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15 March 2024

EFSA priorities for deeper and more efficient EU capital markets

A series of major shocks have exposed the European Union's vulnerability resulting from too strong dependency on third countries in strategic sectors such as pharmaceuticals, energy and defence. This - together with growing tensions between geopolitical and economic powers - has led to intensified and accelerated competition in sectors of key importance for future development, which challenges the competitiveness of the European Union on a global scale.

Meanwhile, the European Union must transition to a sustainable and digital economy, while meeting the challenge of an ageing population. This will require investments of more than €700 billion while increasing expenses as highlighted in the 2023 EU Commission's Foresight report[1].

In this context, it is crucial that the EU financial markets are sufficiently deep, open and efficient to be used by Member States and EU companies to attract capital from investors and with a better ability to raise capital within the EU. Meanwhile - and despite two action plans and a total of more than 49 legislative and non-legislative measures[2] - the European economy remains highly bank intermediated. Financial markets continue to play a less significant role than their potential allows, which deprives the EU from important opportunities and stimuli for developing and transforming its economy. Accordingly, the EU urgently needs a growth plan for its capital markets which is truly fit for purpose.

The aim of this paper is to contribute to the current reflection on the forthcoming European Commission agenda on financial services with what we consider to be guiding principles and targeted proposals.

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[1] https://commission.europa.eu/system/files/2023-07/SFR-23_en.pdf

[2] For further details please refer to the 2015 CMU Action Plan and the 2020 Action Plan

Defining clear objectives for EU capital markets

EFSA believes that a clear political vision and commitment is needed to strengthen the EU capital markets and allow them to fulfil their role more effectively. Overall, we believe that:

(i) European capital markets must be efficient and competitive both within the EU, but also compared to third countries
(ii) European capital markets should encourage financial market access for EU companies' and in particular SMEs'
(iii) European capital markets should facilitate further retail and long-term investments – as an important contribution to finance the necessary green, digital and demographic transitions and actively promote long term, high-performance investments in the EU economy

To enable these aims, we likewise consider it necessary that:

(iv) The regulatory process should be streamlined and ESMA mandate reformed

This vision will not only require new adequately designed and calibrated regulations to become a reality, but also targeted actions from Member States. It should also translate into dedicated indicators that can be monitored over time to measure progress or define alternative actions. This could for instance include the size of the capital markets, the level of investor participation in the capital markets, the level of funding etc.

(i) European capital markets must be efficient and competitive both within the EU, but also compared to third countries

A few guiding principles should be systematically considered when developing new reforms. These should include the impact on the growth of capital markets, the competitiveness of EU financial institutions including with regards to their competitors outside the EU, and the relative performance of the EU markets compared to the US, the UK, and Asia. It is crucial for the Union to measure and compare the efficiency of its markets with its competitors to ensure it remains attractive for companies and investors.

Financial stability, increased transparency and investor protection have been the main focus of regulators since the financial crisis, which we fully understand. However, at the same time we must not neglect the positive and indispensable role that securities markets play for the economy as a whole. Therefore, any potential future regulatory initiatives must carefully weigh the demand for more regulation against its potential negative effects on markets, if the EU shall not fall further behind. In other words, to ensure that the envisaged "Open Strategic Autonomy" of the EU can deliver meaningful results, a stronger focus on the competitiveness of EU capital markets is indispensable.

Competitiveness should be considered a key issue both within the EU between firms delivering services and products as well as at the level of the EU versus its main competitors. It is important to preserve EU actors' ability to offer services outside EU borders on terms that are attractive to clients and will not drive firms out-of-market. Competitiveness should therefore be taken into account from the outset of the EU legislation and be systematically included in the impact assessment.

EFSA supports the proposal from the European Economic and Social Committee in its Opinion[3] on the Renewed CMU Action Plan which recommends including an ad hoc competitiveness test in the impact assessment of any new legislation.

Within the Union, a key concern should be to increase the competition between market infrastructures. Voices call for consolidation of infrastructure[4] - but beware that consolidation may be a foil to competition: essential infrastructures in capital markets, such as trading venues, CCPs, CSDs, are by nature critical to the functioning of these markets. These infrastructure companies are also natural monopolies - by the very nature of what they do within their core business, and supported by economy of scale, large entry barriers and network effects. From listing of companies, providing of information, registration of and facilitating of trading, clearing to settling of trades, their value chain and profits improve with sheer size, leading to continuing growth and consolidation. Proper regulation is therefore of utmost importance to avoid the monopoly rents that infrastructures can derive from their consolidated activities, resulting in fewer choices and higher costs for market participants as well as for their clients. This would in the end lead to less efficient markets and even more challenged competition[5] that would go against the CMU project.

Looking on the other side of the Channel, the horizontal review of the EU regulatory framework undertaken by the UK authorities through the Financial Services and Markets Act[6] should be duly taken into account. While we definitely do not promote any regulatory "race to the bottom" and the EU must not become a passive "rule taker", it is also paramount for companies and Member States alike that the Union's capital markets can compete on equal footing with the UK, which became a powerful third country competitor within the same time zone as a result of "Brexit". And it goes without saying that the dynamics of global financial market competition also deserves appropriate political attention. This also means that adjustments to the existing legislative and regulatory framework may be needed and fast reactions to new market-structural developments and financial innovations are key. The EU should have the legal tools and the necessary political will and agility to carry out such adaptations in a timely manner (*for further details please refer to the paragraph on the No-Action letter p.6*).

[3] https://www.eesc.europa.eu/en/our-work/opinions-information-reports/opinions/capital-markets-union-people-and-businesses-new-action-plan
[4] I.e. A Kantian shift for the capital markets union (europa.eu)
[5] The problem with European stock markets (New Financial)
[6] https://www.legislation.gov.uk/ukpga/2023/29/contents

(ii) European capital markets should encourage financial market access for EU companies' and in particular SMEs'

EFSA has seen benefits in the top-down approach taken since 2015 to harmonise EU wholesale markets. However, this objective, which is particularly important to meet the needs of larger corporates and international investors, needs to be complemented by recognising the role that efficient local financial markets[7] can play in meeting regional/local financing needs. In this respect, one size does not fit all, and a kind of subsidiarity principle should apply so that deep and liquid pan-European markets coexist with thriving local markets with a particular focus on SMEs, which are central to job creation and innovation in the Union. While we recognize the importance of comparable regulatory standards, such a harmonized approach must not unnecessarily jeopardise regional diversity which should be seen as an asset of the Union's financial markets landscape.

Therefore, the top-down approach followed so far should be complemented by a bottom-up approach to enable the development and strengthening of the ecosystems (e.g. investors, investment firms, analysts) necessary for these local markets to grow and be a useful tool for financing SMEs. Financial markets are dominated by large players who are not necessarily interested in investing in or providing services to the local economy and do not have the knowledge of the local ecosystems. It is therefore paramount not to unnecessarily impede but to encourage the development of local players.

Some domestic markets have developed specific features to meet these local needs, while others, less mature, have not yet done so. The growth of these markets should be encouraged, while allowing their specific features to co-exist with the more standardised features of larger pan-European wholesale markets. Maximum harmonisation should be pursued only where it is useful and beneficial, while allowing local markets to grow with their own particularities. Full harmonisation should only be pursued once a certain level of maturity has been reached.

(iii) European capital markets should facilitate further retail and long-term investments

Given the Union's financing challenges and the need to develop financial markets to support the allocation of savings to productive assets, long-term investment including of retail savings should be further encouraged.

The development of financial markets depends on the presence of long-term investors, who are able to finance riskier investments, as is the case for instance in the US and, to a lesser extent, in the UK with pension funds. The question is how such long-term funding could be encouraged by the EU. We see a value in finding means to incentivise such active participation in securities markets. Such incentives must be adapted to local markets, as investment behaviors and risk appetite vary in different markets and among different types of investors and are to some extent a result of different cultures, habits and history of financial

[7] By local markets we mean those segments of the market, whether primary or secondary, addressing the needs of SMEs and retail investors.

markets. Nevertheless, EFSA believes that the EU has a role to play in encouraging Member States to design plans for such incentives.

These would certainly include tax incentives that the EU could promote, even if tax matters essentially remain the responsibility of the Member States. Tax incentives do not necessarily mean tax reduction but could also include simplifications when it comes for example to the taxation and declaration of investments and capital gains. Different procedures for the handling of withholding tax within the EU is also detrimental to encourage cross country investments.

Moreover, while consumer and investor protection are important regulatory objectives, the right balance should be found in the regulatory actions designed to mitigate the unequal distribution of power and information asymmetries among market participants. Citizens should be empowered in order to make more responsible decisions based on their individual preferences. In other words, EU citizens should not only be adequately informed about investment risks but also be made aware of the opportunity costs of not investing parts of their savings in securities. We believe that with the right information a retail investor is fully capable of understanding that investing in a security is not risk free but that with a medium to long term horizon and a reasonable variation in assets held there is a fair chance to take advantage of a return that is higher than a saving account.

(iv) The regulatory process should be streamlined…

The pace of new and additional financial market legislation has not slowed down since the financial crisis of 2008. This makes it very difficult for market players, especially smaller entities, to cope with the many necessary adjustments to comply with the regulatory framework. It also tends to create a bureaucratic approach to the matters at stake.

Furthermore, the periodic review clause built in every piece of EU legislation very often does not allow sufficient time to adequately assess the impact of the newly implemented rules and thereby inherently bears the danger to increase the complexity of an already overly detailed regulatory framework.

In order to avoid unnecessary constraints on EU actors, any review of existing legislation therefore should be based on proven shortcomings in order to amend the legislation only when needed. Any review should therefore be strictly evidence based, rely on objective data and also take into account the effect of the proposed measures on the competitiveness of EU market players.

Equally important, it appears necessary to ensure a better synchronization between level 1 and level 2 texts, even more since the timing of the review of the level 1 text leaves insufficient time for the full, industry level implementation of the text and to measure its impact.

Finally, it is highly important that fundamental decisions, which require political authorization on Level 1 are not shifted to the administrative Level 2 which lacks the democratic legitimacy to take substantial legislative decisions. Therefore, Level 2 should be strictly dedicated to technical calibrations.

…and ESMA mandate reformed

The EU's concern for competitiveness requires a profound change of the political approach, which should be reflected also in the very mandate of the supervisory authorities, as they play a fundamental role in the development and implementation of regulation. In this way, the ESAs' mandate, and in particular the one of ESMA, should be revisited. The objectives set by ESMAs founding regulation (*Regulation (EU) 1095/2010, Art. 1.5*) should be modified. Alongside the contribution to "*ensuring the integrity, transparency, efficiency and orderly functioning of financial markets*" and to "*enhancing customer and investor protection*", ESMA's mandate should include "*promoting and supporting the competitiveness of the financial markets*". This should enable ESMA to consider competition aspects when it is engaged in rulemaking or supervision, from both the perspective of the internal EU markets and the competitiveness of EU financial markets to other markets.

Another issue concerns the EU's ability to increase the responsiveness and pace of its legislative process: this is a question which affects the competitiveness of its actors vis-à-vis third-country jurisdictions that are often more agile from a legislative perspective.

Presently, much time elapses between the adoption of an EC proposal and its publication in the EU Official Journal. This can be detrimental to the business of EU market players when the matter at stake is particularly topical and has a direct impact on their ability to deliver a service to their clients. Given the length of the EU legislative process, it may therefore be worthwhile to consider a stepwise approach where certain provisions on which mutual agreement has been reached can apply before the end of the full legislative process, in order to remedy specific, adverse market configurations.

In the same vein, EFSA proposes that the scope of the no action letter that can be issued by the ESAs, and ESMA in particular, be broadened similarly to the powers of the SEC in the US.

Another area where the role of the ESAs is critical is in ensuring supervisory convergence and consistent enforcement across Member States. In due time, and based on a thorough process, this shortcoming calls for a single rule book as already known for EU banking legislation. And this calls for greater powers for ESMA, in particular when it comes to the supervision of infrastructure entities that deliver services critical for the entire Union but reside under local supervision.