EU CAPITAL MARKETS

Policy Reforms with Global Impacts

U.S. CHAMBER OF COMMERCE'S CENTER FOR CAPITAL MARKETS COMPETITIVENESS

POLICY POSITIONS & RECOMMENDATIONS

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CENTER FOR CAPITAL MARKETS COMPETITIVENESS®

Introduction & Executive Summary

European Union (EU) institutions have recently enacted and proposed policy changes that will impact the global capital markets. In some cases, policy proposals have deliberate extraterritorial applications, particularly where firms provide services to EU-based clients; whereas other policies have inherent global impacts. Either way, European institutions should aim toward striking the appropriate balance of ensuring financial stability and protecting consumers in Europe, and preserving the integrity of the global capital markets.

The regulations with extraterritorial impacts, as recently proposed by the European Commission (Commission), could increase market fragmentation, decrease competition among financial services firms, decrease liquidity, and ultimately increase costs for consumers and businesses in the EU and around the world. To prevent these unintended consequences for the markets, we advocate for outcomes-based equivalency regimes, deference to third-country regulations, cross-border harmonization, more effective cross-border communication, and flexibility for market participants to avoid stifling innovation and progress.

The European Union is an integral component of the world's capital markets. A strong EU Capital Markets Union with effective and workable regulation will ensure the EU remains competitive, while preserving EU counterparties' ability to do business with third countries and keeping costs low for EU investors. To promote strong EU and global capital markets, we make the following recommendations related to key policy reforms:

- ***Common Ownership:*** Common ownership has not been demonstrated to cause anti-competitive effects. There is extensive research that finds no anti-competitive results due to non-controlling interest in competing companies. Moreover, proposals to limit common ownership could actually harm consumers rather than protect them. Some of the solutions proffered for common ownership may adversely impact the ability of businesses to raise capital and have similar consequences for economic growth. Therefore, we encourage European regulators to consider the absence of a clear problem, and the potential negative impacts to the global economy, EU markets, and EU consumers before proceeding with policy changes.

- ***Portfolio Delegation:*** As EU regulators continue to consider the future arrangements for portfolio delegation, we caution against imposing overly burdensome conditions under which firms may delegate to entities outside of the EU. Rather, we encourage cross-border cooperation among EU and third-country regulators to ensure adequate information flow on the oversight of funds.

- ***Prudential Regime for Investment Firms:*** While we appreciate the Commission's proposed simplifications to the prudential regime for investment firms, we caution against applying a more robust equivalence regime to third-country investment firms than already exists under MiFID II.

- ***Third-Country CCPs:*** To avoid potential market fragmentation and increased costs for end-users:
  - » European authorities should uphold existing equivalence agreements.
  - » Application of EU rules to third-country CCPs and withdrawal of recognition should be a last resort, given the potential impacts to markets and consumers.
  - » Comparable compliance should be automatic for jurisdictions already assessed to be equivalent and the assessment should take place prior to the application of EU rules.
  - » Relocation of CCPs to the European Union should not be required.

- ***Sustainable Finance:*** Incorporating ESG factors into financial services should be market-driven and we caution against prescriptive regulatory requirements.

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Common Ownership

There has been increasing discussion in the EU and among international standard-setters around the theory that simultaneous ownership of shares in competing firms by institutional investors (common ownership) has an anti-competitive impact. While there have been no formal policy proposals made, there has been academic work suggesting restricting the voting rights of index funds, limiting index funds to owning one company per sector in concentrated industries, applying existing competition law to common ownership, and other recommendations.

Preliminary academic research asserted there are anti-competitive effects in the airline and banking industries arising from common ownership. In contrast to this small subset of studies, numerous subsequent studies have found no relationship, and some have even concluded that common ownership promotes competitive outcomes (see Table 1). The following points have been made by researchers:

- ***Non-controlling shareholders do not have the ability to influence competition.*** Even if common owners had the incentive to affect performance in an industry (which they may not), they would not have the ability to do so since shareholders do not have the opportunity to vote on competition strategy.

- ***Asset managers have a fiduciary duty to all of their clients and act on their behalf. Attempting to influence anti-competitive results in an industry would go against this duty.*** Asset managers' common ownership has been a focal point of some researchers. However, asset managers do not invest on their own behalf and are accountable to all of their clients—not just those with common ownership shares.

- ***Limiting common ownership would increase the costs of investment products for retail investors, including retirees and investors saving for retirement.*** Some have proposed to limit common ownership in a variety of ways, including through changes to existing antitrust laws or new regulation. Such policy changes would limit institutional investors' and mutual funds' abilities to diversify their holdings, which ultimately increases costs and risks borne by individuals saving for retirement and other purposes.

Table 1: Key Common Ownership Research Findings

Studies finding no anti-competitive effects	Key Findings
Daniel P. O'Brien and Keith Waehrer, "The Competitive Effects of Common Ownership: We Know Less Than We Think," February 22, 2017.	"Institutional investors (e.g., mutual funds) frequently take positions in multiple firms in an industry in order to offer diversified portfolios to retail investors at low transaction costs. A change in antitrust or regulatory policy toward these investments could have significant negative implications for the types of investments currently available to retail investors."
Elaine Buckberg, Steven Herscovici, Branko Jovanovic, and James Reitzes, "Proposal to Remedy Horizontal Shareholding is Flawed," July 1, 2017.	"There are doubts whether horizontal shareholding creates a competitive problem that justifies invoking a particular blanket 'remedy,' as opposed to a case-by-case analysis and more selective remediation. Analysis of the costs of the proposed blanket solution, which may be substantial…is lacking."
Pauline Kennedy, Daniel P. O'Brien, Minjae Song, and Keith Waehrer, "The Competitive Effects of Common Ownership: Economic Foundations and Empirical Evidence," July 2017.	"Contrary to recent research based on the same data, we find no evidence that common ownership raises airline prices."
Carola Schenone, Patrick J. Dennis, and Kristopher Gerardi, "Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry," January 2018.	"This paper questions the applicability of the theory of horizontal mergers and cross-ownership theory on the context of common ownership, and empirically analyzes the relationship between ticket prices and common ownership in the airline industry. In sharp contrast to the findings in Azar, Schmalz, and Tecu (2017), we find no evidence of such a relationship."
Douglas H. Ginsburg and Keith Klovers, "Common Sense About Common Ownership," April 27, 2018.	"We believe the argument for antitrust enforcement against common ownership is misguided. First, proponents conflate management by investment managers and economic ownership by individual account holders and therefore incorrectly attribute allegedly anticompetitive conduct to the investment managers."
Thomas A. Lambert and Michael E. Sykuta, University of Missouri School of Law, "The Case for Doing Nothing About Institutional Investors' Common Ownership of Small Stakes in Competing Firms," May 2018 ("Lambert and Sykuta (2018)")	"The theory as to why current levels of intra-industry diversification would occasion consumer harm is implausible, and the empirical evidence of such harm is both scant and methodologically suspect. The policy solutions that have been proposed for dealing with the purported problem would radically rework an industry that has provided substantial benefits to investors, raising the costs of portfolio diversification and enhancing agency costs at public companies."

CCMC Recommendation

Common ownership has not been demonstrated to cause anti-competitive effects. There is extensive research that finds no anti-competitive results due to non-controlling interest in competing companies. Moreover, proposals to limit common ownership could actually harm consumers rather than protect them. Some of the solutions proffered for common ownership may adversely impact the ability of businesses to raise capital and have similar consequences for economic growth. Therefore, we encourage European regulators to consider the absence of a clear problem, and the potential negative impacts to the global economy, EU markets, and EU consumers before proceeding with policy changes.[1]

> *"Common ownership has not been demonstrated to cause anti-competitive effects . . . proposals to limit common ownership could actually harm consumers rather than protect them."*

[1] See further comments in The U.S. Chamber's comment letter to the Federal Trade Commission, submitted on September 17, 2018, available here: https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/09/180914_Comments_FTCCommonOwnership_Final-002.pdf

Portfolio Delegation

The Undertakings for Collective Investment in Transferable Securities (UCITS) and the Alternative Investment Fund Managers Directive (AIFMD) frameworks were established to offer greater investment opportunities by creating a harmonized regime across the EU for investment funds. These frameworks, particularly UCITS, have become a European success story and a global brand, seen as promoting investment opportunities efficiently across borders and regulating funds to a high standard.

Similar to other major global regulatory regimes for asset management, the UCITS and AIFM directives accommodate portfolio delegation--a common business practice where fund management firms outsource some of their business functions to another location for efficiency, access to expertise, and cost-saving purposes, ultimately benefiting their customers. Under UCITS and AIFMD, firms can delegate functions such as custody and portfolio management as well as risk management to third-country entities, while remaining subject to EU regulation and strict oversight by the management company's national regulator. This model has proven successful for investors around the world, particularly in Europe, and European regulators have not identified any market failures or systemic wrongdoing due to portfolio delegation. Yet, European authorities are proposing to make changes.

Under the European Supervisory Authorities (ESAs) Review, the ESAs would gain new powers to review delegation arrangements—a shift from the existing regime where national competent authorities (NCAs) authorize and supervise funds. Over the years, funds have domiciled in a few concentrated jurisdictions and those local NCAs have developed expertise and a rigorous approach to supervising funds. It is expected that there will be much greater scrutiny over delegation arrangements in the future, given the proposed increased discretion for ESMA, which could potentially restrict the use of this common practice. This means experienced, highly regarded investment advisers based outside of the European Union could be restricted from engaging in EU business. Additionally, funds with existing delegation arrangements could be forced to meet additional requirements or risk losing those arrangements.

Concerns of regulatory arbitrage and the potential to circumvent EU rules are already sufficiently addressed by the existing provisions of AIFMD and UCITS. In fact, European authorities introduced provisions under AIFMD specifically to prevent "letter-box" entities from forming[2] which have been further reinforced by a set of legal Opinions from ESMA on outsourcing, including portfolio management in 2017[3].

If portfolio delegation is restricted, EU investors would lose access to cost-effective investment options and UCITS' international credibility could suffer.

CCMC Recommendation

As EU regulators continue to consider the future arrangements for portfolio delegation, we caution against imposing overly burdensome or unreasonable conditions under which firms may delegate to entities outside of the EU. Rather, we encourage cross-border cooperation among EU and third-country regulators to ensure adequate information flow on the oversight of funds.

> *"If portfolio delegation is restricted, EU investors would lose access to cost-effective investment options and UCITS' international credibility could suffer."*

2. Articles 78 and 82 of Commission Delegated Regulation 231/2013
3. ESMA's three Opinions, published July 13, 2017, are available here: https://www.esma.europa.eu/press-news/esma-news/esma-issues-sector-specific-principles-relocations-uk-eu27.

Prudential Regime for Investment Firms

European institutions have proposed to amend the current prudential rules for investment firms. Under the proposals, the largest and most systemically significant investment firms (class 1 firms) would be subject to the same regulatory regime as European banks. Smaller/non-systemic investment firms would no longer be subject to rules that were originally designed for banks (class 2 and 3 firms).

The prudential regime was in need of updating and CCMC welcomes the simplification of firm classification from 11 categories down to three, as well as the simplified requirements for class 2 and 3 firms. In particular, we support the Commission's proposed relaxation of remuneration requirements for class 2 firms, which reflects a more proportionate and appropriate approach.

However, we have concerns with the potential approach regarding equivalence for third-country investment firms. Proposed amendments to the existing rules under the Markets in Financial Instruments Regulation (MiFIR) would unduly complicate the ability of third-country firms to provide investment services in the EU and could possibly even lead to reconsiderations of servicing the EU market. Moreover, as the EU co-legislators proceed with the formulation of their positions on the proposal, ideas of developing a more robust and challenging equivalence regime emerged including a requirement for firms to establish a physical presence in the EU (which the U.S. and other countries do not require of EU firms). Similarly as in other proposals, attempts to extraterritorially apply EU regulation to third countries or force relocation would result in market fragmentation, reduced liquidity, and higher costs to EU customers and investors.

CCMC Recommendation

While we appreciate the Commission's proposed simplifications to the prudential regime for investment firms, we caution against applying a more robust equivalence regime to third-country investment firms than already exists under MiFID II.

Third-Country CCPs

There is increasing uncertainty regarding the EU's treatment of third-country central counterparty clearinghouses (CCPs). EU authorities are considering amendments to the European Market Infrastructure Regulation (EMIR), which could make it harder for EU counterparties to access third-country CCPs around the world.

Amendments to the supervision and regulation of non-EU CCPs, as proposed under the review of the EMIR, would establish more rigorous equivalence and recognition processes. From an institutional perspective, a stronger regulatory/supervisory role of the European Central Bank (ECB) over CCPs would be accompanied by new supervisory powers granted to ESMA over third country CCPs.

The proposed changes to EMIR would introduce a new two-tiered system for classifying third-country CCPs. Tier 2 CCPs would be subject to EU rules and oversight by EU authorities, including ESMA and the ECB. While we appreciate the provision to allow for comparable compliance by Tier 2 CCPs, comparable compliance should automatically be granted where jurisdictions have already been determined to be equivalent, rather than be required to comply with the additional requirements under EMIR for a certain period of time until comparable compliance is determined.

Further, ESMA would have discretion to impose EU rules directly on CCPs in jurisdictions that have already been determined to have equivalent regulatory frameworks. Application of duplicative, and in many cases conflicting rules to the entirety of a third-country CCP's global clearing activities is not only inappropriate, but will increase the cost of clearing globally, likely reduce the number of CCPs willing to serve the EU markets, and result in reduced liquidity for EU customers.

> *"Proposed changes to EMIR have the potential to introduce significant costs for global futures and swaps markets, clearinghouses, and market participants, including commodity end-users who trade energy and agricultural derivatives."*

The European Commission would also have increased discretion to deny or withdraw recognition to third-country CCPs which could significantly fragment liquidity, increase costs for market participants, and cause activity to shift out of EU markets into more cost-efficient third-country markets. The cost of clearing would be higher because the OTC derivatives contracts subject to the EMIR clearing obligation would need to be cleared in a less liquid EU market. This extra cost would likely be passed on by the CCPs to their clients. EU counterparties using non-EU markets would not be able to use non-qualifying CCPs because the capital costs of facing such a CCP would be uneconomical.

Finally, the most systemically significant CCPs would be required to relocate to the EU, effectively creating a Tier 2 “plus” category. Forced relocation would fundamentally disrupt markets and increase costs. The International Swaps and Derivatives Association (ISDA) estimates in a research paper[4] that a location requirement for euro-denominated swaps could raise initial margin levels by 15-20 percent.

This is because clearing members would no longer have the ability to net all exposures in the same liquidity pool to one CCP. These extra costs will be passed down to end-users hedging their risks and ultimately consumers.

Proposed changes to EMIR have the potential to introduce significant costs for global futures and swaps markets, clearinghouses, and market participants, including commodity end-users who trade energy and agricultural derivatives.

CCMC Recommendations

To avoid potential market fragmentation and increased costs for end-users:

- European authorities should uphold existing equivalence agreements.
- Comparable compliance should be automatic for jurisdictions already assessed to be equivalent and the assessment should take place prior to the application of EU rules.
- Application of EU rules to third-country CCPs or withdrawal of recognition should be used as a last resort, given the potential impacts to markets and consumers.
- Relocation of CCPs to the European Union should not be required.

4. ISDA, “Brexit – CCP Location and Legal Uncertainty,” August 2017.

Sustainable Finance

The European Commission has established a comprehensive plan to integrate environment, social, and governance (ESG) factors into financial services. Based on recommendations from the High Level Expert Group the Commission established in 2016, the Commission issued an Action Plan ("Financing Sustainable Growth," March 2018) and several legislative proposals in May 2018. One proposal would create an EU classification system to define what constitutes sustainable economic activity to prevent "green washing" and create a common language of what is "sustainable." Another proposal would enhance disclosure requirements on how institutional investors and asset managers integrate ESG factors in their risk processes and disclose ESG information to their clients. Another would amend MiFID II to require investment firms and insurance distributors to incorporate ESG preferences into suitability assessments.

The integration of sustainability considerations into investment decisions and the advisory process requires flexibility. We therefore believe that the market should ultimately drive this important agenda to the benefits of investors and consumers alike and have concerns about the prescriptive nature of some of the Commission's proposals.

Regarding the Commission's proposal to amend MiFID II, it is unclear how firms would include ESG considerations in suitability assessments, given that factors taken into consideration in a suitability assessment are quantitative and the success of meeting those requirements is easily measured. Suitability is built around investment horizon, risk tolerance, and cost; whereas an investor's ESG preferences are fundamentally qualitative. It is not clear how an investor's potential sustainability preferences should be taken into account, particularly when the sustainability of an investment product may cut across the existing financial factors of suitability. Moreover, it is difficult to imagine how a firm would determine which investments are suitable for an investor, based on the common definitions of sustainability, when those definitions do not yet exist.

We also have significant concerns with the draft amendments to the proposed disclosure regulation put forth by European Parliament Rapporteur Paul Tang on August 2, 2018. The draft report includes amendments that would drastically alter the Commission's original proposal by adding a full overarching, mandatory due diligence framework for all financial market participants, including a duty of care component. This would require financial markets participants to have in place due diligence processes that ensure that the identification and management of sustainability risks are sufficiently integrated in investment decision-making, requiring investors to identify, prevent, mitigate and account for ESG factors. We were pleased to see that the Commission's initial proposals did not alter the principle of fiduciary duty, and thus have significant concerns with the draft report's amendments regarding due diligence.

CCMC Recommendation

Incorporating ESG factors into financial services should be market-driven and we caution against prescriptive regulatory requirements.

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The Center for Capital Markets Competitiveness's (CCMC) mission is to advance America's global leadership in capital formation by supporting diverse capital markets that are the most fair, transparent, efficient, and innovative in the world. CCMC advocates on behalf of American businesses to ensure that legislation and regulation strengthen our capital markets allowing businesses—from the local flower shop to a multinational manufacturer—to mitigate risks, manage liquidity, access credit, and raise capital.

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