Deutsches Aktieninstitut

Capital Markets Union Mid Term Review: Don`t forget the needs of the companies using capital markets

Perspective of listed companies and corporate end-users of capital markets

Deutsches Aktieninstitut`s Response to the Mid-Term Review of the Capital Markets Union Project, 17 March 2017

Introduction

Deutsches Aktieninstitut welcomes the work already performed by the EU Commission and the co-legislators to improve the capital market financing of the European economy under the Capital Markets Union project. We believe that capital markets can promote growth and deliver jobs as they provide finance and risk management solution of the European companies of the real economy.

In addition, we believe that the outcome of the UK referendum reinforced the necessity to rethink the regulation of listed companies for the sake of the competitiveness of European companies. The prospect of EU's largest capital market moving outside the EU will probably result in an increased market fragmentation and a decrease of liquidity and depth in Europe, unless decisive EU action promotes deeper and better integrated markets. Furthermore, EU companies will still need access to the UK capital markets. Hence, due consideration should be given to reforming third country regimes with the aim of allowing for deeper, faster and more transparent equivalence tests and strengthening the approval process. A general extension, harmonisation and more efficient structuring of existing third-country regimes would enhance the attractiveness of European capital markets vis-à-vis third countries.

Against this background, the mid-term review of the CMU project offers the possibility to take a broader view on the CMU and remind the co-legislators on core needs of companies using capital markets not only for financing purposes. More concretely, we believe that the work on the CMU project -though generally welcome- takes a too narrow view regarding the following aspects:

- We generally believe that the CMU project currently focuses too much on SMEs and firms that seek venture capital. Though it is true that the financing of young and small companies promotes innovation, growth and thus jobs, it is also true that capital markets are currently mainly accessed and used by larger (listed) companies with proven business models. We believe, that the **needs of larger companies** with a lot of experience in capital markets, generally robust relations to international institutional investors and last but not least, millions of employees should be better reflected in regulation. It is further worth to note that any regulation which sets disincentives to the use of capital markets for larger companies will surely also do so for SMEs and younger companies. We therefore call for better reflecting the needs of the experienced players which will also serve smaller companies. In contrast, if the interests and concerns of larger companies are not taken seriously the CMU will never be successful from a macroeconomic point of view.

- This basically means that regulation should be relieved of bureaucratic burdens and elements that set obvious disincentives to use capital markets. In other words: we still feel that the **needs of the companies seeking capital market finance (**i.e. the **demand side** of the capital markets) should be better reflected in the regulation. Additional regulation regularly goes hand in hand with additional direct and indirect costs of accessing the markets. We also believe that this does not necessarily mean to reduce the level of investor protection but rather to better balance the interests of both the investors and the companies seeking finance.

- A broader view should also be taken regarding the services provided by capital markets to non-financial companies. In particular, the CMU project should also keep an eye on risk management services, i.e. **derivatives provided 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. The **European Market Infrastructure Regulation (EMIR) review** will be the point of proof for the willingness of the legislator to avoid negative consequences for non-financial companies in the future by exempting them from the clearing obligation under certain conditions. This is crucial as such transactions are decisive for the normal conduct of business and should not expose non-financial companies to unmanageable liquidity risks. We thus urge the European Institutions not to follow ESMA`s advice to oblige larger non-financial companies, using derivatives almost exclusively for risk mitigating purposes, to clear centrally. Otherwise, significant amounts of liquidity would have to be set aside by non-financial companies for clearing purposes - liquidity which could not be used for investments in jobs, growth and innovation!

- Finally, the CMU project should improve **consistency of the political objectives** across different regulations. We firmly believe that for a CMU being successful it is important that different regulations are cross-checked to deliver a consistent picture of the political will at EU level. In this context, Deutsches Aktieninstitut has appreciated the European Commission's cCall for Evidence on the EU regulatory framework for financial services. A comprehensive revision of the current 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 fails to sufficiently reflect the perspective of listed companies and corporate 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 primarily for the financial industry. Yet, what non-financial companies need is that their perspective is also 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.

Against that background our responses below collect examples of regulation where at least one or our main concerns is relevant. Most of our examples can be summarized under question 2 and 5, because it is finally a matter of regulation whether or not companies will access capital markets or have access to services across borders.

Question 1: Are there additional actions that can contribute to fostering the financing for innovation, start-ups and non-listed companies?

No comment.

Against the background set out in the cover note we are convinced that fostering the financing of innovation will not succeed without reviewing the rules of listed companies. Our comments on Q 2 to 6 thus also apply to Q 1.

Question 2: Are there additional actions that can contribute to making it easier for companies to enter and raise capital on public markets?

Regulation of listed companies

Fewer investment opportunities for investors will arise if companies are reluctant to enter into organized markets due to the high level of regulation, corresponding compliance costs and legal uncertainties. This holds true for both the regulation of primary-and secondary markets. In general, 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 primary and secondary markets' obligations of listed companies.

The examples below thus illustrate where there is a need to better reflect the needs of companies in capital market regulation in order to make the CMU project successful.

Prospectus Regime

The EU Commission has rightly identified the prospectus regime as an important element of the Capital Markets Union project. A meaningful reform would have taken notice of the fact that the present regulatory requirements concerning prospectuses result in time-consuming and costly drafting for issuers, though at the same time investors are not able to read through all these details of a typical prospectus. We don't see that this has been changed significantly by the current revision of the prospectus regime.

In contrast, the result of the proposal has fallen short of that very objective because it will increase bureaucracy instead and create legal uncertainties for companies. The obligation of a categorisation of risk factors and the restriction to provide only the fifteen most material risks in the summary should not have been adopted. A wrong categorisation or a wrong selection of the 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.

Very detailed obligations of the Market Abuse Regulation (MAR) and extension of its scope

Besides a prospectus directive review, lowering barriers for accessing capital markets should include a review of the MAR rules for the benefit of all companies (irrespective of their size) for the following reasons:

In general, there is a growing concern among listed companies that the duties resulting from the MAR have become too detailed and burdensome. Listed companies are still confronted with a high level of legal uncertainty as e.g. central legal definitions remain unclear. Moreover, the European Securities Markets Authority (ESMA) has often interpreted the MAR duties extensively which further adds to complexity. The problems arising hereof are aggravated by the fact that the level of sanctions has been increased dramatically so that listed companies are now confronted with higher sanctioning risks and less legal certainty at the same time. This generally makes a public listing less attractive.

In addition, the scope of application of the MAR has been extended to trading platforms beyond regulated markets. This has substantially increased the level of regulation, in particular for smaller and medium sized companies which are typically listed in the respective segments. These companies now have to compile insider lists, notify managers' transactions, and comply with the duty to publish inside information. Though this has been justified with the argument of investor protection it has nevertheless increased the hurdles for unlisted companies to access organised capital markets.

Against this background we welcome that the EU Commission recognises that secondary market duties may make companies reluctant to seek capital market finance (see report, p. 9), However, from our point of view this is not only an issue for SMEs but for listed companies of any size. It is therefore more important to reduce the level of bureaucratic burden in general than to evaluate some smaller reliefs for SMEs with respect to SME growth markets only.

Reporting requirements for listed companies

Issuers need to comply 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.

Though the legislator rightly decided to abolish the obligation to publish interim management statements for companies listed in the regulated markets, which resulted in more reporting flexibility for listed companies, other pieces of regulation will rather lead to additional burdens.

One example is the duty from the Transparency Directive that issuers need to provide their financial statements in an electronic format which applies beginning in 2020. ESMA has just recommended that issuers will have to use the inline XBRL format which is not yet used by issuers and where there is no investor demand for. This will result in significantly higher costs for listed companies, though there would have been the simple option to demand the publication in PDF format. We therefore urge the EU Commission not to follow ESMA's advice in order to keep listings attractive.It is worth to note that level of investor protection will not be reduced if ESMA's advice is not followed.

Another example is the discussion on ESG reporting which will most likely result in additional requirements for listed companies though the benefits for investors are not clear. In particular, the European authorities 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 can be expected, as international competitors could draw conclusions from the published reports regarding margins and business policy of their European peers. This contradicts the aim of the Capital Markets Union to ultimately foster the competitiveness of European companies.

Regulation of corporate end users of derivative markets: EMIR reporting requirements

As mentioned above, the CMU project should be understood in a broad manner – also keeping an eye on regulatory developments in the field of risk management. The use of derivatives is a necessary requirement for export-oriented European companies. Non-financial companies have always supported improved transparency of derivative markets.

However, the current dual-sided reporting framework is not delivering on its objective of supervisory transparency and is at the same time costly and disproportionate for NFCs. The estimated annual ongoing cost for NFCs is between €2.4bn to €4.6bn – expenditure which is essentially unproductive and unjustified from the perspective of financial stability. Moreover, intragroup reporting requirements significantly increase the reporting burden on NFCs as an NFC that centralises its risk management in this manner is responsible for three of more reports for a single external derivatives transaction. Better supervisory oversight in terms of better data quality, as well as significant cost savings for NFCs, could be achieved through a simplified reporting framework where the financial institutions report on behalf of their corporate clients and retain the legal liability for the content and timing of what they report.

Important to note: to achieve a meaningful alleviation of EMIR's reporting burdens, a single-sided entity-based reporting model would have to be combined with an intragroup transaction exemption for NFCs, and the possibility to transfer responsibility for data correctness to the reporting entity. Otherwise most NFCs will have to continue running their own reporting infrastructures.

Distortions by different tax treatment of debt and equity

Distortions followed by the different tax treatment of debt and equity should be removed. The double taxation of equity – on corporate and on investor level – discriminates equity financing vis-à-vis debt financing. E.g. in Germany this results in a total tax burden on earnings of equity investments of ca. 50 per cent compared to a tax burden on debt which amounts up to ca. 28 per cent.

To avoid distortions of capital accumulation to the detriment of equity, it is necessary to implement a tax regime with similar rates for equity and debt. In this regard, we welcome the approach proposed as Consolidated Corporate Tax Base to introduce a corporate tax offset allowance. Nonetheless, in order to make equity or share investments more attractive – an aim expressed in chapter 4 of the consultation document – we would prefer a general tax relief on retail investor level.

Question 3: Are there additional actions that can contribute to fostering long-term, infrastructure and sustainable investment?

Although Deutsches Aktieninstitut welcomes the idea of the EU Commission to promote infrastructure projects by revising the capital requirements of banks and insurance companies, it has to be noted that a number of other asset classes are clearly discriminated in comparison to sovereign debt in particular. This particularly applies to all kind of equity investments of banks and insurance companies that in general have a higher risk weight than other asset classes given their long-term character and performance. If it is an objective of the Capital Markets Union to promote growth through long-term finance, equity investments should not be neglected. From our point of view, it would e.g. be worth to discuss the short-term focus of risk management metrics (such as value–at-risks models), which do create a disincentive for share investments due to the higher short term volatility of shares.

Question 4: Are there additional actions that can contribute to fostering retail investment?

We agree with the EU Commission that a fostered engagement of retail investors could help to promote capital market finance. We basically support any initiative that would raise the interest in and the de facto access to capital market products.

Reducing hurdles for investment

Regulation of investment advice in banks has become tighter over the last decade. Banks more and more struggle with the costs of compliance. As a consequence, banks frequently retreat from providing investment advice especially on shares. This results in a severe damage for the private wealth building with shares, especially at a time when investments in fixed interest instruments hardly yield above the inflation rate. Furthermore, financing SMEs by issuance of shares purchased by retail investors will become more difficult as banks are increasingly reluctant to provide information regarding share investments. Therefore, rules governing investment advice of investment firms should be scrutinised against this background and adjusted.

Improving the starting conditions by investing in economic literacy

The above mentioned examples also illustrate that the objective of investor protection can be overstated at the expense of other important objectives. For the benefit of ensuring effective investor protection we should rather create an environment providing for widespread financial and economic literacy than pursuing an ecosystem with even more regulatory requirements for issuers.

A sufficient level of financial literacy should be ensured. Investors must be enabled to make sound investment decisions in their own responsibility. Future efforts to reform the European framework for investor protection thus should focus on a widespread economic literacy as core element. The objective of promoting education in order to achieve an economy based on knowledge and innovation, as contained in the EU 2020 Strategy, should include measures to improve financial and economic literacy. Investors should be put in a position to evaluate and compare financial instruments and to make informed and sensible investment decisions.

Promoting interest in capital markets through employee share ownership schemes

Employee share ownership is a good opportunity for retail investors to get a first insight into building wealth with shares. Therefore, companies providing broad employee share programs contribute to the equity culture of a country. Employee share ownership should be promoted by an adequate institutional setting. This is what the European Parliament already stated in its resolution in early 2014. We strongly ask the EU-Commission to take action regarding the promotion of employee share ownership in the Member States. Concretely, the legislator should scrutinise existing European legislation posing obstacles for the implementation of employee share plans. In addition, to introduce a level playing field bureaucracy should be abandoned in order to facilitate cross-border implementation of employee share plans across Europe.

Question 5: Are there additional actions that can contribute to strengthening banking capacity to support the wider economy?

Deutsches Aktieninstitut agrees the role of banks in financing the economy should not be overlooked in the CMU project. 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 is bank credit facilities. In addition, also the biggest European non-financial companies need banks as creditors and providers of other financial services. Banking finance and capital market finance complement each other in many respects.

We therefore generally support the EU's initiative on simple and transparent securitisation. The draft proposal – in particular as amended by the European Parliament – needs however to be significantly improved.

In particular, the currently different negotiation stances of all trilogue partners do not address and cover Auto ABS to the extent necessary for a functioning ABS market. As a result, not only the vehicle manufacturers, but also the small and medium sized dealerships and entrepreneurs in the car sales business will lose a crucial refinancing source. It is important to note that 40-60% of the car sales business relies on vehicle loans and leases

For the initiative to be successful, the following main elements with regard to the current trilogue negotiations should thus be improved:

- The definition of the term “originator” will exclude all leasing companies from the securitisation market (Art. 2a par. 1 and 2 STS, Parliament). Delete Parliament’s proposal.

- The proposal to increase the risk retention from 5 % to 10 % will shrink the securitisation market (Art. 4 par. 1 STS, Parliament). Adopt Commission’s proposal.

- The proposal to delegate the interpretation of the STS-requirements to ESMA will cause legal uncertainty for market participants (Art. 7 par. 1b STS and Art. 8 par. 9b STS, Parliament). Delete Parliament’s proposal.

- The proposals for non-impaired exposures do not reflect market practice and will virtually exclude all Auto ABS (Art. 8 par. 7 STS, Commission, Council). Adopt Parliament’s proposal with amendments made by industry.

- The aggregate exposure value to single obligors will exclude securitisations of wholesale transactions (Art. 243 par. 2 (b) CRR, Commission, Council, Parliament). Adopt Commission’s proposal with amendments made by industry.

- A double-accounting of specific provisions and purchase price discounts will substantially increase the originator's capital requirements (Art. 244 par. 1 (b) CRR, Commission, Council, Parliament). Adopt Commission´s proposal with amendments made by industry.

- An increase of risk weights from 7 % to 10 % will shrink the securitisation market (Art. 260, 262 CRR, Commission, Council, Parliament). Adopt industry proposal.

In addition to that, the legislator should generally be aware that there is a growing concern among non-financial companies that the intensity of bank 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 hedging services. In particular, any indirect undermining of the EMIR exemptions must 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 discussion of an EBA guideline, which would partially remove the exemption for uncollateralized 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.

Also the treatment of derivatives within the implementation of the Net Stable Funding Ratio (NSFR) should be analysed in depth. Our general request is that potential negative impacts on the prices and the availability of hedging instruments are carefully evaluated and understood before the NSFR is implemented in Europe. Our concern is that derivatives exposures are treated punitively under the NSFR framework. Without any modifications to the rules, banks will likely be faced with additional funding costs, which may impact the liquidity of derivatives markets. The increase in funding requirements for banks resulting from the NSFR will increase costs to banks. It may also negatively impact market liquidity that is already subdued due to the impact of other regulatory initiatives. Corporates could see costs associated with trading derivatives increase significantly as a result of higher funding requirement for banks.

Question 6: Are there additional actions that can contribute to facilitating cross-border investment?

From our point of view, it is key that the objectives of the Capital Markets Union are consistently followed across relevant regulations in order to promote cross border investment. Also here, it should be recognised that every effort to ease such a cross border investment can easily be undermined by another piece of regulation.

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 markets. It will decrease liquidity, thereby creating a hurdle for smaller companies to successfully use capital markets EU wide 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.

Besides, there should be equal treatment of all (end) investors across Europe when they invest in a security and they should never be subject to uncertainty as to what they acquire when paying for a security. Currently, they face considerable uncertainty whether they really acquire what has been created under applicable law in the country of the issuer or whether they only require a contractual claim against an intermediary, especially in countries which do not offer right in rem but only offer less like a securities interest or similar instruments. Additionally, intermediaries may imposing upon investors a choice of law clause for the account agreement which differs from the law under which the securities has been created.

In its action plan the Commission has targeted action on securities ownership rules in order to address alleged uncertainty over which law applies in the event of legal challenges on ownership in transactions involving different Member states. In our view, differences in national ownership regimes (as well as national company laws defining the nature of the security) have never created legal uncertainties: However, to avoid uncertainties that may result from the above mentioned choice-of-law-practices, a European principle should be created that the law applicable to the acquisition or disposition of securities of any kind should always be the law of the member state under which the securities have been created.

Contact

Dr. Gerrit Fey
Head of Capital Market Affairs
Deutsches Aktieninstitut e.V.
Senckenberganlage 28
60325 Frankfurt am Main
Telefon + 49 69 92915 - 41
Fax + 49 69 92915 - 12
fey@dai.de

Maximilian Lück, LL.M.
Head of EU Regulatory Affairs
Deutsches Aktieninstitut e.V.
EU Liaison Office
58, Rue Marie de Bourgogne
B-1000 Bruxelles
Telefon +32 2 7894102
Fax +32 2 7894109
lueck@dai.de
www.dai.de