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OF YOUNG LAWYERS

Finance for your clients: Harmonisation of Capital Markets

Commission(s) in charge of the Session/Workshop:

BANKING, FINANCE AND CAPITAL MARKETS

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National Report of United Kingdom

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1. Briefly describe the level of integration of the capital markets at the infra-national, national and supra-national levels.

In the UK, all legislation is enacted through Acts of Parliament and other subordinate measures, each of which applies to all parts of the UK. There is no concept of federal, state or regional laws regarding capital markets in the UK. The only “supra-national” laws would be European Directives and Regulations. EU Directives are typically implemented through Acts of Parliament and EU Regulations have direct effect in UK law.

2. Which measures have been adopted (or are foreseen) in your jurisdiction to support access to finance by small and medium sized enterprises (SMEs)? Measures might include (i) supporting venture capital and equity financing; (ii) lowering information barriers; (iii) enhancing access to public markets; (iv) supporting equity financing; (v) facilitating infrastructure investment; and/or (vi) promoting innovative forms of corporate financing.

A recent report by the University of Cambridge and Nesta, *Pushing Boundaries: The 2015 UK Alternative Finance Industry Report* (February 2016), estimated that the UK’s alternative finance market grew to £3.2bn in 2015. This represents an 84% increase from 2014, which itself saw a 161% increase on 2013’s figures. The report estimates the market will surpass the £5bn mark in 2016. But what do these figures mean? The UK alternative finance sector is booming. And is showing no sign of letting up.

Most of the alternative finance models that make up the report’s data directly support SMEs. The largest component of the UK’s alternative finance industry is peer-to-peer business lending, which accounted for £1,490m volume in 2015. Peer-to-peer (P2P) lending is where a crowd of lenders make loans to a business or a consumer. Since many banks stopped lending to SMEs and start-up companies during the financial crisis, P2P lending quickly boomed in popularity and continues to grow exponentially. Even institutional investors are making loans through P2P platforms and investing in funds that provide liquidity to these platforms. This innovative form of financing has seen the traditional bank-led funding model change dramatically and many people suspect the market will not return to the pre-crisis days.

Another fast-growing alternative finance industry in the UK is equity-based crowdfunding. SMEs can pitch to a crowd of investors in order to raise equity financing for their businesses. The equity crowdfunding model saw volumes reach £332m in 2015, an increase of 295% year-on-year. Equity crowdfunding amounted to 15.6% of total UK seed and venture-stage equity investment in 2015.

This represents a significant share of the industry for a model that has only become prevalent over the last three to four years.

Due to the growth of these industries, the UK regulator, the Financial Conduct Authority began regulating the sectors more closely in 2014. Many of these platforms are looking to Europe for expansion and it would be welcomed if the European Commission (the Commission) was able to publish a Regulation promoting the use of these alternative finance models throughout Europe without stifling the industry. However, the Commission is currently considering changes to the EU Prospectus Directive that could dramatically reduce this market. It is hoped that the Commission will see the benefits of this alternative financing model and its popularity and so avoid over-regulating the sector.

Aside from crowdfunding and P2P lending, there are a large number of other schemes in the UK which are specifically aimed at helping SMEs access finance. The Government has introduced loan guarantees for SMEs who lack the security or track record for commercial loans, and start up loans to young people (18 to 30) to start a company. The Business Finance Partnership increases supply of capital through non-bank channels for small businesses, such as P2P platforms, supply chain finance and mezzanine finance for businesses with a turnover below £75m.

To support venture capital and equity finance further there is the UK Innovation Investment Fund, which is a venture capital fund of funds to invest in technology-based businesses in sectors strategically important to the UK, and the Enterprise Capital Fund, which is a public-private venture capital fund that provides equity finance to early stage companies. There are also various tax relief schemes available to SMEs and their investors, for example the Enterprise Investment Scheme.

Regarding future measures, a consultation is currently taking place on a new strategy for the UK's digital communications infrastructure to ensure it remains a world-class digital nation, equipped to harness the emergence of new sectors like FinTech.

Then there are EU initiatives that the UK has implemented, such as European Venture Capital Funds (EuVEECAs), European Social Entrepreneurship Funds (EuSEFs) and European Long Term Investment Funds (ELTIFs). We expect these fund models to emerge over the next few years.

- 3. Has your jurisdiction adopted (or are there any trends indicating that it may do so in the future) any measures to remove barriers to cross-border investment? Measures could include (i) improving market infrastructure; (ii) fostering convergence of insolvency proceedings; (iii) removing cross-border tax barriers; (iv) strengthening supervisory convergence.**

The UK is very much open to cross-border investment and has been for some time. The UK's rules generally tend to be more favourable to non-EU or non-UK investors than is the case in other European Member States (Member States). However, more could be done to promote a true capital markets union.

In addition, the Enterprise Bill aims to ensure that Britain is amongst the best places in Europe to start and grow a business and that people who work hard have the opportunity to succeed. It seeks to cut red tape for business, encourage investment in skills, and make it easier for small firms to resolve payment disputes by setting up a small business commissioner.

- 4. Have specific measures been adopted (or foreseen) to increase choice and competition in cross-border retail financial services and/or insurance?**

Aside from the familiar passporting procedures under much of the European financial services legislation, there have not been any specific UK measures seeking to increase choice and competition on a cross-border basis.

On the European level, though, we expect there will be an increased policy focus in order to try to harmonise regulation across the EU, making it easier for citizens to invest across borders. At present, attracting cross-border retail investment is overly complex, incoherent and inconsistent across Member States. This is an area ripe for integration in an even closer capital markets union. However, the challenges with doing this are immense and it will take time to unpick the issues and truly realise a cross-border investment platform.

5. **Capital markets harmonisation aims to facilitate companies' access to finance, particularly for SMEs by promoting more diversified funding channels that are complementary to bank financing. Is non-bank financing significant in your country? Please consider the role of private equity, venture capital, alternative finance, loan-originating funds, etc.**

As noted in response to question 2, the UK's alternative finance industry is growing rapidly. This non-bank lending market is continually developing and the proliferation of non-bank lenders been one of the most striking developments since the financial crisis began. Many non-bank lenders have entered the mid-market with the global search for yield continuing. More than 60% of businesses in the mid-market already use non-bank lending as a source of finance.

6. **While loans traditionally represent the bulk of the banking assets, most financial entities also invest in capital markets. Do financial institutions in your jurisdiction invest highly in the capital markets? Are bonds and equity investments a significant proportion of the assets of financial institutions in your jurisdiction?**

Yes, many if not all of the traditional bank lenders also have investment banking arms that play a significant role in capital markets. This has led to calls in the UK to separate such bank's retail banking operations from their more risky investment banking operations.

7. **Harmonisation requires standardisation, particularly in terms of credit information. Is SME credit information easily available in your jurisdiction? Is your jurisdiction adopting any measures to boost availability and standardisation of SME credit information at the national and supra-national levels?**

In the UK there is growing momentum behind proposals to mandate the sharing of SMEs credit data amongst potential lenders more widely than is currently the case, in order to facilitate greater competition among lenders. The British Business Bank's aim is to increase the supply of credit to SMEs as well as providing business advice services.

The UK introduced the Small Business Enterprise and Employment Act 2015 which imposed a duty on designated banks to provide information about their SME customers to designated credit reference agencies (CRAs), and a duty, in turn, on the CRAs to provide credit information about SME businesses to finance providers. The intention was to ensure that an SME could still access alternative finance providers if traditional bank lenders refused to lend to the SME.

- 8. Is there any recent or proposed legislation in your jurisdiction aimed to establish a framework for simple, transparent and standardised securitisation? Examples might include measures (i) to simplify prospectus requirements; (ii) to increase/decrease the information required to be provided to investors before making an investment decision; or (iii) to reduce barriers for smaller firms to access capital markets. If there have been no recent developments, please describe the current situation of securitisation in your jurisdiction.**

Until mid-2007 the securitisation market was both active and well developed in the UK. Since then the securitisation market has been severely affected by turbulence in financial markets and investors have been extremely cautious. Despite this the securitisation market in England and Wales remains one of the largest and most developed securitisation markets in Europe. However, the overall issuance of securitised products remains at about a third of pre-crisis levels in Europe and the securitisation market in England and Wales reflects this overall diminution of activity.

The UK is closely following the European Commission's proposed Regulation on simple, transparent and standardised securitisations. We are also seeing simple securitisations creep into the alternative finance space. As such, we expect this market to gather momentum again in the near future.

- 9. In your experience as a banking/capital markets lawyer, have you detected in your jurisdiction any unnecessary regulatory burdens, interactions, inconsistencies and/or rules that have unintended consequences which threaten the ability of the companies to finance themselves?**

We deal most frequently with EU financial services passporting regimes. While these regimes are supposed to make access to the single market easier, there are a number of barriers to a truly single market. For example, the directives allow Member States to impose additional requirements (or "gold plate" the requirements). This makes it difficult for firms to know whether they can freely operate cross border under a true capital markets union. Firms will often have to seek local legal advice in each jurisdiction and find solutions to local barriers to entry. This often results in overly complex structuring or some Member States being beyond limits.

Furthermore, the European Commission relies heavily on the European Supervisory Authorities (ESAs) to publish guidance on the interpretation of European law. This guidance is not always clear or complete and leads to different interpretations in Member States. This can lead to regulatory arbitrage. The ESAs

do a brilliant job in the face of ever increasing workloads, but I would argue the Lamfalussy Process has not helped the capital markets union.

In my view, for a capital markets union that works effectively across borders, Europe should trust its Member States. Directives granting passporting rights should become Regulations, which expressly prohibit gold plating – similar to the EuSEF and EuVECA regimes. The Regulations should say that if a firm is authorised in one Member State and complies with local rules, it could conduct business on the same basis in other Member States, without additional concern for local laws. Europe is bound by the same consumer rights legislation, distance marketing legislation, privacy rules, financial services laws, anti-money laundering requirement and many more. Europe should have confidence in its own legislation and allow firms to operate within a capital markets union that really does not have any additional barriers to the freedom of movement or the freedom to provide services.

Hopefully we see the emergence of a closer capital markets union in the near future – assuming the UK stays in the EU, which is a distraction for another day!

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