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POSITION PAPER
Proposed Regulation:
"European Long-term Investment Funds" (ELTIFs)

The Federation of European Securities Exchanges (FESE) represents 41 exchanges in equities, bonds, derivatives and commodities through 21 full members from 30 countries, as well as 2 Observer Members. FESE is a keen defender of the Internal Market and many of its members have become multi-jurisdictional exchanges, providing market access across multiple investor communities. FESE represents the operators of public Regulated Markets. Regulated Markets provide both institutional and retail investors with transparent and neutral price-formation. Securities admitted to trading on our markets have to comply with stringent initial and ongoing disclosure requirements and accounting and auditing standards imposed by EU laws. As of August 2013, FESE members had up to 8,958 companies listed on their markets contributing towards the European integration and providing broad and liquid access to Europe's capital markets. Many of our members also organise specialised markets that allow small and medium sized companies across Europe to access the capital markets; 1,472 companies were listed in these specialised markets/segments in equity, increasing choice for investors and issuers.

I. Overview of Our position on the ELTIF Proposal

We support the objectives of the newly proposed European Long-term Investment Funds framework,[1] namely, to boost the funds invested in long-term infrastructure projects and other long-term assets that will lead to a sustainable development of the European economy. If designed well, such a framework would have a clearly positive impact on the European economy. We also expressly agree that long-term assets are not limited to infrastructure investments and include more generally all investments with a long-term positive impact on the sustainable development of the economy.

Unfortunately, as currently designed, the draft **Regulation will not achieve its purpose because its scope of eligible assets excludes any instrument listed on regulated venues. This means that thousands of companies issuing well-regulated, transparent instruments will be excluded from the benefit of a larger investor pool in their assets created by the ELTIF framework.**

Based on the Impact Assessment and the Proposal itself, it appears that the European Commission is using the delineation between listed and unlisted instruments as a proxy to distinguish between long-term assets and others (eg because unlisted instruments are deemed to require "patient" capital). In our view, this contradicts the characteristics of public capital markets and how they relate to the sustainable development of the economy. Whether or not an investment is long-term cannot be defined by whether it is listed or not. On the contrary, listing on a public market is an enabler of investment with a long-term perspective and of sustainable economic growth. Whether the issuer issues equity or bonds, the listing of these instruments brings transparency and certainty, and makes a product more attractive to investors – all of which facilitates growth opportunity for companies and benefits their investors. Moreover, public equity markets operate on the basis of "risk capital" – which means that the company gains the independence to undertake investments that it deems necessary with a long-term horizon, in transparency to investors, but without the obligation to make fixed payments. Hence, a big part of the type of investments that the ELTIF framework is designed to promote would be left out of the scope of the Regulation if the scope were to exclude listed instruments. In fact, any regulatory action that would discourage public market instruments would eventually damage long-term investment and sustainable development.

While our comments apply to companies of all sizes, the exclusion of smaller companies is particularly damaging to the objectives of the draft Regulation. As a simple matter of fact, **most of the SMEs that make long-term investments in infrastructure targeted by the ELTIF framework are *listed* SMEs.** They

[1] http://ec.europa.eu/internal_market/investment/long-term/index_en.htm

make significant long-term investments in transportation, infrastructure and energy which require funding. Moreover, as correctly pointed out in the Regulation, SMEs not investing specifically in infrastructure would also benefit from such a framework, and in turn boost long-term growth. Overall, there are about **9,200 listed SMEs** on FESE members' markets which would be left out of this critical investment pool to be created by this framework. Excluding listed SMEs from the scope will prevent the Regulation from achieving **its goal of boosting institutional investor interest and ability to invest in long-term assets that require 'patience' as referred to in the proposal**.

Furthermore, if one of the objectives of the proposal is to inject capital **into illiquid assets** in the EU, it should be considered that listed as well as unlisted assets would benefit from this framework. The draft Regulation refers to all assets on regulated venues as liquid, and all others as illiquid. This is too crude a definition. In fact, liquidity is concentrated among the blue-chips in Europe, with only 13% of the listed companies accounting for 96% of turnover. Hence, **the great majority of the listed assets on regulated venues would actually benefit from an increased investor pool** such as the one created by ELTIFs. While institutional investors do invest, and trade, in the listed instruments below this top tier of turnover, and while regulatory frameworks such as UCITS do to some extent enable pan-European investment, we strongly believe that it would be in Europe's best interest to also include listed instruments in the new pan-European investor pools being created by ELTIFs. **In other words, investors should be able to use both the UCITS and the ELTIF frameworks to be able to invest in listed companies.**

As a result of these considerations, we believe that:

- First of all, any threshold differentiating between listed and unlisted instruments should be removed. There is no reason to limit investing in listed instruments to 30 percent of an ELTIF portfolio.
- Second, listed SMEs should be expressly in the scope of eligible investments. If a threshold of size were to be used to define an SME, we suggest a range between 500 million and 1 billion EUR, based on the difficulties reported by SMEs below these sizes when accessing capital markets.

These changes together will ensure that the ELTIF framework would boost investor demand at the initial and trading stages when an SME is accessing capital markets and that listed assets in general also benefit from these new investor funds.

Separately, we would like to stress that the ELTIF Regulation should be designed and implemented in such a way that it brings net value-added to the other initiatives or current regulation. With the introduction of AIFM, cross-border obstacles in relation to offerings to professional investors have been removed, while retail investors may be less interested in investment opportunities of this nature, in particular given the terms and alternatives being available (e.g. funds etc). The goal of the ELTIF framework should be to increase private sector investment in infrastructure projects, and not simply to replace or re-structure existing investment levels.

Below we provide our remarks on the following questions:

1. **Why should listed SMEs be added to the scope of eligible ELTIF investments?**
2. **How to include listed SMEs in the scope? - Our proposal**
3. **Impact of our Amendment on the EU economy**
4. **Other issues related to the ELTIF framework**

1. <u>Why should listed SMEs be added to the scope of eligible ELTIF investments?</u>

The current ELTIF proposal excludes all listed instruments from its scope, irrespective of how small the listed company might be, or the problems faced by the companies attracting private sector capital. However, separating listed SMEs from unlisted SMEs for the purposes of eligible ELTIF assets is an arbitrary distinction which goes against the objective of the Regulation. **Most of the SMEs that make long-term investments in infrastructure targeted by the ELTIF framework are *listed* SMEs.** They make significant long-term investments in transportation, infrastructure and energy which require funding. Moreover, as stated in the proposal, SMEs not investing in infrastructure are also direct contributors to long-term investment and sustainable development.

Moreover, when financing these investments, **listed SMEs face very significant obstacles that are <u>identical</u> to those faced by unlisted SMEs described in the Impact Assessment of the Regulation**. The fact that an SME is already listed does not mean that its financing problems have vanished. On the contrary, listed SMEs continue to face many obstacles in attracting private sector investors throughout their lifetime, for example in terms of illiquidity, which suppresses the interest from such investors and makes it more difficult for SMEs to list in the first place.

From the point of view of investor protection, adding listed SMEs to the scope would not increase, but in fact **reduce the risk profile of an ELTIF's portfolio,** since listed SMEs are subject to strict disclosure requirements.

Furthermore, limiting the scope to unlisted companies will **distort competition** among companies in those sectors. Discriminating against listed SMEs (and giving an unfair advantage to investments in unlisted SMEs) would further exacerbate existing trends that inhibit investment in listed SMEs. Including listed SMEs would eliminate this distortion.

The exclusion of listed SMEs was not analysed as an option in the Impact Assessment as seems to have been was assumed that an ELTIF framework at the EU level should have only unlisted companies within its scope. Had it been included, we believe that the benefits would have been overwhelming. Page 51 of the Impact Assessment discusses the impact of the regulation on SMEs without any consideration for listed SMEs. The analysis suggests that the authors essentially believe that listed SMEs cease to be in need of financing help. This is manifestly not true as shown by numerous research reports over the last few years, including the Commission's own SME Action Plan, which put a focus on encouraging SME listings through a variety of actions. Amending the ELTIF proposal in a way that allows more investors to invest in listed SMEs would complement these actions.

2. <u>How to include listed SMEs in the scope? - Our proposal:</u>

The scope of the Regulation is defined by Articles 9 (eligible investment assets), 10 (qualifying portfolio undertaking) and 12 (portfolio composition and diversification).

We recommend including all listed SMEs in the scope of the Regulation by amending these articles. **<u>All listed SMEs up to a limit (which could be set between 500 million and 1 billion euros market capitalisation), whether listed on an RM or MTF,</u>** should enjoy the benefits of the ELTIFs. This is because small to mid-cap companies start facing obstacles when attracting the interest of investors if they are below this range.[2]

[2] Despite the continued efforts of exchanges to meet the needs of companies of all sizes, the minimum market capitalisation at which a company can go public in practice has increased significantly due to long-term structural changes in European capital markets (such as the erosion of the local ecosystem of smaller underwriters and market makers). A recent European report by the Securities and Markets Stakeholder Group of the European Securities and Markets Authority reported severe difficulties for companies below 500 million Euro capitalisation, while other reports suggest that companies continue to face obstacles up to 1 billion Euro market capitalisation.

Moreover, Article 12 of the Commission proposal stipulates that at least 70% of invested funds would target eligible investment assets (hence a cap of 30% in other assets). We believe that this floor should be removed, with the effect that there is no maximum cap on the amount that can be invested in listed assets.

3. Impact of our Amendment on the EU economy

The inclusion of listed SMEs in the newly created ELTIF framework will encourage more private sector investors across the EU to invest in listed SMEs. This will not only increase the actual investment in IPOs of SMEs ("demand" side), but it will also reassure potential SMEs considering a listing by lowering the cost of capital due to increased investor demand ("supply" side).

More IPOs by SMEs is not only beneficial for the companies financed or the investors investing in them. IPOs of SMEs have great benefits for the companies as well as the broader economy – in the form of job growth, wealth creation, equitable distribution of wealth, greater productivity and innovation, higher savings, and financial and economic stability.

There is a strong need for urgent EU action to help SME listings. Europe is at a point where IPOs of all companies, but in particular those of smaller companies, must be encouraged. The world's public market funding for new companies is drying up, with disastrous consequences for economic recovery and growth. According to an alarming new report commissioned by the OECD,[i] the world is producing only a third of the IPOs it generated per year in the 1990s[ii]. While Asia is doing better than other regions, it is not enough to pull the world out of a widespread enterprise funding crisis. US stock markets have experienced 15 years of consecutive listing losses. European initial public offerings by new companies are among the worst hit, especially when compared with European GDPs. Over 2008-2012, only 6[iii] out of the 26 top IPO markets were from the EU, and they produced about as many IPOs as Australia and Canada put together. By contrast, Asian countries produced 7 times as many IPOs in the same period.[iv]

These figures pose a big threat for company growth worldwide and in Europe in particular. At a time of systemic bank deleveraging, companies cannot grow independently if they have no access to capital markets. Numeorus reports show that fewer IPOs also make it more difficult for venture capitalists to exit from their investments, thereby stifling innovation and productivity growth. Of course, promising enterprises continue to emerge in Europe and elsewhere. But as they grow, they are often integrated into bigger (often foreign) companies, or simply stop growing.

This in turn is damaging for economic growth. **The study commissioned by the OECD estimates that the US economy might have produced between 6 and 19 million more jobs over the last two decades if its IPOs had kept pace with GDP growth.**[v] This is consistent with another major study that showed that 92% of the new jobs created by companies come after becoming public.[vi] As the world's biggest economic bloc, Europe could greatly benefit from job growth on a similar scale. Moreover, company growth generates subsidiary beneficial activities, such as corporate headquarters, intellectual property, innovation, leadership, growth and wealth generation.

As important as economic growth is, we need IPOs for other reasons as well, related to no less valuable social benefits – notably **stability, sustainability and transparency**. Fewer IPOs means fewer dynamic companies benefitting from broad investor participation and less equitable wealth distribution among savers in the economy. When investors chase a shrinking pool of assets, there is less diversification, more systemic risks and greater instability, resulting in less saving possibilities for retirement and endangering the pension schemes of future generations. All of this is sure to undermine governments' efforts to make financial sectors safer, more resilient, and more equitable.

4. Other issues for re-consideration in the ELTIF proposal

More generally, we strongly caution against the assumption (implicitly included in the Commission's proposal) that **listed products are speculative or of a short-term nature.** Products listed on exchanges can and are often used to provide long-term financing.

We also support the use of derivatives for overall hedging purposes and not only for currency hedging.

Finally, the draft Regulation does not prescribe predetermined holding periods for investments in unlisted companies. It will be necessary to define **holding periods for eligible listed companies** as well as **explicit exit scenarios for ELTIF managers**. This is something for which policy makers will be required to work out the details – provided that listed companies are included in the framework as we propose. In this case, one could also design appropriate holding periods for unlisted instruments.

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[i] "Making Stock Markets Work to Support Economic Growth / Implications for Governments, Regulators, Stock Exchanges, Corporate Issuers and their Investors", David Weild, Edward Kim and Lisa Newport http://www.oecd-ilibrary.org/governance/making-stock-markets-work-to-support-economic-growth_5k43m4p6ccs3-en

[ii] Please see Exhibit 7 in Weild et al, which shows global and U.S. IPO trends from 1993 to 2012, as compiled by the OECD. The authors believe the OECD data to be « the most accurate numbers available », offering the following observations: « The global number of IPOs declined from **over 2 000 per year** in the early 1990s to less than **750** in 2012. And the IPO decline is widespread and not confined to U.S. markets and therefore, likely precipitated by the proliferation of computer-based trading and low- transaction-cost electronic markets. » (emphasis added)

[iii] Poland, UK, France, Italy, Spain, Germany. Two additional non-EU European countries (Norway and Turkey) were also in the top 26.

[iv] For further analysis on the world-wide IPO decline and possible reasons, please also see "Who Cares? Corporate Governance in Today's Equity Markets" http://www.oecd-ilibrary.org/governance/who-cares-corporate-governance-in-today-s-equity-markets_5k47zw5kdnmp-en by Mats Isaksson and Serdar Çelik.

[v] Weild et al, Exhibit 9.

[vi] Chart A : IPOs Finance Significant Job Creation, cited in Rebuilding the IPO On-Ramp Putting Emerging Companies and the Job Market Back on the Road to Growth, http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf
Original data comes from the Venture Impact 2007, 2008, 2009, & 2010 by IHS Global Insight; IPO Task Force August 2011 CEO Survey.