Frankfurt am Main,
17 March 2017

European Commission public consultation on the capital markets union mid-term review 2017

The Capital Markets Union (CMU) project is of utmost importance for BVI members being fund and asset managers with significant cross-border operations. Therefore, BVI[1] is glad to contribute its views to the public consultation on the mid-term review 2017 of the CMU.

1. Financing for innovation, Start-Ups and non-listed companies

Q: 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.

As regards financing for innovation, start-ups and non-listed companies, further improvements should be expected from enhancing the range of eligible assets especially for EuVECAs and ELTIFs:

- The current restrictions regarding **eligible assets for EuVECAs** only allow for an investment decision within a very narrow set of investment instruments. In practice, these strict rules hinder the success of EuVECAs since it proves very difficult to set up and manage the fund according to clients' demands. In this regard, we welcome the Commission's proposal to extend the definition of qualified portfolio undertakings. The wider the investment possibilities are, the more likely fund managers will be able to build a portfolio appropriate for the investors. Furthermore, we propose to reconsider the limits regarding qualifying investments as well as the limits regarding investments in loans. Our members see a significant demand for loans regarding SMEs. An extension of both the investment limits and the qualifying investments would serve all three parties, i.e. the SME who get more access to financing, the investor who will be able to use EuVECAs as investment vehicles as well as the asset manager.

- The current restrictions in the **ELTIF Regulation** regarding both portfolio composition as well as additional requirements for marketing of units to retail investors have significant impact on the attractiveness of ELTIFs for both investors and fund managers. While we understand the general concerns and agree with many of the safeguards to be in the interest of investor protection, we perceive the 10 percent threshold for the aggregated portfolio of retail investors with a portfolio not exceeding Euro 500,000 as a critical impediment to the market success of ELTIFs. It is hardly conceivable how the ELTIF manager or a distributor shall ensure that it obtains full and complete information on the overall financial portfolio of retail investors. Given this uncertainty, the rules bear significant liability risks for the manager or the distributor despite the legislator's intention in the trilogue to reduce such risks, since they will also be subject to interpretation under national civil law. These unresolved issues considerably reduce the attractiveness of retail marketing and may discourage management companies from setting up ELTIFs altogether.

[1] BVI represents the interests of the German investment fund and asset management industry. Its 98 members manage assets of EUR 2.8 trillion in UCITS, AIFs and discretionary mandates. As such, BVI is committed to promoting a level playing field for all investors. BVI members manage, directly or indirectly, the investments for 50 million private clients in over 21 million households. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

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We believe that the mentioned requirement is of no additional value to investors. The ELTIF regulation already provides for sufficient safeguards such as internal governance procedures to assess whether the ELTIF is suitable for marketing to retail investors and rules which require an appropriateness test in cases of direct marketing. In addition, MiFID II strengthens the general standards of investor protection and provides for appropriate safeguards for the whole range of products (including ELTIFs) in case of third party distribution.

From the perspective of professional investors, such as insurance companies, the regulatory conditions of investing in ELTIFs are not yet attractive. The current rules on portfolio composition, investment limits, a fund's lifetime and redemption rights are quite detailed and strict. On this basis, the practical opportunities for asset managers to structure an ELTIF which requires at least five typical ELTIF assets with a similar lifetime to cover at least 70 percent of the ELTIFs' capital are fairly limited. The fact that the implementing measures to the ELTIF Regulation are still outstanding provides for additional uncertainty.

2. Making it easier for companies to enter and raise capital on public markets

Q: 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.

- <u>Effect of MiFID II rules on research</u>

  The new rules in MiFID II regarding the treatment of research will possibly have significant impact on the amount of research provided on smaller and medium-sized companies and may thereby add new barriers for them to enter and raise capital on public markets. Therefore, we encourage the Commission to closely monitor the effect that the new rules will have on research and consider, if necessary, options to facilitate the provision of research to make it easier for companies to enter and raise capital on public markets.

- <u>Streamlining disclosure requirements for publicly offered closed-ended funds</u>

  In the course of revision of the Prospectus Directive, together with EFAMA, BVI has argued in favour of an exclusion of the closed-ended funds from the scope in order to account for the already comprehensive disclosure requirements under AIFMD and to avoid unnecessary duplicative burden under the prospectus regime. We regret that this has not been reflected in the final text agreed in the trilogue and consider it still important and in full alignment with the objectives of the CMU to ensure a simple disclosure requirements regime for all investment funds of the same type. For that reason, we would advocate a further rationalisation of the disclosure requirements for closed-ended funds that are publicly offered which could be at least partially tackled in the upcoming work at Level 2.

3. Investing for long term, infrastructure and sustainable investment

Q: 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.

In our view, the following steps would materially contribute to fostering long-term, infrastructure and sustainable investment in the EU Single Market:

- Enlarging the scope of the AIFMD marketing passport

The current definition of professional investors under AIFMD which is derived from the MiFID framework does not sufficiently consider certain categories of institutions. In particular, entities such as foundations, charities, national providers of pension schemes, church organisations or family offices are generally not able to qualify as professional clients because they do not fulfill the relevant criteria in Annex II section II.1. of MiFID II, even though their level of financial expertise is generally far above the average retail investor. As a consequence, these investors which generally favour long-term engagements matching their long-term obligations are in most cases deprived of the possibility to exploit investment opportunities available to professional investors. In Germany, these investors have been granted access to professional AIFs at national level on the basis of them being classified as “semi-professional”. A similar approach applies in Luxembourg where professional AIFs are open to “well informed investors”, a group that does not only comprise professional investors according to MiFID but also other institutions and experienced investors. However, under the current rules, they are not able to take avail from the marketing passport under the AIFMD and to choose from EU-wide suitable investment opportunities e.g. with focus on infrastructure or SME financing which are mainly set up for professional investors.

We believe that the introduction of a new EU category of “semi-professional” investors in the AIFMD or ultimately in the MiFID framework could broaden the professional investor base and further diversify the supply of funding to long-term projects in the EU. In our view, such new investor category should be modelled along the lines of EuSEF/EuVECA Regulations which inter alia impose a minimum investment amount for investments by other than professional investors[2]. We also think that introduction of “semi-professional” investors in the ELTIF framework with reference to the same criteria would eliminate the legal uncertainty concerning the treatment of this investor category which up to now has only been reflected in a recital to the Level 1 Regulation[3].

- Introducing “Low Leverage AIFs” as investment vehicles for semi-professional investors

The term “alternative investment fund” or “AIF” which determines the scope of application of the AIFM Directive is very broad and covers basically every collective investment vehicle not authorised as UCITS. In consequence, AIFs stand for a variety of fund solutions ranging basically from retail funds regulated and supervised in a UCITS-equivalent manner, but with a somewhat different investment focus (e.g. on real estate), to highly leveraged hedge funds or specialised closed-ended funds investing e.g. in infrastructure or private equity. Given these differences in the investment strategies and the level of risk pertinent to AIFs, it should be clear that the current general limitation of the AIFM passport to professional investors prevents utilisation of unemployed capital in the retail market and denies certain proficient entities access to investment opportunities which could fit into their risk propensity profiles and match their long-term liabilities (cf. our considerations on semi-professional investors above).

We believe there is a case for introducing a regulatory distinction of AIFs in the course of the upcoming AIFMD review. Such distinction could in our view be based on the level of risk

[2] Cf. Art. 6(1) of Regulation (EU) 345/2013 and Regulation (EU) 346/2013 respectively.
[3] Cf. recital 42 of Regulation (EU) 2015/760.

associated with AIF investments, i.e. on the level of employed leverage. This new sub-category of AIFs ("Low Leverage AIFs") should be available to semi-professional investors on the basis of an extended EU passport.

In our view, it is reasonable to distinguish AIFs on the basis of employed leverage. Leverage is of crucial relevance as a factor for assessing both the potential for systemic risk (macroeconomic dimension) and the risk of losses for investors (microeconomic dimension). Thus, it should represent a suitable foundation for distinguishing the level of risk inherent in AIFs. Even though the AIFMD regime does not provide for regulatory limits on leverage, it imposes upon all AIFs a consistent measurement approach (so-called commitment approach) and requires reporting of the employed leverage level to the authorities. Consequently, all AIFs already calculate leverage employed at the fund level according to the same methodology.

- <u>Taking steps to improve cross-border distribution of investment funds</u>

Introduction of standardised processes and avoiding as much as possible national regulations gold-plating the EU rules on marketing is crucial for facilitating cross-border distribution of investment funds and functioning of the EU passports. As highlighted in our response to the Commission's consultation on cross-border distribution of investment funds, some of the persisting deficiencies could be tackled by Level 3 measures and thus may be easy to achieve such as common definitions on pre-marketing, marketing and private placement. While ESMA should not be considered universally responsible for dealing with any shortcomings, we believe it can provide valuable guidance and serve as information hub for all NCAs and market participants. **In consequence, we see the case for further harmonising the marketing standards for investment funds making use of the EU passports for marketing their units cross-border.**

Significant improvement for which legislative action might be required would further comprise:

- Defining a European semi-professional investor type, e.g. by drawing a parallel to the EuSEF and EuVECA Regulations and expanding the AIFMD passport regime to that new investor type (cf. our suggestions to Q3 above).
- A system where all NCAs would have to rely on approval and information provided by the home Member States' NCAs.
- Allowing for a private placement regime for all types of funds.
- Improving the European transaction processing landscape for funds, e.g. by further harmonisation and standardisation in trading, clearing, settlement, custody, asset servicing (including identification of investors and distributors) of fund units and shares.
- Streamlining the notification process, i.e. by providing clarity about suspension of notice period in case NCA requests further amendments and by investigating whether UCITS should at all undergo the notification process for cross-border marketing since they have been authorised in one Member State in accordance with the harmonised rules of the EU UCITS regime.

- <u>Facilitating responsible investments</u>

Responsible investments are becoming increasingly important without so far any significant interference from regulators. While we believe that policy makers can further facilitate this development, we think that the means of doing so should be selected very cautiously. In particular, any mandatory requirements run the risk of shifting the approach to responsible investment from a developing approach to a mere question of compliance which would have an effect of retrogression. For instance, the current proposal by the ESAs regarding PRIIPs which target environmental or social objectives suggests requiring all PRIIPs manufacturers to comply with MiFID II or IDD product governance rules without a proper analysis of the existing rules for fund managers[4]. Furthermore, the proposal bears the risk of impacting all assets where asset managers integrate ESG criteria alongside the mainstream investment analysis. Should the Commission pick up such suggestions, we fear that the growing market of responsible investments would suffer and investors would not be better informed.

Generally, we think governments could play an important part as role models regarding their own investments. They could also encourage standardisation given that in our view the main barrier of responsible investment is a lack of transparency and quantitative long-term data. In addition, we think that education on the importance of RI could further facilitate the development.

4. Fostering retail investment and innovation

Q: 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.

We are convinced that investors' confidence and their willingness to invest in capital markets can be enhanced only by defining clear and rigorous regulatory standards applicable to investment products across sectors. Hence, the issue of level playing field at the point of sale needs to be tackled once for all in a satisfactory manner. Introduction of an EU framework for personal pensions can also contribute to creating a positive attitude towards capital market investments.

- Creating a level playing field at the point of sale

  In the context of the PRIIPs initiative, it has been generally acknowledged[5] by the EU institutions that distribution of all investment products in the retail market, regardless of whether they are sold in a securities or an insurance wrapper, should be subject to equal conduct of business rules in order to effectively protect European investors. Notwithstanding this commitment which has been explicitly enshrined also in the MiFID II legislation[6], it is already clear that the IDD framework will fall behind the relevant MiFID II standards. Specifically, there are still deficits in the following areas:

  - While the **cost information rules** enshrined in Level 1 are pretty similar under IDD and MiFID II and apply to all costs and charges at both product and service level[7], there is significant uncertainty whether the final standards will indeed provide for the same level of transparency to investors. In contrast to MiFID II, the IDD regime does not provide for further specification of the cost disclosure duties at Level 2. As a consequence, it is unclear whether distributors of insurance-based investment products will be required to disclose commission payments received from product providers on separate terms as specifically foreseen under MiFID II.
  - The standards governing the **legitimacy of commission payments and other inducements** are not comparable for financial and insurance distribution channels. The conditions for payment or reception of inducements have been phrased in a different manner under IDD and Mi-

[4] Cf. Technical Advice 2 in the Joint Consultation Paper on PRIIPs with environmental or social objectives from 10 February 2017.
[5] Cf. recitals 1 to 5 of the PRIIPs Regulation (Regulation (EU) No 1286/2014).
[6] Cf. recital 87 of the MiFID II Directive (Directive 2014/65/EU).
[7] Cf. Art. 24(4)(c) and last subparagraph of MiFID II, Art. 29(1)(c) and the following subparagraph of IDD.

FID II, resulting in divergent approaches at Level 2. Most importantly, MiFID II implies that the quality criteria must be fulfilled for each and every individual inducement and shall be duly documented, whereas under IDD, it seems that quality assessment can be related to the generic inducement for selling a particular type of product[8].

- MiFID II strives for **maximum harmonisation** of financial distribution rules and hence takes a different approach to IDD which is based on **minimum harmonisation**. As a result, Member States may significantly influence the insurance distribution framework by setting additional standards at national level. In Germany, the draft IDD implementation act proposes a prohibition for insurance distributors to pass on commission payments to clients. Consequently, insurance intermediaries selling commission-based insurance contracts shall be required by law to take the full commission (as clients will be required to pay it). In our view, this approach significantly alters the conditions under which the legitimacy of inducements according to the future Level 2 IDD provisions can be assessed and prevents further evolvement of inducement schemes in the insurance sector to the detriment of insurance clients. Effectively, it is a material step back as regards the level playing field at the point of sale.

Against the backdrop of the CMU initiative, we would like once again to call upon the EU Commission to work towards equal standards of investor protection and a level playing field at the point of sale. As far as possible, equal or at least equivalent standards should be introduced in the pending work on IDD implementation at Level 2. More generally, we would encourage the Commission to investigate the indicated obstacles to a level playing field as part of its EU retail investment product market assessment to be conducted in 2017.

- <u>Impact of costs on performance must be properly assessed</u>

MiFID II, PRIIPs and IDD, all coming into force at the beginning of 2018, will significantly change the way in which information on product costs is delivered to clients. Especially the PRIIPs Regulation takes a new approach to cost disclosure by accounting for implicit costs which impact the value of underlying assets. When speaking about implicit costs, we mean costs incurred either at the level of underlying assets or as part of a purchase/sale transaction, but which are not explicitly charged to the fund. Underlying assets are booked onto the fund accounts with their current market value which already reflects any costs incurred at the level of the underlying investment. Thus, such costs are already reflected in the disclosure of net performance figures by investment funds and not further included in NAV calculations.

With PRIIPs Regulation coming into force, this understanding of performance-relevant costs might fall out of balance. The expectation described in the draft PRIIPs RTS is clearly to present performance scenarios “net of all applicable costs” in accordance with the cost section[9]. However, taking into account the explanation above, implicit cost elements must not be further deducted from performance figures, since this would amount to double counting of costs. Similar problems might arise under MiFID II which also requires disclosure of implicit costs (such as implicit transaction costs) in investment products[10].

Thus, it is important for the Commission to set the right parameters for its commencing work on the transparency of fees and net performance of long-term retail and pension

[8] Cf. EIOPA’s Technical Advice on possible delegated acts concerning the Insurance Distribution Directive from 1 February 2017, section 5 para. 28.
[9] Cf. Annex IV para. 25 of the draft PRIIPs RTS from 30 June 2016.
[10] Cf. Annex II Table 2 of MiFID II Commission Delegated Regulation from 25 April 2016.

products. In particular, cost figures comprising implicit costs must be treated with due caution and not inconsiderately deemed relevant for assessing net performance of investment products.

- Securing old-age provision for European citizens

  We agree that due to demographic changes, caused by a shrinking EU population and increased life expectancy, private pension schemes will be a key element to ensure an adequate income at old age. Further we see a trend towards establishing commonly accepted standards for personal pension schemes causing significant growth effects within this market. We expect that due to these growth effects, further long-term investments with positive effects for the European economy will be triggered. This development will also create new opportunities for EU citizens to participate in productive capital fueling the European economy. Therefore, **we strongly support the pending initiative to introduce an EU framework for personal pensions**. The biggest challenge will be the interaction with national taxation as tax benefits are essential elements of and drivers for market penetration of pension schemes.

6. Facilitating cross-border investment

Q: 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.

We welcome the various initiatives already undertaken by the EU Commission in order to facilitate cross-border investments. In addition to our suggestions regarding cross-border distribution (cf. our comments under Q3) and our response to the Commission's consultation on cross-border distribution of investment funds we would like to supplement them by the following ideas:

- Reducing procedural difficulties for refunding of withholding tax in cross-border situations

  It has been widely acknowledged that claiming withholding tax relief under Double Taxation Agreements and/or a country's domestic tax laws especially for investment funds is in practice often cumbersome and time- and resource-intensive for governments, financial institutions and foreign portfolio investors. In our experience the process for claiming withholding tax relief has deteriorated over time in many countries, resulting in increased costs and protracted delays for cross-border portfolio investors to obtain tax relief. The types of burdensome procedures being increasingly faced by investors include:

- extensive, non-standardised documentation requirements, often for each income payment;
- the need to hire local counsel to pursue relief procedures;
- requirements for residence country tax administrations to provide certificates tailored to requirements of the source country;
- unclear or unreasonably complicated requirements for withholding tax relief on payments to investment funds, contrary to the OECD's recommendations; and
- lack of effective refund procedures.

This outcome discourages cross-border investments and thus undermines the objectives of the CMU initiative. In addition, it can also contribute to the erosion of the investor's residence country tax base in the absence of mechanisms ensuring that information about the investor's income is conveyed to his home country tax administration.

In 2011 the Commission already consulted on taxation problems that arise when dividends are distributed cross border to portfolios and individual investors and asked for possible solutions. Due to specific problems for investment funds to achieve cross border treaty relief (unknown investor base), **our favoured solution to solve the problem** – also presented as one possible option by the Commission – **was to generally abolish withholding tax (WHT) on cross border dividend payments. This proposal is less radical than it may at first appear.** Further to the judgement of the ECJ on the principles of the free movement of capital (especially "Santander" C-338/11 or "Emerging Markets" C-190/12), some Member States already abolished under certain circumstances WHT for certain types of foreign investment funds (France; Spain; Poland) or limited the WHT rate to 15 percent (e.g. Netherlands, Belgium, Germany from 2018). Other Member States do not levy WHT on certain types of income paid on the basis of their domestic legislation (e.g. UK). **An alternative approach was to impose an EU-wide limit on the WHT rate equal to the rate foreseen in double taxation treaties which is 15 percent. These options should be again considered in the context of the CMU initiative.**

- Reducing administrative burden by streamlining of reporting requirements

The applicable and pending requirements for **transaction-level reporting** under EMIR, MiFID II/ MiFIR and SFT Regulation display considerable differences in terms of reporting details, reporting channels, data repositories and applicable IT standards. The same pertains to the **regulatory reporting** on positions and risks required under AIFMD, UCITS Directive and the future MMF Regulation as well as to **reporting obligations for institutional investors** under Solvency II/CRR which require delivery of data and further support services by asset managers. In addition, reporting is often insufficiently standardised which causes significant problems in the collection of data as currently experienced under AIFMD and EMIR.

The threatening jumble of different data standards and formats presents a huge burden for the industry in both operational and financial terms and impedes efficient supervision concerning in particular systemic risks. Enhancing consistency of regulatory reporting is therefore badly needed in order to enable the regulators to use the stored data for the purpose of detecting systemic risk and to keep the administrative burden for market participants at a reasonable level. Moreover, there is also an urgent need for stronger integration in technological terms. The use of common reporting channels and standardised IT formats would enable regulators to better utilise the loads of submitted information for supervisory purposes, especially for the prompt detection of systemic risk, and might entail cost savings for market participants such as fund management companies which may run into millions of Euros.

As a starting point of discussion, data standardisation along the whole value chain should be based generally on ISO 20022. Overall we believe that ISO 20022 offers the best potential for cost-effective and future-proof implementation. It has a strong methodology and model for defining and structuring financial data, and an open governance process that ensures a level playing field for standardisers and users. It also offers expert international scrutiny of submitted content. ISO 20022 is now being implemented in a growing number of markets, which results in increasing opportunities for automation and interoperability (e.g. MiFID II/MiFIR).

Furthermore, we urge the EU Commission to ensure that regulatory reporting requirements are accompanied by practical implementation deadlines which allow all market participants to implement new regulatory obligations on time. Lessons should be learned from the practical experience with EMIR reporting obligations where the lack of sufficient implementation time combined with legal and operational uncertainty due to undefined ESMA standards have significantly hampered the ability of the market to timely implement the relevant technical specifications. We fear that the MiFID II/MiFIR implementation will suffer from similar shortcomings given that the technical details of the reporting provisions are still being contentiously debated by the EU institutions and ESMA.

In consequence, we would welcome a stronger and efficient integration of regulatory reporting obligations relating to both transaction and position data. In our view, the Commission should launch an initiative for stocktaking of the existing reporting rules, including those awaiting implementation under the pending EU initiatives, and on this basis, should develop a regulatory approach to streamlining of the reporting requirements in terms of data standards and formats.

- Facilitating execution of voting rights

While the barriers regarding the execution of voting rights in terms of cross-border investments generally do not deter investors from investing in equity across borders, they definitely hinder the exercise of efficient oversight over companies. The strengthening of shareholder engagement rules in the revised Shareholder Rights Directive (SRD II) has thus to be supplemented by a removal of barriers for the execution of voting rights and shareholder information. Not only the execution of voting rights on a cross-border basis itself is difficult in a number of countries also within Europe, but also information on whether and how the voting rights have been executed is difficult to obtain. It is therefore crucial that the implementing measures foreseen in SRD II address these problems and facilitate the investors' exercise of control over companies. Furthermore, a facilitation of bond holder communication would support execution of bond holder rights.