# The Future Framework for European Capital Markets

## Conference Report

by Thom Wetzer

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In January 2017, scholars and policymakers met at the University of Oxford with the objective of bringing expertise in law, economics and finance to bear on this issue. The event, which was jointly organised by the University of Oxford, Columbia University and the European Corporate Governance Institute, centred around questions associated with the design of capital markets generally, but also focused on the specific European context. That context, it was candidly noted, has become more complicated now that Europe's single largest capital market, that of the United Kingdom, is set to leave the Union. This conference report will cover three broad themes that were discussed: rules for effective capital markets, institutional design, and the implications of Brexit for further development of the CMU. Because Chatham House rules applied, discussions and comments are anonymised.

# Conference Report:
# "The Future Framework for European Capital Markets – Law and Finance"

Thom Wetzer*

Calls to move away from the heavy reliance on bank-based finance have never been stronger in the European Union (EU). When European banks were hit by financial calamity, a lack of alternative funding arrangements deepened the crisis. As banks restored their balance sheets, they held back the economic recovery. Deeper European capital markets would have changed that picture, because savers and borrowers could have sidestepped frail banks. This rationale has given momentum to the European Commission's push to create a European Capital Markets Union (CMU). The CMU should unlock funding for small and medium-sized enterprises (SMEs) and infrastructure projects, attract more funds to boost economic growth, and diversify the economy's funding sources to increase financial stability. Now, the question is how to best achieve these objectives.

In January 2017, scholars and policymakers met at the University of Oxford with the objective of bringing expertise in law, economics and finance to bear on this issue. The event, which was jointly organised by the University of Oxford, Columbia University and the European Corporate Governance Institute, centred around questions associated with the design of capital markets generally, but also focused on the specific European context. That context, it was candidly noted, has become more complicated now that Europe's single largest capital market, that of the United Kingdom, is set to leave the Union. This conference report will cover three broad themes that were discussed: rules for effective capital markets, institutional design, and the implications of Brexit for further development of the CMU. Because Chatham House rules applied, discussions and comments are anonymised.

## 1. Rules for Effective Capital Markets

### *1. Equity Markets and Entrepreneurial Finance*

In part, the limited role of capital market financing in the European Union can be traced to cross-border obstacles to the movement of capital. But it is equally correct that capital market regulations, because of their fixed-costs aspects, place disproportionate burdens on smaller firms. Given the important role of such firms in spurring innovation and job creation, reform proponents have frequently argued that their regulatory burdens should be alleviated. Opponents countered that reducing these burdens is likely to hurt investors. In an attempt to add rigour to the debate, Merritt Fox returned to first principles in order to distil design rules for the regulation of 'truly new securities'; offerings by issuers new to the market whose securities are not already trading in some kind of secondary market.

The first time securities are offered to the market, Fox argued, the information asymmetries between persons associated with the issuer and potential investors are particularly large. Resulting adverse-selection problems can cause the market to partially or completely unravel. This problem will not be solved by market-based solutions – signalling, investment bank intermediation, expert certification, and buyer search – alone, which implies a role for regulation. That is why Fox views many reforms meant to ease the 'regulatory burden' on SMEs with scepticism; they ignore the fact that these regulatory processes play an essential role in countering the inevitable adverse-selection problems associated with offering truly new securities. Instead of abolishing such regulation, he proposes to review the questions that must be answered under the traditional registration process. Questions that add more cost to the process for

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smaller issuers than they reduce adverse selection should be eliminated. But this approach can only be taken so far. Ultimately, Fox concluded, the hard reality is that, for firms below a certain size, the cost of what is still required will make a public offering and public trading of their shares an impractical form of finance.

Such firms could, instead, turn to various forms of crowdfunding. In Fox' view, allowing these forms of funding can be compared to legalising space for certain kinds of gambling notwithstanding that the odds are always against the gamblers. To the European Commission, however, crowdfunding is a cornerstone of the CMU framework. Lars Klöhn outlined the regulation of crowdfunding in Europe on the level of the member states as well as on the supranational EU level, and assessed whether there is a need for more supranational regulation.

There is currently no specific crowdfunding regulation at the EU level, and more general capital markets regulation, such as the Prospectus Directive or MiFID, allows for a great variety of national regulatory regimes in the area of crowdfunding. Klöhn proceeds to discuss the British and German regimes, which represent two different models. The United Kingdom, he argues, is the paradigm example for securities-based 'crowd investing' (which is covered by the EU's MiFID regime), whereas the German market is paradigmatic for non-securities-based crowd investing. Both markets, Klöhn argues, are functional, and show signs that crowdfunding platforms compete on the quality of their investor protection, whether imposed by law or market-based. This suggests, according to Klöhn, that the 'hands-off approach' currently adopted by the European Commission is appropriate for now.

When a hands-off approach turns to neglect, however, the start-up environment is at risk. Thomas Hellmann warned that, for all the attention on the early-stage start-up financing, European 'scale-ups' – entrepreneurial companies that are past their initial exploratory phase and are aiming for fast growth – lack the access to finance their peers in the United States enjoy. He argued that scale-up investors need to satisfy four criteria (financial muscle, expertise, networks and long horizons), and analysed the funding conditions in the US, Europe and Canada. Europe and Canada, he argued, face six challenges in terms of catching up to the US, related to the overall market size of scale-up funding, the creation of larger venture funds, the challenge of avoiding selling companies too early, the creation of a venture debt market, finding ways of reinvigorating tech IPOs, and designing better markets for secondary shares. By pointing to these challenges, his aim is to create awareness amongst policymakers that a successful start-up environment also requires scale-up financing.

### *2. Debt Markets*

Securitisations, once considered symptomatic for discredited pre-crisis financial engineering, are about to make a comeback. The problem with securitisation is not the tool itself, but the moral hazard that was generated due to the way it was used. Issuers, it is commonly argued, had little 'skin-in-the-game', and therefore lacked incentives to engage in proper screening of loan applicants. Accordingly, post-crisis regulatory reform has focused on increasing the 'skin-in-the-game' for issuers by solidifying risk-retention requirements. Jan-Pieter Krahnen, however, argued that these measures fail to align the incentives of originators and investors. Applying the theory of structured finance to the regulation of asset-backed securities (ABS), he constructed a new risk-retention metric that measures the level of an issuer's skin-in-the-game. Applying this metric, he found that even though the nominal retention is always five percent, the true level of loss retention across available retention options can vary between zero and full loss retention. By requiring disclosure of this new metric for all ABS-transactions, the real levels of risk-retention can be made more transparent, which allows investors to adjust their prices accordingly. That

way, Krahnen concluded, the 'simple and transparent' securitisations envisioned by the European Commission are less likely to recreate past excesses.

For debt capital markets to be truly European in scope, the European Commission believes that insolvency law should be, too. Horst Eidenmüller, however, argued that, because this is currently politically controversial, the European Commission seems to have made the judgment that a safer political strategy is to focus on preventive corporate restructuring frameworks that can be accessed by the debtor pre-insolvency. Creating such a framework at a European level is intended to ensure the free movement of capital and freedom of establishment by ensuring that viable enterprises in financial difficulty have access to effective national preventive restructuring frameworks. Eidenmüller criticised the proposal on the basis that it will lead to a rise in financing costs, because it will create a refuge for failing firms that should be liquidated, and because it rules out going concern sales for viable firms. In addition, he argued that the proposal is essentially a twisted and truncated insolvency proceeding, mimicking a Chapter 11 proceeding without strong court involvement to guarantee a fair outcome of the process.

Instead, Eidenmüller proposed a regulation allowing European firms to opt into a 'European Insolvency Regime' in their charter. By providing companies with an additional option, rather than replacing old ones, horizontal regulatory competition between Member States for the most attractive insolvency law is preserved, whilst also introducing vertical regulatory competition between the Member States and the EU. Such a proposal, he argues, does not contravene regulatory traditions of the Member States, nor does it restrict their freedom to experiment. If the proposal is flawed, it will simply not be selected by market participants.

### *3. Regulating Financial Innovation*

Regulating a rapidly changing financial sector poses challenges for regulators, especially if the innovation that drives this change takes place outside the conventional regulatory perimeter. Dan Awrey unpacked one such set of financial innovations, those related to 'shadow payment systems'. This sector has developed rapidly over recent years, and, crucially, has done so outside the scope of banks. Legally and operationally, payment systems have traditionally been part of the conventional banking system. The stability of payment systems has benefited from the regulatory framework that governs this system, which includes prudential regulation and, critically, liquidity support from the central bank at the apex of the system. In effect, this means that the application of traditional insolvency law has been relaxed so that the banks, and the payment systems within them, can continue to operate even during periods of stress.

The rapidly developing shadow payment system, which includes crypto-currency exchanges, peer-to-peer payment systems, and mobile money platforms, resides outside the perimeter of regulated banks, and therefore does not benefit from the support bank-based payment systems enjoy. Practically, this means that general corporate insolvency law is not relaxed under periods of stress. At the same time, these institutions still perform the basic payment functions: combining the acceptance of funds (storage) with the promise to return or transfer these funds on demand (liquidity).

Awrey examined the potential risks this creates for customers of shadow payment systems, in effect asking how credible the commitment of shadow payment institutions to perform their core payment functions really is. Two risks, delayed conversion or transfer (illiquidity) and a potential write-down of customers' claims wherever they are characterised as unsecured liabilities in the context of an insolvency proceeding (loss of value), stand out. Awrey examined the effectiveness of various strategies that might be employed to address these risks. The strategies he discussed, including portfolio restrictions, third party insurance, outsourcing the storage function to deposit-taking banks, and utilising trusts as a

mechanism for ring-fencing customer funds, although not without merits, were found wanting. The broader contribution of the paper, Awrey concluded, is to highlight the important role of the law and legal institutions in supporting liquidity and stability within the financial system.

Financial innovation can also be a (sometimes unintended) consequence of financial regulation. When regulators, after the financial crisis of 2007-2009, imposed heightened capital and liquidity requirements, their aim was to improve the resilience of the affected institutions. But, as Kathryn Judge outlined, these same regulatory initiatives may in fact have contributed to the fragility of the financial system. She proposed a framework for understanding the relationship between financial regulation, investor preferences, and financial innovation. A new legal intervention, here the introduction of capital and liquidity regulation, can act as a source of constrained capital. That is, to meet the new regulatory requirement, investors increase their demand for a particular type of financial product. When the 'natural supply' of this type of asset is insufficient to meet that demand, such assets might be synthetically produced. That process of financial innovation, in turn, can lead to increased complexity, interconnectivity, and rigidity in financial markets, which can increase financial fragility. This framing, Judge concluded, illuminates the importance of interactions between market forces, regulatory interventions and the business cycle.

## 2. Institutional Design

Designing a Capital Markets Union also entails the creation of a new institutional architecture that covers the entire EU. Doing so, however, is easier said than done: harmonizing conditions in previously fragmented markets comes with challenges. Luzi Hail studied the implementation of two EU directives, the Market Abuse Directive (MAD) and the Transparency Directive (TPD), and assessed their effect on market liquidity. Both directives were designed to give investors more and better information, which should increase market liquidity and, ultimately, lead to more efficient capital markets. Hail's study used the different implementation times for various Member States to estimate causal effects, and found that, on average, this goal was achieved; both directives increased liquidity in European financial markets by ten percent relative to prior liquidity.

However, these benefits are not uniformly distributed. Countries with a history of higher regulatory quality and stronger track records of implementing and enforcing rules saw liquidity rise by about twice the average, whereas countries with a weaker track record saw virtually no benefits. Somewhat counterintuitively, harmonization actually led to larger differences between countries. The result that prior conditions matter poses a challenge to regulatory harmonization initiatives, because those differences are not easily overcome by isolated regulatory initiatives alone. Instead, Hail argues, overcoming such hysteresis may require coordinated institutional change, of the kind that can be politically complex to achieve.

As regulatory reforms are designed and ultimately implemented, it is critical to remain keenly aware of their interaction. Veerle Colaert examined the multitude of post-crisis reforms in the area of investor protection, and sorted them into three 'building blocks': information, service quality requirements (conduct of business rules), and product regulation. Using this categorisation, she identified four pervasive trends.

First, in the area of information, the paradigm of rational investment decisions remains central to investor protection regulation, but has been fine-tuned in light of behaviour insights. Because information must not only be found, but also processed and understood, regulation in this area increasingly focuses on the presentation of that information. At the same time, it is increasingly accepted that behavioural biases

cannot only be resolved by changing the way information is provided. That is why conduct of business rules and product regulation take on increasing importance.

Conduct of business rules have been enhanced, and their scope of application has been broadened. MiFID II, for example, now applies such rules to structured deposits (banking products), in addition to the traditional financial instruments (investment products). Finally, in a departure from a liberal approach towards retail investor protection, product regulation has been revolutionised. Product quality requirements are an important part of the directives that apply to the management of investment funds (the UCITS Directive and the AIFMD). Product governance rules, which require manufacturers and distributors of financial products to identify the target market for financial products and develop their products accordingly, are increasingly used. And, in some cases, outright products bans, usually adopted to protect retail investors, now operate as a backstop mechanism of EU investor protection. These three building blocks frequently interact, sometimes in ways that are not fully understood. Accordingly, Colaert concludes by noting that, as EU capital market regulation becomes more comprehensive, the key challenge will be to knit the three levels of investor protection together into one well-functioning investor-protection scheme.

### 3. Brexit, and New Proposals for the Capital Markets Union

Incontrovertibly, the debates surrounding the impending Brexit will affect the developments of the Capital Markets Union project. It is, however, uncertain what form Brexit will take, and views on this topic differed widely. Georg Ringe took up the task of addressing the elephant in the room, arguing that Brexit is irrelevant for European financial markets. Opposing those who fear an 'almost Apocalypse-like' scenario, his optimism is grounded in the substantial economic stakes for the United Kingdom and the twenty-seven remaining Member States ('EU27') in retaining the benefits of the European Single Market for financial services. Given the joint economic interests, and based on past examples in EU financial market integration, Ringe argued that the outcome will satisfy the referendum result, but still keep Britain closely involved in the EU's financial markets. The broader point, he concluded, is that there is a strong tradition of politics or economics trumping law. Brexit will inevitably come, but more in form than in substance.

In the discussion that followed, Ringe's account was questioned on three fronts. First, it was noted that the politicians in charge of the negotiations vastly underestimate what is at stake. In the United Kingdom the value of reciprocal access is overestimated (the United Kingdom is far more reliant on access to the EU than vice-versa), and in the EU politicians have no experience with being cut off from the Union's major financial centre, so that any threat from London that the City would no longer be accessible for European firms will be too easily dismissed. Second, the misalignment of objectives – returning sovereignty on the one hand, and retaining market access on the other – runs deep. Understandably, the EU aims to retain control over its financial system, which is difficult when its major financial hub sits outside its jurisdiction. Paradoxically, the one deal that sustainably resolved this tension, membership of the European Union, has just been rejected. Third, any deal will be complicated, and once it is reached it will likely be too late. Firms will respond to the protracted uncertainty a negotiation process might entail, and move out of the City. Understanding these dynamics ex ante will undermine incentives to conclude a deal in the first place, especially in the EU. As one discussant grimly concluded: 'it is likely that what none of us wants to happen will happen anyway'.

European Union officials have publicly stated that Brexit does not invalidate the CMU project, but rather underscores its importance. Discussants largely agreed, but also noted that the plans for the CMU will have to change dramatically. Currently, the EU's capital market activity overwhelmingly takes place in the

United Kingdom, and this has strongly influenced the negotiation leading up to the initial CMU plans. The United Kingdom particularly objected to any changes to the division of power, and refused to cede authority to the Paris-based European Securities and Markets Authority (ESMA). That meant market oversight remained fragmented, although in practice most of it was carried out in the United Kingdom.

Brexit thus creates opportunities for institutional reform. It was widely agreed that seizing this opportunity has to be a part of the CMU moving forward. Discussants agreed that the fragmented regulatory architecture, while serving the needs of the United Kingdom, was already problematic prior to Brexit. Market participants noted the problems associated with cross-border capital flows stemming from different enforcement strategies, and the quality of the domestic regulators differed widely. Now that the major centre for capital markets activity, along with its regulatory expertise, leaves the Union, the EU has to fill the void. ESMA is currently not authorised, but also not equipped, to take up that role. It operates more as a technical body that cooperates on technical standards, rather than as a strong regulator in its own right. New CMU proposals should, therefore, not only include a new mandate for ESMA, but also reform its governance and expand its funding. If implemented, a single regulator would allow the CMU to integrate beyond what was possible prior to Brexit.