AFG's answer to the Capital Markets Union (CMU) mid-term review consultation

Executive summary

*L'Association Française de la Gestion financiè*re (AFG) is grateful for the opportunity to respond to the consultation of the EC on the Capital Markets Union (CMU) mid-term review.

AFG has supported the CMU initiative from the start. The upcoming Brexit strengthens the need to accelerate its development though an ambitious and a pragmatic approach to fulfill its objective to « establish the building blocks of an integrated capital market in the European Union by 2019 ». It is essential for the development of jobs, growth and competitiveness and sovereignty of the European Union that it benefits from strong financial centers located in the Union, able to channel savings into investments.

In order to foster this essential project we would in particular recommend the five following actions:

1. Take into account the new situation created by the Brexit

The European Union is built on the principle of the four freedoms of movement of goods, services, capital and people within its member states. This is reflected in the establishment and functioning of a single market founded on a single body of rules. In the area of asset management, membership to the single market principally entails the granting of a "passport" enabling operators to conduct their management and distribution activities on a cross-border basis within the EU, while maintaining a level playing field between actors – avoiding regulatory arbitrage and banning "letter box entities" and ensuring investor protection.
The agreements that the European Union enters into, if necessary, with third countries – those outside the EU – should only give access to the single market provided that full compliance with all of these rules is accepted and that it is the subject of full reciprocity to facilitate the access of EU operators in third countries, while being closely and regularly monitored. In respect of asset management on behalf of third parties, this arrangement is all the more crucial as it allows equal protection of investors and savers and develops their trust.
Negotiations that will begin, regardless of their duration and the soft or hard nature of the talks, must protect the interests of all stakeholders for the benefit of the integrity of the European Union and its founding principles. It would be unimaginable for economic actors located in countries that are not EU member states to be able, particularly through ill-conceived and/or not legally binding "equivalence" regimes, or not being the object of a regular review, to enjoy the advantages of the single market without being subject to the rules imposed on European operators.
The new legal regime should be promptly established without a transitional period that would cast doubts on operating rules in force and add to uncertainty, in order to protect the relationship of trust that exists between industry operators and their clients. Maintaining the strength of an industry that is even more crucial than ever to the financing of the real economy will depend on the speed with which the new ecosystem can be put in place.

2. Go forward with key initiatives which will actually deepen the CMU:

- **Launch the long-awaited PEPP initiative:** AFG strongly supports the will of the EC to launch Pan-European Personal Pensions. We believe it will give substance to the CMU project as it could further link long-term savers with long-term investment opportunities, such as company stocks, private equity and infrastructures.

- **Finalize level 2 measures for ELTIF & level 1 negociation on STS securitisation:** After more than a year after the entry into application of the ELTIF regulation, stakeholders are still waiting for level 2 measures. We call the EC to find practicable solutions (in particular regarding eligible assets and the lifetime of the fund) in the context of the RTS, in order to ensure ELTIFs will materialize their added value and increase their market potential. Regarding the negotiations on STS securitisation, we call EU institutions to conclude swiftly their negotiations and to deliver a final text which will actually revive securitization market, not make it more burdensome.

- Continue and develop **the "recalibration" process of Solvency II capital requirements**, in particular for investing directly and through funds in non-listed and listed equities as well as in infrastructure ELTIFs and funds investing long term should be incentivized.

- **Come up with pragmatic non-legislative tools to facilitate cross-border distribution of funds**, such as guidelines regarding the notion of pre-marketing.

3. Give up on initiatives which go against the CMU's objectives:

- **Give up on the EFTT:** This tax would create a distortion of competition among participant Member States, other Member States and the rest of the world, and it would result in a fragmentation of the European capital markets. Ultimately, this tax would be borne by retail investors, who, on the contrary, should be more incentivized to invest in capital markets. This initiative is blatantly going against the CMU project.

- **Apply a carve out regarding the treatment of equity and investment funds under IFRS 9**: IFRS 9 will force certain institutional investors to strengthen the allocation to bonds and give up on equity and investments funds. This accounting standard is not adapted to such long-term investors, therefore we call the EC to propose a carve out for the treatment of funds and equity.

- **UCITS Share-classes guidelines:** the restrictive guidelines of ESMA on share-classes are an impediment to create economies of scale through larger and cost-efficient fund in the EU.

4. Implement the Better regulation principles to ensure smooth development of CMU:

- **Refrain from reviewing recently adopted and well working legislative framework such as UCITS and AIFMD:** As level 2 measures (ex. Commission Delegated Regulation (EU) 2016/438, Commission Delegated regulation (EU) 2015/514) have only been adopted recently, we believe it is key to have a legislative pause at this stage and to wait a few more years of implementation before asking for concrete feedback from stakeholders in order to assess the need for a revision. We believe most of the challenges identified in the specific CMU consultation on the *Crossborder distribution of investment funds* can be tackled by ESMA via non-legislative texts.

- **Provide realistic implementation timelines (at least 18 months between the publication of level 2 and entry into application) and avoid the need for last minute (welcomed) quick fixes (i.e. MiFID 2, PRIIPS).**

- The entry into application of EMIR variation margin requirements in the EU on March 1st 2017 while the rest of the world (Hong-Kong, Singapore, Australia, U.S.) was postponing for 6 months the international commitment shows the **urgent need to grant to the ESAs the power of releasing no action letters.**

- **Refrain from regulating at an early stage new emerging sources of funding (ex.loan funds) and apply more widely the proportionality principle,** which would allow for a better calibration of the rules, modulation of their implementation and adaptation of the supervision according to the size of entities.

- **Avoid gold plating and major changes introduced by the ESAs at level 2, 3 and 4 (PRIIPS, MIFID):** Deep changes (not foreseen at level 1) can sometimes be introduced by the ESAs at level 2, 3 or 4. One example could be the introduction of the “market impact” in the transaction costs methodology by the ESAs and the EC in the PRIIPS RTS. Although taking into account “market impact” in the transaction costs methodology was not prescribed by level 1 text on PRIIPS and clearly excluded by level 1 of IDD and MIFID, the ESAs and the EC, disregarding current market practice, legislative coherence and controversy around such methodology, have decided to introduce it.

- **Reducing administrative burden by streamling and aligning reporting requirements:** Current and pending reporting requirements (data, formats, channels) vary under EMIR, MIFID, SFTR. The EC should take advantage of the EMIR review and the SFTR level 2 measures to ensure more coherence and to reduce administrative burden by enabling a single counterparty to report (instead of both today). More globally, ESMA should play a key role of data collector.

5. Four policy aeras which can be further developed to boost the CMU:

- **Enhance financial literacy of EU citizens:** AFG encourages the EC, the ESAs, and Member States to improve the quality of financial information given to citizens. For instance, AFG is convinced that if future pensioners would get at a early stage an estimation of the actual State pension they will get at retirement date, they would be more encline to save via workplace or complementary individual pension products, investing a larger portion of their savings in the financing of the real economy.

- **Ensure a better tax treatment for investors:** Fiscal incentives are key to channel savings toward productive investments. We urge Member States to improve at national level tax treatment of capital gains and call for the Council to ensure the best national tax treatment possible for key initiatives such as ELTIF and the PEPP**.**

- **Towards a European label on products pursuing environmental and social objectives:** AFG encourages the EC to further investigate concrete legislative and non-legislative actions to foster sustainable investments, such as the convergence toward a common definition of Socially Responsible Investment (SRI), and work towards the creation a European label for funds and other investment products/assets which meet SRI criteria.

- **Lastly and very importantly enhance the competitiveness of European stakeholders abroad and in the EU**: The EC needs to better take in account the regulatory developments abroad and ensure its own framework is competitive. Third country passports and equivalence regime put European actors in a situation of unlevel playing field, as true equivalence is rarely witnessed. EC should only consider giving to a third country some access to the Single Market if it can actually demonstrate it complies with all relevant European laws and if reciprocity is secured. A mechanism should be adopted to repeal such access to market if the European law is breached.

1. FINANCING FOR INNOVATION, START-UPS AND NON-LISTED COMPANIES

Q1 -Are there additional actions that can contribute to fostering the financing for innovation, start-ups and non-listed companies? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

Go forward with initiatives which can actually deepen the CMU:

AFG welcomed the EC's proposal to review **EuVECA and EuSEF framework**, which includes the possibility for asset managers whose assets under management are above 500 million euros, to manage such funds. We believe this proposal could indeed contribute to increase the number of of private equity funds and therefore contribute to the financing of non-listed companies and further develop alternative sources of funding of the European economy. AIFM managers of these funds would be given a passport. **AFG encourages the Council and the EP to engage negotiations in order to adopt swiftly the targeted a changes introduced by the EC.**

Avoid initiatives/practices which go against the CMU's objectives:

AFG would like to state the need for more flexible State aid rules, in particular regarding the financing of innovative SMEs and start-ups. Current State aid rules are questioning income tax break meant to boost investment in innovative SMEs. Indeed, according to EU Law, such tax incentive could only be granted for companies, which have been operating commercially for less than 7 years. If such tax breaks qualify as State aid this would force asset managers to withdraw investment from key innovative companies.

Implement the Better regulation principles to ensure smooth development of CMU:

AFG also agrees to say that the development of **private placement** opportunities is also largely contributing to achieve such goal. In this regard, AFG strongly welcomes the cautious approach of both ESMA and IOSCO regarding the need for a specific regulation of **loan funds**, which often invest via private placements. AFG would like to stress in particular that these funds have already to be compliant with AIFMD and with additional stringent national rules. It's still too early to assess if it would be relevant to launch work on the need, or not, for a specific European label or harmonization. French loan fund framework has only been set up very recently (2016).

If **crowdfunding** can also foster the creation of companies and contribute to their development, it seems crucial that it is governed by further developed rules. Generally speaking, the European Union should overcome the paradox existing between promoting crowdfunding (very risky by definition) and the addition of ever more restrictive measures (e.g. PRIIPs, MIFID II) in the context of the placement of regulated products that have proven themselves such as UCITS or AIFs. More specifically, AFG would recommend to ensure a greater level of investor protection (for both loans and capital contributions). Some studies show indeed urgent need to address the issue of deceiving of information (in particular risk/reward indications) provided to European citizens and the lack of alignment of interests between the platform and the investors due to the commission based remunerations of employees of the crowdfunding platform. Given the risky nature of crowdfunding and following the basic rule of diversification, **AFG strongly recommends NCAs to set a limit for retail investors' exposure to crowdfunded projects (i.e. certain part of their wealth and/or their annual income).**

Essential policy areas which can be further developed to boost the CMU:

AFG notes that only a small number of regulators put in place databases on the solvency of SMEs. The EC should encourage all other regulators to put in place similar databases and to examine the possibility of them use in conditions that would preserve the confidential nature of the data on SMEs and without regulators being considered as credit rating agencies. Ultimately the EU should aim at creating a European Central Credit Register accessible to all relevant market participants.

2. MAKING IT EASIER FOR COMPANIES TO ENTER AND RAISE CAPITAL ON PUBLIC MARKETS
Q2. Are there additional actions that can contribute to making it easier for companies to enter and raise capital on public markets? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

Avoid initiatives which go against the CMU's objectives:

By prohibiting that financial research charges are mutualised between large capitalizations and small/mid capitalizations, MIFID II delegated act will result with a significantly lower coverage of small and mid capitalizations. Some brokers already announced that they would cut small-mid cap research by 50%, as such new restrictions will indeed considerably increase its cost. As of today, the situation is already unsatisfactory as, for example, 50% of small and mid-sized companies listed on Euronext do not benefit from any financial research and 16% only have one analyst. Let's recall here that in France 50% of assets under management invested in small and mid-sized companies are managed by small and mid-sized asset management companies, which will be particularly impacted by the increase in functioning costs. **AFG would recommend for the EC to conduct post-implementation impact assessment as soon as possible.**

3. INVESTING FOR LONG TERM, INFRASTRUCTURE AND SUSTAINABLE INVESTMENT
Q3. Are there additional actions that can contribute to fostering long-term, infrastructure and sustainable investment? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

Go forward with initiatives which can actually deepen the CMU:

AFG has welcomed the **ELTIF** regulation and the recalibration for ELTIFs under Solvency 2. We consider this could be a concrete step forward in the debate on boosting long-term investment in the EU and towards meeting Europe's pressing needs for financing growth and long-term development. Nevertheless, AFG would like to stress the need of ensuring the maximum flexibility for the ELTIF framework, in particular on the eligibility of the underlying assets and the lifetime/lifecycle of the funds. **Therefore, we call the EC to find practicable solutions in the context of the RTS and to apply such flexibility and adaptability, in order to ensure ELTIFs will materialize their added value and increase their market potential. The EC should also continue its work on the recalibration of Solvency II capital requirements, in particular for non-listed and listed equities and infrastructure. ELTIFs and funds investing long-term should be more incentivized.**

AFG very much welcomes the launch of a High-Level Expert Group on sustainable finance and agrees to say the focus should not just be on green finance but on the wide definition of sustainable finance (including environmental, social and governance aspects). We encourage the EC and the HLEG to further investigate concrete legislative and non-legislative to foster sustainable investments, such as the convergence toward **a common definition of Socially Responsible Investment (SRI), and, progressively, common standards on transparency requirements on ESG investment policy (respect of a transparency code for instance). In a mid/long term perspective, common standards of quality could be achieved by creating a European label for funds and other investment products/assets which meet SRI criteria. We would also be supportive of a more a favourable prudential treatment when institutional investors invest in/fund assets/projects complying with SRI criterias.**

Avoid initiatives which go against the CMU's objectives:

Public institutions such as Caisse des Dépôts, and electricity providers/nuclear operated (such as EDF and Areva) are long-term institutional investors, will be impacted by IFRS9. In France, the French law obliges electricity providers/nuclear operators to constitute dedicated assets in order to secure financing of long-term obligations (i.e. for the decommissioning of nuclear power plants). Therefore, these companies also act a long-term investor: they invest in assets (billions of euros) whose primary goal is to cover future cash outflows that will range over many decades. Therefore, they have built up a portfolio of dedicated assets. Most of these assets take the form of diversified equity securities, bonds and shares of investments funds (UCITS, AIF) provided by the members of AFG.

IFRS 9 will illogically force such actors to strengthen the allocation to bonds and give up on equity and investments funds. Indeed, when investing in a fund under IFRS 9, the unrealized gains or losses will have to be registered in the yearly income (i.e. profit or loss, P/L), irrespective of the investment horizon. Given this discrimination of funds, long-term investors might redeem significant amounts of out of EU funds and more generally reduce their exposure to equity since, unlike bonds, direct exposure to equity does not allow to recycle profit, i.e. to have realized gains or losses added to the profit and loss account. Therefore, not only IFRS 9 will narrow of investment options for such actors and make it more difficult for them to fulfil their legal obligation, it also goes against the Capital Markets Union's objectives, as it will:

- Discriminate indirect investment via investment funds compared to direct holding
- Penalize long-term investors holding equity
- Reinforce the debt bias in the EU

Our understanding is that the EC cannot modify IFRS 9, but however it can adopt a carve out for specific actors or part of the standard. Therefore, we urge the EC to propose to include a temporary carve out for treatment of funds and equity. The EC should also regain its sovereignty that is has the power not to endorse the parts of IFRS/IAS proposals that would be detrimental to the well functioning of CMU.

<u>Essential policy areas which can be further developed to boost the CMU:</u>

AFG would recommend to grant a better solvency ratio for ELTIFs that only invest in qualifying infrastructures (qualifying infrastructures benefit with a 30% ratio). Some provisions could be introduced in terms of diversity of infrastructure types in order to better take into account the diversification advantage of ELTIFs. For instance we could consider that ELTIFs invested in a diversified portfolio of qualifying infrastructures could benefit with a 22% ratio.

A reflection should also be carried out on the eligibility of ELTIFs to the "free" 10% ratio and to the 30% eligibility ratio of UCITS and AIFs.

4. FOSTERING RETAIL INVESTMENT AND INNOVATION

Are there additional actions that can contribute to fostering retail investment? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

<u>Go forward with initiatives which can actually deepen the CMU:</u>

AFG is strongly in favour of the **PEPP**. We very much hope the EC will be able to launch a legislative imitative soon enough for it to be adopted before the end of this term. Ahead of this publication announced for the summer 2017, we want to highlight that EC's proposal need to be as flexible as possible in order to be successful. This means regarding the **decumulation phase** that it should be open to both **lump-sum payments** and annuities. This option should be left to the investors, who will face very different needs and projects at the age or retirement. We also urge the EC to allow for flexibility regarding the **default option**: the obligation to propose guaranteed options would have drawbacks. Guarantees are indeed very expensive, often result in delivering poor returns to pensioners, and would de facto reduce the number of potential PEPP providers, which could mean less competition in the market and higher fees to be paid by future pensioners. Therefore we would rather recommend, as OECD did, to consider the **derisking of portfolio** (life-cycle funds) as the default option.

<u>Avoid initiatives which go against the CMU's objectives</u>:

AFG would like to state again that the launch of an EFTT would be a massive blow for the CMU project. **<u>Ultimately, this tax would have to be borne by retail investors.</u>** An EFTT limited to 10

Member States would create a distortion of competition among participant States and other States, a fragmentation of the European capital markets and a relocation of financial services activities which would be to the detriment of the States participating to such an enhanced cooperation. Moreover, if it were to apply both to fund units on primary and secondary markets and their underlying securities, the EFTT would not encourage individual investors to invest through investment funds, such as ELTIFs, UCITS or AIFs, as they would become more costly than direct investments**.** For this reason, the EFTT would create a bias in favour of products to which it does not apply, such as insurance contracts or savings accounts. We therefore call on the European authorities to drop this project.

Investor confidence is key for the development of the CMU initiative. This is why NCAs powers to stop misseling of dangerous "investment" proposals generally based on deceiving marketing materials should not be imprudently weakened.

AFG consider that the PRIIPS RTS is a missed opportunity to truly enhance financial literacy. We very much fear that some key elements of the KID could be misleading retail investors and in particular:

- Performance scenarios methodology: by prolonging almost automatically bull market and bear market trend, we fear this methodology will give unrealistic estimation of potential returns and no indication of potential market downturn or recovery;
- Methodology to compute transaction costs (including the "market impact") could result in giving inflated, false and misleading figures (i.e. negative costs);
- The lack of disclosure of past performance, despite consumers' associations' recommendations.

For all these reasons, AFG would call for the EC to stick to review clause of PRIIPS by the end 2018 and propose a solution to swiftly fix the main issues identified above.

Essential policy areas which can be further developed to boost the CMU:

AFG would also strongly recommend that the EC develop a strategy to enhance financial literacy in the EU. More than the lack of trust, it is the lack of understanding on the different type of assets and their performance/risk over time, which is one of the main impediments to development of CMU. Access to basic knowledge on this matter should not be limited to students following financial careers but should instead be widespread to EU students**.**

AFG wishes that the essential role of depositaries and custodians is not weakened through the CMU process, and asset segregation preserved.

5. STRENGTHENING BANKING CAPACITY TO SUPPORT THE WIDER ECONOMY
Are there additional actions that can contribute to strengthening banking capacity to support the wider economy? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

Go forward with initiatives which can actually deepen the CMU:

AFG is overall supportive of the draft STS securitisation regulation proposal, but they are key points which absolutely need to be taken on board by the final agreement between the EP and the Council in order to truly revive this market:
-Stick to 5% minimum risk retention rate in line with global standards;
-Avoid regulatory burden, particularly in relation to transparency requirements;
-Allow a flexible approach when it comes to certification;
-Set a prudential framework (review of the CRR & Solvency 2 directive) that is sufficiently incentivizing for the sell-side.

6. FACILITATING CROSS-BORDER INVESTMENT
Are there additional actions that can contribute to facilitating cross-border investment? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

Go forward with initiatives, which can actually deepen the CMU:

AFG encourages the ESMA to come up with pragmatic non-legislative tools to facilitate cross-border distribution of funds:

- In this regard, we very much welcome the progress made by the EC and experts of Member States to find a common definition of pre-marketing, in order to allow for the distribution of draft fund documentation to a limited number of professional clients and to make the launch of new funds easier. We now call for this work to be translated into guidelines by ESMA.

- We also a recommend the EC to explore the feasibility of a European register of **".eu" Isin codes'** funds notified by NCAs: it should be envisaged that funds compliant with the UCITS, AIF, ELTIF, EUVECA and EUSEF Directives be granted, at the fund management company request, a ".eu" ISIN code by their national regulators (NCAs) instead of the usual ".fr", ".it", ".sp"., ".lu" (etc.) ISIN code. **ESMA could then in the future maintain a repository of the list of these funds published on an internet portal.** This initiative would enhance transparency and safety to the benefit of the end investor.

- AFG would also recommend to facilitate the access to key cross-border information through a specific internet portal produced hosted by ESMA and fully available in a language customary in the sphere of international finance including tables updated by NCAs presenting national regulatory fees, main national tax regimes, marketing requirements.

- Regarding taxes, from our point of view the easiest solution to solve complex legal and practical withholding tax (WHT) problems in Europe and to foster retail investment and cross border distribution of funds would be the abolishment of WHT on transferable securities for payments made to UCITS and AIFs within the EU and partner jurisdictions to the EU. As an alternative approach, it also could be considered to at least impose an EU wide limit on the WHT rate equal to the rate foreseen in double tax treaties which is 15%. As major source countries in Europe already followed those approaches, this would also help to create a level playing field for all countries within the EU and partner jurisdictions and to boost the competitiveness of the Single Market as a whole. As to a potential 'treaty shopping' argument against this, it is worth reiterating that investors invest in a widely held fund to benefit from professional management of a diversified portfolio. They do not have control over the investment decisions and treaty benefits are not the primary objective of investing in a fund.

Avoid initiatives which go against the CMU's objectives:

UCITS Share-classes guidelines: the restrictive guidelines of ESMA on share-classes are an impediment to create economies of scales, larger and cost-efficient fund in the EU.

Regarding potential action on securities ownership rules and third-party effects of assignment of claims, AFG would like to state again that securities ownership chain should keep relying on the notion of right to property, which is a sound base of the continental securities law. Today, in our view, a European initiative on this field won't be relevant and will greatly affect the majority of continental law.