A European Capital Markets Union: What? Why? How?

1. On 18 February 2015 the European Commission launched a consultation on Capital Markets Union ("CMU")[1]. The consultation closes on 13 May 2015 and is accompanied by two related consultations (on high quality securitisations and a review of the Prospectus Directive) which identify possible and relatively short term action points. The consultation papers are genuinely consultative and the Commission is offering interested parties a real opportunity to shape CMU. Based on the input received, the Commission proposes to adopt an Action Plan on CMU later in 2015. The Action Plan will set out the actions to be carried out over the next five years. The ambitious objective is to create a liquid, transparent, integrated and well–regulated single capital market by 2019. This legal alert explains the Commission's objective but also considers the obstacles that currently stand in the way of CMU and the challenges the Commission faces in attempting to address those obstacles.

Why is pan-European action necessary?

2. One of the two original core objectives of the European Economic Community, the forerunner of the European Union ("EU"), was the development of a common market, which in turn became known as the single or internal market. The internal market is envisaged as "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured..."[2]. As the European Court explained in 1985:

> *"The Treaty, by establishing a common market and progressively approximating the economic policies of the Member States seeks to unite national markets in a single market having the characteristics of a domestic market..."*[3]

The 'four freedoms' of goods, persons, services and capital lie at the heart of the internal market. The general rule is that Member States may not discriminate against those who exercise their rights to one of the four freedoms nor impose non-discriminatory obstacles to the four freedoms unless those obstacles can be justified.

3. Despite the internal market and free movement of capital being original objectives of what is now the EU, there is not a single EU capital market: fragmentation, largely along national lines, remains. It is this fragmentation that the Commission now wants to tackle.

4. In the immediate aftermath of the financial crisis, the EU focused on financial stability objectives. The new Commission is still grappling with some legacy financial stability issues[4] but it has a new focus on boosting jobs and growth. It regards CMU as necessary to increase access to funding (particularly for small and medium-sized enterprises ("SMEs")), reduce reliance on bank funding, attract third country investment into the EU, enhance financial stability by diversifying the sources of funding and ultimately boost jobs and the EU economy.

1 The Green Paper Building a Capital Markets Union (COM (2015) 63 final) was accompanied by a Commission Staff Working Document Initial reflections on the obstacles to the development of deep and integrated EU capital markets (SWD (2015) 13). These documents are available at http://ec.europa.eu/finance/capital-markets-union/index_en.htm

2 Article 26(2) of the Treaty on the Functioning of the European Union ("TFEU").

3 Case 207/83 Commission v United Kingdom [1985] ECR 1201.

4 In addition, much of the legislation adopted under the previous Commission has yet to come into force. Solvency II and MiFID II / MiFIR are obvious examples but there are also pieces of legislation, such as EMIR, which are in force but whose obligations have yet to come fully into effect.

5. The Commission's research, however, reveals that:

   a. investment in the EU remains heavily reliant on banks;

   b. there are significant differences in financing conditions between Member States;

   c. there are differing rules and market practices for products like securitised instruments and private placements;

   d. shareholders and buyers of corporate debt invest mainly within their own Member States; and

   e. many SMEs still have limited access to finance.

6. The Commission draws an interesting comparison with the United States. It notes that Europe has traditionally relied more on bank finance, with total bank sector assets far exceeding those of the US. As a consequence, EU capital markets are not as developed as those in the US. Accordingly and although the EU economy is slightly larger than that of the US:

   a. medium-sized companies receive five times more funding from US capital markets than they do in the EU;

   b. US public and private equity markets are almost double those of the EU in size[5];

   c. the volume of US private placement is up to three times bigger[6];

   d. the volume of corporate (non-financial) debt securities is three times as large in the US[7];

   e. the volume of corporate high-yield securities is more than 2.5 times as high in the US[8].

   In addition, mid-sized EU companies turn to the US private placement market due to an insufficient EU investor base.

5 138% of GDP in US versus 64.5% in EU
6 $50 billion versus €15 billion in the EU
7 40.7% of GDP in US versus 12.9% in the EU
8 €187 billion versus €68 billion in EU

7. There are also divergent positions across the EU. For example, domestic stock market capitalisation exceeded 121% of GDP in the UK and 98% in the Netherlands, compared to less than 10% in Latvia, Cyprus and Lithuania.

What are the obstacles to CMU?

8. The creation of a CMU is an ambitious objective and the Commission recognises that there are numerous obstacles to consider. It also appreciates that many of these obstacles are long-standing, have been recognised as such for many years and result from divergent domestic legislation that has developed to reflect the requirements of national markets. The obstacles that the Commission has identified are those set out in the following paragraphs.

Underdeveloped or fragmented markets, due to regulatory and legal barriers, institutional shortcomings and other reasons

9. The Commission has identified divergent national laws in areas including taxation, insolvency, company law, securities law, market rules, market access, investor / consumer protection, contract law, conflict of law rules and recovery and resolution for non-bank entities[9]. This is not surprising. As Andrew Bailey, the UK's top prudential regulator, commented in 2013:

> *"Despite the integration of financial markets, all markets are not the same and national interest is still a dominant influence."*

10. One of the EU's responses to the financial crisis was the creation of a single rulebook in financial services regulation. This is intended to create greater regulatory harmonisation between the 28 Member States but it cannot do so completely, at least in the foreseeable future, for a number of reasons including the following:

    a. As part of the trend towards greater regulatory harmonisation, there has been an increasing tendency to use regulations as opposed to directives as the legal instrument of choice post-

9 Detail of the Commission's findings can be found in the Staff Working Document *op cit* fn.1 at section 3.

financial crisis. Regulations are binding in their entirety and directly applicable in all Member States without the need for implementation: directives, on the other hand, are binding only as to the result to be achieved but need to be implemented into the domestic legislation of each Member State. Regulations are not, however, appropriate for all policy objectives, particularly where it is necessary to preserve existing differences in Member States or to grant them a discretion in implementing their obligations. Accordingly, some directives remain in force and new directives are still adopted. The result is that where directives are in use there will be inevitable differences between Member States. This may be because the directives deliberately grant Member States a discretion, because they permit gold-plating[10] or simply because the form and method of implementing a directive is up to each Member State.

b. The EU can only operate within the competencies conferred on it. Article 5(2) TFEU provides that: *"Under the principle of conferral, the Union shall act within the limits of the powers conferred upon it by the Member States in the Treaties to attain the objectives therein."* This means that if a competence is not conferred on the EU, Member States retain their national competence. Broadly speaking, matters such as direct taxation, substantive insolvency law and private law matters remain primarily a matter of national competence, although the EU can regulate those elements which, for example, create obstacles to trade in the internal market[11] or relate to consumer protection.

c. The internal market and consumer protection are 'shared competences' which means that Member States as well as the EU can pass legislation in these areas, provided domestic legislation does not contradict EU legislation and the EU has not 'occupied the field' so that there is no further room for domestic action in the particular area. Where the EU acts it must do so in compliance with the principles of subsidiarity and proportionality which mean respectively that: the objectives of the proposed action cannot be sufficiently achieved by the Member States acting on their own and they can, therefore, be better achieved by action on the part of the EU; and EU action must not exceed what is necessary to achieve its objectives.

d. Domestic legislation has developed over centuries to suit national markets, customs and practices whereas the EU is a recent construct[12] with a different objective. As a result, there are inevitable differences in the 28 Member States of the EU.

11. In addition to different laws, there are also different regulatory and supervisory practices throughout the EU. Based upon the principles of subsidiarity and proportionality, the EU has traditionally had responsibility for financial services regulation but deferred to Member States as regards operational supervision and enforcement: in practice, there has been a distinction between the centralised making and the local application of rules. Member States have often provided their national regulators with largely discretionary powers to supervise financial institutions and enforce the law. This permitted different regulatory responses within different Member States. These differences, poor cooperation between regulators, the inability of national regulators to take common decisions and the tendency for them to adopt localised, not pan-European, measures were heavily criticised after the financial crisis. This criticism led first to the creation of the European System of Financial Supervision, in which the European Supervisory Authorities have an important role to play in ensuring both regulatory and supervisory convergence, and then to the creation of banking union under which the European Central Bank has prudential responsibility for all banks within the Eurozone and direct supervisory responsibility for around 200 of the largest banks. These are giant steps towards common regulatory and supervisory practices but, for the same reasons identified above plus the fact that the Euro-outs have retained their own prudential regulators, different regulatory and supervisory responses remain throughout the 28 EU Member States.

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10 Gold-plating or super-equivalence is when implementation goes beyond the minimum necessary to comply with a Directive.

11 For example, Article 50 TFEU, which is concerned with freedom of establishment, enables the EU to harmonise various aspects of company law, Articles 114 and 115 have been used to regulate elements of private law, such as taxation and contract law, which create obstacles to trade in the internal market and Article 352 allows the Council to act by unanimity in areas not specifically foreseen under the Treaties but which are within the framework of the policies set out in the Treaties.

12 In 1957 the Treaties of Rome established the European Economic Community and the European Atomic Energy Community.

12. The barriers to a single capital market are long standing and have long been recognised as such. In the last century the Commission created a group of experts known as the Giovannini Group[13]. The Group published two reports in 2001 and 2003 on cross-border clearing and settlement[14]. The first report identified fifteen barriers, which became known as the Giovannini barriers, to efficient cross-border clearing and settlement of securities in the EU. The Group sub-divided the barriers it identified into three main headings:

    a. Barriers relating to national differences in technical requirements/market practice

       The Group identified ten such barriers including differences in information technology; differences in national rules relating to corporate actions, beneficial ownership and custody; restrictions to direct access to settlement systems by foreign institutions; different lengths of settlement periods; differences in operating hours and settlement deadlines; and the requirement that issues in listed securities be deposited exclusively in the local settlement system.

    b. Barriers relating to national differences in tax procedures

       The Group identified three types of tax as sources of barriers to cross-border securities trading within the EU: national withholding tax regulations, capital gains tax and transaction taxes such as stamp duty.

    c. Barriers relating to issues of legal certainty that may arise between national jurisdictions

       These barriers included in this section were the absence of a pan-EU framework for the treatment of interests in securities; differences in legal definitions of, for example, pledges, settlement finality and rights from securities; and uneven application of national conflict of law rules. The Group, however, noted that:

> *"Barriers relating to legal certainty are of a different order to the others, as they cannot be removed without affecting basic legal concepts... National legal systems relating to the nature of and dealings in securities have evolved to reflect the specific socio-economic culture of each Member State, resulting in significant diversity across the EU."*

13. The second Giovannini report outlined measures to remove the Giovannini barriers which required steps to be taken both by industry, the Commission and Member States. Target2 Securities ("T2S")[15] and the Regulation on securities settlement and Central Securities Depositories ("CSDR")[16] are hailed as together reducing nine of the fifteen identified Giovannini barriers yet CSDR only came partially into force on 17 September 2014 and T2S is scheduled to go live in phases from 22 June 2015 – 6 February 2017. Further, T2S is a non-mandatory settlement solution offered to Central Securities Depositaries not a binding solution. Some of the Giovannini barriers re-surface in the Commission's consultation on CMU. For example, the Commission also identifies national tax regimes and non-harmonised conflict-of-law rules in the area of company law as obstacles.

14. Specifically in the context of national tax regimes, the CMU consultation document proposes a review of the tax treatment of different forms of finance, based on the contention that there is a corporate tax bias in favour of debt finance over equity "which may increase companies' reliance on debt and bank funding". However, it is not clear how this "bias" would be corrected. If the suggestion is either that payments of interest would cease to be deductible from taxable profits, or that companies could be given a tax-deductible allowance for their equity, a significant rewriting of the domestic tax rules would be required in most Member States. Furthermore, this proposal would presumably have to follow the lead of the ongoing Base Erosion and Profit Shifting ("BEPS") project[17] being undertaken by the Organisation for Economic Co-operation and Development.

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13 The Giovannini Group was a group of financial market experts, formed in 1996 to advise the European Commission on financial market issues. In particular, the work of the Giovannini group focused on identifying inefficiencies in EU financial markets and proposing practical solutions to improve market integration.

14 The First Report of the Giovannini Group (2001): *"Cross-border clearing and settlement arrangements in the European Union"* and the Second Report of the Giovannini Group (2003): *"Second report on EU Clearing and Settlement Arrangements"*. The reports are available at http://ec.europa.eu/internal_market/financial-markets/docs/clearing/first_giovannini_report_en.pdf and http://ec.europa.eu/internal_market/financial-markets/docs/clearing/second_giovannini_report_en.pdf

15 T2S is a is a new European securities settlement platform which aims to offer centralised delivery-versus payment settlement in central bank funds across all European securities markets. For more information see here https://www.ecb.europa.eu/paym/t2s/about/about/html/index.en.html

16 Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 is available here http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32014R0909&from=EN

17 Information on the BEPS project is available here http://www.oecd.org/ctp/beps.htm

15. In a similar vein, there are some obvious open questions in relation to CMU where national tax regimes and other market or regulatory initiatives intersect. For example, the financial transaction tax proposal[18] currently being discussed in eleven participating Member States (ten of whom have indicated an intended implementation date of 1 January 2016) presents a fundamental challenge to CMU, as the introduction of such a tax will conceivably make affected European capital markets a less attractive place for investors and thus reduce liquidity. In addition, regulatory rules such as those on the retention of net economic interest and other requirements related to exposures to transferred credit risk in securitisation transactions, as set out in the Capital Requirements Regulation and the Alternative Investment Fund Managers Directive (commonly referred to as 'risk retention rules'), highlight potential mismatches between national tax regimes. As risk retention can be achieved in a number of different ways (for example, subordinated/'first loss' notes, retention of equity interests, reserve accounts, retention/vertical slicing of the required proportion of each class of notes, deferred purchase price etc.), arguably CMU cannot truly function as intended unless and until there is parity of tax treatment of risk retention techniques across national tax regimes, in the same way as for the debt/equity conundrum referred to above.

16. Given the above, steps that the Commission can take to eradicate all of the differences it has identified that will both be acceptable to Member States and effective appear limited, particularly if there is a desire to see results in the short to medium term. This does not mean, however, that there is nothing that can be done and there are certainly options to consider including the following:

    a. Rather than legislation to tackle differences head on, can steps be taken to encourage a particular approach, to educate interested parties about different approaches and to change embedded culture? This could include actions that are industry or market led as opposed to regulatory initiatives.

    b. Should consideration be given to an optional "29th regime" that runs parallel to, rather than replaces, the national regimes of the 28 Member States?[19]

    c. Should the regulatory burden created by financial services legislation be reviewed more generally, as the Commission proposes in relation to the Prospectus Directive (see paragraphs 35 - 41 below)?

17. The Commission does, however, also want to explore whether there are targeted measures, even in difficult areas, which could materially contribute to the goal of CMU and whether it is possible to build a consensus around them.

Barriers on the demand side of the market in terms of access to finance, in particular as regards SMEs[20]

18. The Commission has identified the lack of easily available credit information about SMEs as one of the explanations behind SMEs' dependence on bank financing. SMEs are less likely to have a credit score and to be covered by investment research and analysis. The financial statements that non-listed companies have to provide and the accounting standards they use vary *inter,* and sometimes *intra,* Member States. This means that SMEs' balance sheets and performance can be opaque from an investor's perspective. Banks, however, have longer term relationships with their customers and are better equipped to carry out due diligence exercises on those who wish to borrow money from them. This may explain SMEs' reliance on banks but it means that they are vulnerable when bank financing becomes less available or more expensive. In order to facilitate SMEs' access to finance, the Commission is considering steps that can be taken to increase SMEs' visibility and ensure that investors have greater access to SME credit information. In particular, the Commission seeks views on whether developing a simplified, common and high-quality accounting standard tailored to

18 For more information on the financial transaction tax see our legal updates at http://www.mayerbrown.com/files/Publication/e09f3272-3dd0-4dea-96c4-51dbb12de97a/Presentation/PublicationAttachment/69b27cc6-e3c5-482d-a7c3-62d3fc846674/Legal%20Update_apr2013_financial-transaction.pdf and http://www.mayerbrown.com/files/Publication/e0fe77c3-e85e-4bbf-9f5b-b960d978e828/Presentation/PublicationAttachment/b7c3b9a1-17a2-454d-adb7-c23a87f03a8c/130225FTT.pdf

19 Such a regime is not without its own legal obstacles, notably whether there is a proper legal basis for such action.

20 Detail of the Commission's findings can be found in the Staff Working Document *op cit* fn.1 at section 4.

companies listed on certain trading venues[21] could have the potential of increasing the transparency and comparability for such companies and making them more attractive to cross-border investors.

19. The Commission also notes that access to public capital markets is costly and burdensome. It is necessary, for example, to disclose information, meet certain corporate governance requirements and perhaps commission an external rating. This means that SMEs are more likely to turn to private debt and equity markets, if they access capital markets at all. The Commission pays particular attention to the requirements of the Prospectus Directive[22] which creates a pan-EU regime for prospectuses which are required when a public offer of securities is made or when a company is seeking admission to a regulated market. The process of drawing up a prospectus and having it approved by a national regulator can, in the opinion of the Commission, be costly and time-consuming. Accordingly, the Commission intends to review the directive with a view to improving its effectiveness and reducing burdens on smaller firms (see paragraphs 35 - 41 below).

Constraints on the supply (i.e. investor) side of the market that limit the flow of savings into capital market instruments

20. Households are the principal net savers in the EU but they tend to deposit their savings in a bank, invest in real estate or save via a pension or insurance contract. There is little direct household investment in capital market instruments. The Commission believes that this investment pattern may be explained by factors including a lack of trust in financial markets and intermediaries, divergent approaches to investor protection, lack of financial knowledge and expertise and a preference for investment in real estate. It also notes that any household investment that does occur shows a strong home bias and posits that is a result of unfamiliarity with the languages, characteristics and legal regimes of other markets.

21. The Commission seeks views on how retail investors could better benefit from Undertakings for Collective Investments in Transferable Securities (UCITS) funds. There remain differences between Member States regarding the regulatory costs of setting up UCITS, the procedures for authorisation of UCITS managers and the selling of the funds across borders. The Commission believes that reducing costs for setting up funds and marketing them across borders would lower barriers to entry and create more competition.

Market distortions or regulatory failures that limit or impede direct financing of investments with a long-term horizon

22. Pension funds are major institutional investors but are far bigger market actors in the US than in the EU. US private pension funds hold more than double the assets of EU pension funds. Most EU citizens are eligible for some form of public pension which means that funded (occupational and private) pensions are a smaller market force. Increasing the provision of occupational and private pension in the EU could increase investment in capital market instruments and facilitate a move towards market-based financing but the nature of pension provision is generally a national competence. The Commission notes that the providers of personal pensions are subject to a number of different pieces of EU legislation and, therefore, questions whether the introduction of a standardised product, for example through a pan-European or 29th regime, could remove obstacles to cross-border access, potentially strengthen the single market in personal pension provision and have a positive impact on the size of EU capital markets.

23. The Commission also notes that institutional investors, such as pension funds, do not favour long term investment and tend to hold a disproportionate amount of liquid assets, including cash, whilst at the same time the EU needs a significant amount of new infrastructure investment. The Commission, therefore, wants to identify measures which could attract a greater flow of capital from institutional investors to a broader range of assets, such as long-term projects, start-ups and SMEs. These would include measures to reduce the costs of setting up and

21 For example, SME Growth Markets which are new markets which will be set up from 2017 when the Markets in Financial Instruments Directive II comes into force.

22 Directive 2003/71/EC of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC

marketing investment funds across borders, to boost investment in infrastructure, develop personal pensions and promote the provision of risk capital.

What are the Commission's short term aims?

24. The Commission is not proposing significant institutional and infrastructure changes as some Member States, most notably the United Kingdom, initially feared. Instead it is proposing a bottom-up approach of identifying obstacles and addressing them one at a time. Thus CMU will be achieved gradually, not in a "big bang". Given the extent of the obstacles, the establishment of a genuine single capital market where investors are able to invest in funds from different EU jurisdictions without hindrance and businesses can raise the required finance from a diverse range of sources irrespective of their location must be a long term plan. In its 2014 Investment Plan[23] the Commission, however, identified some short term aims which will pave the way to CMU and these are as follows:

    a. To develop proposals to encourage high quality securitisations and free up bank balance sheets to lend;

    b. To review the Prospectus Directive to make it easier for smaller firms to raise funding and reach investors cross border;

    c. To start work on improving the availability of credit information on SMEs so that it is easier for investors to invest in them;

    d. To work with the industry to put into place a pan European private placement regime to encourage direct investment into smaller businesses; and

    e. To support the take up of new European long term investment funds ("ELTIFs") to channel investment in infrastructure and other long term projects.

25. The Commission has already started work on the first two aims and, in conjunction with the green paper on CMU, published consultations on high quality securitisations[24] and a review of the Prospectus Directive[25]. The closing date for these are the same as for the main consultation: 13 May 2015.

The development of proposals to encourage high quality securitisations and free up bank balance sheets to lend

26. Following the financial crisis, securitisations[26] were heavily regulated, including through the imposition of higher capital requirements, to the extent that securitisations became less attractive. Despite EU-originated securitisations having suffered few losses during the financial crisis, as compared to the US securitisation markets, the EU markets remain subdued. Conversely, the US markets, which suffered greater losses, have recovered more strongly.

27. The Commission recognises that securitisation is a crucial element in well-functioning financial markets. Accordingly, in its Investment Plan the Commission committed to reviving high quality securitisation markets without repeating what it termed "mistakes made before the crisis". The Commission undertook to reflect on the best ways to develop criteria for simple, transparent and

23 Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic And Social Committee, the Committee of the Regions And The European Investment Bank *An Investment Plan for Europe* (COM(2014) 903 final) available at http://ec.europa.eu/priorities/jobs-growth-investment/plan/index_en.htm

24 Commission Consultation Document *An EU framework for simple, transparent and standardised securitisation* (Brussels, 18 February 2015) available at http://ec.europa.eu/finance/consultations/2015/securitisation/index_en.htm ("securitisation paper").

25 Commission Consultation Document *Review of the Prospectus Directive* (Brussels, 18 February 2015) available at http://ec.europa.eu/finance/consultations/2015/prospectus-directive/docs/consultation-document_en.pdf

26 Securitisation is commonly described as a financial practice whereby the credit risk of an asset or a pool of assets is transferred to an external undertaking which then transfers this credit risk onwards to investors via securities issued by that undertaking. It can be used as a way to fund assets or as a means of transferring and diversifying risk. The definition of securitisation used for most purposes in EU regulation comes from bank risk-based capital requirements, and refers to tranching of credit risk of an exposure or pool or exposures into senior and subordinated positions, with payments on those positions depending on performance of the underlying exposures, and subordination of tranches determining distribution of losses during the life of the transaction (regardless of whether any special purpose entity is involved or securities are issued to investors). Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJ L 176, 27.6.2013, pp. 1–337, available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0575, Article 4(1)(61), (67).

consistent securitisation, building on existing EU legislation as well as international work in this area. It is the Commision's view that reviving the securitisation market will help develop a deep and liquid secondary market, attract a broader investor base and improve the allocation of finance to where it is most needed.

28. The Commission's securitisation consultation is part of an initiative to ensure a comprehensive and consistent prudential approach for "simple, transparent and standardised" securitisation. That comprehensive and consistent regulatory approach is meant to:

    a. re-establish high quality securitisation as an effective funding channel for the economy;

    b. allow for effective risk transfers to non-bank institutional investors as well as banks;

    c. allow some non-banks, as well as banks, to obtain funding via securitisation; and

    d. at the same time, protect investors and the markets from systemic risks that could arise from opaque or flawed securitisation.

29. Lawmakers and market participants in the EU have been developing the concept of qualifying securitisation for some time and there are already regulations in place that set out criteria and provide more favourable treatment for qualifying securitisations in insurance company capital requirements under the Solvency II Directive[27] and in the Basel III liquidity coverage ratio under the EU Capital Requirements Regulation[28]. In January 2015 the European Banking Authority ("EBA") completed a consultation on criteria for simple, standard and transparent securitisations to be used for bank capital requirements and adapted for other purposes in European regulation[29]. At the international level, the Basel Committee and the International Organisation of Securities Commissioners also recently conducted a consultation on criteria for "simple, transparent and comparable" securitisation[30].

30. While those existing regulations and the EBA consultation set out fairly detailed and specific criteria for qualifying securitisation, the Commission's securitisation paper deals with the concept much more generally, asking for comments on a wide range of issues including:

    a. what kinds of criteria should be used,

    b. how compliance with those criteria should be verified,

    c. how qualifying securitisations should be treated for purposes of prudential capital rules, risk retention, disclosure requirements and other rules affecting bank and non-bank investors,

    d. what alternative credit quality measures should be used to reduce reliance on external credit ratings, and

    e. how to facilitate securitisation of credit provided to SMEs.

31. The securitisation paper specifically mentions short-term securitisations including asset-backed commercial paper, and points out that the other existing and proposed criteria for qualifying securitisation are not designed for and do not cover asset backed commercial paper ("ABCP"). It describes these instruments as "important financing tools for non-financial companies" and suggests they need additional or separate criteria reflecting the different characteristics of these short-term instruments[31].

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27 Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), OJ L 12, 17.1.2015, pp. 1–797, available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32015R0035 Article 177 (type 1 securitisation positions) ("Solvency II CDR").

28 Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions, OJ L 11, 17.1.2015, pp. 1–36, available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0061&from=EN , Article 13 (Level 2B securitisations) ("LCR CDR").

29 *EBA Discussion Paper on simple standard and transparent securitisations* (14 Oct. 2014), available at https://www.eba.europa.eu/regulation-and-policy/securitisation-and-covered-bonds/technical-advice-on-simple-standard-and-transparent-securitisations ("EBA DP").

30 Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions Consultative Document: *Criteria for identifying simple, transparent and comparable securitisations* (11 Dec. 2014), available at http://www.bis.org/bcbs/publ/d304.htm

31 Securitisation paper, Section 2.2, pages 7-8.

32. The securitisation paper also discusses the idea of creating a harmonised "EU securitisation structure", a single legal structure that could be used for different asset classes in different countries across Europe, and would provide more simplicity and legal certainty for transactions that use that structure[32]. This idea may be inspired by the securitisation laws that several Western European countries have adopted and that have proven versatile and successful. Like the CMU project itself, creating a harmonised EU securitisation structure is an ambitious concept, as it would involve changes or additions to company law, insolvency law and other areas covered by member states' national laws.

33. The securitisation paper describes securitisation as "transactions that enable a lender ... to refinance a set of loans or other assets ... by converting them into securities".[33] This is a fair description but it is different from the most widely used European regulatory definition of securitisation which appears in the bank risk-based capital requirements based on the Basel Committee capital accords and defines securitisation as a transaction in which credit risk is split into senior and subordinate positions with payments depending on performance of the underlying assets, and does not require any issuance of securities[34].

34. This difference in definitions highlights one of the recurring issues in discussions around criteria for qualifying securitisation. So far the criteria that have been legislated or proposed take as their model securitisations of traditional asset classes, such as home mortgage loans or auto receivables, in capital markets debt securities offerings and include requirements such as admission to trading on a regulated market and public disclosure of details of the underlying assets[35]. The regulatory definition of securitisation is much wider and encompasses many private, even bilateral transactions that may not involve issuance of securities, much less stock exchange listing or publication of asset-level data. One of the important issues to be considered is what the concept of qualifying securitisation will mean for financial products that are beneficial and important but perhaps less traditional, less liquid, less standardised than the most widely-offered asset backed security ("ABS") products. In the securitisation paper the Commission's recognition of ABCP, and in the CMU Green Paper its discussion of private placement markets, show that the Commission is aware of the importance of and the need to accommodate private as well as public investment markets.

A review of the Prospectus Directive to make it easier for firms, particularly smaller ones, to raise funding and reach investors cross border

35. Consistent with its Better Regulation agenda, in its Investment Plan the Commission also committed to reviewing existing measures, such as the Prospectus Directive, to lighten the administrative burden on SMEs, making it easier for them to comply with the requirements for offering of transferable securities to the public in the EU or the listing of transferable securities on an EU regulated market. This in turn would make it easier for SMEs to access the public equity and debt markets.

36. Accordingly, the Commission has launched a consultation to gather views on the functioning of the Prospectus Directive and its implementing legislation. The Prospectus Directive sets out the rules governing the prospectus that must be made available to the public when a company makes an offer to the public of transferable securities in the EU or applies to have transferable securities admitted to trading on a regulated market in the EU. The prospectus must contain all material information about the issuer and the securities to be offered or listed in the EU[36]. Once drawn up by

32 Securitisation paper, Section 2.5, pages 9-10.

33 Securitisation paper, Section 1, page 2. Though it goes on to say that the originator "sometimes" organises the loans into different risk categories, the paper does not identify credit tranching as a defining characteristic.

34 *Op.cit.* fn. 26.

35 E.g., Solvency II CDR, Articles 177(2)(b), 177(2)(t); LCR CDR, Articles 7(6), 13(9); EBA DP, Criterion 17.

36 Article 5 of the Prospectus Directive provides that a prospectus must contain all information about the issuer and the securities necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses and prospects of the issuer (and any guarantor) and of the rights attaching to the securities. On top of this general disclosure requirement, the Prospectus Directive secondary legislation (which was amended as recently as 2010) contains prescribed disclosure requirement which, whether material or not, must be included in a prospectus, with variations in this aspect of prescribed disclosure on the basis of the type of securities to be offered or listed and their minimum denomination.

an issuer under the Prospectus Directive's rules, the prospectus has to be approved by the national regulator before the beginning of the offer of the relevant securities or their admission to trading on the regulated market. Thus compliance with the Prospectus Directive is, at least in some cases, necessary before a company can access the public capital markets, and, in the view of the Commission, it is important to test at this stage whether compliance currently constitutes a material barrier for companies that need funding (and, in particular, SMEs). The Commission wishes to ensure that a prospectus is required only when necessary, that the regulatory approval process is as simple and efficient as possible, that the mandatory information to be included in prospectuses is genuinely useful to investors and, in the case of SMEs, is not unduly onerous to produce and, accordingly, that barriers to cross-border funding are not unnecessarily created.

37. Prospectuses, however, also have an important investor protection function. They contain the information which is necessary to enable investors to make an informed assessment of the issuer and the securities offered or admitted to trading on a regulated market. They are intended to provide an equivalent level of investor protection across the EU and to enable the comparability of investment options for investors across the EU. The Prospectus Directive was reviewed in 2010 and amended so as to reduce the administrative burdens for certain types of issuers through various proportionate disclosure regimes (including for SMEs, companies with reduced market capitalisation and rights issues) and to recalibrate the thresholds below which no prospectus is required *inter alia* but Member States have not implemented these exemptions entirely consistently across the EU. It is, therefore, important that any further amendments to the Prospectus Directive properly balance the need for investor protection with the need to ensure that the requirements contained within in it are applied proportionately to smaller companies.

38. The consultation covers a broad range of fundamental issues focusing on three main areas: when a prospectus should be required; the information it should contain; and the requirements for prospectus approval. The consultation also considers whether the process can be streamlined and the content simplified so as to reduce the administrative burden of offering and listing securities. The Commission seeks views on whether the regime can be made more appropriate for SMEs and companies with reduced market capitalisation. Thus this review seeks to analyse the amendments already made to the Prospectus Directive, as well as assess the current impact of the regime, and whether it disproportionately inhibits the issuance of equity and debt by SMEs.

39. Under the first of the headings considering when a prospectus is needed, the Commission questions include:

    a. whether the current exemption thresholds should be adjusted;

    b. whether the scope of the Directive should be adjusted;

    c. whether an exemption for secondary issuances should be created;

    d. whether the regime should be extended to admittance to trading on multi-lateral trading facilities (albeit under the 'proportionate disclosure regime' if necessary which will itself be revised);

    e. whether exemptions for employee share schemes and certain types of closed-ended alternative investment funds should be created; and

    f. how to balance the favourable treatment of issuers of debt securities with a high denomination per unit with liquidity on the debt markets.

40. Under the second of the headings considering what information a prospectus should contain, the Commission questions:

    a. the effectiveness of the proportionate disclosure regime;

    b. whether a bespoke regime for admission to 'SME Growth Markets' (under MiFID II) should be created;

    c. the interaction between the disclosure requirements of the Transparency Directive, the Market Abuse Directive and the Prospectus Directive;

    d. the objectives of the prospectus summary and possible overlaps with the key information document required under the PRIIPs Regulation;

    e. whether a length limit to prospectuses should be imposed; and

    f. the harmonisation of the sanctions and liability regimes across Member States.

41. Under the third of the headings considering how a prospectus is approved, the Commission questions:

    a. how the approval process of prospectuses by national regulators can be streamlined further;

    b. an extension of the base prospectus facility;

    c. how the 'tripartite regime' (i.e. the separate approval of a registration document, a securities note and a summary note) is used in practice and what improvements could be made;

    d. moving to an all-electronic system for the filing and publication of prospectuses; and

    e. the equivalence of third-country prospectus regimes.

Starting work on improving the availability of credit information on SMEs so that it is easier for investors to invest in them

42. As discussed above, information on SMEs is limited and typically held by banks. As a result, the Commission believes that some SMEs struggle to reach the broader investor base of non-bank investors that might suit their funding needs. The Commission believes that improving credit information would help build an efficient and sustainable capital market for SMEs and that this could be done by the development of a common minimum set of comparable information for credit reporting and assessment. In addition, it suggests that standardised credit quality information could help the development of financial instruments to refinance SME loans, such as SME securitisation. The Commission plans to hold workshops on SME credit information in 2015 to take forward this work.

Working with industry to put into place a pan European private placement regime to encourage direct investment into smaller businesses

43. The Commission points out, that despite the increasing popularity of private placement markets in the EU, medium-sized EU companies are still accessing the US private placement markets. As discussed above, the US private placement market is almost three times bigger than that in the EU. The Commission is concerned that, although they are relatively well established, the French and German private placement markets only provide investors with localized solutions and there remain barriers to the development of pan-European markets including the aforementioned differences in national insolvency laws and the lack of standardised processes, documentation and information on the credit worthiness of issuers.

44. Industry has already taken steps to help identify and promote best practice in the market, key principles and standardised documentation. On 10 February 2015 the Pan-European Private Placement Working Group ("PEPP WG")[37] launched the Pan-European Corporate Private Placement Guide[38] which it is

37 The PEPP WG is led by the International Capital Market Association ("ICMA") and currently includes the Association for Financial Markets in Europe ("AFME"), the European Private Placement Association ("EU PPA"), the French Euro Private Placement ("Euro PP") Working Group, the Loan Market Association ("LMA"), TheCityUK and The Investment Association. It also brings together representatives from major institutional investors and benefits from the support of the official sector participating in an observer capacity (including the Banque de France, the Bank of Italy, the French Trésor and HM Treasury).

38 See: http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Primary-Markets/private-placements/the-pan-european-corporate-private-placement-market-guide/

hoped will develop into a market standard. Both the Loan Market Association and the French Euro Private Placement Working Group[39] have recently published standard model framework documentation for both loans and bonds/notes coordinated within the PEPP WG, to which users of the Guide are directed. The Commission has welcomed these initiatives but asks whether any EU action is needed to support them.

To support the take up of new European long term investment funds to channel investment in infrastructure and other long term projects.

45. As discussed above, investments in the EU are at a historic low and are predominantly short term. The EU has developed a new type of collective investment scheme, the European long term investment fund ("ELTIF"), which is intended to bring together investors who want to put money into companies and projects for the long term with enterprises in need of long term financing. ELTIFs are designed to increase the amount of non-bank finance available for companies investing in the real economy of the EU by enabling long term investments in infrastructure assets such as airport concessions, transport infrastructure, electricity grids, as well as 'social' infrastructure, for example, social housing, hospitals or municipal services. ELTIFs can also invest in SMEs regardless of whether they are listed on stock exchanges. The Commission asks what it and Member States can do to encourage the use of ELTIFs.

39 A French financial industry initiative bringing together corporate borrowers, investors and intermediaries, supported by the Banque de France and the French Trésor.

46. The sheer scale of the Commission's ambition is clear on reading the consultation papers and the supporting documents. It is equally clear, however, that the new Commission is not wedded to a wholly regulatory solution: the Commission appears to give greater priority to market-led initiatives, the education of investors and a change of embedded cultures. This may be a pragmatic approach but it does not make the Commission's objective any easier to attain: changes to 28 national markets which have evolved over centuries cannot be achieved in the short term. The Commission may, however, be developing a blueprint for the next evolutionary stage in European capital markets and it is feasible that in the long term changes can be made that will start to make the Commission's objectives attainable.

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