Deutsches Aktieninstitut

Accepting Challenges – Moving Ahead:

Deeper Integration of EU-Capital Markets despite the Brexit Vote

Deutsches Aktieninstitut's Position Paper
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Introduction

In a globalized world, the member states of the European Union are exposed to competition from the economic powerhouses in Asia or the Americas. The reaction to a competitive environment shaped by revolutionary technologies and developments such as digitalization cannot be to turn back the European idea and return to nationalism. On the contrast, a deeper European economic integration is needed. Only in unity the European countries will be strong enough to sustain in a rapidly changing world by delivering much needed innovation.

The Brexit vote has not changed this general situation. Even though regrettable, it may even have reinforced the need to react to these developments by setting the European political, fiscal and economic framework in a way that it promotes growth and innovation in order to create jobs for the benefit of Europe as a whole.

Raising capital for financing innovation is a crucial prerequisite to enable companies to grow and provide jobs for people in Europe. After a period of comprehensive post-crisis regulation, primarily focused on the elimination of financial market risks and thus increasingly restricting the functioning of capital market financing, the EU Commission acknowledged with its Capital Markets Union initiative the potential of capital markets as lifeblood of the economy in fostering growth and employment. Just two weeks ago the EU Commission renewed this commitment and emphasized the intention to implement the key measures set out in Capital Markets Union Action Plan as soon as possible. Deutsches Aktieninstitut recommends to take measures based on this perspective in order to ensure that capital markets can fulfil this task.

Higher emphasize should be put on the effects of capital markets regulation on the users of financial services. Capital markets regulation needs to better promote entrepreneurial freedom, so that capital markets can be effectively used for the purpose of corporate finance as well as for risk management of European companies. In this context, inconsistencies in capital markets regulation, leading to additional burdens for companies when using capital markets, need to be removed and to be avoided in the future. Moreover, investor protection needs to be rebalanced. Instead of paternalism, investors should rather be enabled to make sound investment decisions autonomously. Future efforts should thus focus on fostering financial literacy and general economic knowledge in order to achieve an economy and a society based on knowledge and innovation.

The answer to the Brexit-vote must not be resignation. Europe has to look ahead and use its creativity and potential – also by setting the right capital markets parameters. In this context important aspects are:

- The reduction of barriers for public listing will be key for the success of the Capital Markets Union, in particular whether the prospectus regime will be set right.
- Bureaucracy in secondary market regulation needs to be reduced in order to raise the attractiveness of capital market funding from the perspective of the demand side.
- The Capital Markets Union project should not only focus on capital market funding but also on potential negative consequences from capital market regulation for the use of derivatives and the supply of credit.
- The Capital Markets Union project will fail without consistently following the key objectives of promoting funding, risk management and the benefits of capital markets across different regulations.
- The Capital Markets Union project needs to be embedded in the EU`s Better Regulation Agenda.

1 Reduction of barriers for public listings is a key issue – set the prospectus regime right

Fewer investment opportunities for investors will arise, if companies are reluctant to enter into organized markets due to the high level of regulation and corresponding compliance costs and legal uncertainties. The regulation of primary markets is thus a decisive factor for the attractiveness of capital markets as means of funding. In this context the EU Commission has rightly identified the prospectus regime as key element of the Capital Markets Union project.

We welcome the initial intention of the EU Commission to facilitate the prospectus regime and thereby making capital markets finance more attractive to European companies as an alternative or supplement to traditional bank funding.

However, the current proposal falls short of that very objective because it will increase bureaucracy instead and create legal uncertainties for companies. In particular, the proposed removal of the most commonly used prospectus alleviation for bond issuers for offers of non-equity securities ("100k bonds") would be detrimental to the aims pursued by the Capital Markets Union project.

Moreover, the current idea of a classification of risk factors and the restriction to provide only the five most material risks in the new summary should be abandoned. A wrong classification or wrong selection of the five most material risk factors could be interpreted as misleading presentation triggering liability risks and law suits thereby making capital markets less attractive and creating unnecessary burdens for companies.

2 Attractiveness of primary capital markets also depends on secondary market regulation – reduced bureaucracy is needed

Barriers to make use of capital markets as a means of bond or equity finance do not only arise from primary markets regulation but also from the compliance duties with regards to secondary markets. Rules imposed on listed companies over the past decade and in the aftermath of the financial crisis have led to a massive increase of compliance costs.

The Capital Markets Union project will be less successful in increasing the attractiveness of capital markets, if there is no political will to reduce the bureaucracy of secondary markets' obligations of listed companies.

Only two examples:

- Market Abuse Regulation (MAR)

  The extension of MAR to trading platforms beyond regulated markets has substantially increased the level of regulation and corresponding costs for SMEs which are typically listed in these segments. These companies now have to compile insider lists, notify managers' transactions and follow ad-hoc publicity rules which have become overly complex over the past years (see below).

- Reporting requirements:

  Issuers are faced with various layers of reporting requirements, resulting in a patchwork of different, often unconnected reports. Companies try to address the needs of stakeholders by producing different reports, which sometimes have overlapping scope and content. In addition, if there is no overlap, different reports are often completely unconnected to each other. Unnecessary, inconsistent and overlapping reporting requirements should thus be abolished. The recent amendments to the MAR obligation have resulted in additional bureaucracy, legal uncertainties and compliance risks for listed companies where substantial benefits for investors are at best unclear (e.g. collecting private telecommunication data for the insider lists).

3 The Capital Markets Union project should not only focus on capital market funding but also on potential negative consequences from capital market regulation for the use of derivatives and the supply of credit

The Capital Markets Union project should target more than only capital market funding. Capital markets and intermediaries provide end users of financial services also with risk management services, i.e. derivatives to hedge against commercial risks (fluctuations in exchange rates, interest rates or commodity prices). The case of the derivative regulation has clearly shown that non-financial companies are increasingly drawn into the scope of financial markets-regulation. This tendency must stop!

The European Market Infrastructure Regulation (EMIR) review as well as corresponding regulation will be the point of proof for the willingness of the legislator to avoid those negative consequences in future: The current EMIR framework exempts non-financial companies under certain conditions from the central-clearing obligation, which is necessary, as such transactions are crucial for the normal conduct of business and do not expose non-financial companies to unmanageable liquidity risks. We thus urge the European Commission not to follow ESMA`s advice[1] to oblige larger non-financial companies, using derivatives almost exclusively for risk mitigating purposes, to clear centrally. Such an obligation would present an additional huge financial burden on non-financial companies.

Furthermore, any indirect undermining of the EMIR exemption has to be avoided in order to ensure that risk management activities of non-financial companies can be performed effectively and in order to ensure consistency among different regulations. A prominent example is the current discussion of an EBA guideline, which would partially remove the exemption for certain derivative positions of banks with non-financial companies from the obligation to provide own funds for Credit Valuation Adjustment (CVA) risks resulting from these positions. We call on the European Commission to ensure that the guiding principle in EMIR is applied to other regulatory initiatives, too.

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1 See ESMA EMIR report no. 1 “Review on the use of OTC derivatives by non-financial counterparties” released on 13 August (ESMA 2015/1251).

Deutsches Aktieninstitut has supported the strengthening of banking regulation in the aftermath of the crisis. From our point of view the regulation of banks is pivotal to an effective credit intermediation and a reliable provision of financial market services to the economy. We are also aware that the new regulation is not costless for banks and, consequently, non-financial companies using financial services.

However, we are concerned that the level of regulation may ultimately undermine the ability of banks and other intermediaries to provide non-financial companies with the services they need in a competitive global environment. Thus, the Capital Markets Union project should also keep an eye on more traditional forms of finance.

We therefore urge the European legislator to evaluate any additional proposal for bank regulation very carefully with regard to potential negative consequences on the supply of credit and other financial services. Though it may be preferable that more SMEs get funding from capital markets (including venture capital), for the time being the main source of finance for SMEs will be bank credit. In addition, also the biggest European non-financial companies need banks as creditors.

4 The Capital Markets Union project will fail without consistently following the key objectives of promoting funding, risk management and the benefits of capital markets

From our point of view, it is key that the objectives of the Capital Markets Union are consistently followed across regulation. More precisely this means that any regulation should be checked against whether it contradicts the Capital Markets Union idea as laid down in the European Commission's Action Plan.

- A perfect example of inconsistency is the proposal to introduce a financial transaction tax. As has frequently been expressed over the past years, Deutsches Aktieninstitut rejects the financial transaction tax as it will harm the functioning of securities and derivatives. It will decrease the liquidity in stock markets, thereby creating a hurdle for smaller companies to successfully use capital markets as a source of finance. Clearly these effects run counter the very objectives of the Capital Markets Union, as they would make capital market finance and risk management more difficult or costly.

- Similarly, the European institutions should refrain from introducing a country specific reporting for multinational corporations which has to be made public (so-called „Public Country-By-Country Reporting"). Competitive disadvantages for the European economy are expected, as international competitors could draw conclusions from the published reports regarding margins and business policy of their European counterparts. This contradicts the aim of the Capital Markets Union to ultimately foster the competitiveness of European companies.

5 The Capital Markets Union project needs to be embedded in the EU`s Better Regulation Agenda

The Capital Markets Union project needs to be part of the EU`s Better Regulation Agenda – otherwise its success is at stake.

This holds especially true for the role of the European Supervisory Authorities (ESAs) in the legislative process: Even though the ESAs have completed a tremendous work in order to enable a timely implementation and entering into force of the post financial crisis legislation, the work of the ESAs has to be carefully evaluated. In particular, a Capital Markets Union can only be established, if the political will on Level 1 to provide better access to capital markets throughout Europe is not undermined on Level 2. The past has shown, however, that the ESAs have on several occasions overstepped powers conferred to them resulting in Level 2 measures not being consistent with the political will set out on Level 1. The upcoming "white paper" on the governance, accountability and funding of the ESAs constitutes an excellent opportunity for improvement in that regard.

To lead the Capital Markets Union project to success, it is furthermore crucial to define the right balance between harmonization and national specifics. Having a level playing field in place should not be an end in itself. The EU constituting element is subsidiarity. From that perspective a Capital Markets Union does not need complete harmonization. Any new initiative should thus reflect legal diversity, as a one-size-fits-all-solution stands in sharp contrast to the idea of the subsidiarity principle, disrespecting national and local customs. This holds particularly true in areas where there is no clear link to the very objectives of the Capital Markets Union. A good example is the review of the Shareholder Rights Directive, where the EU Institutions need to acknowledge regulatory diversity and existing well-developed mechanisms in European corporate governance systems. In particular the characteristics of the monistic and the dualistic system should be respected.

Last, Deutsches Aktieninstitut welcomes the European Commission's Call for Evidence on the EU regulatory framework for financial services launched at the end of last year. A comprehensive revision of rules on a regular basis under the aspect of coherency and consistency is essential and should form a firm part in the Better Regulation Agenda of the European Commission. However, we are concerned that the outcome of the Call for Evidence will fail to reflect the perspective of issuers as end-users of capital markets and financial services. The impression of Deutsches Aktieninstitut is that the European Commission envisages as a follow up to the call to make EU legislation more proportionate but for the financial industry only. Yet, what issuers need is that their perspective is taken into account and that the

regulatory framework strikes the right balance between financial stability and entrepreneurial freedom, so that capital markets can effectively be used for the purpose of efficient corporate finance and risk management. Thus we recommend to enhance the scope of the Call for Evidence to also analyse unintended negative consequences of financial markets regulation on non-financial companies.

Detailed commentaries on different issues related to the Capital Markets Union project and other legislative initiatives can be found in the position papers and studies of Deutsches Aktieninstitut on:

https://www.dai.de/en/home.html

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