

Building the Capital Markets Union - CMU - in the EU

June 2015

The Capital Markets Union (CMU) is described as a flagship initiative of the Commission. It has been described as one of the important initiatives initiated by the European Commission to be considered over the next few years.

It aims to unlock funding for capital markets whereas at the moment European businesses remain heavily reliant on banks for funding. In essence, the task is to find ways of linking investors and savers with growth. This involves a number of measures rather than any single initiative. The idea is that cumulatively the impact will be significant.

The Commission's Green Paper on Building a Capital Markets Union¹ marked the beginning of a three month consultation which ended on 13 May. The Commission plan to organise a conference in the summer of 2015 to draw the Consultation to a close. An Action Plan on Capital Markets Union is to be published later in 2015.

In this Briefing Paper we set out some of the key proposals put forward by the Commission and highlight some of the key comments made by regulators so far on priorities for action.

Key proposals

Some of the key proposals in the Green Paper which have relevance for asset managers include:

- **EFSI**

The European Commission has announced an investment plan that will unlock public and private investments in the economy of at least Euros 315 billion over the next three years with the establishment of the new European Fund for Strategic Investment (EFSI) and published a communication on long term financing of the European Economy setting out a range of measures to boost investment.

- **ELTIFs**

This is communicated alongside the recently finalised ELTIF regulatory framework which will allow investors to put money into companies and infrastructure projects for the long term – these are expected to have a particular appeal to investors such as insurance companies or pension funds which need steady income streams or long term capital growth (Paragraph 3.2, page 11 CMU Green Paper). Note the Commission is inviting views on what further role the Commission can play in Member States in supporting the take off of ELTIFs.

- **Venture capital funds**

A key challenge is seen as increasing the scale of venture capital funds and how public and private funding together could contribute to this:

- The EuVECA initiative might help alongside the EuSEF Regulations. A particular concern though is that this only helps small managers where portfolios are less than Euros 500 million. Widening the range of market participants using EuVECAs could increase the number of these funds available.
- The Commission is looking at whether measures can be taken to create a better environment for business angels (individual investors usually with business experience who provide capital for start-ups).
- Public funding can also play a role, with regional authorities being significant funders of a venture capital in several Member States. Mention is made here of EU financial instruments such as the Competitiveness and Innovation Framework Programme (CIP), European Structural Investment Funds (ESIFs) and equity based financing supported by the Structural Fund programmes which have been successful in mobilising venture capital for

¹ http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf

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SMEs. They want to build on this.

Paragraph 4.1 of the Green Paper indicates that the EU requires a significant amount of new infrastructure investment to maintain its competitiveness. The flow of funds into such project is however restricted by short termism, regulatory barriers and other factors. Also many infrastructure projects display characteristics of public goods implying that private financing alone may not be appropriate to deliver the optimal level of investment. Whilst the EFSI will make an important contribution to boosting investment in infrastructure projects, the Commission welcomes views and other means of achieving this goal. In the context of infrastructure investments, the European Structural Investment Funds (ESIF) can also play an important role provided the eligible ability criteria are met.

- **Private placement markets**

Paragraph 3.5 of the Green Paper points out that, as a first step towards developing European private placement markets, a consortium of industry bodies has established a market guide on common market practices, principles and standardised documentation private placements, compatible with a diversity of legal frameworks. The Guide was recently published and the first issues using it should follow soon. The European Commission welcomes this market led approach which could help to facilitate the creation of a European private placement market in the short term. In the Green Paper, one question is whether any action by the EU is needed to support the development of private placement markets other than supporting market led efforts to agree common standards. (One wonders how this fits with the perceived need to shut off the private placement option under AIFMD?!)

- **AIFMD**

Obviously a sustainable Capital Markets Union should be founded on financial stability and investor confidence. Interestingly the Q&As indicate that "the intention is not to backpedal on the reforms agreed during the last years".

The international regulatory community has set out a path to deal with shadow banking risks and a monitoring framework which has been implemented in Europe, for example, through AIFMD whereby all funds are subject to authorisation and regulation. Given that it is supposed to be a fund managers' directive rather than fund regulation, at least it now admits clearly that they are looking towards authorisation and regulation **of the funds** - or effectively so.

- **Money market funds**

The Commission note that negotiations are also ongoing on proposals for money market funds and securities financing transactions in the Parliament and the Council. The

Commission is to keep monitoring the situation, relying on the work of the European Systemic Risk Board at the European level and is to remain vigilant to the risks of shadow banking while enabling the economy to benefit from a more diverse range of funding. Hopefully this means that they will find a way of keeping the money market funds industry content that they can operate.

- **Retail investors and lack of adequate financial expertise**

The preference for pooled investment rather than direct investment in capital markets is noted. Pooled investment vehicles here though refer to investment funds, pension funds and life insurance contracts that are managed by institutional investors. Whilst there is reference to the KIID and prospectively the PRIIPs Regulation providing the relevant knowledge which could reverse this trend, another explanation is that they think that financial advisers are no longer marketing direct investment products to retail investors.

- **Crowdfunding**

The Commission identify that, although there is a growth in online natures of mechanisms such as peer to peer lending and crowdfunding, which would suggest great potential to contribute to the financing of the economy across national borders, there is limited evidence of cross border or pan European activity.

One follow up to their Communication on Crowdfunding is gathering information on industry approaches to information disclosure and Member State approaches to regulation. They appreciate that the preliminary results suggest diverse national approaches in these areas may encourage crowdfunding locally but may not necessarily be compatible with each other in a cross border context.

One question in the Green Paper is whether there are 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?

Gaps and issues, and possible ways to address them, are helpfully summarised in the Advice on "Investment based crowdfunding" published by ESMA on 18 December 2014. In that paper, quite rightly, ESMA identify the likely prospective increase in use of collective investment schemes and so the relevance of AIFMD, EuVECA and EuSEF legislation in respect of crowdfunding propositions.

In relation to development of appropriately regulated crowdfunding or peer to peer platforms including on a cross border basis, ESMA think that a more appropriate legislative framework would enhance investor protection and help encourage the development of a pan European crowdfunding market. This would have the potential to offer an attractive investment proposition to investors

including a sub set of retail investors provided the right safeguards are in place – the use of the term "sub set" is interesting of itself.

- **Technology and digitalisation**

There is a recognition that modern capital markets depend on adequate market infrastructures for trading, clearing and settlement of transactions and information provision. Markets are invariably hosted on computer based electronic trading systems.

One of the recent developments is the rise of the FinTech sector which can be defined as a breed of new companies that combine traditional financial services with the use of new digital technologies. A good example happens to be crowdfunding where non-traditional investors can get access to investment opportunities for the first time and where start-ups and SMEs can obtain funding for the investments and operation through the internet.

You should note that the UK FCA in its response to the European Commission's Green Paper (published on 27 May 2015) emphasises that one of the priorities for action should be the need to harness the benefits of digitalisation. As ever, the FCA is already seeking to embed digitalisation issues in its own regulatory approach, recognising that there is a movement away from the predominant model of paper based disclosure regimes which have underpinned the development of European disclosure requirements such as provision of KIDs in PRIIPs, and KIIDs in UCITS so far. Communication and disclosure models should accommodate a range of channels and formats to match consumer preferences.

- **Data and reporting**

Whilst technological advances in the IT sector have enabled easy processing of vast data volumes, the data has to be gathered and systemised first to enable this process and, where gathered across EU Member States, it may not correspond to the same standards and definitions, making aggregation challenging. There is evidence that market data services can cost seven times more in the EU than in the US.

The industry has been given two years to come up with a solution otherwise, under the revised MiFID II, the regulator can appoint a consolidated tape provider. (Seven years after the EU opened up European stock exchanges to competition, it is still not possible to get a full picture of price information across the EU market despite repeated industry efforts to consolidate the data stream from Europe's markets into a "consolidated tape".)

The Green Paper identifies that more efficient approaches towards supervisory and market reporting involving national authorities or ESMA, e.g. for common IT approaches for certain reporting requirements, could be

helpful for market participants. Views are requested on whether and what further work is needed to improve data and reporting in the EU.

- **Supervisory powers and supervisory convergence**

The Commission Report (2014) 509 identified a number of areas where possible improvements could be made in the short and medium term on implementation and on consistent enforcement of European rules. The Green Paper identifies that further consideration could be given to the role played by the European Securities Authorities (ESAs) in this context.

ESMA's response is that supervisory convergence is important but "it would not be realistic to aim for full convergence in the short to medium term and full convergence may not be needed in all areas to achieve the CMU's objectives". One area where the supervisory convergence is seen as being of crucial importance is investor protection and, in order for the MiFID II/MiFIR Rules that play an important part in achieving the required investor protection to deliver their entire benefits, the text needs to be fully and consistently implemented and enforced all over Europe.

In considering what measures the European Securities Authorities might wish, the ESMA Response Paper suggests that the ESAs and local regulators could benefit from having the possibility to suspend temporarily the application of a particular rule if its application could lead to unintended consequences or if its application requires guidance or technical specifications that are not yet available, without the application of the relief itself leading to consequences unintended by the law. The example given is clearing obligations laid out in EMIR or the trading obligations laid out in MiFID II which could detrimental effects in the case of a sudden drop in the liquidity of a product. Generally the possibility of local regulators giving a waiver of MiFID provision would be helpful where there are numerous instances where, in the UK, a waiver of a non MiFID provision can usefully be obtained and is constructive whereas, in the MiFID territory, it is simply impossible for them to grant a waiver. We therefore have various instances where the issue has been thought about and it unfortunately has been impossible, due to the inability of the FCA to give waivers of MiFID derived provisions.

- **Market infrastructure and securities law**

The Commission intends to bring forward a legislative proposal to create a European framework for the recovery and resolution of systemically relevant financial institutions such as central counterparties.

In addition, views are requested on whether work should be undertaken to facilitate an appropriately regulated

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flow of collateral throughout the EU. With the demand for collateral arising, there are risks that the same securities are being reused to support multiple transactions as was the case pre crisis and work is underway internationally to look at these issues. (The demand for collateral has increased driven by market demand for more secured funding as well as new regulatory requirements such as set out in EMIR and the Capital Requirements Regulation (CRR).

As regards legislation relating to investors' rights to securities, these differ across Member States. Views are requested on whether any target to change this legislation on securities ownership rules that could contribute materially to more integrated capital markets within the EU is feasible and desirable.

Achieving greater legal certainty in the cases of cross border transfer of claims and the order of priority of such transfers, particularly in the cases such as insolvency, is an already identified area for focus. A report identifying the problems and solutions is to be published by the Commission within 2015.

- **Tax**

As ever, differences in tax regimes across Member States can impede the development of a single market for capital. By way of an update:

- The Commission is to take action as necessary if any discriminatory rules are found and discriminatory tax rules on cross border investments by life insurance companies and pension funds in real estate at a later stage.
- Work is continuing on simplifying withholding tax relief procedures related to post-trading.
- It is acknowledged that, in addition to tax treatment for different market participants, there are also differences in the tax treatment of different types of financing which may create distortions (e.g. differences in the tax treatment of debt and equity financing might increase reliance of companies on debt and bank funding).
- Further, differences across Member States in the definition of "debt" and "equity" and their respective tax treatment, including in relation to regulatory capital instruments, might hamper a level playing field, fragment markets and create opportunities for profit shifting.

- **Boosting institutional investment**

Under the banner of boosting institutional investment, the Green Paper looks at the European asset management

industry generally and, within that, UCITS and AIFMD. Given the level of regulation, there is some irony of then presenting a key issue as being reducing costs for setting up funds and cross border marketing more generally being encouraged. Certainly, reduced costs should be encouraged as this should create lower barriers to entry and create more competition. However, of course, a key component of the cost for asset managers has been the costs of complying with much regulation.

Implementation of AIFMD has brought alternative fund managers into the fold of regulation but has of course set up barriers to entry for new entrants.

The next sentence in the Commission Green Paper states: *"Alongside new entrants, it is also important that funds can grow and benefit from economies of scale"*. The impact of recent regulation has been to encourage larger groups.

Usefully the new prudential regime for insurers from 1 January 2016 under Solvency II will allow companies to invest more in long term assets by removing national restrictions on the composition of their asset portfolio. And the Commission has ensured that the standard formula to calculate insurers' capital requirements could also play a role. Mention is made here of EU financial instruments such as should not impose obstacles to long term investment and matching long dated liabilities with long dated assets. The question raised is whether further work is needed to identify lower-risk infrastructure debt and/or equity investments, with a view to a possible review of prudential rules and creation of infrastructure sub-classes so as to encourage tailored treatment of infrastructure investments.

- **Pension provision**

Pension provision itself is also to be tackled.

- New rules on occupational pensions are under discussion which could remove barriers to pension schemes investing more in long term assets.
- On personal pensions, the question is raised of whether the introduction of a standardised product, for example, through a pan European or 29th regime that removes obstacles to cross border access could potentially strengthen the single market in personal pension provisions.

In its response, the UK FCA appears to be against a parallel regime to the existing domestic products which are available because it could actually increase complexity for investors and lead to regime shopping, with providers opting for the least onerous regime. One suspects this needs to await developments in EIOPA's advice to the

European Commission on the development of the single market personal pensions, including consideration of the 29th regime which is due to be returned to the Commission in February 2016. (The challenges on personal pensions are being looked at by the European Insurance and Occupational Pensions Authority (EIOPA) with its call for evidence on personal pensions of July 2014 which is expected in February 2016.)

Interestingly, the Commission Working Document comments "that pension fund assets in the EU make up only about 40% of those in the US. In 2012, EU occupational and personal pension funds had Euros 3.6 trillion (20% of GDP) in assets under management compared with Euros 8.8 trillion (70% of GDP) in the US."

ESMA's Response

ESMA published its Response Paper to the Capital Markets Union Green Paper on 13 May 2015². Some of its comments are particularly interesting, disclosing some of the areas where some specific consequences might follow.

Steven Maijoor, ESMA's Chair, has commented:

"In order to achieve the aim of a unified capital market, the right environment to allow it to flourish has to be created. This will involve ensuring that those rules governing financial markets are applied, and supervised, in a consistent manner across all member states ensuring equal access for all. This in turn must be complemented by adequate levels of investor protection to build confidence in participating in this unified capital market.

Finally, we believe that a European Union with open capital markets that seeks to refuse fragmentation will attract investment and strengthen Europe as a global financial centre and boost the competitiveness of EU firms."

ESMA's high level comments include the following:

- **Remaining barriers**

There are still too many barriers within the single market hampering the flow of capital even if there is consistent implementation of rules such as those on OTC Derivatives (EMIR) and Central Securities Deposits (CSDR), and increasing transparency of transactions and reinforcing investor protection with MiFID II or product transparency under PRIIPs – each of which has its own contribution to make in establishing more robust market infrastructure and practices.

- **Investor protection**

All CMU initiatives, especially the ones that could give

greater access to investors to capital markets, need to embed investor protection objectives to ensure long lasting positive effects of the initiatives.

- **A strong and robust regulatory framework**

The regulatory agenda for 2011-14 was comprehensive with major regulatory changes initiated, mainly as a response to the financial crisis but also in the most recent period to stipulate alternative sources of funding for the European economy. Happily, whilst there is indication that the intensity of the regulatory agenda for the 2016-20 timeframe can be expected to be much lower, ESMA stands ready for the additional regulatory work which might be required in the context of CMU in particular in areas such as the review of the Prospectus Directive and any possible upcoming initiatives on securitisation and crowdfunding. In a recent speech³, Steven Maijoor has emphasised that, whilst the asset management industry should expect less new regulation, there will be close scrutiny from regulators – with an emphasis on ensuring that there is a strong and robust regulatory framework, and trying to make the existing legislation work better.

More specific comments include:

- **How can cross border retail participation in UCITS be increased?**

UCITS efficiency improvements were intended to be achieved by UCITS IV but further improvements are being considered.

ESMA believes that the notification procedure would be even more efficient if the regulators of the home member state of the UCITS were in charge of transmitting the updates of documents. ESMA proposes introducing clarity on the split of competencies between home and host regulators and clarifying the types of additional requirements that are permitted at national level for cross border marketing of UCITS and AIFs, which should further incentivise passporting activities and simplify their operation. Consideration may be given to clarifying further the division of competencies between the UCITS Directive as regards the rules of conduct in situations where UCITS management companies establish branches in a host member state to manage UCITS.

- **UCITS: Harmonisation of cost disclosure**

Concrete ideas include ideas to work towards better harmonisation on remuneration and cost disclosures – we need more than simply transparency of these and also further work to ensure effective cross border marketing of UCITS and AIFs. Certainly a longstanding problem has been differing approaches to costs.

² http://www.esma.europa.eu/system/files/esma-2015-856_esma_response_to_ec_green_paper_on_cmu.pdf

³ <http://www.esma.europa.eu/news/Steven-Maijoor-delivers-speech-CMU-Asset-Management-and-Stability-IBA-Annual-Conference-Paris?t=326&o=home>

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The UK, for example, has always been quite prescriptive and although it removed prescription of the various payments out of funds, it still has provisions regarding the nature of fees and expenses and there is a need to disclose them fully in the Prospectus and one cannot take promotional costs out of the fund. This is not though the case in Dublin and Luxembourg. This may hamper the comparability of different product offerings and thereby reduce the attractiveness of UCITS to retail investors. This is somewhat ironic given that the UK had identical charging structures and this had comparability which was forfeited when the move to more flexible "payments" on a disclosure basis was introduced. One wonders quite what is in ESMA's mind in this connection.

As regards the UCITS and KIIDs, ESMA recognises that managers in different member states applied slightly differently the requirements of CESR Guidelines on the methodology for the calculation of the ongoing charges figure in the KIIDs and the methodology for the calculation of the synthetic risk and reward indicator in KIIDs. It proposes to modify the guidelines or to clarify the interpretation of the existing guidelines in corresponding Q&As. ESMA suggests that there must be as much alignment as possible of the UCITS and PRIIPs cost and risk and reward disclosure regimes (the PRIIPs provisions applying from the end of 2016).

The issue of comparability of costs of different products comes up again under the heading of "UCITS – Fund calculators/central data bases". ESMA observe that, whilst progress has been made on improving cost disclosures for investors through recent initiatives such as MiFID, UCITS and PRIIPs, its experience has shown difficulties of disclosing comprehensive and relevant information on costs in one table or one summary cost indicator. They therefore think it might be useful to complement the information on cost disclosure required by this recent legislation via the setting up of reliable online calculators or central databases on the costs of these products. This might be led through voluntary industry or consumer led initiatives or on the basis of legislative requirements.

- **UCITS: Improvements on the Fund offering**

Regulatory incentives to increase investor choice might still leave room for differentiated application at national level. The Commission's heading of "Improvement on the fund offering" encompasses the way in which cross border retail participation in UCITS might be increased by encouraging providers of financial services to offer investors ready access to a wider choice of funds at competitive prices and refers obviously to the MiFID II framework. Whilst MiFID II has its obvious benefits, one wonders though quite how this increases choice when MiFID II introduces further requirements for the appropriateness test in respect of structured UCITS and other complex products, and so effectively reduces investor choice.

ESMA's comments indicate that the Commission should consider further refining the meaning of "sufficient range of financial instruments" as indicated in ESMA's Technical Advice on MiFID II delegated acts currently being drafted (including the possible consideration of the element of internationally diverse offerings) or rely on possible ESMA Level 3 measures, as ESMA suggested in its Technical Advice.

- **Looking at new fund types**

In relation to EuVECA and EuSEFs, the limited interest from the industry on these vehicles is noted. ESMA Q&As already clarify that asset managers can market such vehicles but possibly amendment of the EuVECA and EuSEF Regulations reflecting such clarification would encourage asset managers that there was certainty on the issue.

In relation to loan funds, it is interesting that ESMA believe that the development of harmonised rules, whether as an opt in regime or as a mandatory regime, for all funds originating loans at European level should be explored with the aim of creating more favourable conditions for cross border marketing of these funds in Europe, whilst at the same time ensuring an appropriate level of investor protection including the absence of marketing of these funds to retail investors and mitigating risks to financial stability. Ireland and Germany have recently introduced loan originating debt funds and there may be increased interest in this area.

More radically, the UK FCA in its Response Paper has asked that there should be consideration of whether, with the creation of a passport under AIFMD, there is a migration of certain types of strategies and funds from the UCITS to the AIFMD framework and, if so, whether this development could allow for a simplification of the scope of eligible investments allowed under the UCITS umbrella which could in turn encourage further retail investor participation.

Obstacles to progress?

Not surprisingly, there are remaining obstacles. As one might expect, tax regimes remain different in different Member States and this is seen as inhibiting UCITS fund mergers. In fact, given the history on mergers before UCITS IV mergers were invented, tax might actually not inhibit fund mergers per se but certainly tax is an obstacle in other areas.

Differences in laws on bankruptcy and insolvency are also potential obstacles.

The challenge for the CMU is perhaps to focus on those areas in which realistically one can expect improvements to be achievable, such as improvements to the Prospectus Directive.

Likely items for early progress

Early progress is seen as likely to result from:

- developing proposals to encourage high quality securitisation and free up bank balance sheets to lend;
- review of the Prospectus Directive to make it easier for firms, particularly smaller ones, to raise funding and reach investors cross border;
- work on improving the availability of credit information on SMEs so that it is easier for firms to invest in them;
- working with the industry to put in place a pan European private placement regime to encourage direct investment into smaller businesses; and
- supporting the take up of new European Long Term Investment Funds, ELTIFs, to channel investment into infrastructure and other long term projects.

The link between CMU and stable financial markets

The broad scope of the CMU initiative should not be underestimated. Interestingly, Steven Maijor, Chair of ESMA has recently indicated⁴ that the CMU and stable financial markets go hand in hand. His approach is that successful steps have been taken to increase the asset management sector's importance as a source of funding and further steps should be taken to achieve a pan European sector which is transparent and competitive. A key point though under the CMU is that any bigger and more interconnected asset management sector also requires enhanced supervision including its stability risks.

Please see Fieldfisher's separate Briefing Paper⁵ on financial stability issues for asset managers and investment funds for further information.

Focusing on the bigger picture

From this brief outline of the aspects of the CMU which are relevant to asset managers, you will see that the CMU proposals are extremely broad ranging. This initiative asks us all to look at the bigger picture – not just the minutiae of particular regulation (s). Only though if there is a willingness to progress a number of these initiatives, and in a co-ordinated fashion, will a cumulative positive impact which the Commission wish to see be likely to be the result.

It is very likely that different national regulators will take different perspectives or key priorities from the initiative and it will be interesting to see how the Action Plan to be published later this year is formulated, and the momentum which is generated for taking that forwards.

⁴ <http://www.esma.europa.eu/news/Steven-Maijor-delivers-speech-CMU-Asset-Management-and-Stability-IBA-Annual-Conference-Paris?t=326&o=home>

⁵ <http://www.fieldfisher.com/media/3074920/briefing-paper-systemic-risk-for-asset-managers-and-investment-funds.pdf>

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