In his political guidelines for the new EU Commission, President Juncker pledged to create a European Capital Markets Union to increase non-bank financing of the European economy and further integrate capital markets. This paper outlines the recommendations of the European purpose-driven law firm Frank Bold on the guiding principles of a proper functioning Capital Markets Union.

Financing through capital markets is not appropriate for most private companies, especially SMEs, which will continue to be primarily financed through relationship-based bank lending. Private companies are often rightly concerned about listing due to the risk of pressure from capital markets. We therefore recommend clarifications to the role of investors in corporate governance and the protection of corporate purpose.

More broadly, future policy should integrate sustainability and corporate responsibility into its central priorities. We highlight necessary changes to insolvency, company and tax laws for the development of a strong, stable and equitable pan-European financial market.

We strongly support the use of green bonds but suggest that the EU should strengthen the green bond principles to increase their credibility, foster investor confidence and support the expansion of the green bond market.

The Commission should work in concert with global initiatives to develop robust standardised definitions and measures at the international level that are meaningful, useful and comparable. At the same time, monitoring and enforcement mechanisms are needed to avoid greenwashing.

Environmental, social and governance matters (ESG) may be financially material to any investment, particularly over the long-term and should be considered in all investment decisions, not simply those labeled ‘green bonds’.

Frank Bold therefore recommends three additional concrete changes to promote standardised, transparent and accountable ESG in all asset classes:

1. Mandating comprehensive ESG consideration and disclosure by corporations, as well as by investment managers and institutional investors, results in a better understanding of risks and benefits for investors, regulators, and businesses themselves. Standardisation will also reduce the unnecessary burden of needing to comply with multiple different sets of indicators and requirements in different jurisdictions.

In its ‘Level 2’ measures for the Directive on non-financial reporting and diversity information (2014/95/EU) that will come into effect in 2016, the Commission should therefore provide:

   1. Key performance indicators (KPIs) and guidance addressing the scope and measurement methods for the reporting of non-financial indicators for environmental and natural resource impacts and risks. The guidance should address the scope and measurement methods for reporting of ESG impacts and risks, including at least: land use, water use, greenhouse gas emissions and use of materials.

   2. The priorities and best performance benchmarks for reporting the non-financial risks with respect to specific business sectors or operations with high risks of severe adverse impacts on non-financial matters set out in the Directive. These sectors should be determined by the Commission after consulting the Non-financial Disclosure Guidance Board, taking into account those sectors identified in the European Commission Resource Roadmap and subsequent actions and the Priorities of the European Union in implementing the United Nations Framework and Guiding Principles on Human rights.
Issuing clear and thoughtful guidance to Member States is needed to ensure the successful transposition of the Directive. Without it, the broadly worded requirements may result in reporting that reflects what companies wish to disclose rather than what is most meaningful and needed to satisfy the Directive’s underlying objectives.

**Require Statements of Investment Principles**

Institutional investors and asset managers should be required to produce Statements of Investment Principles (SIPs). These SIPs should include meaningful information on how investors are managing long-term risks, including ESG risks; their approach to engagement with investee companies; and voting.

**Clarify Fiduciary Duties**

The Commission should also clarify the principle of fiduciary duty, or comparable duties upon investors to invest in beneficiaries’ best interests. The UK’s Law Commission concluded in its 2014 report on ‘Fiduciary Duties of Investment Intermediaries’ that these obligations are often misinterpreted as a duty to maximise short term returns and justify the exclusion of ESG considerations.

We suggest that the Directorate-General for Financial Stability, Financial Services and Capital Markets Union cooperate with DG Environment and Climate Action on their study of fiduciary duties and efficient resource use across Europe. Where European Directives and Regulations refer to investors’ duties to invest in beneficiaries’ best interests, for example in Article 20 of the IORPs Directive, it should be clarified that this means their long-term best interests and that financially material ESG factors must be considered.

**Barriers to the development of appropriately regulated crowdfunding or peer-to-peer platforms including on a cross-border basis**

We note the proliferation of diverging national rules on crowd and peer-to-peer funding, which creates the possibility of further fragmentation of Europe’s nascent crowdfunding market. Certain Member States do not permit crowdfunding as it is classified as unregulated non-bank lending.

We therefore support the Commission’s emerging mapping and research exercise on alternative sources of financing and suggest that a common framework for crowdfunding be considered.

**Additional actions in the field of financial services regulation that could be taken to ensure that the EU is internationally competitive and an attractive place in which to invest**

A strong regulatory framework is needed to ensure macroeconomic and financial stability, as well as boost investor confidence. Simpler and more transparent securitisation products are desirable. As a result, practices that introduce complexity and conflicts of interest, such as tranching, should be discouraged. More generally, decreasing market volatility and slowing down turnover would help to channel finance to long-term investment.

**Main obstacles to integrated capital markets arising from company law, including corporate governance**

We suggest that the Commission should clarify the role of investors in corporate governance through a regulatory framework that promotes sustainable companies over the long-term. Companies distrust capital markets partly due to the fear that activist investors will steer business strategy away from sustainability and long-term value. Similarly, long-term investors may be less inclined to invest in companies if there is a risk that they may fall victim to the short-termism generated by the pressure from capital markets. Readjusting company law and corporate governance to protect long-term sustainable value creation is necessary to create well-functioning capital markets.

We further suggest that the reliance on stewardship principles be revisited. There has been recent focus in Europe on soft law standards, namely stewardship codes. However important critics - such as the UK’s Kay Review - have pointed to their ineffectiveness in promoting good shareholder behaviour and engagement by institutional investors. In the UK, for example, the fragmentation of shareholding structures in the past 20 years has increased the number of non-UK investors (who are not covered by the Stewardship Code) and rendered it unlikely that the Stewardship Code will substantially increase
shareholder involvement in corporate governance. Soft law approaches should therefore be viewed with skepticism, and efforts to increase shareholder engagement should be scaled back. To the extent that stewardship principles are used, the Commission should ensure that they are simple and clear to apply, and grounded in the regulatory framework.

Finally, we welcome the recent move in the context of the Shareholder Rights Directive to link shareholder participation rights to commitment to the company, i.e. length of shareholding. This will reward ‘patient’ investors who are willing to take a long-term investment horizon.

**Address Corporate Purpose**

At present, the societal purpose of companies is not explicit in law, and this has created space for short-termism to flourish in capital markets. The Commission could therefore consider requiring all Member States to allow companies to specify long-term purposes in their constitutional documents. A clear statement of purpose would introduce legal clarity; complement many of the other suggestions set out above; and create a level playing field for companies that wish to contribute to a sustainable and innovative economy. These statements of purpose might cover environmental, social or scientific goals.

In addition, EU company law could require that companies be able to lock-in those purposes against opportunistic change by short-term shareholders (perhaps by requiring a supermajority to amend the purpose clause). This would protect companies from short-term capital market pressures that conflict with their core purpose. EU company law could also go further to specify more clearly the societal purpose of companies generally, creating an explicit duty for directors to pursue sustainable value.

**Encourage firms to integrate ESG-performance criteria into remuneration policies**

The Commission should act to encourage companies to adopt remuneration policies that measure performance against both financial and non-financial criteria, including environmental, social and governance indicators.

Since remuneration is one of the key instruments for companies to align their interests and those of their directors and in view of the crucial role of directors in companies, it is important that the remuneration policy of companies is determined in an appropriate manner. Integrating ESG-performance criteria will correspond to the needs of investors concerned with impact, sustainability and long-term value.

In contrast, transparency, disclosure of information and extending shareholder voting rights to pay - such as those proposed in the current revision to the Shareholder Rights Directive - will not on their own result in better governance. There is clear evidence that very few shareholders have used advisory "say on pay" votes in the UK and US (where this right already exists) to express dissatisfaction with pay policies. Nor is there any reason to believe that moving to a binding shareholder vote will suddenly result in remuneration policies that better align executive incentives with outcomes beneficial to companies, shareholders, employees and broader society. Instead, increasing shareholder empowerment will allow activist investors to place further pressure on companies to increase their short-term share price, but will not create any incentive for currently passive institutional investors to assert a more dominant voice.

**Harmonise conflict of law rules**

We support the Commission’s review of conflict of law rules and suggest that they be harmonized in support of the ‘real seat’ theory.

At present, Member States regulate conflict-of-law rules in the area of company law and the content of these rules differs significantly across the EU. The connecting factor determining the applicable law varies significantly among Member States with some Member States follow the real seat theory, meaning that the law governing a company is determined based on the country where the company is reallocated.
by the place where the central administration of that company is located while other Member States follow the incorporation theory, i.e. the law governing a company is determined by the place of its incorporation.

Adoption of the real seat theory will increase legal certainty for companies undertaking cross-border operations and reduce the likelihood of regulatory arbitrage.

| Introduce safeguards to proposed SUPs |

The Green Paper notes there is no Europe-wide online registration of companies. The Commission has proposed to address this through its proposed Directive on single-member private limited liability companies (SUPs), which would permit online registration with a minimum capital requirement of only 1 euro. While it is desirable to facilitate the ease of creating companies, this must not be done without proper standards in place. For example, the currently debated SUP has no limits on its size, allowing it to be used by large companies. At a minimum, this should be addressed through strict limits on the size of the company or possibly by restricting its use to physical persons before moving forward with the proposed Directive.

Specific aspects of insolvency laws that need to be harmonised in order to support the emergence of a pan-European capital market

| Facilitate early-stage restructuring |

The Commission should consider measures to improve and harmonise insolvency rules in order to foster recovery without resorting to bankruptcy. The number of insolvencies in Member States remains much higher than pre-crisis levels. High numbers of insolvencies have negative consequences for the economy and society more generally due to the loss of jobs and skills.

European insolvency frameworks tend to work slowly, frequently result in liquidation and often fail to protect both employment and private creditor rights. The Commission should facilitate out-of-court restructuring, which is underdeveloped in Europe, particularly in comparison to the US.

In several Member States, the substantive rules prevent flagging enterprises from restructuring a company at an early stage, before formal insolvency proceedings are opened. Research suggests that early restructuring is more likely to be successful and yields higher returns to creditors.

In other Member States, early restructuring exists, but the procedures are inefficient or expensive. Complex and costly procedures disincentivise companies from restructuring at an early stage when the business might still be rescued.

| Link main insolvency proceedings to the ‘real seat’ |

We suggest that the opening of the main insolvency proceedings should be linked to the “real seat”. This is consistent with our recommendation above that the Commission harmonise conflict-of-law rules in favour of the real seat theory. The current practice in insolvency, which should be changed, is that the jurisdiction for opening insolvency proceedings is established in accordance with the principle of the centre of a debtor’s main interests, meaning where the company is registered. This allows businesses to locate or transfer their registered offices or transfer assets to countries where creditor and employment protection is weaker in order to take advantage of insolvency regimes that benefit shareholders.

| Create European banking insolvency regime |

Finally, a sustainable integrated banking union should be fostered through the creation of a specific European insolvency regime, perhaps restricted to the largest banks. We note that although capital markets are and will remain important, further steps should be taken to strengthen the banking system.

Barriers around taxation that should be looked at as a matter of priority to contribute to more integrated capital markets within the EU and a more robust funding structure at company level

| Introduce Country-by-Country Reporting |

We suggest that the Commission should move forward with its review of country-by-country reporting on profits, taxes and subsidies (CBCR). There has been renewed public focus on corporate transparency and tax payments, particularly since the LuxLeaks scandal. CBCR is being looked at by the EU in the context of the accountancy directive, the 2015...
Commission communication on tax transparency as well as the Shareholder Rights Directive. CBCR information is relevant to tax authorities and investors to strengthen their understanding of the risks involved in investing in a given company.

The EU should also actively participate in discussions at the international level, including most notably the OECD’s work on “Base Erosion and Profit Shifting Action Plan (methods for determining “transfer prices”, content and application of information exchange agreements, etc.) to promote global consistency.

| Eliminate the Debt-Equity Tax Bias |

We strongly support the European Commission’s proposal to address differences in the tax treatment of debt and equity financing. Companies are encouraged to borrow, since interest payments are deductible, while the cost of equity capital is not. Yet too much debt lay at the core of the financial crisis.

We fully agree with the assessment that the preferential treatment of debt creates detrimental distortions and incentivises leverage. We also agree that differences across Member States in the tax treatment of debt and equity may create opportunities for profit shifting that should be addressed.

How can the EU best support the development by the market of new technologies and business models, to the benefit of integrated and efficient capital markets?

The Commission should continue to support the development of green and alternative business models to public companies by facilitating access to funding and consider the adoption of a common European statute for social enterprises.

The number of public companies worldwide has fallen significantly over the past decade--by 48% in the UK and 38% in the US. At the same time, their life expectancy has decreased. It is therefore worth looking at the rise of alternative business models.

For example, social enterprises have been shown to foster innovation and they create sustainable growth by taking into account their environmental impact and through a long-term vision for addressing social and economic problems. And they promote inclusive growth through their focus on people and social cohesion. The B-Corp movement has shown promise in allowing for-profit companies to create positive material impacts on society and the environment, and protecting the company's purpose when the company does public or seeks to raise external capital. Yet there exist barriers to access funds and scale viable business ideas. It is difficult for them to operate across the EU since regulatory differences vary significantly, especially in relation to tax. Moreover, there currently exists no standard Europe-wide definition of a social enterprise.

As a result, it may be appropriate for the Commission to adopt a specific definition of social enterprise, with sector representatives being closely involved in the process. Additionally, as noted above, we support the Commission’s emerging mapping and research exercise on alternative sources of financing, including crowd and peer-to-peer financing.

We note that the introduction and expansion of alternative business models must occur in tandem with the promotion of sustainability within traditional public and private companies.

Conclusion

We support the Commission’s efforts to promote sustainable financing of European companies and curb suboptimal market behaviour. Capital markets are inherently short-term and further reforms are needed to the corporate governance of both public companies and banks to encourage long-term investment in innovation and incentivise countercyclical behaviour. We have put forward a number, namely:

- Clarify the role of investors in corporate governance
- Address corporate purpose
- Encourage firms to integrate ESG-performance criteria into remuneration policies
- Harmonise conflict of law rules
- Introduce safeguards to proposed SUPs

Finally, we suggest that sustainable growth and job creation will result principally from measures to reduce inequality and increase the purchasing power of lower and middle class Europeans, not from increased access to credit.