Europe's untapped capital market: Rethinking integration after the great financial crisis

The Final Report of the European Capital Markets Expert Group (ECMEG)

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EUROPE'S UNTAPPED CAPITAL MARKET

RETHINKING INTEGRATION AFTER THE GREAT FINANCIAL CRISIS

FINAL REPORT OF THE EUROPEAN CAPITAL MARKETS EXPERT GROUP

FEBRUARY 2016

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The findings of this Final Report do not necessarily reflect the views of all the members of the ECMEG and the Task Force or the views of their respective companies. However, ECMEG members have been involved during the drafting of the Final Report and provided input to the discussions through presentations and provision of data and other materials, which have been used for the Final Report. A set of principles has guided the drafting process to allow all of the interests represented in the Task Force to be heard.

The Final Report was independently drafted by Diego Valiante, who is solely responsible for its content and any errors. Neither the ECMEG members nor the Task Force members (or their respective companies) necessarily endorse the conclusions of the Final Report.

Suggested citation: Valiante, D. (2015), *Europe's untapped capital market: Rethinking integration after the great financial crisis*, CEPS European Capital Markets Expert Group (ECMEG) Final Report, Rowman & Littlefied.

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EMBARGOED UNTIL 3rd FEBRUARY 2016 at 13h CET

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Executive summary

Policy recommendations

The **objective of an action plan** should be the gradual removal of these barriers and the creation of better conditions for the diversification of the financial ecosystem and to favour cross-sectional and cross-country risk sharing via capital markets.

This report does not offer an exhaustive list of barriers, but rather offers a selection of them and a methodology with which to identify and prioritise intervention, on the basis of their impact on the cost predictability of a financial transaction.

Working groups of experts at European and domestic level should then work to home in on the identified areas to investigate those barriers and survey the outstanding practices by public or private entities that are most damaging to the single market for capital. The proposed methodology also helps to identify areas in which an immediate 'top-down' policy response is necessary, supporting the 'bottom-up approach' proposed by the European Commission.

The following sections list all the **policy recommendations** included in the report and the cross-border barriers that the recommendations will try to tackle. In accordance with the summary table at the end, the type of barrier also defines the urgency of the policy interventions that are suggested in the following sections.

Price discovery

Due to a multitude of agents and information asymmetry, market-based mechanisms require information, which is reflected in prices and disclosed by third parties (trading venues, data providers and so on). **Information disclosure** allows ex-ante pricing (contracting) and ex-post renegotiation (exit on secondary markets or via private enforcement mechanisms) by signalling the relevant information to price risk and fill the informational gap between counterparties.

Europe currently lacks **a common informational infrastructure**. Low comparability of company (financial and non-financial) data and credit risk information is a fundamental barrier to the creation of a pan-European price discovery process (and risk evaluation). Internal risk assessment methodologies are currently a source of concern in cross-border transactions for both listed and unlisted companies. Moreover, there is still a lack of data about conflicts of interest, including data on ownership and related-party transactions, especially for unlisted companies. This kind of information is crucial to build assumptions about future cash flows and so allow discounting and efficient pricing of financial instruments.

Information on the underlying asset

1) *IFRS calculation methodology (Barrier 1).* The options available for IFRS **asset evaluation methodologies** should be tightened, with more detailed definitions and a harmonised approach among EU supervisory practices. A 'comply-or-explain' regime could apply to the calculation methodology, in case a tailored approach is necessary to improve accounting quality. In the new IFRS 9, for instance, the loan impairment

requirement, dealing with the recognition of lifetime losses on loans in case of a "significant increase in credit risk" since initial recognition, leaves the key terminology undefined.

2) *IFRS reclassification (Barrier 4).* Under IFRS, more discretion can be given to the firm on the **reclassification** of balance sheet items because this option still allows the investor to replicate the reclassification of the items according to established methodologies available to the public (and so make proper use of this information). However, different reclassifications for civil and taxation purposes remains a source of cost and uncertainty, as local fiscal authorities often apply different interpretations. EU institutions should work closer with local fiscal authorities to streamline this process and perhaps define ex ante the classifications under uniform accounting rules to be used for fiscal purposes and allow bilateral case-by-case examination when alternatives can be used. The work of the European Commission on a **Common Consolidated Corporate Tax Base (CCCTB)** can be instrumental to the simplification and alignment of reporting for accounting and fiscal purposes.

3) *Alternative performance measures (Barrier 5).* Allowing **alternative performance measures**, which 'adjust' IFRS figures according to internal models for publication purposes, can create uncertainty or even misleading communication. For instance, 21 companies of the FTSE 100 treated restructuring costs as "exceptional" (for their own adjusted profits), even though they were reported for four consecutive years. Tighter supervision of practices and greater transparency with an explanatory note on how and why the firms use it might be an improvement for data comparability. The inclusion in the financial statements, under audit assurance, might be an easier option.

4) *Off-balance sheet items (Barrier 11).* There should be detailed criteria or full transparency of methodology to define the likelihood of an outflow "probable", with probability above 50%, for **'off-balance sheet' items**, such as contingent liabilities or guarantees. In countries where the regulatory system is stronger and voluntary disclosure higher, there is a general trend to provide more information about these items. Cross-border data comparability of these items is severely impaired.

5) *Listed companies' filings (Barrier 3).* As the US SEC does with EDGAR, ESMA could be also given the role to directly collect **company filings for listed companies** with a standardised format and made easily accessible across Europe via a common repository. ESMA would also coordinate with member states if there is additional information requested by national laws and try to act to limit this additional flow or to standardise formats and report timing as much as possible.

6) *European business registry (Barrier 7).* There is also no **European registry** to disseminate basic information about private corporations. There are currently 28 national registers, which are often very costly and opaque, charging firms when they deposit information and data users when they collect it, applying different standards and procedures across countries. General information about a company should be easily accessible to the public at a reasonable cost or even for free. National repositories should be linked to each other with common search tools and data standards to reduce problems with data comparability. As a result, the creation of a

European business register should be further encouraged and supported at European level. This coordination role could be given either to ESMA or to the European Commission.

7) *Central database (Barriers 3 & 7).* The **centralisation**, under a common database, of official **company filings** for listed companies and information collected by national business **registries about all private companies** could be an important innovation and provide a significant boost to the adoption of common practices for data disclosure and improve cross-border data comparability. The benefits of this simplification would trickle down to investors and in particular companies, both domestic and international, which will deal with one entity only under a transparent and fair procedural framework.

8) *Accounting standards for unlisted companies (Barrier 2).* **Accounting standards for private (unlisted) companies**, including SMEs or subsidiaries of multinational companies, would provide high data comparability and a common set of information to compare firms and sectors across borders. The integration of consolidated and individual annual accounts with the EU Directive 2013/34 is an initial step towards a common set of standards for unlisted companies, which takes into account the size of the firm. Nonetheless, more should be done to align the framework of accounting rules with the IFRS for SMEs and, most important, to reduce the options given to member states and achieve greater convergence of accounting practices. To ensure consistency and proportionality, finally, the application of IFRS standards to listed companies (now used for consolidated accounts) should be expanded to annual accounts.

9) *Credit information (Barrier 8).* As of today, there are no common guidelines for **credit scoring** (including the definition of 'defaulted exposure'), **and credit risk information** is stored in national credit bureaus that are not linked to each other. To promote convergence, an initial step could connect the national credit bureaus in Europe via a network that would facilitate cross-border access to credit scores with a centralised infrastructure. This first step could benefit from ongoing initiatives, such as the one run by the ECB (Anacredit), under EBA supervision. A second step would promote a gradual convergence of credit score methodologies under the direction of a common body, such as the European Banking Authority, with the support of the European Commission and the ECB.

10) *Related party transactions (Barrier 9).* Rules on **related party transactions** (included in IAS 24) are particularly complex and designed to allow significant flexibility. They apply to all IFRS reporters (listed companies). However, several key definitions are left to the local regulator, such as the definition of "control" or of the person who can have a significant influence on the company. The possibility to use different definitions should be coped with a comply-or-explain regime.

These ideas are further developed in section 4.5.1

Financial Instruments information

11) *Key Information Document (Barrier 15).* The implementation of the **Key Information Document (KID)** for all the other packaged retail and insurance-based investment products (PRIIPs) should be closely monitored to avoid new barriers to data

comparability between UCITS issued in different countries or UCITS and non-UCITS PRIIPs. At a minimum, information should be collected and classified in the same way and in same formats. Moreover, KID requirements could be extended to all types of retail investment products (especially long-term ones) offered by pension funds, insurance companies and banks, in order to standardise different disclosure requirements that are applied by domestic authorities (often rather opaque).

12) *Listing authority (Barrier 16).* On top of the monopolistic rent, **national fragmentation of equity markets** inhibits market liquidity because it increases the informational rent of informed investors, who can pay to access multiple exchanges, and prevents investors from benefitting from the positive network effects (market externalities) brought about by each additional market participant. The costs of fragmentation are a barrier to a truly consolidated pre-trade European Best and Bid Offer (EBBO). MiFID II should overcome some format issues via the direct licensing requirements for data providers (including trading venues), but the consolidation of the financial infrastructure depends on multiple factors, including competition policies. AS a consequence, due to this cross-border nature, ESMA could become the listing authority of a basket of the most liquid share (European blue chips), using the network of national supervisors and ensuring that its binding supervision ensures greater convergence of practices. More should be done as well to identify and remove the bias in national laws towards the nationality of the regulated market where listing of the security takes place, which should be extended to any member state of the European Union where the venue has been authorised to operate.

13) *Ongoing performance disclosure (Barrier 12).* **Ongoing performance disclosure** might help to create sectorial performance indicators. Periodic disclosure of performance for investment funds, benchmarking it with the sector, can be a great incentive for investing in cross-border investment products. A standardised template about ongoing performance disclosure during the lifetime of the investment product and disclosure of exit conditions could be proposed. Ongoing contractual information is currently very fragmented, which increases the costs of cross-border investments due to limited comparability. Policy action should also include all products performing similar functions, like life insurance products wrapping collective funding schemes.

These ideas are further developed in section 4.5.2.

Execution

- Cross-border barriers to the **accessibility of financial contracting and renegotiation** are difficult to spot and are often entrenched in the domestic legal system, as well as in the regular practices of local authorities or incumbent market participants (e.g. the static implementation of execution policies).
- Transparency and simplification should be the guiding principle to ensure that entry and exit procedures are fair and do not add unnecessary costs to cross-border transactions.

Entry procedures

14) *NCA's filing procedures and quality standards (Barrier 19 & 21).* There are several differences in the **filing process for UCITS** at national level, including registration fees, which make procedures more burdensome for cross-border service providers. These aspects could be left to regulatory competition in the presence of a uniform regulatory environment for the marketing of investment products that does not leave pockets of uncertainty over costs. A review of registration procedures, nonetheless, may be necessary to understand whether different quality standards for supervision hide behind those differences.

15) *Marketing rules (Barrier 19).* The fragmentation of rules and procedures for the **marketing of investment products** keeps distribution channels fairly different across EU member states. A review of marketing rules to ensure no discrimination between foreign and local distributors, together with rules to improve transparency of products (as discussed above), would provide a tool to open up distribution channels and increase choice and returns for end investors.

16) *Open access (Barrier 19).* There should be constant monitoring of the procedures set up by domestic financial authorities to resolve disputes about the application of **open access requirements** for non-domestic market infrastructures. ESMA might need more binding powers in the mediation of the implementation of open access requirements locally, if the national authority does not sufficiently justify the decision related to an access request.

17) *Execution policies (Barrier 17).* The static implementation of **execution policies** leaves too much discretion at the intermediary level, as conditions related to costs of execution remain vaguely defined. MiFID II attempts to improve the quality of execution policies, but a more uniform cross-country implementation of current policies is even more important. In particular, execution policies to retail investors should be more dynamic, with a binding annual revision, more specific conditions for the identification of a 'material change' that triggers the revision and the possibility for investors to easily compare policies with the use of standard formats.

18) *Taxation arrangements (Barriers 18 & 23).* There are currently situations in which investment funds are treated differently by fiscal authorities according to their nationality, with the application of different tax rates on dividends (for instance). The European Commission should review all current **taxation arrangements at national level** and monitor their development over time.

These ideas are further developed in section 4.6.1.

Exit procedures

19) *Withholding tax reclaim (Barrier 23).* Procedures for **withholding a tax reclaim** are a significant cost to cross-border trading activities, estimated at roughly €8.4 billion per year. While capped to the value of the tax to be refunded, this is a cost that is simply transferred on to end investors, with limited benefit for integration. Building upon the work of the European Commission and the OECD, policy action should focus on: electronic processing and standardisation of formats; recognition of power of attorney

and self-declaration of residence, together with a memorandum of understanding among national fiscal agencies for data sharing on fiscal residence and tax reporting with a common identification system. These actions should ultimately create conditions for **relief-at-source as the default procedure**.

20) *Exit rights disclosure (Barrier 24).* **Availability and disclosure of exit rights** are important aspects for a financial transaction, especially for investment products. There is currently no harmonised regime concerning the disclosure of such information, which is usually left to patchy national requirements.

These ideas are further developed in section 4.6.2.

Enforcement

- **A sound legal architecture and the enforcement infrastructure** are essential for the development of market-based mechanisms in an environment with dispersed agents and dispersed information provided by third parties. The evidence suggests that EU directives produced intended (positive) effects mainly where they were implemented more strictly.
- **Uncertainty of enforcement proceedings**, in effect, may produce a lack of enforcement and impact the cost predictability of a cross-border financial transaction, reducing ex-ante incentives to enter into a contract in the first place. Unclear obligations for the counterparties may signal weak enforcement and can also lead to more misconduct.
- Enforcement includes all public and private measures to ensure a **credible deterrence of misconduct** and so the smooth performance or renegotiation of a financial contract. The ex-ante incentives that a good enforcement mechanism provides are crucial for contracting in a cross-border setting with multiple jurisdictions and legal systems.
- Moreover, public enforcement authorities typically set the legal sanctions via regulation, but private enforcers can actually impose significant direct sanctions via the judicial system, e.g. class litigation, and indirect sanctions by preventing the wrongdoer from raising funds in the future (reputational mechanisms). Comparatively, private remedies are more important for institution-based systems, while public remedies are more effective for market-based systems. This observation points to the importance of two key components: **a punitive system of sanctions and a well-functioning and flexible judicial system**.
- **Public enforcement** encompasses the supervisory architecture (including powers of intervention, governance, information sharing and other regulatory practices), the sanctioning regime and the architecture of the legal system, e.g. securities law and judicial system.
- **Private enforcement** mechanisms include: gatekeepers' supervision (including liability), insolvency proceedings, private settlements, functioning of courts (e.g. choice-of-law regime), and whistle blower programmes and other redress procedures (e.g. class action suits, minority shareholders' rights).

Public enforcement

21) *Breach of EU law and ESMA top management appointment (Barrier 28).* The procedure of Article 17 of the ESMA Regulation on the possibility to act against a **breach of EU law** by a member state has never been used to date because of the conflicts in the governance of the authority between the Board of Supervisors (BoS) and ESMA's top management. ESMA's credibility to tackle national decisions and promote supervisory convergence in a cross-border setting with national gold-plating of EU laws is at stake. A more independent action of ESMA's top management is crucial. Either the approval of the recommendation under Article 17 (to start the procedure) or directly the **appointment of the top management** (or both) should be given to an external body such as the European Commission or the European Parliament, which could then directly choose ESMA's top management.

22) *Independent components in BoS (Barrier 28).* Overall, there is a need to strengthen the **EU-wide interests** in ESMA's decision-making process. In this respect, it would help to reinforce the management board with additional independent components (nominated by the European Commission), and to give them voting rights in the Board of Supervisors, which would ensure that the EU-wide interest leads the decision-making process.

23) *Direct supervision (shared competences with NCAs; Barriers 1, 2, 3, 4, 7, 14, 16, 21, 22, 28, 29).* Evidence discussed in the report suggests that the enforcement of EU legislation is weak. **ESMA's direct supervision in well-defined areas** to support regulatory and supervisory convergence can be strengthened in different ways. One of the following three options, to be implemented with a 'phased-in' timeline, could be considered:

    a. Make ESMA responsible for the direct supervision of all EU listed companies,
    b. Make ESMA responsible for the direct supervision of all the firms that will be classified as 'cross-border' (either listed-only or both listed and unlisted companies)[1] and
    c. Allow an entity, when applying for a EU passport, to opt into ESMA supervision.

24) *Areas of supervision (Barriers 1, 2, 3, 4, 7, 14, 16, 21, 22, 28, 29).* The **'well-defined areas'** where ESMA will exercise its **direct supervision** will be in reality part of a joint supervisory framework, through colleges of supervisors, with ESMA acting with voting rights and issuing binding decisions for NCAs as part of the ESMA network. ESMA could already take up the role of direct supervisor in the following areas:

    a. Accounting rules and practices for listed companies (IFRS) and for unlisted companies (if common EU principles will be harmonised);
    b. Supervision and collection of listed company filings, with responsibility over the harmonisation of timing and formats;
    c. Coordination of the national business registries;
    d. Listing authority of firms that want to cross-list in an EU country different from where their legal headquarters are located;
    e. Licensing and ongoing supervision of UCITS and AIFs;
    f. Prospectus issuance approval and monitoring; and

g. Licensing procedures of the EU passport granted by NCAs, and the power to revoke the license.

ESMA's decision in these areas, with the approval of the Board of Supervisors, would become binding for NCAs and be directly enforced by them, so the new supervisory architecture would still rely heavily on the current network and resources of national authorities. The decision-making arrangements of the main body issuing decisions within the SSM or the new European Deposit Insurance Scheme could offer a good benchmark of governance to start negotiations.

25) *Exclusive competence for selected entities.* Beyond credit rating agencies and trade repositories, the **exclusive competence** of ESMA could be extended to other entities such as data providers (under MiFID II), benchmark providers, trading venues, central securities depositories, auditors (via more binding powers over the committee of national auditing oversight bodies, for instance) and central counterparties (CCPs), which are the backbone of a pan-European market architecture.

26) *Due process (Barrier 30).* Recent jurisprudence, such as SV Capital vs. EBA or Grande Stevens et al. vs. Italy, have emphasised the importance of ensuring an adequate judicial review (**due process**) of the ESAs' decisions in order to strengthen their decision-making power and credibility, and to protect human rights. ESMA's decision should be subject to a fair trial, run by an independent tribunal that has full jurisdiction over the case (and not an internal body of the authority), with the possibility for the defendant to exercise his/her right to be heard in a public hearing.

27) *A pan-European consumer agency (Barrier 29).* A **pan-European consumer agency** that provides unified supervision in matters of consumer protection is one of the missing pieces of the European institutional architecture and is in the spirit of the post-crisis financial reforms. There is no integrated capital market without retail markets integration, and national consumer laws protect the current fragmentation of retail service providers. A dedicated agency would provide support for a more coherent implementation of national consumer laws and limit the proliferation of local supervisory approaches, offering more tools for investor protection with stronger monitoring and easier access to private enforcement tools against harmful practices. This agency could be set up under the management and control of ESMA, falling under its broad mandate of protecting investors and consumers of investment services. Nonetheless, a pan-European consumer agency can only achieve meaningful results if sufficient resources to deal with the cross-border nature of its regulatory and supervisory activities are provided.

28) *Sanctions (Barrier 30).* **Sanctions** are also another area of divergence across member states. Combined with passporting of financial services, the wide variety of sanctioning regimes (going from administrative sanctions to criminal charges) found among member states is a source of significant regulatory and supervisory arbitrage that can discourage cross-border trading activities and service provision. An accurate separation

[1] A 'cross-border' firm could be any legal entity with legal headquarters and operations in a different EU country.

between criminal and administrative charges should be taken into account when further harmonising sanctioning powers.

29) *Securities law (Barrier 25, 26 & 27).* **Securities law** provides the essential toolkit for public enforcement of a financial contract. It embodies the necessary legal architecture to recognise and apply contractual terms in financial transactions. Uncertainty over the legal terms of a financial transaction creates significant entry barriers in a cross-border setting. Limited recognition, across EU countries, of 'good faith' acquisition can produce cross-border barriers and hamper collateral fungibility. There should be a clear recognition that the registration of the security in the account of the CSD is the decisive moment when the legal transfer takes place. In addition, the conflict-of-laws regime in the FCD (Article 9) could be extended to all other acquisition or disposition of securities.

Private enforcement

30) *Gatekeepers' supervision (Barrier 35).* Divergence of supervisory practices in relation to gatekeepers (entry and ongoing requirements) might result in distrust among supervisors relating to the quality of their information and action, and thus may raise costs for end investors. In this respect, the decision to assign exclusive competence to ESMA for credit rating agencies would be an important precedent for **extending the competence to other gatekeepers,** such as auditors, in line with the objective of strengthening supervisory convergence on accounting standards.

31) *Functioning of courts.* The quality of the judicial system across European countries is on average very low, compared to other advanced economies such as Japan and the United States. Investments might be necessary to improve the functioning of courts across Europe. If cross-countries divergences do not come down, there should be a gradual introduction of a **system of European courts,** with branches in every member state and dedicated to cross-border financial transactions in specific areas to be identified in insolvency proceedings and/or enforcement of private contracts, could be an important step forward. Domestic financial transactions would still be run under local proceedings, with the possibility to opt into the EU system in very specific situations.

32) *Insolvency proceedings (Barriers 31, 32, 33 & 34).* Current insolvency proceedings, even after the recent reform, still create cost unpredictability in a cross-border setting. **Secondary proceedings** are still too cumbersome and leave a great deal of uncertainty, as the court of the country of establishment may tend to be excessively conservative in its attempt to protect local creditors under local laws (as history tells us). Perhaps, as requested for the conflict-of-law in the opening of the main insolvency proceeding, a more neutral venue, such as a European court (with the creation of a dedicated arm), could assess the need to open a secondary proceeding in the country of establishment. For instance, the situations in which the interests of the local creditor may be affected could be further specified in a positive list (whatever is not in the list shall not be considered a justification for opening the secondary proceeding). Another source of potential uncertainty comes from the use of **stays**. An automatic stay when the proceedings begin, rather than the current patchy framework across Europe, may be preferable. Stays on request could be more clearly regulated with criteria that are as

objective as possible. Finally, the standard conflict of law system relies on the principle that the proceeding will be opened in the **Centre of Main Interest (COMI)** of the debtor (*lex concursus*). For individuals, the regulation refers to the 'habitual residence' of the individual without further specifying how 'habitual residence' shall be defined. The uncertainty about the COMI presumption for individuals can still be a source of cross-border litigation in insolvency proceedings, after the new rules enter into force in 2017. It may be preferable to have a centralised European court where such decisions can be subject to appeal. Alternatively, the law could provide for European courts to directly resolve matters of where to open proceedings, with a contractual clause signed ex ante.

33) *European Alternative Dispute Resolution (ADR) system and Ombudsman service (Barrier 36).* Access to ADRs is still very cumbersome in some countries and certainly in a cross-border setting. The current FIN-NET solution is inadequate for the proportions and complexity of cross-border capital markets activities. As a consequence, it may be beneficial to strengthen, on the one hand, the quality of ADR procedures across member states, which were first introduced by the Directive 2013/11 on alternative dispute resolution for consumer disputes. On the other hand, a bolder action is required to create an EU-wide 'Financial Ombudsman Service', which could be run by a dedicated infrastructure under the current European Ombudsman Service and Network, acting as a single point of contact for users of financial services. This European Ombudsman, through the use of the Ombudsman network, would collect and run a first screening of the complaints regarding the cross-border provision of financial services, which may involve a local broker and a foreign service provider (FSP). Once the validity of the complaint is confirmed, the EU body would connect the national ombudsmen that are involved and offer mediation in defining which of the two national authorities shall take the initiative first, in relation to whether action will be taken against the local broker or the FSP. The FSP may also provide services directly in the country, in which case the EU 'ombudsman' will directly contact the home authority and make sure that the procedure begins and the results or request for information are communicated to the user.

Introduction

This report builds upon an intensive year-long research effort, enriched and guided by discussions within a group of experts, the **European Capital Markets Expert Group (ECMEG)**, including stakeholders, academics, policy-makers and industry experts. The aim of this report is to contribute to the debate at the EU and international level on what kind of Capital Markets Union (CMU) Europe needs.

The report offers a **comprehensive overview of the current state of financial integration** in Europe and an assessment of major barriers to further capital market integration.

I. Financial integration policies: A historical overview

- EU policies aimed at capital markets integration go back more than half a century. Since 1957, these policies have evolved over **three major phases,** each spanning roughly 20 years and driven by major political and economic events.

Building blocks of European policies for financial integration

	Political trigger	Period	Integration process	Legal principles
First wave	Post-World War II reconstruction	Late 1950s – late 1970s	✓ Gradual removal of capital restrictions	Non-discrimination
Second wave	Post-end of Bretton Woods crises and end of the Cold War	Early 1980s – mid-2000s	✓ Policy coordination ✓ Mutual recognition (passporting) ✓ Minimum harmonisation	Equivalence
Third wave	Financial globalisation and EMU incompleteness	Late 2000s – to present	✓ Institutional convergence ✓ Single Rulebook ✓ Removal of cross-border barriers	'Enhanced' subsidiarity

Source: Author.

- Until the recent financial crisis, **mutual recognition (with home country control)** was the main tool used to promote integration among Europe's capital markets. It was at the core of five key post-EU Single Act Directives, such the Second Banking Directive (SBD) and the Investment Services Directive (ISD), and several other measures under the Financial Services Action Plan (FSAP).
- Nonetheless, the recent financial crisis has exposed important failures of the multilateral model of mutual recognition to amalgamate member states' national interests with the ultimate objective of fostering the European single market. After the De Larosière Report and the Banking Union initiative, in particular, a **strengthened subsidiarity principle** is currently trying to push for more supervisory convergence across Europe.
- New European bodies have been created with stronger legal powers to replace previous committees and to ensure the effective removal of non-tariff barriers to the free movement of capital and services and to secure the stability of the European financial system. However, the role of the **'new' European Supervisory Agencies (ESAs)**, created without a change of the European Treaties, has been focused so far on defining the implementing details (level 2) of EU regulations, but they have produced limited results in the coordination of supervisory practices.
- The Capital Markets Union (CMU) plan combines measures for the **deepening of the single market for capital** with efforts at tackling structural issues in financial markets, such as access by SMEs to market-based finance, suggests that the current CMU plan is a combination of integration, investment and financial stability policies. While it is certainly a commendable objective to act on all these policies, this way of planning may further complicate the implementation process, as the **ability to measure the achievement of objectives (accountability)** is diluted by the fact that these policies may result in conflicting outcomes.
- Hence, the CMU plan should only focus on integration policies and leave investment and financial stability policies to separate policy actions. This plan is an opportunity to **rethink financial integration** in Europe in order to produce a financial ecosystem that balances cross-border traditional banking with capital markets activities and, most notably,

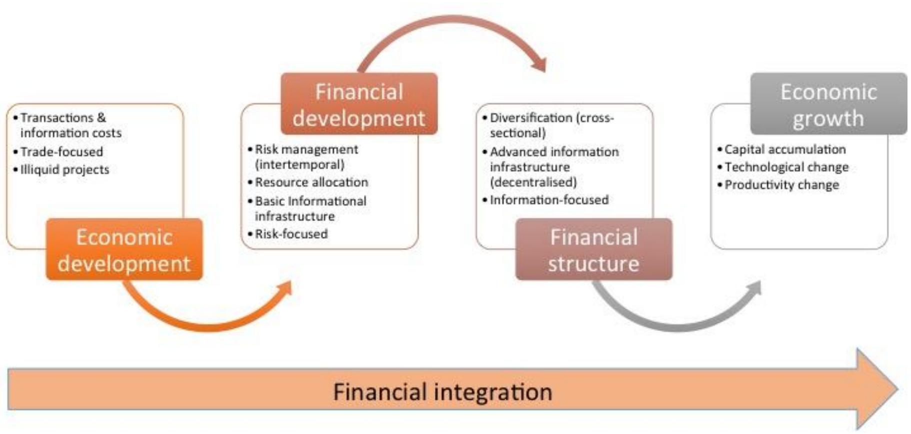
produces a pan-European financial architecture to the single market that can stand strong in the global financial system by integrating and putting in competition national markets for the benefit of investors and companies. The convergence of supervisory practices is an important step in this process.

These ideas are further developed in chapter 1.

II. Financial integration, risk sharing and economic growth

- The organisation of the financial system, however, is a complex **interaction of legal norms** (including investor protection) **and economic incentives** that shape the behaviour of institutions and investors. General legal principles, such as the right of establishment and free movement of capital and services, are not sufficient conditions to ensure high-quality financial integration, i.e. sound risk diversification.
- **Financial integration** is the process through which different regions or countries become more financially interconnected, ultimately producing **risk sharing** in case of an asymmetric shock, like the recent financial crisis. The integration process involves the free circulation of capital and financial services to allow cross-border holdings of assets (private risk sharing), which would determine an increase in capital flows across these regions and a convergence of prices and returns on financial assets and services.
- **Financial development** can be defined as the size and sophistication (interconnection) of a given combination of institution-based and market-based intermediation. **Financial structure** is then a given combination of credit and equity (funding types) by intermediaries and markets (funding means). A given **combination of financial structure and development** determines the quality of financial integration, which can produce a more efficient allocation of capital (via private risk sharing) and so unleashes further economic development and ultimately growth.

Financial development and integration channels to economic growth



- **Risk diversification** is at the core of any integration process. Relationship-based (or institution-based) finance, e.g. traditional banking, and market-based finance, e.g. capital markets, can improve together the quality of financial integration and can create a **financial ecosystem** that limits the concentration of capital flows and thereby reduces the risks of asset bubbles and a permanent loss of productivity.

- Nonetheless, the growth of the financial sector should be continuously monitored. As the financial sector grows and increase availability of credit, entrepreneurs tend to invest more in low-productivity projects with returns that are relatively easier to pledge. High-productivity projects are typically less tangible and more difficult to pledge. Therefore, beyond a certain threshold, there is a **negative relationship** between the size of the financial sector (and in particular private-debt growth) and **economic growth**. A balanced financial ecosystem would prevent the unsustainable growth of individual pieces of the financial system to drive growth for the entire sector, as the traditional banking sector did in Europe.

These ideas are further developed in chapter 2.

III. Rationale for more capital markets integration

Risk sharing

- **Cross-sectional** (horizontal in space, i.e. market-based) **and intertemporal** (vertical in time, i.e. institution-based) **risk sharing** are complementary, as they provide respectively a cushion against both aggregate (permanent shocks, such as the recent financial crisis with widespread failures of financial institutions) and idiosyncratic risk (temporary shocks, such as the failure of one or few financial institutions).

- Strengthening the role of capital markets, nonetheless, would improve financial development, by preventing the financial network from concentrating capital flows (and ownership of foreign assets) in those sectors and areas that generate more positive externalities irrespective of the risk that is being created. In effect, after the initial benefit of cross-border integration, if there were no **private risk sharing**, capital flows would cause risk concentration in good times, with heightened risks of sudden stops and reversals during crises. Risk sharing improves capital allocation, as risk is borne by those who can bear it (whether public or private agents) irrespective of the geographical location, thereby reducing the likelihood of a capital reversal during a financial crisis, as the same risk is shared across areas through their financial integration.
- Overall, evidence shows that **Europe** lacks both cross-sectional and intertemporal risk sharing, i.e. **cross-border capital markets and banking activities**, compared to other regions like the United States. The single currency only limitedly contributed to more risk sharing, exposing the euro area to the build-up of excessive capital inflows in some areas in the pre-crisis period and a significant capital reversal from the beginning of the sovereign crisis.
- As a consequence, financial integration, measured as the law of one price (LoP), may only be the result of a temporary convergence in risk. The **composition of cross-border capital flows** is even more important for financial integration policies. The free movement of capital is beneficial only if the composition of these flows is well balanced. Comparative evidence with other financially integrated regions across the world suggests that Europe needs rebalancing from cross-border (interbank) debt to more **equity and FDI contributions** (with measures like the removal of the debt/equity bias in laws and taxation).

These ideas are further developed in chapter 2.

Monetary policy transmission

- **Funding concentration** in the financial system**,** whether debt or equity, can cause asset bubbles and impair the mechanisms of transmission of monetary policy, which can affect information flows and increase interconnection among financial institutions.
- Greater transparency, required by a diversification towards market mechanisms supports the propping up of **financial markets plumbing** by providing accessibility/contestability of established markets, which may ultimately result in greater consolidation at pan-European level and more efficiency (lower costs) due to the network properties of the financial system. This market structure would also reduce **over-reliance on bank-driven reference rates** and improve the overall market pricing.

Access to finance

- The development of a truly European capital market, within a diversified financial ecosystem, would allow easier access to funding, thanks to greater **competition among intermediation channels**, and more specifically among banks and alternative funding sources (see Chapter 3 for data analysis).
- The current financial fragmentation, which hampers access to finance and harms **financial development**. The deepening of capital markets can increase financial development, which usually produces greater positive impact on the small firms that are currently struggling to obtain more credit.
- Ultimately, access to finance also means **greater choice for end investors.** Investors, in effect, often face limited choice and high costs from domestic providers of investment products. More cross-border competition in the provision of investment services and products can abate costs, increase returns and attract more cross-border volumes.

Finance for innovation

- Capital markets-based funding mechanisms are not only beneficial in times of crisis. Our findings suggests that cross-sectional risk dispersion, typical of market mechanisms, is ideal **for funding innovation**, as it provides easier access for high risk-high return projects that are not capital-intensive. Moreover, market mechanisms are preferable for the easier exit options than an institution-based funding relationship, which may be less costly but may not offer easy liquidation.
- Highly innovative projects benefit from **risk dispersion and customisation**, thereby making more 'relationship-based' market mechanisms, such as private equity, venture capital and crowd finance, suitable for high-potential growth firms. By facilitating trading, hedging and pooling of risks, a highly developed financial sector allows investors to fund investment opportunities that would otherwise be forgone.

Bank restructuring

- The **legacy of the recent financial crisis** for European banks is a heavy one. Banks are carrying huge non-performing exposures that they struggle to write off due to the lower margin environment. This situation also affects the ability to signal risk, making banks even less willing to disclose bad exposures for fear of reputational damage.

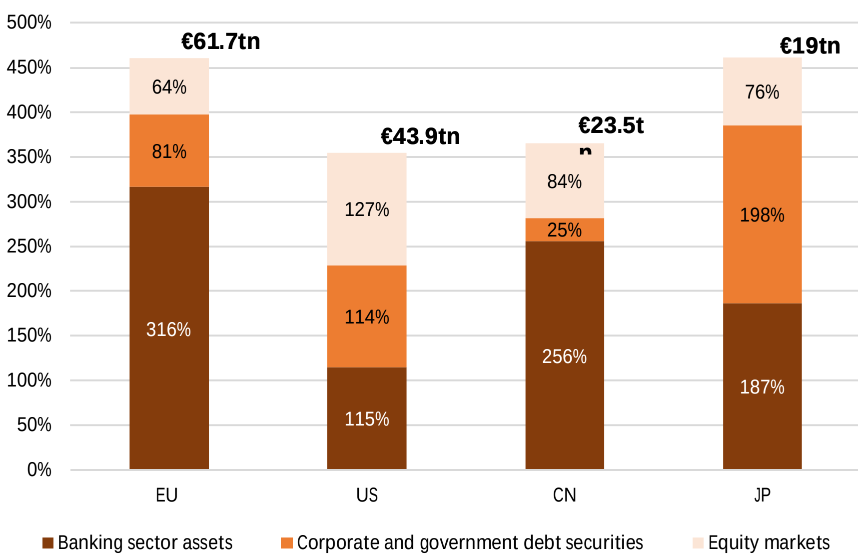
- Market mechanisms may create an easier exit option for the liquidation of those assets, helping **bank restructuring** and thereby improving the quality of the financial system and rebalancing funding sources.
- Well-functioning capital markets also increase **cross-border contestability of bank ownership**, which can be a great source of diversification and risk sharing, as the experience of Eastern European countries demonstrates.

These ideas are further developed in chapters 2 and 3.

IV. Integration and structure of Europe's capital markets

- After the slump caused by the financial and sovereign crises, **financial integration** (measured by price and quantity indicators) has gradually picked up. Quantity indicators have kept converging, but the convergence of price indicators is still well below pre-crisis levels. The countercyclical growth of cross-border equity holdings, compared to the drop in cross-border debt securities holdings, shows the ability of equity flows to withstand asymmetric shocks.
- The **structure of the European financial system** relies heavily on traditional bank intermediation, which is even bigger than the sector in China.

Simplified structure of the financial sector in the EU (% GDP, average 2010-14)



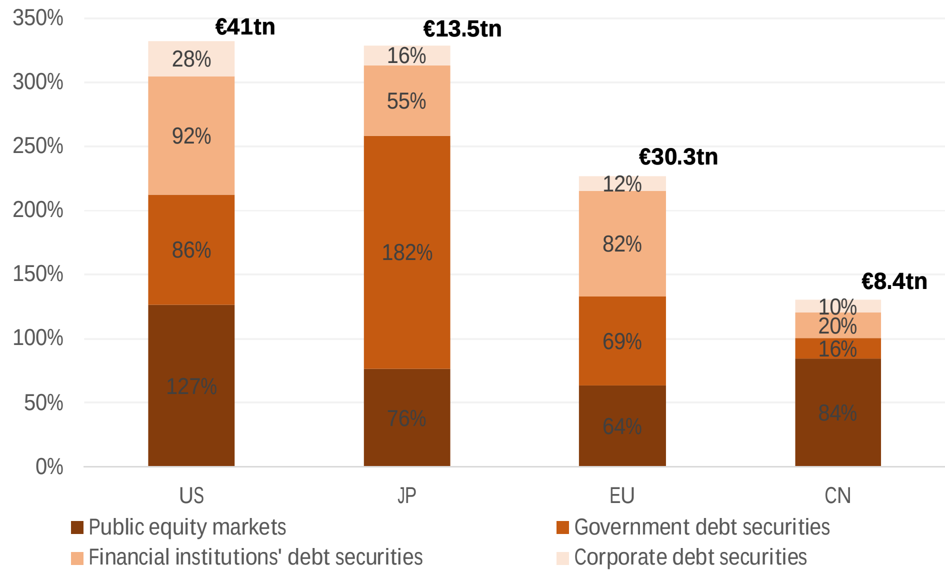
Note: For debt securities, we use outstanding amounts and exclude financial institution debt securities (which are implicitly included in the banking sector assets statistics). For equity, we use domestic market capitalisation. For US bank assets data, we include gross notional value of derivative positions and credit union assets.

Data sources: IMF (GDP), BIS, ECB, US Fed, BoJ, PBoC, WFE, FESE, individual stock exchanges. Eurostat for exchange rates.

- **Europe's capital markets** are on aggregate smaller than markets in the United States and Japan. Equity markets are also smaller than Chinese markets in percentage of GDP.

Moreover, issuance of government and financial institutions drives debt markets, while the corporate bond market is just 12% of GDP.

Capital markets structure (value of outstanding securities, excl. derivatives; average 2010-14; % GDP)

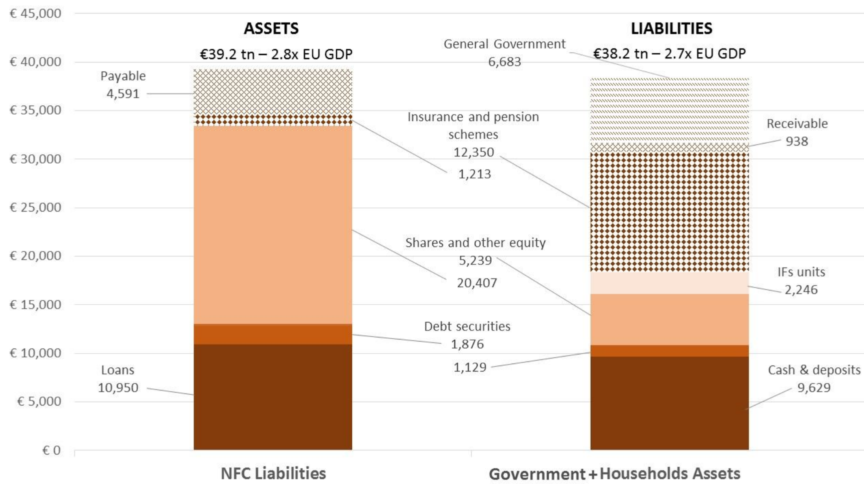


Note: Derivative markets, excluded from this figure, include securitisation, derivative contracts, and indexes (exchange-traded products; see following sections). 'Public equity markets' are equal to domestic market capitalisation.

Data sources: WFE, BIS, individual stock exchanges. Eurostat for exchange rates.

- European **non-financial corporations' (NFCs)** rely heavily on bank loans for funding, which account for 77% of all NFCs debt funding, compared to 40% in the United States. Only 12% of NFC funding is provided by corporate debt issuance, despite the positive net issuance in recent years offset the drop in net lending.
- With highly fragmented markets and high uncertainty in the financial system, **risk aversion** is at historically high levels **among European households**, 31% of their financial assets held in cash or deposits and only 23% in shares and investment funds, compared to 13% and 44%, respectively, in the United States.
- Nonetheless, the **situation varies widely from one country to another**, with some (like UK and the Netherlands) regularly investing in pension funds and shares, while many others (like Greece, Spain or even Austria) have above-average cash and deposits holdings. Taking out all the cash and deposits that go back in the system to fund household or corporate lending (such as consumer credit and mortgage lending to households), we estimate that roughly €1.8 trillion in deposits or cash could be mobilised and invested in more profitable (and riskier) instruments.

Matching household and government assets and NFC liabilities: The balance sheet of the (financial) economy (€bn; end of 2014)



Data sources: ECB & Eurostat. Eurostat for exchange rates.

- **Households' direct funding of NFCs** (ultimate users of capital) via shares and debt securities instruments is just 16%. **Governments** have significant interference in the EU economy with direct equity holdings equal to roughly 10% of all NFC equity, compared to 0.8% in the US. Insurance and pension funds are almost one-third and the main vehicle through which households' assets flow into NFCs.
- As a result, the low percentage of listed shares in NFC, the limited participation of households and main institutional investors (insurance and pension funds) and the high government interference in the ownership of companies suggest that a general **lack of risk-taking environment and low contestability of control** in the EU economy. After a significant economic shock, this environment might be unable to attract investments and to create growth and jobs.

Financial industry structure

- The drop in trading volumes, the tightening of capital requirements (especially for those holding large securities inventories) and an environment with very low long-term interest rates have increased the costs of big inventories and pushed **dealer banks** to cease well-established trading activities or restructure their entire business model. In some cases, this entails the adoption of more hybrid models that combine securities dealing and asset management services.

- The evidence about the **impact on liquidity** of dealer banks shrinking their business is mixed, as widening of spreads in some markets is offset by no impact or even improvements in other markets. For instance, despite the move of the US corporate bond market in recent years towards a more agent-based model, liquidity is still resilient. Hence, a well-functioning market can replace some dealer-driven market structures, but the transition to the new model is important and should be closely monitored.

- The **financial sector,** including intermediaries other than banks, is currently at its historical peak with total assets of roughly €100 trillion. While the total size has not declined, despite the crisis, the weight of the different components is changing rapidly.

- The **asset management industry** has grown at an incredible pace in the post-crisis period, doubling its assets under management (from €9.9 trillion to €19.9 trillion) between 2008 and 2014. This situation was supported by the fast retrenchment from direct holdings of market instruments by **insurance companies and pension funds**.
- The high number of funds and small average size keeps a **fragmented and costly market** for investment fund units across member states. At the end of 2010, the total expense ratio (TER) of European funds was 32% higher than the US equivalent. Since then, this gap has widened, as the US TER fees decreased to 120 basis points, while there is limited evidence of the same move in Europe. Fixed charges (subscription and redemption fees) have even increased in recent years and fee structures continue to greatly diverge across countries.

Financial markets structure

- **Primary and secondary equity markets** activity is fragmented and fragile. IPO activity in Europe is not far from that of the largest market (US) in absolute values. Moreover, 73% of newly raised money went to fund already-listed companies in 2014. Despite the liberalisation of trading venues activities, with the abolition of the national concentration rules, and resulting in a structural drop in bid-ask spreads, competition in secondary markets is limited on average to the top 50 most-liquid listed shares in main indexes. The efficiency of secondary trading is still very low, as newcomers struggle to diversify the trading flow with more retail and institutional investors' activities.
- **Cross-border integration** among trading venues thus slowed down and markets still remain fragmented along national borders rather than along specialised segments, such as SMEs or high-tech listings. The low level of participation in equity markets of household and some institutional investors, such as insurance and pension funds, weighs heavily on the integration process.
- European **private equity and venture capital funds** in Europe are far from being systemically relevant, with a combined average amount raised per year in the period 2010-14 equal to €37 billion, compared to €119 billion in the US.
- **Negative net issuance of equity**, driven by buybacks in a very active secondary market, and the 'carried interest' tax mechanism suggest great (ex-post) exit opportunities for equity investors (not necessarily in the market) and thus high ex-ante incentives to inject equity into fast-growing companies and hold for a long time.
- **Crowdfunding** is a new funding model that combines risk dispersion with reputational mechanisms (relationships). It complements private equity and venture capital. Its nature is cross-border and careful minimum regulatory and supervisory design should not hamper their cross-border nature. EU action may actually pre-empt disorderly national actions.
- **Debt securities markets** have shown greater integration over the years, driven by wholesale dealer banks after the monetary union and EU financial reforms, e.g. FSAP. This is particularly true for bonds issued by governments and financial institutions. However,

the impact of the financial crisis on wholesale banks produced a reversal of capital flows and that integration process is currently retrogressing.

- For **government and financial institutions,** the market for primary issuance is still fairly fragmented, as country risk (adjustment) leads to different local environments.
- Primary issuance of **corporate debt securities** is developed only in a few countries, such as Portugal, France and Germany. Most notably, issuance of debt securities can also take place in a closed environment (so-called private placement), which today amounts to roughly €16 billion, compared to €822 billion of corporate debt gross issuance in Europe.
- **Private placement markets** in Europe are fairly local with limited international participation of issuers and investors. The market structure lacks information flow between issuers (mostly unrated companies), and investors may naturally keep this market to a niche compared to public listings or bank lending.
- The high level of outstanding debt securities in Europe creates the conditions for active **secondary markets** in the region. Trading activities today take place mainly over-the-counter via electronic platforms (RFQ) or voice-matching systems. The average size of debt transactions is €70,000 for order books and €8.5 million for negotiated deals matched by exchanges over-the-counter.
- **Participation** is mainly offered to institutional investors or banks, which interpose themselves directly or on behalf of a client. Retail investors' participation only occurs on limit order books available in a few markets, such as Italy. They only represent 3.3% of all secondary bond trading. Matching systems based on voice are mainly used for government bonds trading and represent almost one-third of the total. Electronic platforms are mostly based on a request-for-quote model.
- Overall, by considering the outstanding value of shares (market capitalisation) and outstanding value of debt securities over the related trading turnover, bond and equity markets in Europe show similar levels of activity (one to one), despite their OTC nature. Once again, this points to the poor functioning and **competitiveness of Europe's equity markets** compared to the US, where this ratio is two (turnover) to one (market capitalisation) based on a five-year average.

These ideas are further developed in chapters 2 and 3.

V. Building Europe's capital market: Guidelines for an action plan

- **More integrated European capital markets** have been a long-awaited outcome of European policies, to ensure greater financial stability and sufficient funding for EU firms competing in a global economy. Financial integration stimulates further financial development, which can ultimately advance economic development and thus produce more growth and jobs.
- The lack of **cross-sectional risk sharing** in Europe is the main source of the recent retrenchment of capital flows and, after flooding with credit southern European countries in past years, it is now an important contributor to the growing funding gap for companies at an early stage of development that are in need of fast liquidity injections, and for mid-

sized fast-growing companies that are looking for cheap and stable (equity or debt) funding opportunities to expand their business activity.

- Improving the quality of the financial integration process is a core aim of the Capital Markets Union project, which should thus promote the removal of legal and economic barriers to the free movement of capital and financial services in order to create a complementary **EU-wide, cross-border private risk sharing mechanism** to support the public ones.
- While **CMU and Banking Union** aim at more private risk sharing, they differ in some respects. In particular, CMU may not necessarily require the creation of new institutions and public risk sharing mechanisms, such as a common fiscal backstop for bank deposits. The CMU plan should entail a set of reforms to reorganise and strengthen the current institutional framework and to remove major **economic and legal barriers,** so to leave to the **single market** the decision if Europe needs 28 equity markets. Unlike Banking Union, there is no emergency in the financial system that requires an immediate policy answer. CMU can be spread over the years, but with a **detailed and firm timeline, as well as measurable objectives,** to ensure certainty.

Methodology for the barrier removal test

- Due to the nature of a financial claim in a market environment (with dispersed monitoring), the **legal system** (calibrated for investor protection) is a cornerstone of the financial system for public and private remedies, which supports a solid financial integration process. A weak legal system does not yield deep capital markets.
- Indeed, as **financial sophistication** increases, there is a pressing need for a more effective system of rules and an informational infrastructure (disclosure rules) in order for market mechanisms to complement bank lending and create a financial ecosystem that is conducive to a more diversified resource allocation (private risk sharing).
- Nonetheless, both financial institutions and markets face **specification costs** (ex ante) and **monitoring costs** (ex post), due to the inability to write the 'perfect contract' or to opportunism.
- To deal with the information asymmetry that creates moral hazard and contract incompleteness, financial contracting in market-based systems requires public information collected and re-elaborated by third parties, on top of private information. This can happen alternatively via **contracting or renegotiation**. 'Contracting' is the process leading the investor to enter a financial transaction after using all the information available to price the product and the credit risk of the counterparty (pre-investment). 'Renegotiation' is the process of redefining the terms of a financial contract, via contractual negotiation, or exiting a financial transaction, via a sale in the secondary market, before the end of the contract (post-investment).
- The **financial contracting approach** is used in this report to identify and classify barriers on the basis of their harm to cross-border trading. This approach reduces discretionary actions and increases measurability against well-defined objectives. It also helps to draw

a line between measures that require harmonisation and areas that can be left to regulatory competition among member states.

- Contracting and renegotiation take place via three key components: price discovery, execution and enforcement.
    - **Price discovery** is the process of 'discovering' the market price that is the closest approximation to the reserve value of the investor, considering his/her assessment of counterparty risk or of the value of the underlying asset at that moment in time.
    - **Execution** is the set of procedures that are involved in the execution of financial transactions taking place with the contracting or renegotiation phase. This includes market entry and exit requirements.
    - **Enforcement** is the process of ensuring the smooth performance or renegotiation of a financial contract, i.e. the enforcement of private contracts, including minority shareholders, retail investors and creditors' rights.
- A **'barrier'** can be defined as any domestic or European rule (law), (market and supervisory) practice or procedure that impedes data comparability (price discovery), fairness of procedures (execution) and legal certainty (enforcement) in the contracting or renegotiation phases of a financial transaction. Barriers can be artificial (exogenous to the transaction) or structural (embedded in the transaction), as well as domestic or cross-border (or both).

Cost predictability in cross-border market-based financial contracting

Functions	Output	Cost predictability
Price discovery	Data	Comparability
Execution	Entry/exit requirements	Fairness
Enforcement	Rules & procedures	Certainty

- Barriers are most harmful when they make the costs of a financial transaction **unpredictable**. The more unpredictable costs become, the more negative the impact will these barriers have on financial contracting. In effect, at the core of every market-based financial transaction is the ability to discount **future cash flows**. The less is the information about direct and indirect costs of the transaction that may affect future cash flows, the lower is the ability to discount future scenarios. Once discounting is impaired, the financial transaction will most likely not take place.

Measurability

- **Measurability of objectives** plays an important role for the success of a financial integration plan like CMU, as it ensures accountability. With no accountability, the political support to achieve the objectives of this complex project would most likely fade away. As a consequence, we can identify three measurable objectives:
    a. Improving **data comparability** about underlying assets and financial instruments;
    b. Reducing discrimination in **market entry and exit**; and

c. Increasing **legal certainty and accessibility** of public and private **enforcement** mechanisms.

These ideas are further developed in sections 4.3 and 4.4

Summary table: Selected cross-border barriers*

Cross-border barrier	Nature	Cost predictability	Policy outcome
PRICE DISCOVERY			
A. INFORMATION ON THE UNDERLYING ASSET			
1. IFRS optionality for discretionary evaluation models, e.g. asset retirement obligations, loan provisions, etc.	Artificial	No	Immediate action
2. Domestic accounting standards for non-listed companies	Artificial	No	Immediate action
3. Reporting formats, e.g. half-yearly reports, etc.	Artificial	Yes	Action needed
4. IFRS optionality for alternative calculation methodologies or definitions, e.g. classification problems, such as pension interest in income statement as interest or operating expense or calculation of debt at amortised cost or fair value	Artificial	Yes	Action needed
5. Alternative performance measures	Artificial	Yes	Action needed
6. Voting share disclosure threshold	Artificial	Yes	Action needed
7. Domestic business registries	Artificial	Yes	Action needed
8. Credit risk scoring and national credit bureaux	Artificial	Yes	Action needed
9. Rules on related-party transactions (definitions)	Artificial	Yes	Action needed
10. Compensation disclosure (methodology)	Artificial	Yes	Action needed
11. Off-balance sheet items	Structural	No	Action needed
B. FINANCIAL INSTRUMENT INFORMATION			
12. Ongoing performance disclosure (domestic market practices)	Artificial	No	Immediate action
13. Exit conditions disclosure (domestic market practices)	Artificial	No	Immediate action
14. Prospectus disclosure requirements	Artificial	Yes	Action needed
15. Calculation methodologies for PRIIPs costs (in KID)	Artificial	Yes	Action needed
16. Market data formats/costs & national bias in securities listing	Artificial	Yes	Action needed
EXECUTION			
A. ENTRY PROCEDURES			
17. Execution policies	Artificial	No	Immediate action
18. Tax discrimination	Artificial	Yes	Action needed
19. Local facilities, paying agents & other marketing rules	Artificial	Yes	Action needed
20. Corporate action standards	Artificial	Yes	Action needed
21. UCITS filing process	Artificial	Yes	Action needed

22. Passport processing fees	Artificial	Yes	Action needed
B. EXIT PROCEDURES			
23. Withholding tax refund and collection procedure	Artificial	Yes	Action needed
24. Full disclosure of exit charges and conditions	Structural	n/a	Action needed
ENFORCEMENT			
A. PUBLIC ENFORCEMENT			
25. 'Good faith' acquisitions	Artificial	No	Immediate action
26. Acquisition and disposition of securities	Artificial	No	Immediate action
27. Conflict-of-laws regime	Artificial	No	Immediate action
28. Art. 17 Breach of EU law proceedings (ESMA)	Structural	n/a	Action needed
29. Art. 9 consumer protection powers (ESMA)	Structural	n/a	Action needed
30. Sanctioning regimes (illicit profits restitution)	Artificial	Yes	Action needed
B. PRIVATE ENFORCEMENT			
31. Automatic stays	Artificial	No	Immediate action
32. Company's valuation in insolvency (principles)	Artificial	No	Immediate action
33. Secondary proceedings (conditions & deciding court)	Artificial	No	Immediate action
34. COMI for legal persons (uncertain presumption) & decentralised appeal	Artificial	No	Immediate Action
35. Gatekeepers' supervision	Structural	n/a	Action needed
36. Cross-border Alternative Dispute Resolution (ADR) mechanism (EU-wide)	Structural	n/a	Action needed

***This list contains a selection of the most harmful barriers and should not be considered exhaustive.**