3) Under-sized EU27 pension fund sector and pools of investible capital[7]: Differences in regulatory frameworks for retail investment and pension systems among Member States partially account for this. Pension funds are a good and stable source of long term funds to finance a range of investments as discussed in questions 3 and 5;

4) Low capital markets participation in some Member States, with sizeable differences across EU27, as found in the analysis by New Financial and GFMA from January 2019. Notably, the report finds that, in the EU27, France ranks first in terms of size of its capital markets, while Luxembourg has the deepest capital markets relative to its GDP (followed by Sweden and the Netherlands).[8]

5) Unhelpful local taxation regimes and practices: this weakness is manifested in tax systems that (a) favour short term investment over long term, (b) favour debt over equity, and (c) tax cross-border investment more heavily than domestic investment. In addition, if a potential new European tax on financial transactions (FTT) is introduced, we believe this development would also weaken the CMU[9].

6) Home Member State bias in part driven by factors such as differences in infrastructure, lack of information, taxation practices and regulatory complexity.

How do you view the role of EU and national supervisors?

Following the recently undertaken review of the funding and governance of the EU supervisory authorities (with legislation adopted in 2019), we believe that the focus in the coming period should be on continuing to advance supervisory convergence in securities markets. Targeted efforts should continue towards refining and improving the consistency and coherence of approaches across the EU supervisory authorities. A more inclusive and transparent approach to supervisory convergence, including mechanisms for consultation with market participants, would also help to ensure that harmonisation of supervisory practices is better understood, and undue outcomes are minimised. Where the increased convergence powers of the ESAs warrant further enhancements, a targeted review should also be considered as a second step.

How does Brexit change the prospect for a financial integration in the EU?

It is premature to provide a full response to this question considering current uncertainty concerning the future EU-UK relationship and the type of Brexit that will occur on day one and beyond, as well as ongoing financial sector preparations for Brexit. AFME has recently compiled a detailed list of disruptions that Brexit may cause to specific financial market sectors in a report that is available here[10].

As a general observation, AFME strongly believes that Brexit makes the case for the CMU project and the fulfilment of its objectives more important and urgent for the EU27 for reasons discussed throughout this submission.

In question 8 we discuss how relationships with financial markets in third countries – including the UK in the future – should be strategically shaped.

[7] In the United States, for example, 30% of household financial assets are saved on pension funds (e.g. retirement funds like employer-sponsored 401K retirement accounts) compared with a median of 14% in the EU where some countries' private pension systems are comparatively underdeveloped.
[8] New Financial and GFMA, *The New Financial Global Capital Markets Growth Index* (January 2019) available here.
[9] Discussions on this proposal continue among participating Member States at the time of writing. Though the proposal remains under consideration, we believe it merits being mentioned in this submission given its potential to negatively impact the CMU. In our view, not only would an FTT make financing more expensive for European corporates due to increased transaction costs and reduced market liquidity, it would have a direct negative impact on end-users who would ultimately bear its burden, and it would significantly increase the complexity of cross-border investment (as the scope of the tax, and the collecting and reporting mechanism, may differ by participating Member State). A new tax on equity instruments would be a negative signal at a time when the EU should be creating incentives to promote equity finance and cross-border investment.
[10] See AFME *Brexit: Remaining no-deal risks in financial services*, July 2019.

3. **Is European SME's financing satisfactory beyond bank finance? Why is access to capital markets (debt and equity) so difficult? Are there relevant differences between national financial markets in this respect? How could access to market financing facilities be improved for all size companies in each stage of their growth?**

The EU's level of SME financing beyond bank finance is currently unsatisfactory in that it represents a fractional amount of financing provided to these businesses[11]. The EU needs more equity capital to generate economic growth and employment. Equity risk capital is particularly suitable for early-stage enterprises with a limited or no track record but above-average growth prospects. Established companies also benefit from equity capital for example to expand into new markets or build new production sites, or to start a completely new business with uncertain outcomes. The gap in equity risk capital in the EU has been analysed in AFME's report *The Shortage of Risk Capital in Europe* (March 2017), with the support of 12 other European associations. The report outlines the existing sources of risk capital for growing businesses, why shortages occur, and highlights recommendations for European and national policymakers to improve its supply. The report is available here.

Changes to regulation are needed to encourage companies to seek equity risk capital and to incentivise institutional investors and high net-worth individuals to invest, in particular, in unlisted SMEs and venture capital funds.

Recommendations on the IPO regulatory environment (particularly for SMEs)

1) Harmonise relevant regulatory standards: such as the liability regime across the EU for the marketing offerings of issuers and investment banks, and the rules governing the ability of issuers to incorporate information into a prospectus by reference.
2) Improve the efficiency of the IPO process in the EU: by creating a central EU filing system for offering documentation to facilitate the flow of information about companies to potential investors and other participants, and by permitting issuers to submit prospectuses to competent authorities online.
3) Harmonise (and reduce) the free float requirements across European exchanges: to allow comparison between venues based on the availability of investors/liquidity rather than regulatory differences.

Recommendations on the pre-IPO environment

1) Improve the environment for business angel investment: create a passport regime for business angel investors, as well as encouraging Member States to review relevant tax and fiscal frameworks.
2) Create a category of sophisticated investors: to incentivise high net worth individuals to invest directly in venture capital funds. We would suggest amending MiFID 2/R to ensure that "sophisticated" investors are recognised as a specific investor category.

Supporting the development of long-term investment

Long-term investors are indispensable to the creation of an ecosystem that fosters the development of innovative companies. Because of the duration of their liabilities, pension funds are perfect candidates to bolster the investment in equity across Europe. While the creation of the Pan-European Personal Pension Product (PEPP) was a step in the right direction, the EU should promote further development of pension funds aside from traditional national retirement schemes. Our recommendation is to work towards simple, fair and efficient tax systems and to eliminate harmful tax biases (e.g. any undue biases that make long term less attractive). It is also crucially important to ensure that the PEPP technical rules are open to a range of pension

[11] The absolute amount of risk capital in Europe is significantly below that of the US. The annual amount of risk capital in the US has more than doubled since the financial crisis, from €58.9bn in 2007 to €132.4bn in 2017. While in Europe the amount has increased from €12bn in 2007 to €22.7bn in 2017. This makes US risk capital 5.8 times the amount in Europe in 2017. Compared to the size of the respective economies, US pre-IPO risk capital represents 0.8% of GDP vs. 0.15% of GDP in the EU. Source: AFME CMU KPI 2018 Report.

providers and offer flexibility to savers that have a diversity of retirement needs. Furthermore, it would be beneficial at a later point to review the functioning of the European Long Term Investment Fund Regulation and the extent to which it has achieved its objectives of channelling funding into infrastructure, SMEs and other long-term financing projects. Policy-makers should give investors incentives to allocate funds to both unlisted and listed equity. Moreover, current regulations should be adapted to include a larger spectrum of investors including through the definition of professional investors in MiFID 2/R.

4. **Home bias in investments still characterizes the EU landscape. What would you say are the main issues limiting cross border flows and what steps could be taken to encourage more cross-border activity?**

Measures to encourage cross border capital flows

Focusing on regulatory actions that can be tackled at EU level, there are still important obstacles to financial markets consolidation in the EU27. To improve efficiency and connectivity in EU securities markets, AFME recommends:

1) Continuing to develop and actively promote common EU products, asset classes and frameworks in different areas – recent examples are the PEPP framework in the field of pension products and the STS framework in relation to securitisation (see question 7). It is crucial that such products are designed with a view to making them attractive to market participants; EU frameworks that feature insufficient incentives and benefits to their targeted users, or are unduly burdensome, are unlikely to succeed;
2) Where harmonisation of legal frameworks is difficult – for example, corporate insolvency and securities laws – supporting the development and promotion of "29th regime" type frameworks which market participants seeking to undertake cross border activities could voluntarily use. Another beneficial approach could be for Member States to take the initiative to harmonise specific legal frameworks using the enhanced cooperation procedure;
3) Addressing the impediments to an integrated post trade landscape, by dismantling the barriers identified by the European Post Trade Forum in 2017, such as inefficient withholding tax collection procedures;
4) Establishing a central source of consolidated trading data (a "consolidated tape") which, in our view, would represent an opportunity to provide greater transparency to market participants, promote integration and facilitate market access
5) Building a Digital Single Market to maximise the opportunities provided by new technologies to encourage cross-border capital flows.
6) Addressing fragmentation in the EU banking system – please refer to the heading below.

Fragmentation in the EU banking system - The need for an integrated and functioning single market for banks

In discussing the main issues limiting cross border flows, it is vital to emphasise the importance of an integrated and functioning single market for banks, together with an ambitious CMU. In recent years banks have stopped developing plans for expanding cross-border operations. In many cases, they have instead retrenched into national markets, as the business case for cross-border banking has weakened, partly as a result of the many national barriers.

As a result, Europe has remained vulnerable to local/asymmetric economic shocks. In fact, achieving deep integration in credit and financial markets would be the most effective way to absorb such shocks, and therefore prevent and reduce risks. This is what is called "private" risk-sharing, where risks can be shared (and through such sharing, reduced) without the need for any public money.

As explained in more detail recent AFME publications[12], the comparison with other integrated areas (e.g. the United States) shows that in the EU an unnecessarily high proportion of economic shocks are not smoothed or absorbed via risk-sharing channels.

[12] See the following AFME publications: *The European Banking System: Tackling the Challenges, Realising the Opportunities - Achievements and Next Steps for the New EU Legislative Cycle* (July 2019) here and *Creating an Integrated Financing Union for the EU – The important role of Banking and Capital Markets Unions* (May 2019) here.

Fragmentation, through its negative impact on the efficient allocation of bank resources and by disincentivising cross-border consolidation, is also an important contributing factor to banks' continuing low level of profitability. This, amongst other things, manifests itself in low levels of retained capital restricting their capacity to support the many services they provide in the capital markets in areas such as issuance, underwriting, trading and risk management to the benefit of governments/public authorities, businesses and investors of all sizes.

For these reasons, the Banking Union and Capital Markets Union projects are intrinsically linked and mutually reinforcing. A future review of the CRD/CRR framework represents an opportunity to address instances of harmful fragmentation. Our recommendations include:

1) Allowing cross-border banks need to manage their capital and liquidity at a consolidated level and to achieve diversification and economies of scale;
2) Completing the Banking Union, focusing on considering it as a single jurisdiction in terms of prudential requirements, achieving effective depositor protection, and, in the context of broader considerations, a solution for a European safe asset.

5. **Are there obstacles for households to invest their long-term savings into capital market instruments (directly or through dedicated financial vehicles, like investment firms, pension funds, insurers ...)? What can be done to overcome these impediments? Who should take such measures?**

Households need the right choice of investment products, tailored to a diversity of needs and risk appetites, as well as attractive, transparent, cost-effective and tax-efficient frameworks to channel their savings into productive investments in the capital markets. Encouraging more retail investor participation in EU capital markets is one of the keys to unlocking the true potential of CMU and delivering direct value to citizens and the economy.

The need for an EU retail investment strategy

The EU should consider establishing a comprehensive retail investment strategy that contemplates a variety of actions focusing on the availability of appropriate products for retail investors and incentives to invest in them. Consideration could be given to the following: roll-out of auto-enrolment pension schemes; exploring the concept of an EU Investment Savings Account so that retail investors can invest in shares and bonds in a tax-efficient way; and measures to enable retail participation in a broader range of products, such as loan fund products. The strategy should be supported by Member States and seek to include commitments to facilitate national-level measures that would promote greater access to retail products.

Tackling cross-border obstacles for retail investors – considering measures such as those mentioned in question 4 – should be part of the strategy. The strategy should consider the extent to which there are existing national barriers to the marketing of retail investment products across borders and seek to encourage similarly open approaches by Member States for the benefit of their citizens.

An additional aspect to consider is the importance of financial education – this is relevant to retail investors, entrepreneurs and other users of financial services. The EU could work together with Member States to promote long term measures aimed at improving the level of understanding in the overall EU population of financial planning, investment practices and finance concepts.

Reforming pensions systems

The recently adopted Pan-European Pension Product (PEPP) initiative should contribute towards removing cross-border barriers and help consolidate the asset management industry in the EU. The accompanying level 2 measures and its tax treatment will be crucial in ensuring that the PEPP instrument is attractive for savers and providers. For instance, it is essential that the PEPP regime promotes a range of risk mitigation strategies for pension products, fee caps in the default options are not set so low as to exclude certain valid strategies, and that disclosures are clear and comprehensible for pension savers.

Beyond the PEPP, it is important to provide the right incentives at the national level. Member States should undertake reforms of pensions systems with a view to:

- Addressing statutory limits on portfolio allocations of institutional investors setting minimum or maximum restrictions on investing in certain asset classes;
- Addressing regulations requiring the provision of a capital guarantee which can discourage investment and reduce long-term risk-adjusted returns of private pensions assets;
- Addressing overly conservative regimes that reduce long-term returns, discourage the development of alternative sources of financing (e.g. foreign assets, venture capital funds, infrastructure or private equity) , favour investment in low-yield instruments or limit the allocation of funds in alternative assets to very restrictive levels;
- Providing favourable tax treatments to retirement accounts, including flexible limits on tax relief on retirement savings are also relevant considerations. Retirement savings (and more generally long-term savings) can be influenced by the fiscal regime applied to them, both in terms of income tax relief and capital gains tax treatment.

6. **Digital transformation and artificial intelligence are both causes for disruption and opportunities for innovation. How should the Capital Markets Union develop to provide a welcoming environment for start-ups and scale-ups? and in the financial sector for FinTech? How to develop a dynamic ecosystem of financial innovation? Do you find the "sandboxes" and related initiatives useful? How can new technology support an efficient and sustainable functioning of Europe's capital markets? What are best practices?**

Financial technology (FinTech) is transforming capital markets via the introduction of new technologies and services improving efficiency, reducing overheads and helping firms create or maintain a competitive advantage. AFME believes, new technologies will drive changes across global capital markets, impacting various areas of the banking sector value chain[13], such as across finance functions, the workforce, and industry partnerships. Success will depend on the ability to achieve the long-term benefits from new technologies by prioritising investment, collaborating where possible, building a culture of innovation and developing the skills needed; all while managing the potential risks this may introduce for resilience and cybersecurity.

A strong digitalisation agenda is therefore essential for the EU to remain competitive and at the forefront of innovation in the global landscape. Digitalisation could be an enabler for European integration and the CMU by reducing barriers to cross-border business and transactions costs. Clarity on regulatory requirements and facilitating venture capital will benefit the development of FinTech in Europe. This could be accelerated by means of harmonising regulation, adopting universal standards, increasing interoperability between solutions and promoting risk capital in Europe.

Analysis by AFME & PWC has found that where banks, innovators, policymakers and regulators were engaged in collaborative dialogue on the impact of new technologies, there was increased pragmatism and optimism on the delivery of future benefits to the industry[14].

Furthermore, regulatory sandboxes and innovation hubs can play an important role in building awareness, educating on the impact and opportunities of new technologies, and testing in a controlled environment use cases, where regulators, firms and third-party providers can collaborate, learn and share knowledge on new technologies. Further, these activities provide a dedicated point of contact for firms to raise enquiries with competent authorities on FinTech-related issues and to seek guidance on regulatory and supervisory expectations. In this regard, AFME welcomes the ESAS joint report "Regulatory Sandboxes and Innovation Hubs".[15]

Overall, AFME identified four new technologies that have the potential to transform banks and the industry: Data & Analytics, Cloud Computing, Artificial Intelligence (AI) and Distributed Ledger Technology (DLT). These technologies can offer solutions in several capital market segments and functions, such as equity issuance, corporate governance, asset management, investment intermediation, product distribution and post trade market infrastructure including securities custody services. We propose the following actions in order to harness their potential:

1) Review barriers to the adoption of cloud computing: AFME believes that cloud computing is a foundational technology for EU competitiveness. We believe further work is needed to incentivise the adoption of this technology across and allow the industry to reap its full benefits.
2) Address considerations on ethics and trust in Artificial Intelligence: AI capabilities are not new to financial services and firms have mature codes of conduct and controls in place to manage their

[13] Source: GFMA & PWC: Technology and Innovation in Global Capital Markets (March 2019): see Figure 9 "*Where do you expect to see a positive impact of new technologies across the bank functional value-chain*" (page 23)

[14] For instance, the set up of an expert group on Regulatory Obstacles to Financial Innovation, introduced by the European Commission in Q1 2018, is a welcomed initiative to address this need (Source: AFME & PWC: Technology and Innovation in Europe's Capital Markets (September 2018). Other welcomed initiatives include (non-exhaustive list provided): the European Commission Digital Single Market Cloud Stakeholder Group (Source: https://ec.europa.eu/digital-single-market/en/news/dsm-cloud-stakeholder-meeting-0); the European Union Blockchain Observatory and Forum (Source: https://www.eublockchainforum.eu/); and the European Banking Authority Fintech Knowledge Hub (Source: https://eba.europa.eu/financial-innovation-and-fintech/fintech-knowledge-hub).

responsibility to protect and treat clients fairly. However, we have identified elements unique to AI as a technology that merit further consideration. We group these into two themes: data input and design (e.g. AI acting on data set bias); and understanding and control (e.g. a lack of transparency of AI-related decisions).

3) Work towards a digital assets (e.g. cryptoassets) taxonomy: Digital assets (e.g. cryptoassets) and tokenisation in general, can bring benefits to market participants. But it is key that authorities effectively identify, assess and address risks arising from this emerging activity in a coordinated fashion, including potential risks to consumer protection and market integrity. AFME believes that a globally consistent taxonomy is required to develop a common framework for analysis and a harmonised regulatory framework for the treatment of cryptoassets. We also believe that it is urgent to undertake a deep analysis of the applicability of EU existing regulations, and their potential limitations, in regard to the treatment of cryptoassets.

Balancing new technology, security and operational resilience will be a key priority in demonstrating the suitability of future technology change to both internal and external stakeholders. We propose the following actions in order to ensure the appropriate use of emerging technology:

1) Ensure a regulatory framework that is both outcome-based, rather than prescriptive, and proportionate/principles-based, supporting the aim of balancing security and innovation while maintaining a level-playing field, in financial market regulation. Fostering a collaborative environment between policy makers and market participants, such as Regulatory Sandboxes and Innovation Hubs, can support achieving this goal.
2) Ensure an efficient and integrated securities market structure, underpinned by strong operational resilience standards and efficiency, geared towards servicing end-users.
3) Develop a pan-European cyber-crisis governance model between the public and private sector which is consistent with global practices and provides clarity on decision-making in response to a large scale cyber-crisis.
4) Ensure a level playing field in the Digital Single Market, among other things, by fostering a coordinated and pragmatic application of outsourcing guidelines and ensuring that an appropriate regulatory perimeter and requirements are applied equally to all market participants, including Big Tech firms in line with the principle “same activity, same risk, same regulation and supervision”.

7. **How should capital markets play a role about climate change and aging? How can this be organized in such a way that capital markets grow themselves as well and become more stable? How to bolster the Union's capacity to finance its sustainable growth and job creation?**

It is very positive that there is wide political support in the EU towards the promotion of sustainable finance, which has contributed to positioning the EU at the forefront of international efforts in this area[16].

The EU should continue to build on its global leadership on sustainable finance through the completion of the EU taxonomy to classify environmentally sustainable economic activities, followed by an effort to encourage its adoption by other jurisdictions or international convergence while, at the same time, allowing for some flexibility that takes into consideration the different situations and speeds among countries. AFME recommends:

1) Achieving a practical EU-wide taxonomy, starting with investment management and investment advice activities, ensuring it is progressive, flexible and proportionate, and promote gradual convergence at the global level;
2) Enhancing corporate reporting and disclosures of climate-related information as well as environmental, social and governance (ESG) information more broadly, to end investors to facilitate informed decision making by the users of such information and encourage sustainable investment.
3) Establishing a common definition of green securitisation to facilitate the development of a green securitisation market in Europe.

At an international level, sustainable finance is a growing field of finance and several jurisdictions are engaged in putting in place standards and regulatory frameworks. Companies with cross-border operations could have difficulty navigating an environment with a patchwork of different jurisdictional regimes, which in turn may disincentivise or slow down some companies in their transition towards low-carbon standards and business models. For this reason, we stress the importance of EU leadership in promoting the sustainable finance agenda at global level and a progressive alignment of international standards in this area.

[16] The EU issues a significantly higher percentage of sustainable assets compared to other jurisdictions: during 2018, issuance volume of green, social and sustainable securities amounted to €69 bn in the EU, representing 43% of the global total. Source: AFME CMU KPI 2019 Report (Unreleased).

8. **What are crucial elements for a well-functioning deep and liquid financial market within the EU27? How should the EU27 Capital Markets Union be structured to be a globally competitive and attractive financial market? How should the relations with financial markets in third countries be strategically shaped?**

   We address each of these questions individually in the paragraphs below.

What are crucial elements for a well-functioning deep and liquid financial market within the EU27?

We believe the following are crucial elements to foster a deep and liquid financial market within the EU 27:

1) Efficient and integrated pan-EU markets for issuance of financial instruments (the supply side): As discussed in question 3 and elsewhere, particular focus should be given to promoting the issuance of equity risk capital by SMEs and midcap firms. Attention should also continue to be given to fixed income products – securitisation, corporate bonds, covered bonds, project finance and others – building on the CMU initiatives undertaken so far.

   In relation to securitisation, the new framework for simple, transparent and standardised (STS) securitisation rightly constituted one of the building blocks of the CMU. Following its enactment in December 2017, policymakers must continue working towards creating an environment which supports an high quality and dynamic European securitisation market. Authorities should closely monitor the performance of the new STS framework and utilise upcoming legislative reviews to re-evaluate and fine-tune regulations impacting on securitisation, to recognise STS securitisation as "best in class" in capital and liquidity regulation, and to ensure this vital mechanism linking bank lending and the capital markets remains safe but also viable and attractive for EU issuers and investors.

2) Availability of capital pools for investment in capital market instruments (the demand side): As discussed in question 5 and elsewhere, it is vital that CMU improves the incentives for both institutional and retail investors to make long-term investments in Europe's capital markets.

3) High quality and more converged legal frameworks and supervisory practices that encourage cross-border market-based finance: As discussed in question 4 and elsewhere, these include insolvency, taxation, securities laws and other frameworks.

4) An efficient and integrated securities market structure: There is a critical link between primary and secondary markets, as the efficiency and depth of secondary markets have a direct influence on capital allocation in the economy and the cost of funding for companies and governments. We discuss below the attributes of an efficient and integrated securities markets structure.

How should the EU27 Capital Markets Union be structured to be a globally competitive and attractive financial market?

We would like to focus on what AFME believes are the six essential attributes of an efficient and well-developed securities market structure that CMU should support[17].

These attributes can be advanced particularly through a review of MiFID 2/R and addressing long-standing barriers to an integrated post trade system. Our members believe that the overly complex nature of MiFID 2/R and certain requirements such as the share trading obligation undermine the competitiveness of EU markets internationally.

[17] These recommendations are discussed in the AFME document *Finance For Europe – Building competitive, resilient and integrated financial markets – A financial services strategy for sustainable growth and competitiveness in 2019-2024* (July 2019).

AFME Attributes of an Efficient and Integrated Securities Market Structure

1) Operational resilience and efficiency in the service of end-users: An optimal market structure is designed with a primary focus on providing stable and cost-effective channels for the issuance, distribution and trading of securities to the benefit of investors and non-financial companies.

   AFME believes that further work is needed to address requirements and impediments under MiFID 2/R and in the post trade area that undermine market efficiency, integration and connectivity.

2) Strong and well-calibrated levels of investor protection: Investors must be protected from being misled or unfairly treated. Rules should be well calibrated to ensure retail and professional investors, who have very different profiles, receive appropriate information and levels of protection according to their needs.

   We believe a number of areas in EU regulation would benefit from a better distinction between professional investors and retail clients.

3) Transparency regimes that support liquidity and market confidence: Transparency, in the form of publication of trade details after a transaction, is important to support price discovery and price formation. However, financial instruments have different characteristics, which must be reflected in the transparency regime. Careful calibration and alignment are necessary to avoid risks to liquidity and higher costs for end-users.

   AFME supports a well-calibrated transparency regime for equity and non-equity instruments – we believe there could be improvements on the design of the current regimes under MiFID 2/R.

4) Availability of high-quality data at reasonable costs: Access to data is indispensable for financial market participants to carry out their activities. Concerns about data quality, data availability and high fees can lead to less efficient pricing of securities, more volatile and less liquid markets, and an unlevel playing field among participants.

   Market data costs have increased significantly since MiFID 2/R and data licences are complex for investment firms consuming this primary input. We believe further EU level action is needed to address these problems.

5) A high level of conduct, culture and ethics: Trust and integrity are fundamental to the smooth functioning of markets and preserving confidence among participants.

   It is important for the EU to focus on effective rules in the fields of financial crime and market conduct, building on the significant work already undertaken in conduct, ethics, fitness and propriety protection of whistle-blowers and personal accountability of management and risk-takers. This includes improving the effectiveness of tools and frameworks to fight against market abuse, money laundering and financing of terrorism.

6) Fair and open access to market infrastructures: Fair and open access to trading and clearing infrastructure is essential in a true single capital market: it is vital for maintaining integrated, safe, efficient and continuous markets. Open access leads to lower costs, deeper pools of liquidity, improved service levels, greater capital efficiency and innovation. Fragmentation often undermines the need to achieve economies of scale that bring benefits to users of capital markets. This is particularly true for post trade infrastructures where, currently, European CCPs are able to offer privileged access to trading venues within their own corporate group (with venue and CCP often based in the same Member State). AFME is anticipating the expected benefits of MiFID 2/R's open access conditions for CCPs (central counterparties) and trading venues, which should contribute to innovation and competition in the European markets from July 2020 onwards.

How should the relations with financial markets in third countries be strategically shaped?

The following selection of figures in different asset classes illustrates the significant degree of interconnectedness between EU markets and third countries.

- **Government bonds:** Around 78% of German government bonds are traded with counterparties located outside the euro area [Deutsche Finanzagentur]
- **Equities**: 44.9% of Euronext's average daily turnover of cash instruments is executed by trading participants headquartered in the US and at least 60.5% by entities headquartered outside the EU. [Euronext]
- **FX:** 43% of global euro FX trading (FX Spot, Swaps, Options, and Forwards) is executed from London trading desks (including by EU27 headquartered banks), compared with 16% in the Euro area (20% in the EU27) and 19% in the US. [BIS]
- **Pools of capital (supply of liquidity):** The United States is the world's largest fund domicile hosting 47.1% of worldwide investment assets. Five European countries rank among the top ten world's largest fund domiciles: Luxembourg (9.8% of the world's market share), Ireland (5.4%), Germany (4.5%), France (4.1%), and the United Kingdom (3.6%). [EFAMA]

Alongside continuing to develop the size, capacity and connectivity of capital markets within the EU, it is important to consider the EU's relationship with third countries in the context of the evolving international environment including (but not limited to) the withdrawal of the UK from the EU.

For EU capital markets to thrive, it is vital to maintain and continue to develop open capital markets that are able to provide access to international capital pools and funding opportunities while ensuring market integrity and fairness of treatment between EU firms and third country entities. The largest and most successful global financial centres are characterised by their openness, access to global pools of capital, their scale and financial ecosystem. These characteristics jointly facilitate cross-border business, enabling firms to provide the best services for their clients around the world.

It is also important to consider the distinction between markets that are global, regional or more local in nature, and the need to for regulatory frameworks tailored to their specific characteristics. EU regimes need to be proportionate and calibrated according to the nature of a specific market and the set of market participants concerned.

We believe that the following objectives should underpin the EU's relationships with third countries with respect to financial services:

1) maintaining market integrity, financial stability, fair competition and investor protection in the EU;
2) promoting open, competitive capital markets and minimising barriers to cross-border business;
3) increasing choice for sophisticated investors;
4) creating a stable, transparent and predictable framework; and
5) developing arrangements for close supervisory and regulatory cooperation.

These objectives are vital to further the aim of continuing to strengthen and develop EU financial markets. Continued connectivity with third countries is important to maintain financial stability and resilience to internal and external shocks; provide efficient, sustainable financing and risk management options for businesses; and finance growth in all sectors of the economy. The objectives should also support the global competitiveness of EU27 providers of financial services through greater access to third country markets, connectivity to global capital and liquidity, and reduced fragmentation.

Brexit will place greater emphasis on EU third country regimes and makes it even more important to establish effective arrangements to manage risks and maintain access to international capital markets for businesses in the EU. Therefore, alongside CMU, it is important to review and further improve the framework for the EU's engagement with third countries to put in place effective, stable and proportionate arrangements which support the efficient financing of European businesses.

International regulatory fragmentation also carries a risk of working against other objectives that CMU is seeking to promote, as we discuss in question 7 in relation to sustainable finance.

A well-functioning equivalence framework

The equivalence framework should provide the basis for a stable relationship with the relevant third country. It should aim to minimise duplication in terms of regulatory and supervisory compliance and facilitate cross-border business and access to market infrastructure based on strong regulatory standards that ensure market integrity, financial stability and investor protection. It should also help to promote and maintain regulatory convergence, based on international standards, and minimise fragmentation in global capital markets.

We propose five key principles for equivalence determinations:

1) Decisions should be proportionate and risk-sensitive;
2) The equivalence assessment should generally be focused on the alignment of regulatory and supervisory outcomes in the area under consideration;
3) There should be appropriate transparency in the decision-making process;
4) Decisions should be made in a timely manner and provide predictability and certainty for market participants; and
5) Risks should be mitigated appropriately to minimise the impact on affected market participants.

It is important that equivalence is not a one-off determination but is supported by ongoing monitoring as part of the continuous relationship with the third country, particularly for "high impact" third countries. This should be supported by close regulatory and supervisory dialogue.

Regulatory and supervisory cooperation

An important priority should therefore be to further develop the arrangements for regulatory and supervisory cooperation with key third countries, considering how this can support equivalence assessments, effective cross-border supervision and ongoing monitoring of equivalence. Areas which should be enhanced include:

1) Expanding and strengthening bilateral regulatory dialogues with key third countries
2) increased dialogue at an earlier stage in policy development and implementation to identify and discuss forthcoming regulation and potential impacts on the EU and the third country;
3) regular informal dialogue in between formal meetings;
4) identify areas of harmful fragmentation and consider ways to address them;
5) facilitating monitoring of EU equivalence assessments and third country deference arrangements; and
6) increased transparency and engagement with industry stakeholders.

We are currently in the process of developing a more detailed position on the EU's third country framework and would be happy to provide more information as a follow up to this questionnaire.

9. What should be the 3 key priorities for the next phase of Capital Markets Union?

To organise the response to this question and to summarise our views in this submission, we list below three priority principles and three priority policy areas for action in the next phase of CMU, with a number of recommendations.

Three priority guiding principles and recommendations for the next phase of CMU

1) Better, more proportionate regulation to support market-based finance: Markets need appropriate conditions and frameworks to develop, a number of which we have considered in this submission. To build a vibrant CMU it is essential that the overall regulatory framework and individual rules make market-based finance economically attractive to market participants, or at least do not discourage it. Regulation also plays a fundamental role in the competitiveness of the EU financial services industry in a global environment, which is a central element in building a strong CMU. It should also be emphasised that significant new regulation is not always the solution to deepen capital markets.

   The quality of regulatory frameworks is a key consideration in advancing the CMU. Future regulatory workstreams need to maintain a focus on improving proportionality, connectivity and market efficiency. Among the examples, we have listed in question 2 the STS securitisation framework as a CMU inspired initiaitve which has resulted in an overly complex and conservative framework for market participants.

   - AFME recommendation: the principle of better regulation and proportionality should be embedded in future CMU regulatory workstreams. The Commission should use future regulatory reviews to undertake a fitness check of relevant frameworks. The Commission launched some time ago a call for evidence on the impact of financial services regulation. We would recommend a similar exercise with a view to assessing the suitability of frameworks to promote the CMU and its objectives.

2) Balancing the need to build CMU internally and ensuring external openness: For EU capital markets to thrive, it is vital to maintain and continue to develop open capital markets that are able to provide access to international capital pools and funding opportunities while ensuring market integrity and fairness of treatment between EU firms and third country entities. The internal dimension of CMU (building capacity within the EU27) and external dimension (maintaining openness and connectivity with non-EU markets) are clear complementary in building a strong CMU.

   - AFME recommendation: we recommend the establishment of a senior level consultative group comprising leading market participants – from the EU and from outside the EU – to provide advice on relationships with non-EU markets in different areas.

3) Ensuring a forward-looking CMU strategy: For the next phase of CMU, we believe it is important to develop a clear, long term strategy that should serve as reference to develop the EU27 ecosystem and inform the objectives and policies as part of the CMU for the next five years and beyond. A High Level Group on Sustainable Finance was established to provide the broad thinking that was reflected in the Action Plan and measures that followed in this area. We believe the broad CMU project would benefit from a similar approach to establish a consistent overarching CMU strategy and set of principles. Given the way technology is fundamentally affecting capital markets and the nature of regulations and connectivity, this should be a main area of focus for the group.

- AFME recommendation: we recommend the establishment of a "wise persons" group with a mandate to advise on the long term development of the CMU in the digital age. The group should have a broad mandate to provide forward looking ideas and perspectives on the CMU strategy for the digital age.

Three priority policy areas and recommendations for the next phase of CMU[18]

1. **Improving efficiency and connectivity in securities markets**

   AFME recommendations:

   - Undertaking a recalibration of MiFID 2/R with a view to improving EU competitiveness, proportionality and efficiency of outcomes for end-users – including SMEs and investors – and advancing CMU objectives (as discussed in question 8). The recalibration should focus on the following areas: market structure; transparency, reporting and disclosures; reference data quality and availability; market data costs; investor protection; issues arising from Brexit;
   - Addressing impediments to an integrated post trade system by dismantling the barriers identifies by the European Post Trade Forum in 2017; particularly in relation to withholding tax collection and securities laws;
   - Ensuring a well-functioning equivalence framework regulating access to EU and non-EU markets, following the five key principles for equivalence determinations noted in question 8.

2. **Expanding the size and capacity of EU capital markets**

   AFME recommendations:

   - Adopting a comprehensive strategy to promote retail investment in EU capital markets;
   - Fostering better conditions for accessing private and public equity capital by implementing measures to improve the regulatory environment for IPOs (particularly for SMEs and removing disincentives against equity finance in taxation and other frameworks;
   - Supporting the development of long-term investment through the promotion of fair and efficient taxation practices and structural reform of retirement schemes;
   - Working towards further convergence of national legal frameworks and supervisory practices by taking incremental steps to address harmful national divergences in securities and markets supervision, corporate insolvency regimes and securities laws.

3. **Promoting a strong and integrated EU banking sector in support of CMU**

   AFME recommendations:

   - Completing the Banking Union, focusing on considering it as a single jurisdiction in terms of prudential requirements, achieving effective depositor protection, and, in the context of broader considerations, a solution for a European safe asset;
   - Removing harmful fragmentation in the EU banking sector by addressing supervisory divergences and options/ discretions in the banking regulatory framework which serve to perpetuate fragmentation and inhibit the free flow of capital and liquidity within the EU; a

[18] These priorities are discussed in more detail in the AFME document "Financing for Europe – Building competitive, resilient and integrated financial markets" (July 2019)

future review of the CRD/CRR frameworks would represent an opportunity to address these issues;

- Achieving a sound implementation of Basel III by respecting the commitment to avoid significant increases in capital requirements, preserving the risk sensitivity of the framework and ensuring global consistency and a level playing field.