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# A new drive for the Capital Markets Union

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For two decades, the lack of private investment has been one of Europe's biggest economic weaknesses, undermining productivity, hampering growth potential, and damaging its competitiveness. Moreover, different financial conditions across the euro-area Member States have contributed to diverging levels of investment and economic growth, while fragmented capital markets have aggravated financial instability by reducing risk-sharing and shock absorption through private equity markets. Many hopes were pinned on Capital Markets Union as a policy to address both Europe's underinvestment and a redistribution of excessive savings throughout the euro area.

The European crisis after 2011 has worsened the situation, increasing uncertainty and fragmenting the European credit market along national lines. The consequence was a widening of the structural investment gap between Europe and the US. Between 2008 and 2015, gross fixed investment had declined by around 15 per cent in the euro area and the investment rate had dropped by around four percentage points. In the US, on the contrary, the investment rate had gradually recovered from its trough in the aftermath of the financial crisis.

At the end of 2014, the European Commission launched the initiative for a Capital Markets Union intended to provide Europe with stronger financial integration and risk sharing mechanisms, contributing to macroeconomic stability and more productive allocation of national savings.

While many of the legislative initiatives under the Juncker Commission's CMU Action Plan were brought forward, these hopes were in the main disappointed, owing to structural limitations in the initiative that revealed to be fateful. They were mainly related to three aspects. The first one is that the Action Plan was never really intended to overcome national market segmentations and protections. It was mainly directed at enhancing the non-bank financing of the economy within the national markets; its measures on cross-border transactions were mainly aimed at freeing portfolio investment.

The second limitation boils down to the utter failure of the regulatory architecture reforms dubbed under the name of Jacques Larosière. The new regulatory authorities that were meant to promote uniform standards of implementation of European Directives turned out in the main to reflect the interests of national financial communities and proved unwilling to break national idiosyncratic protections embedded in Level II regulations.

The third limitation relates more profoundly to the Treaty's approach to capital mobility and capital integration, which has opened the way to full integration of portfolio investment but has maintained a level of interference by national public authorities with real capital market integration.

In fact, while portfolio integration is at an advanced stage, major obstacles still hamper "real" economic integration. Insufficient market integration for goods and services, extensive protection

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of incumbents in network services, and divergent fiscal policies that help maintain divergent trends in prices and productivity all play against cross-border flows of investments in the real economy.

Fragmented capital markets are but a reflection of the insufficient integration of goods and services markets, with consequences that border on paradox. In Germany, for instance, 85% of the stock of the 30 largest companies listed on the Dax30 is in the hands of foreign stockholders, but major network services markets, energy in the first place, are closed to competition. Some energy market leaders are listed, so paradoxically foreign investors benefit from domestic protection, showing the contradiction between portfolio and real capital investments. The required consolidation of corporate structures, notably in network services, where the largest gains in technology and productivity are within reach, cannot take place without effectively opening the markets at least Europewide.

Thus, the reasons for a more decisive policy intervention to address these shortcomings are compelling – even if the appetite for fresh initiatives to foster market integration may reveal scanty. Policy initiatives could usefully concentrate on three domains: reviewing key regulatory dossiers that were badly mishandled during the past legislature; removing institutional obstacles to company mobility; and moving with determination towards a single regulator for capital markets.

## 1. Overhauling European rules

According to the CMU Action Plan, public offers of debt or equity securities are the principal funding for mid-sized and large companies seeking to raise in excess of € 50 million. Public markets are vital for the transition of high growth mid-sized companies to established global players.

To make it easier for companies to enter and raise capital on public markets, the CMU Action Plan envisaged four main measures: (i) modernizing the Prospectus Directive; (ii) reviewing the regulatory barriers to SME admission on public markets and SME growth markets; (iii) reviewing the EU corporate bond markets, focusing on market liquidity; (iv) addressing the debt bias of taxation.

However, the actions adopted so far fail to address these goals properly. There is thus a need to reopen the legislative dossiers, with a view to (i) reducing reporting requirements and administrative burdens for all listed companies; (ii) reviewing regulatory barriers to SME admission to public markets and SME Growth Markets; (iii) eliminating distortions stemming from the different tax treatment of debt and equity.

(i) Reducing reporting requirements and administrative burdens for listed companies

***The Prospectus Regulation (2017/1129)***

The new Regulation should foster unfettered capital mobility through Europe by:

i. making it easier for companies to choose freely where to issue their shares by removing the present constraint of having the prospectus approved by the national Authority of their legal residence;

ii. replacing the whole prospectus with a much-simplified Key Information Document ('KID');

iii. exempting secondary issuances from the publication of the prospectus, since updated information is made available by the listed issuer according to the Transparency Directive and Market Abuse Regulation;

iv. extending the regime of simplification for SME growth markets to all SMEs on regulated markets and speeding up the approval process;

v. giving formal power to ESMA to intervene in order to overcome the delays and complications of the approval of prospectuses by national Competent Authorities.

In this respect, investors should be offered the possibility to opt for a "European prospectus" approved by ESMA, under the default regime established by the new Regulation, to free pan-European offers from administrative and regulatory burdens under the current passport regime (notification to all national authorities, translation of Prospectus summary, national investor protection rules).

***The Market Abuse Regulation (Regulation n. 596/2014, hereinafter "Regulation/MAR")***

There are two main issues that should be tackled: (i) the extension of the rules to multilateral trading facilities (MTFs), and (ii) the two-fold notion of inside information.

(i) ***MTFs***

In 2014, MAR extended all the obligations of the market abuse regime already in place for companies on regulated markets to MTFs (while granting only some facilitations to SME growth markets). In our view this contradicts the goals of CMU to facilitate the raising of capital of SMEs on any trading venue: first, because it raises considerably the cost of access to MTFs, and second, because it hampers cross-border investments. Thus, it is urgent to review MAR in order to eliminate these extra burdens.

A viable alternative to the existing overregulation would be the adoption for MTFs of disclosure obligations inspired by the repealed directive on admission to listing (Directive 79/279/EEC). In contrast to MAR, that directive did not mandate disclosure of prospective events, and therefore did not require issuers to gauge whether a significant development that could influence the share price was likely to occur.

(ii) ***The two-fold notion of inside information in MAR***

The notion of inside information in MAR should be reviewed, since it is at odds with the notion of information to be disclosed under general disclosure obligations of listed companies. These divergent definitions generate legal uncertainty and risk facilitating market manipulation.

The lack of certainty on the application of the new MAR, as well as the fact that market abuse violations are now subject to criminal sanction, may entail unintended consequences. Firstly, financial intermediaries may sensibly limit their trades, ***de facto*** reducing liquidity on European stocks. Secondly, dialogue between companies and shareholders, usually considered as a good corporate governance practice by European Institutions, may be discouraged if the latter feel restricted in their ability to trade.

***EMIR***

The CMU project should be understood in a broad manner – also keeping an eye on regulatory developments in the field of risk management. The use of derivatives is key for active international European companies. Non-financial companies (NFC) have always supported improved transparency of derivative markets. However, NFCs should not be drawn into the scope of financial regulation, and their derivative transactions should be normally exempted from central clearing obligations. Otherwise, significant liquidity would have to be set aside for clearing purposes – reducing the resources available to finance current operations and investment.

The current reporting framework on derivative transactions provided by EMIR appears costly and disproportionate. Better supervisory oversight in terms of data quality, as well as significant cost savings could be achieved moving from the current double-sided reporting to single sided reporting on all OTC derivatives.

***Review of regulatory barriers to SME admission to public markets and SME Growth Markets***

Among the policy actions listed in the CMU Action Plan, there was the review of regulatory barriers to SME admission to public markets and SME Growth Markets. In this respect, the actions taken so far are unsatisfactory. On one side, new regulatory burdens have been introduced for SMEs, notably by MAR; on the other, there has not been any significant reduction of costs by the revision of the Prospectus Directive.

New specific measures should be adopted in order to enable smaller companies to raise capital for investments in innovation and thus grow. To this end, we suggest that regulations should in general refer to "growth companies" rather than SMEs. The definition could be linked both to the size and the period of listing. Growth companies would then benefit from a simplified regime applicable for a definite period (e.g. the first 5 years of listing) that would gradually encourage small and mid-size listed companies to grow.

***Eliminate distortions arising from different tax treatment of debt and equity***

Distortions followed by the different tax treatment of debt and equity should be removed. The double taxation of equity – on corporate and on investor level – discriminates equity financing vis-à-vis debt financing. To avoid distortions of capital accumulation to the detriment of equity, it is necessary to implement a tax regime with similar rates for equity and debt.

## 2. Facilitating cross-border investment

The Action Plan underlined how there are still many long-standing and deep-rooted obstacles that stand in the way of cross-border investments: obstacles that have their origins in national law – insolvency, collateral and securities law – and obstacles in terms of market infrastructure, tax barriers and changes in the regulatory environment that undermine the predictability of rules for direct investments.

***(i) Cross-border company mobility***

The CMU Action Plan has not addressed a key obstacle to cross-border investment, that is, the persisting limits on cross-border company mobility.

According to the principle on freedom of establishment (Articles 49 and 54 TFEU), as defined by the European Court of Justice in its case-law, national legislation can only forbid a company under its jurisdiction to transfer its registered seat to another Member State while retaining its status as a company governed by the law of the country of incorporation. A different case is where a company moves to another Member State and the company is converted into a form governed by the law of the State to which it has moved: here, any barrier to the actual conversion of such a company is to be considered a restriction on the freedom of establishment (ECJ in Cartesio 2008 and Vale 2012). With Centros (1999) the ECJ ruled that a company legitimately incorporated in a Member State can operate everywhere in the EU through a branch. Recently, the ECJ upheld the legitimacy of a cross-border "conversion" of a company by way of a mere transfer of the registered office without any activity in the country of arrival (Polbud, 2017).

Although the right to cross-border conversion is considered as an inherent aspect of the freedom of establishment, it would be ineffective in the absence of a harmonized legislative framework for the cross-border transfer of seat, enabling legal entities to effectively exercise the freedom to convert.

A new Company Law Package providing for new rules introducing comprehensive procedures for cross-border operations (i.e. conversions, divisions and cross-border mergers, the latter amending the rules introduced by directive 2005/56/EU) of limited liability companies established in an EU Member State is close to being approved by the Council and Parliament. The procedure will allow national authorities to block a cross-border operation when it is carried out for abusive or fraudulent purposes. Although the final text is more balanced than the previous versions, the procedure still appears cumbersome and shows a persisting reluctance to free cross-border company mobility.

***(ii) The European market for corporate control***

Although in principle the Member States normally cannot legally block any transactions based on the acquirers' nationality, governments in continental Europe have used various legal and de-facto powers to create obstacles to foreign-driven transactions while supporting domestic transactions aimed at creating so-called national champions.

A study by Dinc and Erel (2013) analyses large corporate merger attempts in the European Union between 1997 and 2006 and finds that supporting actions are often undertaken by national governments for domestically driven transactions, while opposing actions are undertaken to counter foreign acquisitions. The study also finds that the widespread nationalistic approach in continental Europe has had a general depressing effect on the European market for merger and acquisition.

A counterbalancing role may be played by European institutions, and notably the European Commission, which have powers to sanction discriminatory measures in contrast with the European legal framework. The study reports that when the Commission challenges individual country initiatives which can impede the free flow of capital, the foreign-driven transactions are more likely to succeed. The problem is that such interventions by the European Commission are not systematic, not least because of the highly charged political nature of the operations.

A missed opportunity to change this scenario was the adoption of the Takeover Directive in 2004.[2] The proposal for a harmonized legal framework for takeovers in the European Union aimed at

[2] Directive 2004/25/EC of the European Parliament and of the Council on takeover bids, 25 April 2004. The Directive was approved after some fourteen years of discussion since the initial proposal by the European Commission.

facilitating hostile bids while ensuring transparency and adequate protection of minority shareholders. To facilitate the bid, the directive included two key provisions: the board neutrality rule, which reserves the decision on the bid, including any defensive measures, to the shareholders; and the breakthrough rule, which provides that any restrictions, statutory or contractual, to the transfer of shares be lifted after the bid.

Strong opposition by some Member States (especially Germany) eventually led to watering down the directive by provisions that, while maintaining the board's neutrality and the breakthrough rules as the default rules, give the Member States and the companies the option not to abide by them. The framework was made even more intricate by linking this system of options to the principle of 'reciprocity' whereby the two rules do not apply to the target company when they are not respected by the bidding company. The principle of reciprocity represents a blatant violation of internal market rules and, in addition, may give rise to considerable uncertainty of application in individual cases, being open as it is to political interpretations.

Article 20 of the Directive provides that, five years after the transposition deadline, the European Commission should examine the Directive "in the light of the experience acquired in applying it and, if necessary, propose its revision". The Commission published its Report in June 2012 (European Commission, 2012); the European Parliament reacted with its Resolution in March 2013 (European Parliament, 2013). Both institutions concluded, against the evidence, that the regime created by the directive was working satisfactorily, and to date no legislative procedure has been initiated to amend the legislation. Clearly, the issue should be reopened.

In the 1980s and 1990s many governments accompanied the privatisation of state-owned companies with legal and statutory rules leaving them special rights – the so-called ***golden shares*** – to block certain decisions and share transactions deemed in contrast with the public interest.

These special rights can take different forms: caps on shareholdings, including limits on the maximum number of shares that may be held by foreigners; the need for approval by a public authority of share purchases beyond a certain threshold; the right to appoint members of the company's board outside the general meeting; the right to approve or veto certain management decisions such as mergers and acquisitions or the disposal of strategically important assets; limitations on private investors' voting rights.

The ECJ addressed the issue of the compatibility of golden shares and the privatisation laws of different Member States with the freedom of capital movement in several decisions adopted in the early Noughties. Accordingly, the compliance of golden shares with European law should be assessed on the basis of a four-step test, whereby golden shares must be: (i) justified by overriding consideration in general interest; (ii) be non-discriminatory on the basis of nationality; (iii) be exercised on the basis of publicly known criteria established in advance; (iv) be proportionate, i.e. the objective which they pursue could not be attained by less restrictive measures. Economic justifications are in general not recognised as legitimate.

In a decision in 2013 (the Essent case), the ECJ also stated that the neutrality principle set forth in Article 345 of the Treaty – whereby the Treaties shall in no way prejudice the rules in Member States "governing the system of property ownership" – also protects the prohibition of privatisation.[3] It follows from this decision that Member States may legitimately establish or maintain a body of rules mandating the public ownership of certain undertakings. At the same time, the Court indicated that a Member State cannot act in disregard of the free movement of

[3] A law in the Netherlands requires that shares held in an electricity or gas distribution system operator must be held, directly or indirectly, by the public authorities identified by the national legislation.

capital. Accordingly, the prohibition of privatisation falls within the scope of Article 63 TFEU and must be examined in the light of that article.

The application of these legal principles, however, has been undermined by various Member State decisions limiting the freedom of capital flows and the right of establishment based on ill-defined grounds of public and strategic interest, which continue to give rise to legal controversies that are settled by ECJ decisions albeit with long delays.

Recently, a new EU framework for the screening of foreign direct investment was adopted (Regulation (EU) 2019/452).[4] The framework defines a cooperation mechanism where Member States and the Commission will be able to exchange information and raise concerns related to specific investments. The Regulation sets an indicative list of factors to help Member States and the Commission determine whether an investment is likely to affect security or public order; to this end, Member States and the Commission may also consider whether the investor is controlled by the government of a third country.

All in all, the legal framework for inward investment is apparently still open to significant political discretion and altogether uncertain in its application, thus representing de facto an obstacle to real capital market integration.

***(iii) The insolvency framework***

Corporate insolvency/restructuring regimes are economically important because they affect the optimal allocation of resources, facilitating the exit of failing firms from the market and reallocating capital to more productive firms.

The European legal landscape with respect to corporate insolvency/restructuring regimes is characterized by significant diversity and, comprehensively, European insolvency systems today deliver much less than the Chapter 11 system in the US. European institution efforts to harmonize national regimes have failed to reduce such diversity so far. The recast "European Insolvency Regulation" (EIR) of 2017 did not radically change the situation since it maintained the widely differing national views and policies on core insolvency matters such as the ranking of claims in an insolvency. Similarly, the "European Restructuring Directive" (ERD) approved in 2019 is unlikely to foster sufficient convergence in national frameworks as it contains more than 70 regulatory options for the Member States.

To address these problems, further initiatives by the European Commission to force harmonization by means of regulation would require far-reaching changes to commercial, civil and company law at national level. A possible alternative could be the introduction of a so-called 29th (28th after Brexit) regime for insolvency/restructuring. According to this hypothesis, European firms could be given the option of a "European Insolvency" regime, which might be adopted and introduced directly in their charters/statutes. The European regime could be embodied in a "fully specified" European Regulation, thus providing legal certainty to stakeholders of those companies, and enforced by a specialized European insolvency court.

[4] Regulation (EU) 2019/452 entered into force on April 10, 2019 and shall apply from 11 October 2020.

### 3. Fragmented supervisory powers

A fundamental pillar of the European strategy for the integration of capital markets is the convergence of supervisory approaches, which play a paramount role in ensuring that the common rules are uniformly applied and that there is little room for an opportunistic use of discretionary powers by national authorities to protect national interests.

The convergence of supervisory practices entails a gradual build-up of institutional procedures and cultural attitudes, under the constraints imposed by the EU Treaties on delegated powers, as interpreted by the ECJ with its Meroni and Romano judgments.[5]

The first step in this process was the creation in 2001 of the Committee of European Securities Regulators (CESR),[6] as part of the Lamfalussy financial regulatory framework.[7] CESR was essentially a network of the national supervisory authorities, with little legal and functional autonomy.

An improved convergence of regulatory standards was expected to come from the transformation of CESR into the European Securities and Market Authority (ESMA), which was set up as a Union body with legal personality and was entrusted with binding powers to develop common implementing standards of the single Rulebook for capital markets. Furthermore, ESMA was also identified as a single supervisor for a small set of market participants (Credit Rating Agencies and trade-repositories) – a potential harbinger of further transfers of powers.

However, in practice these changes have not altered the very nature of ESMA as a network of national supervisory authorities because of the composition of its governing bodies and its decision-making procedures, which are still based on the principle of national representation. A useful model for reform is provided by the European Central Bank, where a 'management board' independent of national authorities, and composed of independent and highly qualified individuals, acts as an executive board, setting the agenda and preparing substantive decisions, while the representative of the national central banks only intervenes in a broader 'governing council' called to ratify the proposals of the management board. Moreover, the reform in decision-making should also address the other relevant threat to supervisory neutrality in respect of national interests, that is, the discretion that national authorities can exercise in case of large cross-border transactions. A recent proposal by the European Commission for a review of the Regulation on European Supervisory Authorities (ESAs) offered the opportunity to move forward on this front but was not supported by Parliament or the Member States.[8] There is little doubt that without creating a genuine European authority for capital markets, Europe will not succeed in creating a level regulatory environment, and therefore the CMU will not succeed. The US experience confirms the crucial role of a powerful single supervisor in the integration of the capital markets.

Furthermore, such European authority should be given real powers for the oversight (directly or through compulsory coordination power on NCAs) of operations and sectors of a European scale, such as post trading infrastructure, proxy advisors, and market abuses with strong cross-border relevance. These powers should notably include the approval of prospectuses for pan-European offers, at least on a voluntary basis for the issuer, making it possible for large companies to escape

[5] Case Meroni (C-9/56; EU:C: 1958:7), 13 June 1958; Case Romano (C-98/80; EU:C:1981:104), 14 May 1981.

[6] European Commission, Decision establishing the Committee of European Securities Regulators, 2001/527/EC (repealed by Commission Decision 2009/71/EC).

[7] Final Report of the Committee of the Wise Men on the Regulation of European Securities Markets, Brussels 15 February 2001.

[8] European Commission, Proposal for a Regulation amending the ESAs, 2017/0230/COD, 20 September.

cumbersome national procedures. Suffice to mention, in this regard, that when Spotify, a Swedish company, decided to go public in order to raise substantial capital, it chose to list in the New York Stock Exchange. The motivation was clear. Each national market in Continental Europe would be too small to accommodate such a large issue.

## 4. Conclusions

The foregoing analysis shows that the CMU Action Plan was incomplete and deeply flawed since it did not address many fundamental obstacles to real capital market integration. Moreover, some of the legislation adopted under the plan was on the whole counterproductive. Meanwhile, Member States have claimed stronger discretionary powers to vet inward direct investments in an environment where these investments were often seen with suspicion, if not outward opposition.

A fresh initiative would only make sense if it was ready to turn ESMA into an effective supervisor of European capital markets, thus overcoming the present inadequate approach. In addition, a radical overhaul of legislation should squarely address the shortcomings that have been described in the prospectus and MAR rules, as well as create effective channels for access to capital markets by SMEs, and notably growth companies. The rules governing company mobility and the market for corporate control need thorough revision with a view to opening the way to real capital market integration.