BETTER FINANCE reply to the consultation on "Capital Markets Union Mid-term Review 2017"

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

Question: *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.*

Individual investors whom Better Finance represents are not involved very significantly in the direct funding of non-listed companies.

However, a key driver for the development of private equity funding in Europe is the existence of a large and strong Initial Public Offering (IPO) market. Private equity investors need developed exit options such as IPOs. This in turn requires much more developed EU small and mid-cap listed equity markets.

Individual investors do play a proportionally more important role in that market segment than institutional ones, both on the secondary and on the primary markets. However, they are not encouraged to do so and to do it more although diversified portfolios of small and mid cap European listed companies have outperformed by a very wide margin portfolios invested in big caps: +13% for the Stoxx Europe 50 versus +62% for the Stoxx Europe Total Market Index over the last 16 years. Investing tools into listed SMEs are underdeveloped in the EU: very little use of broad indices-based and small cap indices based investment products such as funds, both active and index, compared to the US. More generally, EU policy makers, the media and the financial industry routinely confuse equity markets with big caps ones, always referring explicitly or implicitly to very narrow equity market indices such as Stoxx 50 (only 50 large cap EU companies), ignoring the vast majority of listed companies and the - by far - most performing segment of the EU equity markets: the small and mid-cap one.

EU Authorities must develop practical actions to address this issue blocking the development of private equity funding. Increasing demand for small and mid-cap equity, in particular at the IPO stage is key. One very quick and easy one is for EU Authorities to stop collecting, analyzing, reporting, and communicating only on narrow indices as faulty proxies for equity markets in Europe and to highlight the superior long term returns of broad and of diversified small and mid-cap equity market segments.

In the UK, they have a two tier market – the main market and the Alternative Investment Market ("AIM"). Even if the latter has been claimed by the London Stock Exchange as "the World's most successful growth market", setting up specific SME or "growth equity markets, such as the AIM in the UK", is not enough.

2. MAKING IT EASIER FOR COMPANIES TO ENTER AND RAISE CAPITAL ON PUBLIC MARKETS

Question: *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.*

Better Finance refers to its reply to the first question as it applies even more directly to public equity markets.

Research on listed SMEs is an important issue, and investment firms which make the effort to invest significantly in this research should be encouraged by regulators and supervisors, and their work facilitated.

Regarding corporate bond markets, they are not only very illiquid, but also very opaque, in particular for retail investors as evidence published by Better Finance[1] and by Fin-Use[2] in the past shows. With interest rates at a very low level, retail investors – at least the most affluent and financially literate ones – would benefit from a more transparent and accessible corporate bond market as a more performing alternative to retail bond packaged products: Better Finance showed that mainly due to fees, those products considerably lag the returns of direct investments in bonds.

Corporate bond ETF funds should also be developed to improve liquidity of corporate bond markets (as ETFs imply that there are market makers), and an easier and cost effective access by retail investors.

In the UK it was almost impossible for retail investors to buy corporate bonds due to the argument that it was too expensive to organize. However, in recent years corporate bonds have been appearing for retail investors. They have higher risks but also higher coupon which at a low (or negative) interest rate is attractive to investors.

One problem concerning UK is the requirement of a full prospectus when raising further capital by rights. In order to avoid this obstacle, companies resort to a placing with institutions. This fact means that private investors (usually retail investors who are familiar with the company) are excluded from the process.

3. INVESTING FOR LONG TERM, INFRASTRUCTURE AND SUSTAINABLE INVESTMENT

Question: *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.*

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[1] http://betterfinance.eu/fileadmin/user_upload/documents/Position_Papers/Financial_Markets_Infrastructure/en/CESR_non_equity_transparency_CP_EFI_reply_2010_06041281445868.pdf

[2] http://ec.europa.eu/internal_market/fin-use_forum/docs/non-equity_transparency_en.pdf

Like the EC, we point out the dramatically reduced investment of insurers in equities (6% only of their own risk assets). One cannot count their investments in equity funds as these largely come from unit-linked insurance products where the investment risk is usually borne entirely or mostly by retail clients.

Better Finance believes Solvency II rules must be further adjusted to encourage insurers to go back to the level of equity funding they provided at the beginning of the century (about 20% of their own risk portfolio, i.e. more than three times their current involvement of 6% of their total own-risk assets only). Adjust Solvency II calibrations for insurers' investments in listed equities and in private equity when the insurers' liabilities are very long term (i.e. for pension products liabilities). Indeed, research shows that over the very long term, diversified portfolios of listed equities are less volatile and more performing than fixed income portfolios.

For the very same reason, adjust the risk level of pension PRIIPs and of the future PEPP investing in listed equities and in private equity. Indeed, there are pension products (i.e. very long term products) included in the scope of PRIIPS, notably:

- "life cycle funds" which are precisely designed for retirement purposes;
- And insurance-regulated private pension products with a surrender value.

Also Better Finance supports the development of sustainable investment but warns about:

- The diversity and inconsistency of definitions and measurements around what is to be considered a "sustainable" investments, the confusion and lack of standardization of the use of "Sustainable", "SRI" and "ESG" labels on investment products.
- The labeling as "sustainable" should not be a pretext to market high fee and under performing products to EU savers, as Better Finance found evidence of in its recent research on closet indexing funds[3].

Regarding the main barriers to the cross-border distribution of investment funds, Better Finance refers to the precise proposals it made when replying to the EC consultation closed last October[4].

4. FOSTERING RETAIL INVESTMENT AND INNOVATION

Question: *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.*

There were four Actions mentioned in the CMU Action Plan with regard to retail investment.

a) Improve the transparency of net performance and fees for long term savings.

[3] http://betterfinance.eu/media/press-releases/press-release-details/article/better-finance-replicates-and-discloses-esma-findings-on-closet-indexing/?tx_ttnews%5BbackPid%5D=163&cHash=56d2cd8e3879b231a7915f2ce9c96753

[4] http://betterfinance.eu/fileadmin/user_upload/documents/Position_Papers/Financial_Markets_Infrastructure/en/PP_-_Investment_funds_distribution_EC_consultation_-_091016.pdf

First and foremost, Better Finance is very surprised that one of the key CMU Action Plan actions regarding retail investment is omitted in this consultation paper. Indeed the September 2015 CMU Action Plan mentioned that : "*the Commission will ask the ESAs to work on the transparency of long term retail and pension products and an analysis of the actual net performance and fees*." (page 18 of the CMU Action Plan).

This key action to strengthen the confidence of retail investors and foster their savings into capital markets is omitted in the list of actions (page 13), and it is only indirectly referred to in the "results achieved" column of another CMU Action (see para. c below), which has little to do with it. In addition, <u>there are no "results achieved" and no "next steps" to be found for this action.</u> And the ESAs tell us they have not received any mandate from the EC to deliver on this Action so far.

This is all the more surprising as EC vice president Dombrovskis highlighted the importance of this CMU Action in his 27 September 2016 speech: "*We will also ask the ESAs to look at the transparency of long term retail investment and pension products, and to perform an analysis of their actual net performance and fees. Returns on retail investment products and pensions can be heavily influenced by the fees levied by asset managers and intermediaries. The right data on the net performance and fees of the most commonly sold products is important.*»

This is all the more unfortunate as – at the same time – the European Commission and the ESAs have engaged in an action that is going to do exactly the reverse: to severely reduce the transparency of net performance and fees of long term investment products: the 8 March 2017 European Commission's delegated regulation on the "PRIIPS" (packaged retail insurance-based and investment products) Regulation will indeed:

- eliminate all disclosures about <u>relative</u> performance (relative to benchmarks), leaving only «absolute» performance information
- eliminate all disclosures about performance <u>net</u> of commissions, fees and other charges, the only one that matters to investors
- eliminate all disclosures on historical (past) performances of products and on their benchmarks, replacing them with four «future (gross)» performance scenarios over the recommended holding period set by the product provider : «favorable», «moderate», «unfavorable»,, and «stress».
- These future performance scenarios are not probability-weighted (meaning in particular that the "moderate" scenario is no more probable than any of the others)
- They are nevertheless based on past performance as confirmed by the EC: "*the performance scenarios, based as they are on historical data, will be heavily impacted by PRIIPs past returns*.[5]", in violation of MiFID provisions.
- Eliminate prominent warnings that information based on past performance and information on future performance is not a reliable indicator of future performance, as required by MiFID (which of course makes sense as future capital markets' performance is NOT predictable).

Better Finance is also surprised to read in the consultation paper that "*many smaller investors are paying too much for modestly or sometimes poorly performing retail investments <u>in comparison with a simple bank savings account</u>.*" EU citizens holding simple bank savings accounts are on average <u>losing money after fees and inflation</u>, and the European Commission and EBA do not even measure

[5] Letter from the EC DG FISMA to Better Finance, 18 November 2016

and do not seem to know it! The issue is not that retail investments are sometimes poorly performing in comparison to bank savings accounts (which are currently destroying the real value of savings), but that they are often providing negative real returns (purchasing power) to EU citizens. And bank saving accounts certainly do not do any better there. This is another proof of how more transparency on net performance is so badly needed in the EU. This is all the more urgent in an environment of very low interest rates, rising inflation and often uncompetitive fees.

Therefore complementary actions are indeed urgently needed from the EC:

- Set urgently the missing "next steps" and timetable on this first CMU Action Plan Action for retail investors (Improve the transparency of net performance and fees for long term savings);
- Give a clear mandate to the ESAs for delivering on this action;
- Find a solution to the extremely damaging effect on performance and cost transparency of the draft PRIIPs RTS, by thoroughly amending those as proposed by Better Finance and others, which is also a must due to numerous violations of MIFID I and II rules by these draft RTS.
- A second best solution would be to amend MIFID II delegated rules on past performance information to at least ensure some comparability of past performance information on some of the PRIIPS (mostly investment funds, but not life insurance products).

b) A single market for retail financial services

Better Finance is disappointed by the results as of today of the green paper on retail financial services of December 2015. Of course, the Action Plan on Retail Financial Services expected in Q1 2017 and is still not published at the time of our reply to this consultation, which is unfortunate.
But early unofficial informations make us concerned that this action plan will not include any of the key actions Better Finance and other consumer organizations recommended in their responses to the Green Paper. In particular:

- At last actions to make the biggest financial market of all more transparent and competitive to retail users: the foreign exchange market
- The promotion of independent comparative websites, surfing on the new possibilities offered by fintech."Independent" is the key word here.

c) EU retail investment product markets assessment

This action expected for the end of 2017 is very important as we hope it will provide the EC with much deeper intelligence on the retail investment markets in the EU.

Our concern is that the consultant is a private commercial one that did not involve any independent expert center from the user side. Better finance proposes that early draft conclusions form this assessment be tested with Better finance as an independent expertise center on retail investments supported by the EC, and with other similar organizations.

d) A policy framework to establish European personal pensions

Better Finance strongly supports this initiative from the European Commission and advocates for a simple, cost effective and opened PEPP as a major step to foster retail investment into capital markets and to improve the adequacy of EU citizens' pensions.

This however can only be achieved if this PEPP combines two critical features:

- All PEPPs must be equipped with a simple, cost effective and safe default investment option (such as the one recommended by Better Finance protecting the real (purchasing power) value of pension savings at retirement and during the decumulation phase);
- Thanks to this default option, PEPPs should not be banned from allowing direct investments into equities and bonds, as PEPP are the ideal tool for EU savers to do that being a very long term product and low income and financially less literate savers being protected by the default option (we refer to our more detailed proposals on the PEPP)[6]. PEPP being part of CMU but not allowing direct investments into equities and bonds is - of course - a contradiction in itself.

Otherwise, we disagree with the EC that personal pensions and the PEPP in particular "*help households to … get familiar with capital markets*". Indeed, most current personal pension products do not help them doing that as they do not allow any direct investment in equities, index ETFs and bonds, only in packaged products that loosen – instead of strengthening - the link between pension savings and real economy investments. As the EC rightly pointed out in its CMU Action Plan: "*financial advisers are no longer marketing direct investment products (e.g. company shares and bonds) to retail investors"*[7].
The EC must stop this damaging evolution at least in the most relevant place: personal pensions.

Furthermore, pensions adequacy will be harder to achieve as PEPP would deprive (unlike US households holding an IRA – Individual Retirement Account) EU pension savers from the most performing investment product over the long and very long term: direct equities, as shown by Better Finance independent research on long term and pension savings returns[8].

e) Currently missing actions to ensure the success of the CMU and to effectively foster retail investment into capital markets

- Revive equity culture

The CMU Action Plan points out the lack of equity culture in the EU as an impediment to achieve the CMU goals, but fails to identify any action to improve. EU decision makers should therefore stop discouraging the more affluent and knowledgeable savers to invest in equities, by reviving the equity culture at all levels (citizens but also financial retail intermediaries who have stopped promoting

[6] http://betterfinance.eu/fileadmin/user_upload/documents/Position_Papers/Pensions/en/Better_Finance_reply_to_EIOPA_PPP_consultation.pdf
http://betterfinance.eu/fileadmin/user_upload/documents/Position_Papers/Pensions/en/personal-pension-framework-2016-consumer-organisations_f36382ef-2908-4fc6-978d-e6d010fc7e8c.pdf

[7] EC CMU staff working document p.30, 2015

[8] http://betterfinance.eu/fileadmin/user_upload/documents/Research_Reports/en/Pension_report_2016_For_Web_-_Final.pdf
http://betterfinance.eu/fileadmin/user_upload/documents/Press_Releases/en/Other_investors/PR_-_Better_Finance_Pensions_Report_2016.pdf

equities for decades, the media and politicians who should lead by example and be proud of it): the EC should indeed "*help households to … get familiar with capital markets*" as mentioned in its consultation paper. And financial supervisors should ensure (under MiFID I and II rules) that intermediaries get knowledgeable again in the fundamentals of capital markets, equities, bonds and indexed ETFs (exchange-traded funds), and do not omit to recommend these investment products in their financial advice when appropriate to the more well-off households. Indeed, recent mystery shopping initiatives from National Competent Authorities confirm retail intermediaries very rarely do it if at all.

- In particular, continue to promote information on Employee share ownership, as the workplace is also a great venue for getting more familiar with capital markets.

As pointed out by EFES (the European Federation for Employee Share ownership, a Better Finance member organization), the EU is strongly underdeveloped compared to the US considering employee share ownership, with a 20 years lag. Consequently, employee share ownership contributes much more to the solidity and to the stability of capital markets in the US than it does in Europe.

Europe counts 10 million employee shareholders compared to 30 million in the USA. European employee shareholders hold 350 billion € in shares of their company (mainly large ones), while just the single ESOP model in SMEs counts for 1.300 billion $ in the US.

The recent € 0.5 million "Pilot Project for the Promotion of Employee Ownership and Participation" organized by the European Commission (with Final Report on 28.10.2014) highlighted the need for a European Action Plan in this view, with the launch of a virtual information center in all EU languages, an action program to raise awareness about employee ownership and participation, the setting up of a reliable information and statistical tool, and the promotion of adequate legislation providing optional simple, uniform incentive models. Unfortunately, as of today, the EC has surprisingly stopped any follow-up of this project. This European Action Plan should be resumed and be part of the CMU Action Plan, as the promotion of employee share ownership would also favorably impact the other 5 key policy areas identified by the EC; please refer to the EFES reply to this consultation for more information.

Of course, we are aware that for an ordinary level employee, shares in his employer mean that his savings are at the same risk as his job and, possibly, his pension; and Better finance advocates that individual shareholdings must be well diversified beyond own company shares.

5. STRENGTHENING BANKING CAPACITY TO SUPPORT THE WIDER ECONOMY

Question: *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.*

Additional action recommended by Better Finance: better protect non insider investors and depositors in banks when enforcing the new Bail-in rules (BRRD) throughout the Member States. We refer in particular to the severe damages caused to retail bank investors in Slovenia[9].

6. **FACILITATING CROSS-BORDER INVESTMENT**

Question: *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.*

Yes there are necessary additional actions in our view:

- It is certainly not enough to study discriminatory tax obstacles to cross-border investment by pension funds and life insurers, as the main parties responsible for these tax discriminations are the Member States.

  Contrary to what the EC writes in its consultation document ("*Double taxation agreements concluded between states should normally allow investors directly or indirectly investing (among others) through investment funds to avoid double taxation, either by getting relief at source or by benefiting from full or partial refund*."), most unfortunately there is ample and persisting evidence of the contrary. For example, the Belgium-France double taxation agreement engraves and organizes the double taxation of dividends received by Belgian investors on French stocks and certain investment funds ("FCP") (and vice versa) without any relief at source and without any refund. This is an outright discrimination of Belgian holding shares of French companies (and vice versa) as they end up paying a much higher tax than on Belgian sourced dividends (and also by the way end up paying a much higher tax than French shareholders).

  Another example is the requirement imposed by the French tax authority on investors from abroad to provide a declaration by the French paying institution that they have paid the beneficiary the dividend net of taxes. Generally not accepted is such declaration given by the financial institution from abroad. How should the investor know the name of the paying institution in France? And how should the paying institution in France know that they paid the net dividend to this investor from abroad, given the long intermediaries' chain with omnibus accounts in between?

  Both examples show that the current procedures are obviously violating the free movement of capital rule of the Treaty of Rome, and the study from the EC should not be limited to life insurers and pension funds, and expand to Member States.

  The Code of Conduct, envisaged, for the end of 2017, should – at a minimum ensure that Member States' tax authorities accept refund claims from abroad investors if they are provided with a proof of the dividend payment and the tax withheld issued by the financial

[9] http://betterfinance.eu/fileadmin/user_upload/documents/Position_Papers/Investment/en/Bailin_-_How_far_does_it_have_to_go_-_Better_Finance_-_VZMD_161208.pdf

institution of the shareholder. Furthermore, the following points should be included in a Code of Conduct:

- A recommendation to all Member States to provide for a reduction of withholding taxes for shareholders from abroad to remove this lengthy –and costly reclaim process – this is already possible in a number of Member States, incl. e,g, France, Greece, Iceland, Italy or Portugal.
- The introduction of a standardized refund and reduction/preemption form
- Standardisation of deadlines for reclaiming withholding taxes.
- Standardisation of the adressees of the refund (some Member States foresee that the refund is sent to the company others require it to be sent to the tax authority)
- Abolish all unnecessary hurdles for investors to reclaim the taxes withheld.
- Agree on a cross-border ombudsman to be in charge for disputes. Alternatively, expand the rights of SOLVIT[10] to solve problems between investors and tax authorities with regard to withholding taxes.

- Regarding the Giovanini barriers on post-trade issues, and considering that major obstacles remain to cross-border shareholder engagement within the EU[11], Better Finance recommends that the Level II measures to be taken on the upcoming Shareholders Rights Directive II be integrated in the CMU Action Plan, in particular as regards delegated acts on the duty of intermediaries to ensure EU shareholders are provided with the necessary and timely voting information and documents (article 3c of the new SRD). This implies a close cooperation between DG FISMA and DG JUST since the EC transferred shareholders rights policy issues to DG JUST in 2015: DG JUST must also fully own the European Commission's CMU Action Plan.

[10] http://ec.europa.eu/solvit/index_en.htm

[11] http://betterfinance.eu/fileadmin/user_upload/documents/Research_Reports/en/FINAL_Barriers_to_Shareholder_Engagement.pdf