Green Paper: Building a Capital Markets Union

Response from The Financial Reporting Council

Introduction

The Financial Reporting Council (FRC) is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

The FRC believes that the issues raised in the Green Paper are important to the future of the European economy. Europe must both make its own market attractive to long term capital inward investment and seek to develop and nurture its own pools of long-term capital, if it is to provide the investment needed for sustained economic growth.

Business and investors should have a choice between different forms of capital. In policy terms this means ensuring EU capital markets are healthy, not favouring one above the other. The objective should be to increase the total available capital, not just move existing capital around. While the FRC welcomes in principle the proposals in the Green Paper to lower barriers to access and cross-border investment, and to remove restrictions on investment decisions, we would caution against attempts artificially to direct how investors choose to invest their capital.

In this context, it is important to recognise the contribution of equity markets. Equity markets play an important role in absorbing risk and reducing economic shocks and can serve relatively small innovative companies to raise finance and to grow. Measures to strengthen bond markets or investment in infrastructure, for example, should be in addition to measures to enable equity markets to operate more effectively, and not at the expense of those markets. Levelling the playing field across security classes is desirable. For example, consideration might be given to addressing differential tax treatment.

The FRC welcomes the statement from the Commission that “legislation might not always be the appropriate policy response”. In our experience, non-legislative approaches such as “comply or explain” reporting by companies and investors and the work of the Financial Reporting Lab which brings together companies and investors to resolve reporting problems, can be extremely effective in improving transparency, supporting decision making and contributing to lower costs of capital.

For this reason, the FRC supports the principles set out by the UK Government in its response to the Green Paper. These are: that any initiatives should clearly contribute to growth and competitiveness in the EU; that they should be assessed and prioritised on the basis of impact and feasibility; and that the Commission should require a high burden of proof to justify the creation of new market infrastructures or institutional change.

These same tests should be applied to existing EU requirements, and any that create unjustified barriers to investment or market access should be revised or removed. The FRC welcomes the Commission's decision to review the Prospectus Directive, and endorses the list of priority issues to be considered set out in the UK Financial Conduct Authority's response to that consultation.

Specific answers

Our answers to the specific questions in which we have a direct interest are set out below

<u>Question 8</u>: Is there value in developing a common EU level accounting standard for small and medium-sized companies listed on MTFs? Should such a standard become a feature of SME growth markets? If so, under which conditions?

The FRC is not persuaded that the need for new EU wide accounting standards or credit reporting requirements for unlisted SMEs has been demonstrated. If there is clear evidence to suggest that such an accounting standard would enable such entities to attract more cross-border investment, we suggest that the Commission seek to use established standards as a base. Investors place a value on comparability. Consideration could be given to using an IFRS recognition and measurement framework with reduced disclosures (an "IFRS minus" basis). Alternatively making the IFRS for SMEs available for use in the EU with modifications as appropriate (an "IFRS for SMEs plus" basis) may provide a proportionate solution.

We have incorporated both bases into UK GAAP. We have developed a new national accounting standard for those entities that do not apply full IFRS. We have used the IFRS for SMEs as the starting point and made modifications to ensure that the standard is suitable for a range of entities as well as being consistent with the law. For entities in a group which prepares consolidated accounts on an IFRS basis when preparing their individual company accounts we have introduced a separate standard which allows them to apply IFRS policies but with reduced disclosures.

We have recently undertaken a project to consider the quality of reporting by such companies (including those on the AIM growth market as well as those listed on the Main Market of the London Stock Exchange), the full results of which will be published in June. One of the questions considered as part of the project was whether the reporting regime, and in particular the requirement to report under IFRS, is appropriate for smaller listed companies or whether there is any appetite for a less complex accounting framework such as UK GAAP.

The overwhelming response we have received is that IFRS recognition and measurement criteria provide the appropriate framework for all listed companies as it ensures consistency and comparability. However the volume of required disclosures might be reviewed, some of which is often of little interest to investors. The Capital Markets Union provides an opportunity to develop a differentiated disclosure framework for smaller listed companies, similar to the approach adopted in UK GAAP.

<u>Question 25</u>: Do you think that the powers of the ESAs to ensure consistent supervision are sufficient? What additional measures relating to EU level supervision would materially contribute to developing a Capital Markets Union?

The FRC believes that the ESAs' role in the development of the CMU should be to coordinate the activities of national competent authorities and fostering agreement between these authorities. Hence, by making better use of its current powers and responsibilities as a facilitator at EU level, the ESA's could be better used as a platform for authorities to

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exchange information and best practices. This would improve consistent supervision across the EU, in line with the original rationale for establishing the ESAs. The current powers of the ESAs are sufficient for them to carry out this role in the framework of the CMU. The focus should be on them fulfilling their current roles and mandates rather than extending their responsibilities.

In carrying out their current mandates, it is important that the ESAs are alert to any unintended consequences of their actions which may impact on SMEs seeking to raise capital.

<u>Question 28</u>: What are the main obstacles to integrated capital markets arising from company law, including corporate governance? Are there targeted measures which could contribute to overcoming them?

As the European Commission has already recognised by its proposed revisions to the Shareholder Rights Directive, the difficulties faced by investors wishing to exercise their voting and other rights, and the short-term focus of some of those investors, are obstacles to integrated and sustainable capital markets.

The FRC supports the aims of the Shareholder Rights Directive as it sees investor engagement and effective stewardship as instrumental in ensuring long term investment and promoting the long term success of companies. The FRC encourages increased transparency from investors, specifically on how they engage with the companies in which they invest. In the UK this is encouraged through the Stewardship Code, for which the FRC is responsible and which has close to 300 signatories.

Experience in the UK is that the “comply or explain” approach to reporting by investors has been key to encouraging better stewardship and assisting clients to discuss with their asset managers how their investment approach is in the best interests of the client, while avoiding the box-ticking that may result under mandatory reporting. The FRC therefore believes that this approach should be adopted in the Shareholder Rights Directive, consistent with the Commission’s position on reporting by companies on corporate governance as set out in its 2014 Recommendation.

<u>Question 31</u>: 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 digitalisation of information and the use of new technology may offer opportunities to reconsider the form, structure and content of the annual report to provide users more timely access to the information they want in a form that best suits their individual needs. For example, some analysts want detailed financial statement disclosures for the preparation of their analytical models, whilst other investors concentrate on the narrative of the business performance and its strategy and want financial statements that are more easily reconciled with the narrative and not obscured through disclosure overload.

The FRC’s Financial Reporting Lab – in which investors and companies can come together to develop pragmatic solutions to reporting needs - has recently undertaken a project considering how UK companies have used digital media to report to market participants.

The project identified that both retail shareholders and institutional investors use multiple sources of information, such as presentations and preliminary announcements produced by companies, in addition to the annual report and accounts. The project also found that

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shareholders use PDF annual reports in a sophisticated way, reflecting that a PDF embodies a combination of the attributes of paper and digital documents. The full report can be found at:

https://www.frc.org.uk/Our-Work/Codes-Standards/Our-Work-Codes-Standards-Financial-Reporting-Lab/Published-project-reports.aspx

While the project was focused on the UK, we would expect the findings of this work to also apply to other EU shareholders. In a second project focusing on the future of digital reporting, to be initiated later this year, the Lab will expand its work with companies, investors and other stakeholders to build on the most helpful characteristics of digital reporting identified in this initial project.

More broadly, the FRC believes that the "Lab" concept could usefully be adopted across Europe to promote good practice, innovation and more effective communication in corporate reporting. Its success in the UK in bringing together companies and investors to resolve reporting issues marks it out as a good example of the sort of market-based solutions the Commission wishes to encourage.

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May 2015

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