FESE Response to the European Commission Consultation Document
'Capital Markets Union Mid-Term Review 2017'

A. Financing for innovation, start-ups and non-listed companies

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

In the recent wave of action to regulate the financial industry, with multiple EU and international measures, several regulatory actions have had the effect of:

- Creating "one size fits all" regulation for companies;
- Driving up costs for all companies looking to go public, thus reducing the supply of small and mid-cap companies in particular;
- Disincentivising investment in smaller companies and in equity overall;
- Shifting the economics of trading shares away from long-term investing and towards more high-frequency trading of larger company shares, thus making the IPO process less attractive and more difficult, for smaller companies. This also resulted in the erosion of the local ecosystems catering the needs of smaller companies and investors.

After the crisis, many rules and regulations came in response to various scandals or crises, in order to "restore trust" in public markets. However, a side effect has been the slower growth, destruction of companies' and investors' trust in capital markets and in financial regulation. In short, the regulatory balance needed has not been achieved but shifted to the other extreme. While we wait for the existing wave of regulation to be implemented and reviewed, we believe that there is a need for further, more tailored impact assessments, which specifically consider the different needs of end users, both companies and investors. We also believe that immediate action needs to be taken through both regulatory measures and market incentives that would restore the trust of companies and investors alike, create a favourable European as well as local ecosystems supporting companies of different sizes and various types of investors, and induce much-needed growth and jobs by considering the following actions:

<u>Encourage a diverse funding base in European public markets for companies of all sizes</u>
Due to a complex set of regulatory and technological changes both in the US and in Europe, most capital market activity has focused on blue chips, while trading has become automated, highly efficient, and inexpensive. While these changes are to be welcomed from the perspective of the intermediaries serving this market segment and the investors trading in blue-chips, they have also led to the disappearance of smaller brokers, analysts and advisers who are incentivised to invest time and resources into building the demand for smaller IPOs.

The ecosystem for the smaller players has been disrupted. As a result, two important factors have emerged, both of which suppress IPO markets: First, IPOs of smaller companies in particular have become less visible. Second, the fixed costs of IPOs have become larger for the smaller companies, since the institutions providing these services tend to be larger ones catering to the largest companies. Only 50% of companies on Euronext are currently covered by financial analysts, for example. Business information services may be provided by a wider range of firms in the future, but this area is still developing.

Market infrastructure needs to bring companies and investors together, to allow the dissemination of information, and to provide fair and transparent costs. Companies need access to different regulatory, administrative and fiscal environments appropriate to their financing needs at different stages of growth. Increased connectivity and a better dialogue between European companies and their investors, including end investors, both pre- and post- IPO should be encouraged, for example by helping companies connect with the right prospective investors at least one year before the IPO. FESE, together with several other trade associations, has contributed to AFME's report 'The Shortage of Risk Capital for Europe's High Growth Business' (the report is available here). The report highlights the existing sources of risk capital and what measures are needed to improve its supply to support young and innovative companies.

B. Making it easier for companies to enter and raise capital on public markets

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

FESE acknowledges that the Commission has proposed a number of concrete actions which will help to reduce the regulatory barriers and burdens for European companies looking to raise capital on public markets. However, several barriers that are detrimental for the recovery of the European economy persist. In our previous response (here), we urged the Commission to put in place an action plan to increase public financing, both in terms of short-term & immediate issues, and long term objectives. These priorities remain and are as follows:

1. Short-term/immediate priorities:

(i) Conduct a series of impact assessments to identify and support policy initiatives that will deliver real benefits;

(ii) Avoid introducing overlapping legislation on market data;

(iii) Analyse fully the potential impact of the FTT.

2. Long term objectives:

(iv) Increase the role of public markets;

(v) Increase the transparency of European Derivative Markets;

(vi) Rebalance the fiscal treatment of equity vs debt.

FESE members believe that any additional future policies should tackle in particular the following key issues:

- **Listing Barriers**
- **Taxation Barriers**

Listing Barriers

The Proposal for a Prospectus Regulation

FESE members strongly welcome the European Commission, Council and Parliament's active involvement and agreement in the **introduction of a Prospectus Regulation**. We believe that the Prospectus Regulation proposal is an important first step to reduce frictional costs and to deliver a more unified European capital market, improving funding choices for issuers and investment opportunities for investors. In particular, we welcome the European Commission's proposal to establish an optional, passportable proportional disclosure regime for SMEs and mid-size quoted companies, which will reduce burdens and costs and will be recognised by investors.

We believe that the ideal outcome of the review of the EU Prospectus should be a situation in which issuers have a real choice of differentiated public offer listings alternatives available to them, as opposed to the current regime in which the SME and full Prospectus are nearly identical.

In terms of the **proportionate disclosure regime for SMEs**, we strongly believe that it **should be simple, standardised, short in length and less costly** for small and mid-size companies to produce.

Such prospectuses should focus on the key details of the issuer and the securities, using simple language and making use of incorporation by reference.

To minimise the costs for issuers, we believe that the **proportionate disclosure regime for SMEs should be granted a fast-track approval process** and be vetted directly by the exchange, under the supervision of the National Competent Authority. This system is already used in the several Member States, e.g. Sweden and Finland, where it has proved to be a successful model, which balances the needs of issuers and investors.

<u>The impact of MAR on SMEs listing on MTFs</u>
FESE strongly supports the extension of MAR to MTFs. At the same time, it will be a significant transition for SMEs on smaller growth markets, especially the inside information disclosure obligations which are detailed and complex. Within the scope of MAR, maintenance of insider lists for companies listed on 'SME Growth Markets' will be relaxed starting in January 2018. However, the current market perception is that this 'relaxation' does not go far enough in differentiating requirements for SMEs compared to large companies. Disclosure burdens remain unfeasible for SMEs and further action is required to reduce these burdens in order to make is easier for them to raise capital on public markets. Therefore, we suggest that the Commission and ESMA should closely monitor the impact of MAR on SMEs with a view to recommending changes to MAR or developing relevant guidance where necessary.

<u>Investment Research and Analysis</u>
Few small-mid cap companies have been subject to research / analysis by brokers and intermediaries, raising the 'discovery cost' for potential investors in comparison to large cap or already-listed companies (information asymmetries therefore emerge that raise the perceived risk of investment in smaller companies). Smaller companies are usually covered by analysts within smaller brokers, who may be more local or regional. There is some move towards specialisation by sector among smaller brokers, but analysts covering smaller companies need to be familiar with the different local environments, including accounting, taxation, company law, etc.

Professional and retail investors have different information needs. Retail investors access the following sources of business information, such as literature, media, internet, friends and family, and professional service providers, before making their investment decisions. Also, they tend to focus more on the (shorter) management report than on the full annual report. Professional investors use the financial statements and the related footnotes in the annual reports. They usually get real-time information and are likely to meet with company management.

Payment for analyst research has traditionally been done via commissions paid to brokers providing the research. However, in recent years there has been a trend to unbundle the information provided to investors, so that they can choose what information they want to receive (and pay for). Various models have been tried. What works best is likely to depend upon the local market circumstances. The current broker model is no longer viable as the brokers cannot make enough income to maintain the analysts. We therefore recommend that the 'after-market incentives' for brokers should be improved, such as a pilot programme for tick sizes designed to take into account the needs of smaller companies. Furthermore, the provision of analyst research and /or other third party business information services regarding SMEs should be improved. For instance, Euronext's stock exchange Enternext market created a partnership with Morningstar to develop coverage of tech small caps.

Lastly, we believe that the availability of EU data and research should be enhanced by standardising and improving data collection, in order to enable both companies and investors to understand the comparative costs and benefits of different services provided by capital markets participants.

Taxation Barriers

Treatment of equity vs debt

Taxation is crucial in the functioning of public markets. We understand that taxation is the competence of the Members States; nonetheless, we feel that Member States should be encouraged to use tax policies to stimulate long-term investing and to **ensure the fair treatment of debt and equity financing.**

From a company/issuer perspective, equity is more heavily taxed than debt in most countries, which disincentives equity investment. Interest payments on debt may be deducted from profits before they are taxed, whereas equity financing does not receive any form of tax relief (and indeed is subject to significant taxation both in terms of capital gains and dividend payments). This structural bias towards debt financing encourages companies to take on debt rather than equity; yet high debt-to-equity ratios increase the likelihood of bankruptcy and encourage risk-taking, often at the expense of creditors and governments (rather than shareholders). Rebalancing the current bias towards debt financing could be an important initiative for the CMU for two reasons. Firstly, it may encourage companies to strengthen their equity base and discourage levels of leverage that are too high, thereby improving their financial stability via increased loss absorption capacity. Secondly, it may result in investors paying lower taxes on their equity investments, incentivising provision of equity capital as an alternative funding source.

It is not only important to rebalance this bias, but also to harmonise tax procedures within Europe, in order to create a level playing field and to increase the attractiveness of investing in the region. A consistent tax treatment and exchange of best practice should be promoted in order to ensure that fiscal systems are not a barrier to cross-border savings.

Lastly, we believe that tax incentives to encourage investment both for the longer-term and in emerging growth companies should be introduced.

Consequences of an FTT

We believe that the FTT would be damaging to the European economy, undermining the EU priority of promoting growth and jobs and the progress towards achieving a Capital Markets Union. Its introduction would be detrimental for EU financial markets and its users as it would increase distortion on the market and potentially weaken competitiveness of certain jurisdictions with entities potentially relocating their financial activities outside the FTT zone. It would also reduce the value of existing investments in companies which would fall under the FTT. In light of this, we would urge you to reconsider the proposal.

The negative impact of an FTT on end-users of financial products and investors in financial products and on the economy at large has been well documented and evidenced in recent years[1]. An FTT will ultimately be a tax on European consumers when they act as investors, including where investments are made on their behalf such as through pension arrangement. This additional burden will especially be detrimental for investments made by small businesses, ordinary citizens,

[1] A non-exhaustive but comprehensive bibliography can be found in Annex 6 of the following document: http://www.pwc.fr/fr/assets/files/pdf/2013/11/pwc_ftt_litterature_review.pdf. Also, the ECB recently published a working paper on the effects of the Italian FTT https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1949.en.pdf

pensioners and savers. The tax would come at a time of already existing uncertainty and would undermine the competitiveness of Europe's financial markets.

A number of our key concerns on the FTT include:

- The FTT will increase the cost of raising capital to invest in Europe's economy. Because of an increase in transaction costs and reduction in market liquidity, raising finance will become more expensive and negatively impact economic growth and job creation. An FTT would have a negative impact on money markets in the participating Member States thereby seriously affecting businesses' short-term financial management. Implementing an FTT would notably run counter to policies currently developed to enhance equity financing, in particular for SMEs. The taxation of market making activities, even at a lower rate, exacerbates this negative impact as it will contribute to decreased market liquidity;
- An FTT will have a significantly negative impact on the value of insurance, investment- and pension fund savings. It will lead to a direct reduction in asset values and increase future investment costs hitting those who are saving for the future; especially as the tax is proposed to be levied not only on the management of the assets held by the fund but also on the transactions on the funds' shares. Simply exempting the final transactions done by investors, such as investment and pension funds, although helpful will only partially reduce the burden of the tax. The tax would hit retirement savings thereby partly offsetting financial incentives from governments;
- Taxing derivatives will make it more difficult and expensive for corporates and investors to manage their risks. Coupling Forex and interest rate derivatives are, among others, widely used by end-users to hedge their risk exposure when investing and managing other business risk. An FTT could make certain investments or other business activity uneconomic if risks cannot be hedged properly or only at a too high a cost. Wherever possible it is likely that users of derivative products will seek to minimise the tax burden by trading derivatives outside the FTT zone. It is therefore expected, also by the European Commission, that a significant portion of the derivative business will leave the FTT zone, negatively impacting the expected tax revenues;
- The FTT will have an extraterritorial impact requiring financial institutions in non-participating Member States to collect tax. The joint and several liability approach puts a burden on financial institutions of participating Member States which have to compensate for any possible tax shortfall which they may not be able to recover, undermining their competitiveness vis-à-vis institutions outside the FTT zone;
- The effective tax rate of the FTT will be significantly higher than the headline rate given the cascading effect of the tax. For example, taxing transactions in the portfolio of investment funds as well as the transactions of the fund units themselves, would lead to double taxation. Also, taxing market making transactions will lead to a higher effective tax rate than the headline rate.

At a time when policymakers are focusing increasingly on restoring economic growth and job creation in Europe, we firmly believe that introducing an FTT would send a very bad signal. Considering the overwhelming body of evidence of the damaging impact of an FTT, we urge you to reconsider the proposal.

C. Investing for long term, infrastructure and sustainable investment

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

Green Bonds

We support the CMU efforts to promote long-term and green finance. Green bonds are an important instrument to raise capital market finance for environmentally-friendly and more sustainable investments. The proceeds of green bonds are dedicated to "green projects" which should be transparent to investors in order to maintain market reputation.

We support the work of the High-Level Expert Group on sustainable finance to help define steps towards greener capital markets.

World Federation of Exchanges (WFE) Recommendations and Guidance

In October 2015, WFE presented recommendations and guidance to its members on how to implement their sustainability policies on a voluntary basis. The guidance & recommendations identifies environmental, social and governance (ESG) metrics which exchanges can incorporate into disclosure guidance to companies listed on their markets. 34 key performance indicators are highlighted, including energy consumption, water management, CEO pay ratio, gender diversity, human rights, child and forced labour, temporary worker rate, corruption and anti-bribery, tax transparency in addition to other corporate policies.[2]

D. Fostering retail investment and innovation

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

To help increase active investment, and to improve investor access, we need a streamlined and simplified process for corporate governance, in which intermediaries inform investors adequately and enable them to participate in decision-making in companies. We should avoid unnecessary complexity when meeting investor needs. This not only means reducing the complexity of the intermediation chain, but also avoiding unnecessary complexity in trading.

We believe that retail investors should not only be able to invest in managed funds but also be allowed to have a more direct access to the markets, with nonetheless the need for an equilibrium between the participation of retail and institutional investors considering the 'stabilising' role of the latter on the markets. Hence, we believe Europe needs to keep the markets for e-brokerage open and to ensure access to all European securities. With the greater computerisation of households, e-brokerage creates opportunities by adding to the diversity of methods for investing. In parallel, all Europeans should have access to all publicly traded securities in a cost-effective way.

Retail investors could also have access to the primary bond markets (they are only active in the secondary bond markets today, which is due to the distribution channels). However, this has to be weighed against the greater risks for retail investors, since bonds are more heterogeneous, and there is a downside to retail investor participation in these markets.

More generally, efforts to increase greater direct retail participation have to be balanced against the need of investor protection. While we call for greater possibilities for retail investors to access capital markets directly, we recommend caution against exposing retail investors to risks which they are not well-placed to assess. Markets must facilitate access for investors.

Digitalisation to increase the quality of financial services

[2] WFE, 'World Exchanges Agree Enhanced Sustainability Guidance', https://www.world-exchanges.org/home/index.php/news/world-exchange-news/world-exchanges-agree-enhanced-sustainability-guidance

Further integration of retail financial services markets can deliver greater benefits for consumer and digitalisation may help increasing the quality of financial services across the EU, enabling financial institutions to reach out to a broader range of clients.

Digitalisation alone, however, cannot overcome the statutory obstacles to cross-border offerings. Digital service providers will still face the burden of having to comply with divergent consumer protection, labour and tax laws across the Member States. Similarly, consumer still cannot shop online for retail financial services, while this is a common trend in other business sectors.

The regulatory framework for retail financial services should be flexible enough to permit the continuous development of innovative products and services to enables the best outcomes for investors.

Capital markets must become better at meeting investor needs
Investors with different time horizons and risk appetites use markets in different ways. Well-functioning capital markets should address all of these needs through a variety of robust financial instruments. Currently FESE members have a range of service offerings in place for market participants to choose from. Among others, markets must enable investors to plan for the future and provide for pensions: this means good growth potential and safety within their desired risk parameters. A core attribute of meeting investor needs is to be open to all investors and to treat them equally – without any segregation. All investors should have the ability to **access** financial markets in an equal way, and be adequately informed in order to decide which instruments best suit their investment needs. In particular, the increased difficulty of retail investors to be deemed eligible as qualified investors needs to be addressed.

We need to orient more investor flows into listed equity, bond and derivative instruments by **avoiding** any new or existing tax and regulatory **disincentives** that suppress investor demand (and, in selective cases, by considering whether to provide potential well designed tax incentives).

On the demand side, in addition to incentives, more investors must be able and willing to invest in markets. Financial consumer education plays a key role in encouraging more investors to invest in capital markets. Europe lags behind particularly in the share of investors in the equity and non-equity markets when compared with the US; in which the public opinion for capital markets remains positively associated with entrepreneurial dynamism.

Tax incentives to channel savings into long-term investments
EU citizens as individual investors need positive incentives to channel savings into long-term investments for the real economy. Currently, they are suffering from excessively high financial fees from financial institutions which too often destroy the real value of their savings. In particular, tax incentives for direct equity investments (e.g. share savings plans) would support further growth, especially if channelled to growth companies and connected to a long-term holding period. In addition, further tax exemptions (e.g. stamp duty) apply to investments in growth companies as well.

Although we are aware that tax incentives should not be considered as the principal reason for investment, they can enhance financial returns if the tax incentives are not captured by the providers in higher fees and commissions. And there should be no tax bias in favour of short term investments over equity.

Direct Retail Investments in the Pan-European Personal Pension Product (PEPP)

FESE supports the creation of a Pan-European Personal Pension Product (PEPP) in line with the 2016 EIOPA's 'Advice on the development of an EU Single Market for personal pension products (PPP)'.

FESE believes that creating this product would help the EU in meeting the challenges of an aging economy, the sustainability of its public finances, the provision of adequate retirement incomes and fostering increased long-term investment. In particular, **FESE supports a PEPP that allows retail savers to make direct investments in shares and bonds**, i.e. that retail investors should have the choice on what they invest in via their intermediary. A PEPP designed in this way would help achieve the key objectives of the Capital Markets Union by addressing the debt-equity bias through channelling retail savings into capital markets and supporting retail investors in making provision for their own personal retirement savings.

FESE supports a PEPP that promotes long-term investments through appropriate incentives, without preventing investors from withdrawing from the plan should they wish to do so. However, FESE considers that several obstacles hinder the creation of this PEPP which allows for direct investment in shares and bonds, both at EU level and Member State level. Currently, each Member State presents divergent taxation rules, legislative barriers and legal requirements that make it unfeasible to develop cross-border savings. However, aside from the specific obstacles inherent to the individual legislations of the Member States, FESE is also concerned with barriers that affect the whole EU and not necessarily depend one specific national framework.

<u>Lack of an equity culture</u>
Europe does not currently enjoy an 'equity culture'. In fact, investing and listing on a public market does not have the positive connotations that it has in other markets, such as the US one where the value of capital markets is often seen as a benchmark for economic growth.

FESE believes a PEPP would encourage EU institutions and Member States to facilitate initiatives aiming to educate European citizens about the benefits of diversifying their investments and savings through capital markets. FESE supports a PEPP which is a simple, transparent and transferrable product, so in which investors can understand the product they buy.

<u>Debt-equity bias</u>
In the aftermath of the sovereign debt crisis, EU governments changed rules on pension funds to favour government bonds over other instruments such as equity. However, now that the economy has started to grow again, Europe needs to change these rules back. As recognised in the CMU Action Plan, the EU must adopt a neutral regulatory treatment towards public equity and restore a normal level of pension fund investment in sovereign debt. FESE supports pension fund policies that are not biased either towards bonds or equity and can help rebalance the current investment gap. Moreover, historically equities outperform bonds over the longer term. Given the longer-term horizon of pension funds, making just a small portion of funds available to, for example, SME financing could trigger a huge potential for innovation and growth while adding substantial performance opportunities to retail investors with acceptable risks appropriate to investor requirements.

<u>Insufficient size of EU capital markets</u>
European capital markets are not sufficiently deep and diverse to meet the financing needs of the EU economy, particularly in terms of long-term investment and employment. If compared to other regions of the world, the size of EU capital markets in relation to the overall EU GDP is still underdeveloped (under 100%). FESE would like to suggest an explicit target of 100% to be reached by 2020. We believe that this objective could be very useful in creating the momentum around the range of policies needed to increase the supply and demand sides of the market contribute to a

flourishing CMU, directed to long-term rather than short-term investment goals that can multiply real economy benefits. This would, in turn, help achieve optimal risk diversification and multi-pillar diversification, thereby enabling retail investors to save for the long term in a robust manner. Moreover, a well formulated PEPP could help to deal with issues arising from the increasing changes in EU labour mobility.

We consider that there are still key barriers on taxation issues that would stop a PEPP from truly achieving its goals:

- **Inconsistent tax regimes**: FESE believes that taxation should not be an obstacle in crossborder savings and therefore supports a competitive tax system across the Union that ensures consistent tax calculations and minimum duplication.
- **Insufficient tax incentives**: FESE agrees with the Commission that tax incentives are a key factor in determining the success of a framework for personal pensions. We believe it would be useful to encourage Member States to put in place tax incentives that encourage direct investments of taxpayers. At the moment, direct investment in shares is often more heavily taxed than investment in funds or property. Eliminating or reducing taxation on capital gains would be a particularly powerful tool for encouraging more investment flows into public equity.

In light of the abovementioned challenges, FESE supports the creation of a Pan-European Personal Pension product to allow direct investments in shares and bonds. This instrument would provide retail investors with the option to direct their savings on capital markets in order to safeguard a decent retirement. It would also help unlock a truly efficient market, meet the demands put on the European economy by its aging population and contribute to finance long-term growth in the continent. Also, in the context of a growing use of defined contribution systems, it is better for retail customers to have greater control over their asset allocation.

FESE also agrees with the view of EIOPA and the European Commission that personal pensions should help generate funding for long-term illiquid investments such as infrastructure and SME financing. FESE also encourages the Commission to look at other examples of personal pension products available in Europe such as the Self-Invested Personal Pension (SIPP) in the UK or in the reforms made to the Swedish pension system. These can provide the basis for a workable solution for a European pension product.

E. Strengthening banking capacity to support the wider economy

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

FESE believes that capital markets are just as vital as bank financing and that CMU should focus more on how to increase the attractiveness of public markets for rasing capital. In particular, FESE considers that sustainable growth and standardisation of corporate bond issuance are vital parts of the CMU development.

The development of non-bank funding is at the core of initiatives to drive economic growth and employment in Europe, given that traditional sources have been decreasing. Investors searching for returns in a long-term low interest rate environment would welcome new investment opportunities. We need to orient more investor flows into listed equity, bond and derivative instruments by avoiding any new or existing tax and regulatory disincentives that suppress investor demand (and, in selective cases, by considering whether to provide potential well-designed tax incentives). Moreover, any new tax policy (including proposals such as the Financial Transaction Tax) which would discourage investors from investing in capital markets, in particular in listed instruments, should be avoided. Setting in place the right regulatory and tax environment will lead to a bigger “demand” side for capital markets.

F. Facilitating cross-border investment

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

The European Commission needs to consider carefully what impact the UK exiting the EU will have on the financial sector. Financial markets are going to be a very important discussion topic within the Brexit negotiations with strong bearings on the real economy of the EU27 and its equity financing capabilities. We strongly support the EU in solidifying the CMU project ahead of the conclusion of the exit.