MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

March 17, 2017

Via Electronic Submission

DG Financial Stability, Financial Services and Capital Markets Union
Unit C1 – Capital Markets Unit
European Commission
1049 Brussels
Belgium

Dear Sir or Madam,

Re: Capital Markets Union Mid-Term Review

Managed Funds Association ("MFA")[1] welcomes the opportunity to provide comments to the European Commission (the "Commission") on its public consultation on the Capital Markets Union Mid-Term Review (the "Consultation Paper"). MFA members, as investors in European markets and professional asset managers for European institutional investors, strongly support the goals of the Capital Markets Union ("CMU") project and seek to provide constructive feedback to the Commission as it considers how best to enable the flow of private capital to help EU professional investors, such as EU pension plans, meet their risk management and investment objectives and to provide a complementary source of funding for EU companies.

MFA members have a shared interest with policy makers in ensuring that robust European capital markets provide a complement to bank financing to promote economic and job growth in the EU. Robust capital markets provide businesses diverse sources of financing, help investors – like pension plan beneficiaries and universities – meet financial goals, and diffuse risk across market participants. MFA members also strongly support appropriate regulation of asset managers and other capital markets participants. Given that hedge funds do not have deposit-like funding structures and do not present the same risks as banks, EU authorities should not seek to extend

[1] Managed Funds Association ("MFA") represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

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bank-like regulation to them, *e.g.*, by treating them as "shadow banking entities."[2] Imposing bank-like regulation on capital markets participants such as investment funds will create disincentives to capital markets-based financing, an outcome that would be inconsistent with the policy goals underlying the CMU project. Moreover, we strongly believe that appropriate capital markets-based regulation can fully address policy questions about capital markets activities, without the adverse impacts that bank-like regulation would have on investment funds and other capital markets participants.

As the Commission considers its next steps on a wide range of issues and how best to prioritize those issues, including some larger and longer-term projects, we encourage it to include in its priorities the regulatory issues described below. While these regulatory issues may appear less significant than some of the Commission's larger policy issues, we believe addressing these existing regulatory concerns would help promote investment in EU capital markets by private investment funds, particularly funds managed by U.S. and other third country asset managers. We note that there are several regulatory reviews scheduled for the near future (for example, reviews of the European Market Infrastructure Regulation ("EMIR") and the Alternative Investment Fund Managers Directive ("AIFMD")), which provide an opportunity for the Commission to address issues in those legislative acts and regulations that would help facilitate the CMU objectives.

MFA would like to reiterate its thanks to the Commission for the opportunity to engage constructively in these issues. We would welcome the opportunity to discuss our views in greater detail. Please do not hesitate to contact Benjamin Allensworth or the undersigned at +1 (202) 730-2600 with any questions that the Commission or its staff have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell

Executive Vice President & Managing Director, General Counsel

[2] We note that the European Banking Authority, in its December 2015 *Report on Investment Firms* and its subsequent November 2016 Discussion Paper, *Designing a new prudential regime for investment firms*, has acknowledged that prudential rules developed for banks should be amended in their application to investment firms that do not engage in bank-like activities nor present systemic risk to be more appropriately tailored to the relevant business models and risks associated with the activities of investment firms.

MANAGED FUNDS ASSOCIATION

RESPONSE TO CONSULTATION ON CAPITAL MARKETS UNION MID-TERM REVIEW

A. Financing for innovation, start-ups and non-listed companies

In addition to our specific comment below in response to this policy goal, we believe that the issues discussed in response to the other policy goals in the mid-term review will help promote investment activity by private investment funds in European capital markets. Strong capital markets help facilitate investment in all types of companies including start-ups and non-listed companies as secondary markets with a wide variety of investors provide assurance that there will be liquid markets and price transparency when a long-term investor wants or needs to sell its initial investment. Without robust secondary markets in place to support sufficient liquidity, investors will either be unwilling to take the liquidity risk of a long-term investment, or will charge a premium to the businesses being financed to compensate for the liquidity risk, raising the financing costs to those businesses.

Loan Origination by Investment Funds

In addition to acquiring NPLs that will help free up bank capital for additional lending, we believe that loan origination and other similar financing activities by investment funds can serve as a valuable complement to traditional bank lending to European companies, including to small and medium-sized enterprises ("SMEs"). In a number of EU Member States, however, investment funds either are not permitted, or the regulatory framework makes it very difficult for funds, to make loans to corporates. The lack of an effective regulatory framework that facilitates loan origination activity by capital markers participants adds cost and complexity to financing opportunities for EU companies, contrary to the CMU's goals. It also decreases competition in the corporate lending market, meaning that borrowers have more limited choices in lending institutions. This increased concentration can have an upwards effect on cost, but more importantly, it can limit access to lending for smaller corporates, given that capacity to offer loans is limited. We note that there is work currently being undertaken at a local level in certain Member States relating to loan origination by investment funds. These national initiatives are a positive development, although

challenges remain in developing regulatory frameworks, which we encourage policy makers to continue working to address.

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

No comments

C. Investing for long term, infrastructure and sustainable investment

No comments

D. Fostering retail investment and innovation

No comments

E. Strengthening banking capacity to support the wider economy

Non-Performing Loans ("NPLs")

European banks continue to undergo deleveraging and reducing balance sheet risk, partly as a result of the impacts of the financial crisis and partly due to the regulatory developments implemented in its wake. An essential component of this work has been the sale of NPLs and the associated crystallisation of net loss positions. Investment funds have been key investors in these assets, and have therefore provided important liquidity and price transparency in secondary markets that enable banks to dispose of NPLs and free up their balance sheet capacity for other activities, such as corporate lending, including SMEs.

Banks may in particular gain the following benefits from the sale of NPL portfolios:

(a) Capital adequacy: the sale of an NPL portfolio to an entity not directly or indirectly owned by a bank will reduce its quantity of risk-weighted assets, and will therefore increase its overall capital adequacy ratio.

(b) Liquidity: a bank's liquidity position should improve as a result of the sale, given that a sizeable portfolio of illiquid assets will be replaced by cash generated from the sale.

(c) New Lending: freeing up capital on banks' balance sheets allows banks to engage in new lending, which will allow for new loans to SMEs and other EU businesses.

Reducing risk on bank balance sheets and improving banks' capital and liquidity positions will create stronger balance sheets across the EU banking sector, reducing the potential for an event in the banking system to create financial or systemic risk. It will also permit banks to repurpose balance sheet assets currently being used in connection with NPLs to support increased financing to SMEs and other businesses.

Amongst other things, we note that NPL transactions are often structured in such a manner that, purely as a technical matter, they could fall within the definition of a "securitisation" within the meaning of the Capital Requirements Regulation (CRR). The result of such a classification is that the

securitisation risk retention framework would need to be applied to the transaction. This result frequently proves a complicating factor when structuring NPL portfolio transfers. Such an outcome may dissuade professional investors, including asset managers, from involvement in such transactions (which would otherwise allow banks to de-leverage and divest risk, freeing up capital for other lending activities). We encourage the Commission to look at NPL disposals in a holistic manner, including providing relief in the manner in which transactions may be classified, so as to enable NPLs to be disposed of more efficiently.

We note in this regard the recent work of the European Council's Financial Services Committee, and other policy makers, as they work to develop proposals to address issues associated with selling NPLs from bank balance sheets. We encourage policy makers to continue to work to develop a framework that would help facilitate the ability of investment funds and other capital markets participants to acquire NPLs from banks.

F. Facilitating cross-border investment

Issues Relevant to Third Country Asset Managers and Investment Funds

AIFMD

As discussed in MFA's January 2016 letter[3] in response to the Commission's *Call for Evidence on the EU Regulatory Framework for Financial Services* and its October 2016 letter in response to the Commission's *Consultation Document CMU Action on Cross-Border Distribution of Funds (UCITS, AIF, ELTIF, EUVECA AND EUSEF) Across the EU*,[4] there have been a number of studies demonstrating that non-EU AIFMs do not plan to market AIFs under the AIFMD third country passport because of compliance costs and uncertainty related to the passport regime. As such, the national private placement regime ("NPPR") is vital to enable EU professional investors to invest in AIFs that suit their particular risk profiles and investment criteria. Further, as many of the AIFs marketed under the NPPR invest back into assets in EU Member States in various ways (*e.g.*, by investing in NPLs, or in financial instruments traded on EU trading venues), the NPPR is also ultimately an important gateway for investment in EU capital markets.

There is, however, a high degree of national variation in the application of the NPPR across the EU, including: (1) goldplating of AIFMD requirements by individual Member States; (2) differences in the initial notification and application process to market under the NPPR; (3) reporting requirements; and (4) the definition of "marketing" for purposes of the AIFMD. This variation creates significant compliance costs and uncertainty, which are significant barriers to the cross-border distribution of AIFs in the EU, limiting the ability of EU professional investors to allocate investment capital efficiently and undermining competition in the asset management sector generally. These barriers also limit investment in EU markets that would otherwise come through underlying investments made by the relevant AIFs. To that end, we welcome the publication by the

[3] *Available at:* https://www.managedfunds.org/wp-content/uploads/2016/02/MFA-Response-to-CMU-Call-for-Evidence1.pdf.

[4] *Available at*: https://www.managedfunds.org/wp-content/uploads/2016/10/MFA-comment-letter-on-European-Commission-consultation-on-cross-border-distribution-of-fun.pdf.

Commission on February 27, 2017 of the *Report from the Commission: Accelerating the capital markets union – Addressing national barriers to capital flows*, which seeks to address some of these issues.

We welcome the opportunity to continue to engage with the Commission on possible approaches in addition to the existing AIFMD passport regime and the existing NPPR, which we believe could help reduce barriers to cross-border distribution of AIFs, particularly from third country AIFMs, promoting investment opportunities for EU investors. One additional approach the Commission could consider would be a harmonized NPPR approach, which Member States could opt into, which would provide a consistent set of rules for AIFMs marketing into those Member States. Another possible approach would be to permit third country AIFMs that are subject to rules in their home jurisdiction that have equivalent effect to the AIFMD requirements to market to EU professional investors, similar to the approach taken under the new Markets in Financial Instruments Directive ("MiFID II") and Regulation ("MiFIR"). Because AIFs provide valuable benefits to EU institutional investors and are key investors in EU companies and EU capital markets, developing a regulatory approach that better facilitates increased participation from third country AIFs and third county AIFMs will help further the goals of the CMU.

Third Country Equivalence Determinations

As noted in the February 27, 2017 Commission staff working document, *EU equivalence decisions in financial services policy: an assessment*, a number of EU financial services legislative acts, including EMIR and MiFID II, require the Commission to decide on the equivalence of third country rules and supervision for EU regulatory purposes. Under EMIR, for example, market participants subject to the EMIR clearing obligation can only satisfy that obligation by clearing through an authorised EU central counterparty ("CCP") or a recognised non-EU CCP and non-EU CCPs are prohibited from providing clearing services to market participants or trading venues established in the EU unless they have been recognised. A positive recognition decision in favor of a third country CCP is dependent on that CCP's home state regime being declared equivalent pursuant to Article 25 of EMIR. Under MiFID II and MiFIR, all derivatives that are declared subject to the MiFID II trading obligation must be traded either through an EU trading venue, or through an "equivalent" third country trading venue. Similarly, MiFID II and MiFIR require investment firms to trade equity instruments that are admitted to trading on an EU regulated market on covered EU trading venues or on a third country trading venue that has been determined equivalent.

For third country asset managers and investment funds, many of which invest globally, it is critical to be able to trade with counterparties and on trading venues both within the EU and in other non-EU jurisdictions around the world, including the U.S. An effective and efficient process for making equivalence determinations is critical to achieving this objective. Given the important role that third country equivalence determinations have in making cross-border application of EU legislation and regulation function without creating impediments to cross-border capital flows, it is vital that the Commission acts in a consistent way and makes its decisions on the basis of regulatory outcomes rather than a line-by-line comparison of legal regimes. It is also vital for the Commission to ensure that it is able to efficiently make equivalence decisions, to avoid unnecessary delays that can disrupt cross-border investment activities. An effective and efficient equivalence determination process will help promote investment in EU capital markets by third country investors by removing a significant

potential barrier to cross-border investment activity. We encourage the Commission to continue its work in developing such a process for equivalence determinations.

Research Payments

As discussed in more detail in the MFA-AIMA December 20, 2016 comment letter to the UK Financial Conduct Authority[5] and the MFA-AIMA October 28, 2016 letter to the French Autorité des Marchés Financiers,[6] we continue to be concerned about the cross-border implications of MiFID II requirements on research payments, particularly when it comes to investment managers' (including those EU-based affiliates of U.S. asset managers that are subject to the MiFID II requirements) relationships with US broker-dealers. In particular, we remain concerned about the potential for those requirements to limit the availability of research to and create substantial operational challenges for EU investment managers acting on behalf of investors, particularly those acting on a cross-border basis with U.S. entities. Limiting the availability of research to investment managers will adversely affect investment in EU companies, including EU SMEs, as investors will be less likely to invest in companies if they do not have access to adequate research.

Unlike the approach taken in MiFID II, it is long-standing practice in the U.S. for broker-dealers who provide investment research to investment managers to be remunerated through "soft dollar" arrangements structured in a way that complies with Section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act"). This provides a safe harbor that protects an investment manager from liability, as long as the manager determined in good faith that the amount of the commission was reasonable in relation to the value of the brokerage and research services received. In turn, a U.S. broker-dealer who provides investment research and is compensated through a soft dollar arrangement would typically be excluded from the definition of investment adviser in the Investment Advisers Act of 1940 ("Advisers Act"), which specifically excludes from the definition of investment adviser a broker-dealer whose provision of investment advice is "solely incidental" to the conduct of its business as a broker-dealer and who receives no "special compensation" for providing such services.

We encourage EU regulators to work with U.S. regulators to identify solutions to address this important difference in the regulation of research payments. We further encourage EU regulators to seek to mitigate potential harmful effects on EU investors that would occur if U.S. research providers are not able to service them in a way that complies with MiFID II standards. To the extent that discrepancy in regulation is not addressed quickly by regulators, firms will need clear

[5] *Available at* https://www.managedfunds.org/wp-content/uploads/2016/12/MFA-AIMA-Response-to-FCA-CP-16-29.pdf.

[6] *Available at* https://www.managedfunds.org/wp-content/uploads/2016/10/Joint-AIMA-MFA-Response-to-AMF-CP-on-research-payments-by-investment-fir....pdf.

guidance from EU regulators to allow firms to establish operational structures that can achieve compliance with disparate sets of rules.

Overlapping Reporting Requirements and Data Security

MFA supports effective and cohesive reporting requirements that enable authorities to monitor the markets effectively for abusive behavior and for systemic risk. However, market participants continue to have difficulty analysing and implementing the overlapping reporting requirements under EMIR, the Regulation on Wholesale Energy Market Integrity and Transparency ("REMIT"), MiFID II and the Securities Financing Transactions Regulation ("SFTR"). Each of these reporting regimes applies in a slightly different way in terms of a number of important issues, including: (1) content; (2) which entity has the obligation to report; (3) the ability to delegate; (4) permitting single-sided reporting; and (5) backloading.[7]

In our view, all four reporting regimes should be harmonized to the greatest extent possible, to reduce the operational burden for market participants. We also continue to encourage the Commission to adopt single-sided reporting across all four regimes. A single-sided reporting framework would be beneficial to both transaction counterparties and their regulators, given that it would eliminate the problems associated with ensuring that the data in transaction reports matches. Reducing the unnecessary regulatory uncertainty and operational burdens that result from the different reporting obligations would be a valuable improvement to market participants that invest across EU capital markets, while continuing to provide European regulators with the information they need to fulfill their obligations. Importantly, harmonized reporting will better facilitate regulatory review and analysis of the reported information as regulators will better be able to compare data provided on various reports.

Of even greater importance is the need for regulators to protect the confidentiality of proprietary and other sensitive information reported by market participants, particularly in light of the vast amounts of such information that regulated entities are required to report. At the same time that the amount of information being reported to regulators has increased, information security and cyber intrusion/theft have become among the greatest threats to government institutions, private companies, and to the global economy. The public and private-sectors alike have become more sensitive to the risk of cyber espionage and the real potential that in the wrong hands, sensitive registrant information could damage capital markets.

In light of these increasing risks, we believe it is critical that specific confidentiality protections be included within legislation and regulation that requires reporting of sensitive, confidential information from market participants. For example, we believe the confidentiality safeguards set out in Article 76 of MiFID II should incorporate specific references to data security and a specific confidentiality obligation for trading venues, as a result of their role in collecting position reports under Article 58 of MiFID II, also should be incorporated. We further believe that regulators tasked with collecting sensitive and confidential information should establish robust procedures and protocols designed to protect such information from inadvertent disclosure. MFA members have significant experience in dealing with the protection of their own sensitive information from cyber

[7] *See,* MFA's January 2016 comment letter on the Commission's Call for Evidence for further discussion on these issues.

and other similar risks and we stand ready to work with the Commission and other regulators in developing strong protections for confidential information.

Reporting of net short positions

MFA members are significant participants in EU primary and secondary stock and bond markets, as well as OTC and exchange traded derivative markets. They typically exercise the flexibility to take both long and short positions over various timeframes according to the particular investment strategy being pursued and the particular financial instrument being traded, undertaking intense fundamental and technical analysis to deduce what the fair price of an instrument should be. To this end, the ability to enter short positions is vital to the efficient pricing mechanisms of secondary markets - such that the true value of an instrument is reflected in its price as quickly as possible. This efficiency promotes confidence in secondary markets, which in turn encourages investors to participate in primary market issues and improves access to financing for corporate and sovereign issuers and the broader real economy.

Article 5 of the Short Selling Regulation (the "SSR") requires legal and natural persons to notify the details of their significant net short positions in shares that are admitted to trading on an EU trading venue to the relevant national competent authority ("NCA") on each occasion that their position exceeds or falls below 0.2% of the issued share capital of an issuer, and every 0.1% above this threshold. Article 6 contains a public notification obligation for net short positions in shares exceeding 0.5% of issued share capital. Article 7 of the SSR contains the equivalent obligation for significant net short positions in sovereign debt, with notifications at either 0.1% or 0.5% of outstanding issued debt, depending upon the amount issued. However, our members have continued to experience significant difficulties in seeking to comply with these obligations, particularly in relation to reporting net short positions in shares.

Obtaining accurate data about the current issued share capital of each issuer is particularly challenging for MFA members.[8] While asset managers make efforts to obtain accurate and up-to-date information upon which to base their significant net short position calculations, there is currently no centralised source of issued share capital data, with managers and other market participants typically left to try to obtain the relevant information and to bear sole responsibility for any errors in that data.

Currently, MFA members use a combination of regulatory data feeds, trading venue data and data from issuers themselves to find out total issued share capital. However, the figures given to them by each source often do not match up, often due to differences in how quickly data is updated. Such inconsistency leads to uncertainty, delay and regulatory risk being incurred by a market participant that may make an erroneous notification, or fail to notify at all, and thus incur NCA enforcement penalties.

A key problem is that there is currently no obligation on issuers to provide an 'issued share capital' figure for the purposes of the SSR – in contrast, the Transparency Directive requires that issuers

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[8] *See*, MFA-AIMA October 26, 2016 letter to the European Commission, *available at* https://www.managedfunds.org/wp-content/uploads/2016/10/Joint-AIMA-MFA-Letter-to-the-European-Commission-on-SSR-in-the-context-o...-1.pdf, for a more detailed discussion on concerns with the SSR.

publish the total number of voting rights and capital in respect of each class of share which it issues, for purposes of notifying /reporting major shareholdings. As there is no requirement on issuers to regularly publish their 'total issued share capital', market participants are not able to obtain reliable and accurate information from issuers. 'Issued share capital' for SSR purposes includes (a) all share classes; and (b) treasury shares, but such information is not systematically reported; accordingly it can be impossible to know if all share classes are being captured, how up to date this information is, and whether any shares have been subsequently cancelled.

MFA members believe strongly that the solution is for the SSR to require that issuers provide the requisite issued share capital data and that ESMA should assemble, maintain and publish a single reliable data source for this data. If a centralised data source is not created, we would recommend as an alternative that the preamble of SSR be amended to clarify that compliance with Articles 5-8 of SSR is on a reasonable efforts basis and that a participant will be deemed in compliance with the rules as long as they have acted on a reasonable basis by using an accredited data source to make the net short position calculation. Even if amendments to the SSR are not introduced, we would urge the Commission to support the introduction of ESMA guidance that checking an established data source is sufficient for the purposes of the SSR significant net short position calculation in shares.

Our members also experience fundamental problems under the SSR of identifying which shares and sovereign debt instruments are actually in scope of the SSR, which is likely only to increase for sovereign debt upon the introduction of MiFID II in 2018. The SSR notification rules apply to all shares and sovereign debt instruments admitted to trading on an EU trading venue, including both regulated markets and multilateral trading facilities. The rules will also apply to sovereign debt traded on an 'organised trading facility' as of 2018 when MiFID II enters into effect. However, there is currently no reliable list of in-scope share and sovereign debt instruments maintained at EU level.

MFA members are concerned that the absence of a reliable centralised list for SSR results in unnecessary operational duplications, inefficiencies and regulatory risk. It is current market practice for each market participant to undertake its own process to check every EU trading venue, consulting various sources in order to reach a sufficient degree of satisfaction. This is both time consuming and expensive.

There are already certain centralised EU resources presently available in relation to other legislative measures, for example, the ESMA list of shares admitted to trading on a regulated market under MiFID implementing Regulation No 1287/2006, as well as the list under Article 4 of the Market Abuse Regulation ("MAR") of financial instruments admitted to trading on a trading venue or for which a request for admission to trading has been made (when the list becomes available upon the implementation of MiFID II on January 3, 2018). However, these lists do not match the scope of SSR, with the former list too narrow and the latter MAR list too broad.

While the Commission has already identified some areas relating to short selling reporting that it is working on (notably a single reporting platform on short-selling),[9] we strongly recommend that the

[9] *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions - Call for Evidence - EU regulatory framework for financial services*, November 23, 2016, *available at* http://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:52016DC0855.

SSR be amended to introduce a specialized publicly accessible ESMA list of shares and sovereign debt admitted to trading on a trading venue and against which market participants may check their short positions. We believe that such a list would be beneficial to both market participants and regulators through reduced operational and supervisory costs respectively.

Ensuring that market participants have access to accurate data to assist them in determining their reporting obligations under the SSR will help improve the accuracy and consistency of reporting under the SSR. More accurate and consistent reporting will make the information collected by regulators more useful in fulfilling their oversight responsibilities.