

**Response**  
**COM (2013) 150/2**  
**GREEN PAPER: LONG-TERM FINANCING OF THE EUROPEAN ECONOMY**  
**Interest Representative Register ID number: 71488206456-23**

**Our policy recommendations:**

- Public funding to trigger private investors to invest in SMEs should adopt a more comprehensive approach to address the failures at every stage of the spectrum, from research to venture capital to listed SMEs. The EU should establish a fund to co-invest in listed SMEs at the stage of subscription and at later stages to improve liquidity.
- The European Commission should avoid any new policies - such as the creation of an Organised Trading Facility - that would exacerbate the difficulties faced by SMEs when accessing local capital markets by eroding the local ecosystem of intermediaries further.
- The Commission should undertake a policy review to reduce the cost of accessing capital markets and to improve the incentives provided to investors when investing in SMEs.
- Existing taxation policy should be reviewed to remove any disincentives that work against equity markets. Any new tax policies such as the FTT - which would have a significant negative impact on financing via equity markets and SMEs in particular - should be re-considered.
- Future EU policy should further strengthen investor protection and safeguard investor confidence in markets.

**Introduction**

We find many **issues identified** in the Green Paper valuable (e.g. tax incentives, harmonisation of the covered bond market, securitisation, and the possible extension of the use of public funds to address market failures). However, before we provide answers to the detailed questions, we wish to provide our analysis on **the evolution of EU's capital markets as it relates to long-term financing**. It is in particular our intention to provide constructive input on an issue raised on page 12 of the Green Paper: *'Many also claim that the economy, businesses and investment projects need more equity, rather than more debt. (...) market windows for IPOs have become smaller than ever, limiting companies' access to capital and European stock exchanges increasingly play a role as providers of liquidity, rather than fresh capital. Overall, the cost of equity capital has remained high, while the cost of debt finance has fallen. This highlights the equity gap in Europe, which is likely to take time to address. These developments appear to have had a bigger impact on mid-caps.'*

As we shall explain in detail below, we believe that the phenomenon referred to in the Green Paper above – i.e. that **there is an emerging equity gap for companies** – is a central issue, and needs to be analysed in greater depth. In our view, this gap is directly the result of **the erosion of local ecosystems of capital market financing in Europe**. We believe that this problem has a direct effect on long-term financing. Therefore we recommend that the policy issues raised by this problem be added to any new policy proposals resulting from the Green Paper.

***1. The need for a re-think of EU policy on capital markets to encourage growth***

Exchanges have an intrinsic interest in the financing of long-term investment in the economy. Our member exchanges have long been located in every Member State of the EU, and have financed the needs of companies of all sizes through a wide range of instruments (equity, bonds and derivatives) for decades. They have allowed companies to grow and employ by having access to deep pools of liquidity at critical stages of their development. Companies and investors both benefit from the creation of

transparent and liquid pools of capital through the use of all types of listed instruments. Moreover, exchange-traded derivatives are a valuable hedging instrument for the real economy, allowing companies and investors to manage risks and improving the safety of markets overall.

The EU has taken many important steps over the last few decades to integrate its financial sector and, in the aftermath of the financial crisis, to address the problems created by the crisis and to improve the safety of the sector. Now is the time to take a comprehensive look at the ability of the EU financial sector to deliver on its most important objective: to finance sustainable growth for the European economy.

We wish to stress that the EU must take special steps to increase the ability of capital markets to finance the long-term needs of the economy, because EU capital markets are much smaller than those of the US (for example) and banks need to deleverage. EU capital markets have an important potential to finance long-term investment if the right steps are taken to unleash their potential.

Exchanges can help the economy get back into a path of sustainable growth. To achieve this goal, we believe it is absolutely necessary to take stock of the evolution of EU capital markets over the last decade. A fundamental re-think is needed when it comes to identifying the future agenda for capital market growth.

## ***II. Identifying the Problem: Disappearing local ecosystems***

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The EU has done a lot over the last 10 years to create a deep, liquid, efficient integrated equity market, the objectives of which FESE members have fully supported. However, many of these reforms did not result in better outcomes for investors and companies interested in the long-term.

As a result, EU capital markets have become more efficient and competitive, focusing more on the trading of blue chips, i.e. the largest traded companies – at the expense of the needs of the much more numerous but smaller listed companies that play a critical role in growth and employment in Europe.

Hence, while trading venues specialised in trading blue chips (and with no ability or ambition for helping companies raise capital) have multiplied, actors active in the local capital markets – brokers, analysts, advisors, exchange operators – have suffered from the impact of diminishing liquidity at the local level. These changes have made it more difficult not only for the local capital markets to sustain existing smaller listed companies, but for the great majority of unlisted companies to consider accessing capital markets. Hence, integration has inadvertently undermined the less profitable, but socially valuable functions of capital markets, i.e. the financing of smaller companies at the local level. This development has manifested itself in the lack of the local system of brokers, analysts, advisers and market makers to bring them to the market and keep their stock/bonds liquid once listed.

According to recent figures, 13% of Europe's largest companies (i.e. which have a market capitalisation of over 1 billion EUR) account for 93% of Europe's market capitalisation, 85% of the number of trades and 96% of turnover. This is further illustrated by the fact that the great majority of new trading venues only offer trading in blue-chips.

This problem is also confirmed by the findings of a recent report by the ESMA SMSMG<sup>1</sup>, which states that *'MiFID has also heightened the pressures faced by small and medium sized intermediaries with respect to their cost base. The latter were traditionally providing research activities and listing services to the SME sector. A decrease in the amount of research available for SMEs has negatively affected the liquidity of these shares on public markets'*.

The lack of liquidity also has an impact on the ability to provide analyst coverage or SME broker services and ultimately impacts efficient price discovery.

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<sup>1</sup> Securities and Markets Stakeholder Group – Report on Helping Small and Medium Sized Companies Access Funding: An own-initiative report by the Securities Markets Stakeholder Group to the ESMA Board of Supervisors.

Contrary to the prior policy expectations, the newly integrated market did not step in to fill in the gap created at the local level; this is because the drive for greater scale has an international focus and has neglected the need for the companies to access the capital markets at the local level.

It is important to note that these trends are not the result of any specific decisions taken by the stock exchanges (or other market participants). Stock exchanges have done their best to continue to facilitate capital raising by companies of all sizes despite the obstacles created by the policy environment and structural changes in the market. Today, European exchanges represented by FESE list more than 9,000 companies, of which 7,900 are Midcaps/SMEs. In addition to the Midcaps/SMEs listed on RMs, European exchanges also give such companies access to capital markets through the dedicated MTFs they have set up. There are 13 such MTFs operated by FESE members today, which list more than 1300 Midcaps/SMEs. Please see Chart 1 for all the listing MTFs operated by our members.

**Chart 1: Financing for SMEs via MTFs operated by FESE Members**



For the efforts of the listing venues to bear fruit, however, the local ecosystem must be there to help companies access markets, the companies themselves must want to list and investors must be willing to invest in SMEs.

**III. Why it matters: Impact on IPOs & Economic Growth**

As mentioned earlier, the Green Paper does make a reference to the emerging equity gap in Europe on page 12. However, we believe it is necessary to go into further detail to understand the reasons and impact of these trends so that the EU has a chance to change the direction of the evolution of European capital markets. In the earlier section, we analysed the reasons. Here, we will turn to the impact of these trends on the economy.

The trends indeed show that European capital markets are doing well in terms of turnover but the provision of fresh capital to new companies is more limited. By most measures, the pipeline of new companies listing is drying up, with devastating consequences for the rest of the economy.

Chart 2 shows that the number of IPOs on European exchanges represented by FESE has had a decline since 2007 and has not recovered (unlike some other parts of the financial system).

**Chart 2: Number of IPOs on European Exchanges**

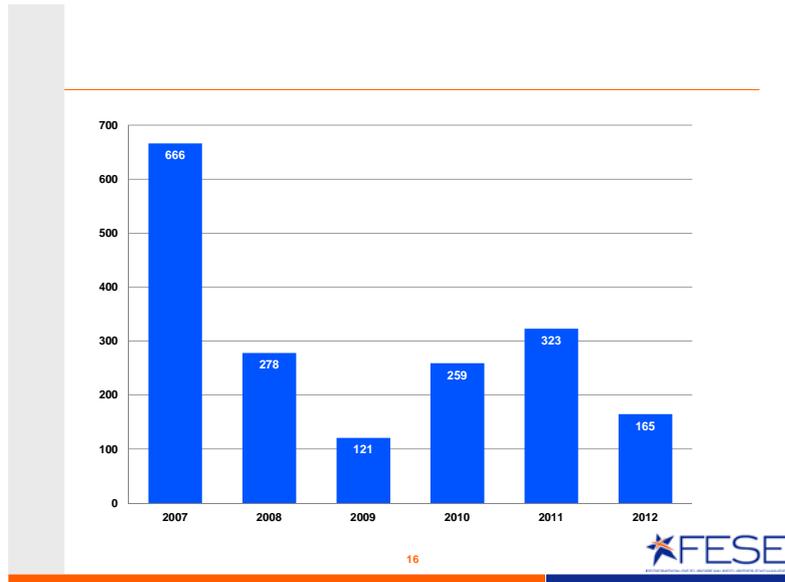
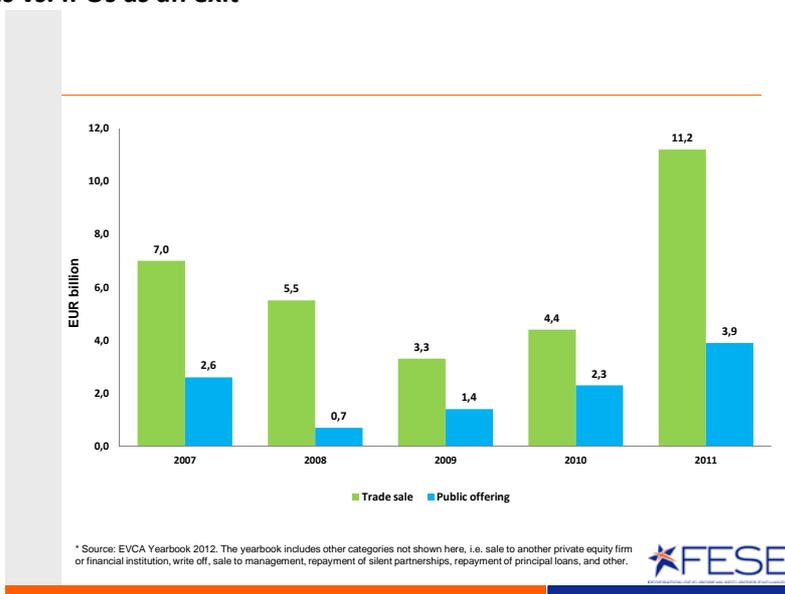


Chart 3 shows the impact of these trends on ‘exits’ by venture capital funds (i.e. when they are ready to end their investments in the small dynamic companies they have financed). While trade sales (i.e. a company being sold to a bigger competitor, foreign or domestic) are increasing, IPOs are decreasing in terms of being a viable exit for venture capital funds. This is not without an impact on the European economy. Compared to other types of exits, when a private company becomes public, the broader economy gains significantly in terms of retaining the entrepreneurial innovation, revenues, taxes, and (often) jobs. While trade sales must continue to exist as an alternative, their role should not be unduly enhanced because of undue difficulties in exiting via public markets.

**Chart 3: Trade sales vs. IPOs as an exit**



More broadly, these dramatic changes in terms of the capital market financing of smaller companies have a direct impact on economic growth. A recent study by the ESSEC Business School and GE Capital, covering France, Germany, Italy and the UK for the period of 2007 to 2010, shows that Small and Mid

Sized Companies created jobs 280,000 new jobs. At the same time, large companies in Europe *lost* almost 1.5 million jobs.<sup>2</sup>

As the Green Paper also rightly acknowledges on page 3, *'an important question is whether Europe's historically heavy dependence on bank intermediation in financing long-term investment will give way to a more diversified system with significantly higher shares of direct capital market financing and greater involvement of institutional investors and alternative financial markets. There is no doubt that, given their risk management skills and local knowledge of and relationships with enterprises, banks will continue to be important players in channelling long-term investment. However, it is uncertain whether commercial banks will resume their practice of holding long-term assets to maturity at previous levels.'*

The financing needs of SMEs deserve particular attention as they have the potential to underpin long-term growth. They need access to bank as well as non-bank financing. Today, many SMEs in the EU are financed through bank loans and will continue to be funded this way. However, bank debt financing is becoming increasingly scarce: the financial crisis has had a negative impact on the ability of SMEs to fund through bank debt. SMEs are seen as higher risk compared to blue chips and sovereigns. There is a decrease of cross-border funding with domestic banks increasingly preferring to fund (larger) domestic companies. Companies are increasingly more dependent on domestic banks with less competition on prices. Banks and insurance companies face tougher own funds requirements and greater liquidity constraints due to the implementation of Basel III/CRD IV and Solvency II.

European capital markets are still underdeveloped compared to the US. Stock market capitalisation in the EU accounts for 46% as a GDP compared to 104% in the US<sup>3</sup>. By contrast, bank credit to the private sector as a percentage of GDP accounts for 136% in Europe as a GDP compared to only 55% in the US. McKinsey calculates that there will be a 3.1 trillion equity gap between demand and supply (estimates 2010-20) compared to the US which will have a surplus of 0.6 trillion<sup>4</sup>.

Exchanges can play a major role by helping companies list on a regulated market or MTF. This is beneficial to the economy because it allows venture capitalists to exit at a relatively early stage (and as explained above, public market exits have unique advantages when compared to private exits such as trade sales). Public markets give the companies fresh low cost capital and allow them to improve the branding of their products and services. Exchanges help retain wealth creation and allow retail and professional investors to share in the benefits of entrepreneurial growth.

Conversely, if IPOs decline in Europe, this means less collective ownership of dynamic companies, loss of the discipline and guidance that fuel further enterprise growth, and less equitable wealth distribution. Additionally, fewer IPOs mean investors chasing a shrinking pool of assets, with less diversification and greater instability resulting in less saving possibilities for retirement.

#### **IV. Potential Policy Solutions**

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In terms of policy steps, we first and foremost recommend that future EU policy **'do no harm'**, i.e. **not exacerbate the trends already in place that make it difficult for the local brokers, analysts and advisers to bring companies to the market**. In this context, the most important threat to the local ecosystem is the introduction of a new trading venue **category in MiFID II which would hinder small brokers' market access**.

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<sup>2</sup> <http://www.essec.edu/faculty/showRef.do?bibID=10477>

<sup>3</sup> Brueghel Working paper, The Changing Landscape Of Financial Markets In Europe, The United States And Japan, Michiel J. Bijlsma and Gijsbert T. J. Zwart, March 2013

<sup>4</sup> McKinsey Global Institute / The Emerging Gap: Growth and stability in the new investor landscape (page 7 – Exhibit E5), Charles Roxburgh, Susan Lund, Richard Dobbs, James Manyika, Haihao Wu, December 2011. For Western Europe only; the gap for the whole EU is estimated to be larger.

As explained in a letter<sup>5</sup> co-signed by German and Nordic brokers associations and FESE, the proposed Organised Trading Facility (OTF) is not an open and neutral trading venue for equities. On the contrary, it will create a two-tier market which risks leaving small and midsize companies behind and compromises a neutral price discovery process. This category will not be subject to all the market facing rules which protect investors and ensure equal treatment of order flows across Europe's capital markets. In practice, only few investors will have the possibility to access prices displayed by the OTFs, namely the clients of the operators. Lack of equal access has negative consequences for intermediation since "local" players will increasingly have difficulties to provide the necessary service to their clients in terms of primary market funding to companies and efficient order execution for clients. The losers will be the small and midsize companies which do not have the same opportunities as the larger companies to use global market players when raising capital. Hence we strongly recommend taking into consideration the effect that the OTF proposals will have on smaller companies in the future political deliberations.

A second policy recommendation is to help repair the local ecosystem and encourage smaller companies to come to the market **by lowering the cost for SMEs to list**. In terms of policy, we draw attention to the numerous regulatory obstacles faced by SMEs which have been analysed in detail by the SMSG, in particular:

- *Improving the Prospectus Directive regime to make it easier for companies to access capital markets, and*
- *Reduction of the actual cost of access and maintenance of the listing (whether equity or debt) of SMEs.*

In addition to helping the 'supply' side (i.e. companies), we also recommend policy actions to help the 'demand' side for investments in SMEs, in particular by **removing the regulatory disincentives for institutional investors to invest in listed SMEs**. EU regulation has had an effect of dis-incentivising investors to invest in equity. While we believe that no asset class should be privileged, this also means that regulation should not create an artificial disincentive against any asset class either. The next generation of reviews should eliminate all such distortive effects, and allow investors to make a choice based on the quality, safety and other features of the instruments. In this context, **the above-mentioned SMSG report also analyses regulatory initiatives which impact the ability of investors to invest in SMEs, and notes:**

*As a result of CRD III and Solvency II and the uncertainty they bring to investors, there is a decrease of investment flows from banks and insurance companies to equities in general as well as to private equity and venture capital funds. If pension funds covered by IORPD<sup>6</sup> would also have to comply with Solvency II type of risk weightings, they will be required to hold additional liquid assets. This will not only have a negative impact on pension funds' ability to invest into equity and other long-term assets, but may over time lead to companies being faced with increased costs for pension benefits, as pension funds find it difficult to generate the necessary long-term returns to match their long-term liabilities.*

*(..) EU Regulation applicable to institutional investors (such as Solvency II for insurance funds) and any future proposals to introduce similar regulation for pension funds must not place conditions that adversely impact the ability to directly or indirectly invest in small caps.*

*[It is necessary to] review [the] UCITS directive to identify ways to attract dedicated UCIT funds for small caps.*

*[There must be] incentives to create investment funds specialized in shares and/or debt of SMEs, for example through a more favourable tax regime and more flexible investment rules, possibly through closed-end funds, given the lower liquidity of the underlying assets.*

<sup>5</sup>[http://www.fese.eu/\\_mdb/posdocs/Letter%20sent%20to%20the%20Irish%20Presidency\\_Problems%20with%20OTFs%20on%20equities.pdf](http://www.fese.eu/_mdb/posdocs/Letter%20sent%20to%20the%20Irish%20Presidency_Problems%20with%20OTFs%20on%20equities.pdf)

<sup>6</sup> Institutions for Occupational Retirement Provision Directive (IORPD).

(Disincentives linked to fiscal policy are analysed in the next item).

If the above-described policy issues are addressed, we believe that:

- 1) There will be more brokers/analysts/advisers/market makers willing to provide services to SMEs on capital markets;
- 2) There will be more SMEs willing to tap capital markets; and
- 3) There will be more investors willing to invest in listed SMEs.

#### ***V. Potential Operational Solutions: Using EU Public Funds Targeted at SMEs More Effectively***

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While the policy steps outlined above are important to increasing the ability of capital markets to finance long-term investments in general and SMEs in particular, regulation has a limit when it comes to creating the right conditions for investors and companies to meet. There are some cases where the market conditions are such that investors, companies or both are prevented from generating the levels of investment that are optimal for the overall economy. This is when public funds are justified to boost the market. The EU has already recognised various such ‘market failures’, notably in the need to finance bank loans to SMEs and – within non-bank finance – the early stage venture capital and private equity funding of SMEs. Up to 40% of venture capital is financed through public funds. However, there are good reasons to consider using public funds to support other stages of SME financing than venture capital.

Europe’s SMEs need efficient and fair access to the full spectrum of finance, not just bank lending. Bank loans and capital market finance are both needed to meet the needs of SMEs. EU support has so far tended to focus on bank lending. A substantial part of the EU financial programmes that are used by SMEs are based on debt instruments such as SME loans via intermediaries or guarantees for SME loans. There are also programmes based on equity-type instruments, but they do not operate directly via the capital market. By contrast, the share of SMEs in the capital market is small when compared with their share of the real economy, the level of employment they provide or even their share in the banking system. Therefore, there is a need for programmes that would foster use of capital markets to provide funding to SMEs. This will become increasingly necessary as, post-crisis, banks face pressure to reduce lending across the board.

Non-bank lending takes different forms which are both complementary and in competition with one another. Capital financing for SMEs takes different forms that are parts of a continuous chain and which meet the evolving needs of differently-sized SMEs at distinct stages of evolution: venture capital, private equity funds, and IPOs on the main market or junior markets. Venture capital helps early stage companies reach a level of maturity suitable for stock exchange listings, while the availability of listing as an ‘exit’ encourages venture capital to invest in risky SMEs. However, these different forms of finance also do compete with one another, especially in the middle segment of the market. In particular, venture capital funds are often interested in companies that might otherwise consider listing on a stock exchange. This fact has to be taken into account especially when public funds are being channelled into specific forms of finance targeting SMEs. Otherwise, public funds would be used inefficiently, replacing private activity that would have taken place anyway instead of addressing a true market failure, and at the same time distorting the market by favouring one set of private actors over another. This is not to say that the middle segment should not be supported. On the contrary, if there is sustainable demand for the middle segment, early stage financing will also be easier. However, in supporting the middle segment, venture capital funds should not be advantaged over securities exchanges.

Listing on exchanges has unique advantages for SMEs and the economy. Within the broad spectrum of non-bank financing methods, listing on securities exchanges gives SMEs access to capital via shares or bonds listed on the main market (Regulated Markets) or junior markets (MTFs). Of the 20 million SMEs in Europe, only several thousand are listed on exchanges; however, this avenue of finance has far wider advantages for the broader economy than its proportionate size might suggest: Listing on exchange

gives the SMEs recognition and visibility and allows shareholders or bondholders to benefit from the performance of dynamic and innovative companies on their way to growth.

As described earlier, the ‘disappearing local ecosystem’ has led to a growing gap between the needs of companies that would like to access capital market financing and the market’s ability to provide such access to these companies. The average IPO levels have increased steadily in the last 15 years. For the smaller companies, access to capital markets is becoming more and more difficult – exactly at a time when bank lending is down. Therefore, there is a **market failure** in the access of SMEs to capital markets which must be addressed by policy. The next generation of EU actions should address these remaining vital market failures, in particular the difficulties faced by local companies to attract private investors. This will generate many benefits for the companies and the wider economy because of the unique advantages of public capital markets (more equitable distribution of wealth, retention of dynamic entrepreneurial growth by the local economies, sustainable job growth, better corporate governance, investor protection, etc).

Therefore, we recommend that **public funds should be used not only to help venture capital funds investing in private companies, but also to help local companies access public capital markets**, which are also faced with a market failure. Hence, the EIB/EIF and other funds should be made available to help smaller companies list publicly through the exploration of a number of different ways of support (direct or indirect), taking into account the diversity of European companies’ needs.

The EU has already been providing capital to private equity and venture capital funds that invest in SMEs. However, focusing on private equity as has been done so far is too limited, since SMEs need both private equity capital and public markets and face a market failure in accessing both.

We recommend that the funding for venture capital should continue, and only focus on early phase SMEs. In addition, the EU should allocate funding to make SME IPOs more attractive to private investors. Public funds could act as a domestic anchor for investors by funding a ‘fund of listed SMEs’, incentivising other domestic and foreign funds to join in.

The best way of doing this is as follows:

- The EU funds should be used to set up a central fund that would invest in SMEs at the subscription stage
- The fund should be professionally managed by asset managers under specific guidelines in terms of objectives, range of eligible investments and expected return
- The fund should invest alongside private investors
- The fund should also aim at investing in existing listed SMEs so as to ensure a target level of liquidity.

A fund designed as above would achieve the following objectives:

- It would boost investment by private investors by acting as an anchor/trigger investor
- It would complement the use of EU funds in venture capital by helping a major form of exit for such investors (and it would reduce the trend of ‘trade sales’ as a vehicle of exit)
- It would alleviate concerns of investors regarding illiquidity

Finally, and separately from the creation of a fund, we also recommend setting up public/private partnerships to produce and disseminate high quality and credible research on SMEs. Where good research exists, it still needs to be widely available. Therefore we suggest the creation or provision of funding for an EU-wide information/guideline website for SMEs. The website could serve potential investors for SMEs listed on European Markets.

## VI. Taxation

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The above recommendations have focused on the policy and non-policy actions needed to boost the demand and supply of SME listings. Another aspect of the investors' decisions that needs to be covered is the effect of taxation.

As the SMSG has also shown, similar to regulatory disincentives, investors also face pervasive tax disincentives when investing in long-term equity or corporate bonds. These must be removed, again to allow investors to make their investment decisions based on the suitability of instruments to their needs. Moreover, positive tax incentives are needed, in particular for SMEs. If Europe wants more investors to look at SMEs, incentives are needed and tax incentives are among the most effective. Incentives on taxation for the smaller and most dynamic companies will be a key instrument.

With these principles in mind, we support the following two recommendations made by the SMSG:

***[The EU should] review [...] EU State Aid risk capital guidelines to allow for effective incentive schemes to be adopted by Member States. The guidelines should recognise the role of expansion capital as genuine risk capital.***

***Tax reforms may be considered in order to encourage more long-term holdings (i.e. better pre-tax off-setting of gains and losses, and tax push forward if realisation proceeds are re-invested) (...).<sup>7</sup> Exemption of certain investment rules imposed on certain investors in the case of investments in SMEs (e.g., minimum ratings, liquidity of securities, etc.). This would need to be balanced with any risk of misallocation of capital.***

Furthermore, as in the policy context, in taxation, too, the principle of 'do no harm' should apply. This means that any new taxation schemes should be judged first and foremost in terms of their impact on the incentives for equity market investments. In this context, one cannot but escape the conclusion that the proposed **Financial Transactions Tax (FTT)** would be detrimental to long-term finance.

Nine European trade associations have co-signed a letter<sup>8</sup> addressed to the Irish Minister of Finance and President of the ECOFIN Mr Noonan. They warned about the negative effects of the proposed financial transaction tax on financial activities that are essential to the functioning of financial markets and our economy as a whole. These effects included government financing, risk hedging and corporate access to finance. The organisations believe that the tax will have a major negative impact on on-exchange trading and clearing, contrary to regulatory reforms implementing the G20 objectives, whilst the real economy will mostly have to bear the additional costs arising from the FTT.

Finally, if, despite all these objections, the FTT is introduced, it should not apply to SME transactions or to market makers. Given that investors in smaller companies usually require a higher rate of return on investment, an additional tax would have a disproportionate impact on the cost of capital for smaller companies and is likely to deter investors from this asset class.

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<sup>7</sup> (...) Creation of specific benefits to certain investors who can invest in SMEs, tax relief or personal internal revenue taxes lower on capital gains on securities of these companies, under conditions of maintenance of such securities over a minimum period of time and a maximum concentration by company (in value and in percentage of capital of each company).

<sup>8</sup> <http://www.fese.eu/en/?inc=news&id=206>

## DETAILED ANSWERS TO SELECTED QUESTIONS

### 3.1. The capacity of financial institutions to channel long-term finance

#### Question 3)

*Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channelling of financing to long-term investments?*

The Green Paper covers both bank lending and capital markets. FESE supports this scope, and believes that the financing of long-term investments requires both kinds of finance to function well. However, given that the EU capital markets are much smaller than those of the US, for example, and given that in the post-crisis period banks need to deleverage, we wish to stress that the EU must take special steps to increase the ability of capital markets to finance the long-term needs of the economy.

Specifically, we believe that what some experts call ‘relationship financing’ – i.e. the financing of local companies at the local level by institutions which are in a place to evaluate them well – should be encouraged. This concept does not only relate to commercial banking, but also the broking activities in support of capital market access. Proximity is very important to the financing of smaller companies. The creation of the Single Market has resulted in neglect for the needs of those companies that start small and which must access markets (lending or capital markets) at the local level. **Our vision for the Single Market is that both bank loans and capital markets must be accessible at the level at which the company needs the finance, for companies of all sizes.**

#### Question 4)

*How could the role of national and multilateral development banks best support the financing of long-term investment? Is there scope for greater coordination between these banks in the pursuit of EU policy goals? How could financial instruments under the EU budget better support the financing of long-term investment in sustainable growth?*

We recommend that **public funds should be used not only to help venture capital funds investing in private companies, but also to help local companies access public capital markets**, which are also faced with a market failure. Hence, the EIB/EIF and other funds channelled through development banks should be made available to help smaller companies list publicly through the exploration of a number of different ways of support (direct or indirect), taking into account the diversity of European companies’ needs.

The EU has already been providing capital to private equity and venture capital funds that invest in SMEs. However, focusing on private equity as has been done so far is too limited, since SMEs need both private equity capital and public markets and face a market failure in accessing both.

We recommend that the funding for venture capital should continue, and only focus on early phase SMEs. In addition, the EU should allocate funding to make SME IPOs more attractive to private investors. Public funds could act as a domestic anchor for investors by funding a ‘fund of listed SMEs’, incentivising other domestic and foreign funds to join in.

The best way of doing this is as follows:

- The EU funds should be used to set up a central fund that would invest in SMEs at the subscription stage.
- The fund should be professionally managed by asset managers under specific guidelines in terms of objectives, range of eligible investments and expected return
- The fund should invest alongside private investors
- The fund should also aim at investing in existing listed SMEs so as to ensure a target level of liquidity.

A fund designed as above would achieve the following objectives:

- It would boost investment by private investors by acting as an anchor/trigger investor
- It would complement the use of EU funds in venture capital by helping a major form of exit for such investors (and it would reduce the trend of 'trade sales' as a vehicle of exit)
- It would alleviate concerns of investors regarding illiquidity

Finally, and separately from the creation of a fund, we also recommend setting up public/private partnerships to produce and disseminate high quality and credible research on SMEs. Where good research exists, it still needs to be widely available. Therefore we suggest the creation or provision of funding for an EU-wide information/guideline website for SMEs. The website could serve potential investors for SMEs listed on European Markets. In this context, we gratefully acknowledge the website set up by the European Commission, which should be a very good first step by providing standardised, comprehensive information to potential issuers.<sup>9</sup>

#### Question 6)

*To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?*

We believe that the regulatory and taxation biases against listed equity and bonds must be removed to help institutional investors invest more long-term.

For example, UCITS should be able to invest in SMEs listed on MTFs up to a higher degree than is the case today. This would be consistent with the high-level of investor protection, transparency and market integrity provided by listing MTFs.

In addition, costs of listings may also need to be tax deductible for companies.

Finally, we stress that these steps would have a more significant impact if they were coupled with the targeted use of public funds to trigger greater private sector interest in listed SMEs as outlined in our answer to Question 4.

#### Question 7)

*How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?*

EU regulation has had an effect of dis-incentivising investors to invest in equity. While we believe that no asset class should be privileged, this also means that regulation should not create an artificial disincentive against any asset class either. The next generation of reviews should eliminate all such distortive effects, and allow investors to make a choice based solely on the quality, safety and other features of the instruments. In this context, **the above-mentioned SMSG report also analyses regulatory initiatives which impact the ability of investors to invest in SMEs, and notes:**

*As a result of CRD III and Solvency II and the uncertainty they bring to investors, there is a decrease of investment flows from banks and insurance companies to equities in general as well as to private equity and venture capital funds. If pension funds covered by IORPD<sup>10</sup> would also have to comply with Solvency II type of risk weightings, they will be required to hold additional liquid assets. This will not only have a negative impact on pension funds' ability to invest into equity and other long-term assets, but may over time lead to companies being faced with increased costs for pension benefits, as pension funds find it difficult to generate the necessary long-term returns to match their long-term liabilities. (..)*

<sup>9</sup>[http://www.fese.eu/\\_mdb/pressdocs/Press%20Release%20\\_Practical%20Guide%20to%20Going%20Public%20In%20Europe\\_10%20May.pdf](http://www.fese.eu/_mdb/pressdocs/Press%20Release%20_Practical%20Guide%20to%20Going%20Public%20In%20Europe_10%20May.pdf)

<sup>10</sup> Institutions for Occupational Retirement Provision Directive (IORPD)

*EU Regulation applicable to institutional investors (such as Solvency II for insurance funds) and any future proposals to introduce similar regulation for pension funds must not place conditions that adversely impact the ability to directly or indirectly invest in small caps.*

*[It is necessary to] review [the] UCITS directive to identify ways to attract dedicated UCIT funds for small caps.*

*Incentives [are needed] to create investment funds specialized in shares and/or debt of SMEs, for example through a more favourable tax regime and more flexible investment rules, possibly through closed-end funds, given the lower liquidity of the underlying assets.*

We broadly agree with these findings.

*Question 8)*

*What are the barriers to creating pooled investment vehicles? Could platforms be developed at the EU level?*

SMEs are generally too small to attract the interest of institutional investors at the EU level; therefore, funds that group SMEs (or even funds of funds) might be necessary to reach the necessary scale. **Scale is the biggest obstacle facing SMEs when accessing the Single Capital Market.** Lack of investor demand (which is a bigger problem than the lack of issuer interest) is mostly rooted in the lack of investable scale, especially in terms of attracting pan-European investors. Due to their size, some SMEs can be attractive to domestic investors, but do not have a viable chance to attract the institutional investors that would be able to offer them a low cost of capital. Hence the most promising option for the smaller SMEs is to be bundled into groups to reach a viable scale. Institutional investors which may find individual SMEs or funds of SMEs too small might well invest in 'funds of funds' of SME. On the other hand, individual SMEs (not necessarily grouped) could be made more attractive to private investors through other means such as appropriate incentives and regulation.

Money- and credit-markets have mostly failed during the crisis, whereas the market infrastructure of exchanges and capital-raising via exchanges as an instrument of equity financing have worked reliably. Initial public offerings are the first entry of a company into capital markets. IPOs and/or capital increases of exchange-listed companies are indispensable strategic instruments for companies. Investments in the company's growth, financing of acquisitions and internationalization strategies can be financed independently, employee stock ownership can be pursued easily, and image and visibility can be improved. Access to capital via IPOs is limited for SMEs, because not enough capital accumulation is focused on SME financing. The large accumulators, funds, pension funds avoid investments into SMEs because of lack of size and liquidity. In certain countries, accumulation of capital for capital market investment is below average, because pension financing is not capital-based but organised via a pay-as-you-go financing system. This is an additional hurdle for IPO financing of SMEs. Due to the lack of domestic capital, SME IPOs are dependent on foreign capital. In order to overcome the existing structural deficits, public funds should be directed into specific SME IPO investments, organised via 'HOLDCO's. They could act as domestic anchor investors, incentivising other domestic and foreign funds to join in.

As we have stated in our response to Question 4, the best way of doing this is as follows:

- The EU funds should be used to set up a central fund that would invest in SMEs at the subscription stage
- The fund should be professionally managed by asset managers under specific guidelines in terms of objectives, range of eligible investments and expected return
- The fund should invest alongside private investors
- The fund should also aim at investing in existing listed SMEs so as to ensure a target level of liquidity.

### 3.2. The efficiency and effectiveness of financial markets to offer long-term financing instruments

#### Question 11)

*How could capital market financing of long-term investment be improved in Europe?*

The mid-market ecosystem which traditionally supported and innovated around European mid and micro cap stocks has been decimated in the last 10 years. As larger players and intermediaries have become more dominant, capturing more of the market value chain, the business case for smaller trading venues, brokers, investment intermediaries and niche advisers has been eroded. For larger intermediaries, the value proposition of mid cap and micro stocks is too small to dedicate resources to them. **As a consequence, mid-market companies struggle to find brokerage, analyst and corporate finance support.** The impact on new entrants is even more pronounced as the market has become more rarefied, the market capitalisation at which a company can go public has increased significantly and primary markets are perceived to be open only to large scale or specific sectoral niches.

These factors suggest that new EU policy should address the structural reasons for the obstacles faced by companies and investors when accessing capital markets. We recommend in particular:

- Repairing the local ecosystem of intermediaries needed to support SMEs
- Increasing investor confidence and interest in listed SMEs
- Improving direct and indirect ways of investors accessing markets

#### Question 12)

*How can capital markets help fill the equity gap in Europe? What should change in the way market-based intermediation operates to ensure that the financing can better flow to long-term investments, better support the financing of long-term investment in economically-, socially- and environmentally-sustainable growth and ensuring adequate protection of investors and consumers?*

As explained earlier, the local ecosystems in Europe are disappearing. The local brokers, analysts, etc are disappearing and the larger ones are not interested in the smaller companies. This trend has to be stopped if we want the capital markets to remain open to companies of all sizes.

One of the ultimate reasons behind the disappearing local ecosystem is the fact that EU financial sector policy has placed an excessive focus on the trading of blue chips. We need a re-focusing on the wider range of companies and services offered by capital markets, in particular issuance.

The EU has done a lot over the last 10 years to create a deep, liquid, efficient integrated equity market, the objectives of which FESE members have fully supported. However, many of these reforms did not result in better outcomes for investors and companies interested in the long-term. Over the last decade, EU capital markets have become more efficient and competitive, but they have also acquired an excessive focus on the needs of a small sub-segment of the economy – the trading of blue chips, i.e. the largest traded companies – at the expense of the needs of the much more numerous but smaller listed companies that play a critical role in growth and employment in Europe. This was at least in part due to the unintended consequences of EU policies. While the creation of a regulatory framework for a Single Market was in itself a laudable effort, integration not only led to a centralisation of the most commercially profitable activities – the trading of blue chips – but also undermined the less profitable, but socially valuable functions of capital markets, i.e. the financing of smaller companies at the local level. This development has been facilitated by the lack the local system of brokers, analysts, advisers and market makers to bring them to the market and keep their stock/bonds liquid once listed.

Contrary to the prior policy expectations, the newly integrated market did not step in to fill in the gap created at the local level; this is because the drive for greater scale had neglected the need for the companies to access the capital markets at the local level. Hence, while trading venues specialized in trading blue chips (and with no ability or ambition for helping companies raise capital) have multiplied,

actors active in the local capital markets – brokers, analysts, advisors, exchange operators – have suffered from the impact of diminishing liquidity at the local level. These changes have made it more difficult not only for the local capital markets to sustain existing smaller listed companies, but for the great majority of unlisted companies to consider accessing capital markets. This is a fact to which the Green Paper makes a passing reference<sup>11</sup> but which we consider to be very important to understanding and changing the direction of the evolution of European capital markets.

We also need more competition and variety in the way retail investors access the capital markets.

*Question 13)*

*What are the pros and cons of developing a more harmonised framework for covered bonds? What elements could compose this framework?*

We recommend further harmonisation. The cost would be exceeded by the benefit of creating a more liquid asset class and an additional channel for financing long-term investments.

*Question 14)*

*How could the securitisation market in the EU be revived in order to achieve the right balance between financial stability and the need to improve maturity transformation by the financial system?*

We recommend a mandatory regulatory framework for securitization which should achieve the following objectives:

- Transparency vis-à-vis the securitized assets
- Transparency regarding the trading of the assets
- Mandatory minimum ‘skin in the game’ to ensure that the originators of the assets have proper incentives

### **3.3 Cross-cutting factors enabling long-term saving and financing**

*Question 16)*

*What type of CIT reforms could improve investment conditions by removing distortions between debt and equity?*

We recommend an EU-wide review of all CIT to remove all distortive effects of taxation, so that investors can decide among asset classes without any taxation bias.

*Question 18)*

*Which types of corporate tax incentives are beneficial? What measures could be used to deal with the risks of arbitrage when exemptions/incentives are granted for specific activities?*

We do think that positive tax incentives for investing in listed SMEs should be considered. Furthermore to support investor demand and to abolish the un-level playing field regarding fiscal incentives for investment in SMEs, the Commission should extend its examination of tax obstacles to cross-border venture capital investment and possibilities for EU harmonisation to tax and similar incentives for retail investors that promote investment in listed SMEs.

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<sup>11</sup> Page 12 of the Green Paper.

Question 19)

Would deeper tax coordination in the EU support the financing of long-term investment?

In line with our answers earlier, we think taxes do play a significant role in investor interest. Coordination could therefore play a positive role in ensuring that taxes do not discourage investors from investing long-term.

### 3.4 The ease of SMEs to access bank and non-bank financing

Question 26)

What further steps could be envisaged, in terms of EU regulation or other reforms, to facilitate SME access to alternative sources of finance?

First of all, we would like to stress several reasons **why public capital markets are important for SMEs**:

- **Europe's SMEs need efficient and fair access to the full spectrum of finance, not just bank lending.** Bank loans and capital market finance are both needed to meet the needs of SMEs. EU support has so far tended to focus on bank lending. A substantial part of the EU financial programmes that are used by SMEs are based on debt instruments such as SME loans via intermediaries or guarantees for SME loans. There are also programmes based on equity-type instruments, but they do not operate directly via the capital market. By contrast, the share of SMEs in the capital market is small when compared with their share of the real economy, the level of employment they provide or even their share in the banking system. Therefore, there is a need for programmes that would foster use of capital markets to provide funding to SMEs. This will become increasingly necessary as, post-crisis, banks face pressure to reduce lending across the board.
- **Non-bank lending takes different forms which are both complementary and in competition with one another.** Capital financing for SMEs takes different forms that are parts of a continuous chain and which meet the evolving needs of differently-sized SMEs at distinct stages of evolution: venture capital, private equity funds, and IPOs on the main market or junior markets. Venture capital helps **early stage companies** reach a level of maturity suitable for stock exchange listings, while the availability of listing as an 'exit' encourages venture capital to invest in (relatively) riskier SMEs. However, these different forms of finance also do compete with one another, especially in the **middle** segment of the market. In particular, venture capital funds are often interested in companies that might otherwise consider listing on a stock exchange. This fact has to be taken into account especially when public funds are being channelled into specific forms of finance targeting SMEs. Otherwise, public funds would be used inefficiently, *replacing* private activity that would have taken place anyway instead of addressing a true market failure, and at the same time distorting the market by favouring one set of private actors over another. This is not to say that the middle segment should not be supported. On the contrary, if there is sustainable demand for the middle segment, early stage financing will also be easier. However, in supporting the middle segment, venture capital funds should not be advantaged over securities exchanges. This also means that public support for listed SMEs could play a very useful role by supporting the middle segment (please see our response to Question 4 for more detail).
- **Listing on exchanges has unique advantages for SMEs and the economy.** Within the broad spectrum of non-bank financing methods, listing on securities exchanges gives SMEs access to capital via shares or bonds listed on the main market (Regulated Markets) or junior markets (MTFs). Of the 20 million SMEs in Europe, only several thousand are listed on exchanges, but this avenue of finance has far wider advantages for the SMEs and the broader economy than its proportionate size might suggest: Listing on exchange gives the SMEs recognition and visibility and allows shareholders or bondholders to benefit from the performance of dynamic and innovative companies on their way to growth. Listing helps companies grow, creating more jobs and tax revenues. Moreover, companies listed on public markets are more transparent, benefit from market discipline, and contribute to lower systemic risks.

For all these reasons, listed SMEs provide positive externalities to the wider economy. Yet there is a market failure when it comes to listed SMEs. They generally lack the scale at which to attract investors, and moreover they suffer from the disappearing local ecosystem described above. Moreover, helping SMEs list is useful for SMEs to have access to the full spectrum of external finance, because without the IPO avenue, other ways of financing SMEs also become more difficult (notably venture capital). In other words, if the listing part of the chain is interrupted, eventually, financing through the earlier stages such as venture capital will also come to a halt (or other methods that are less directly beneficial to the European economy, such as trade sales to foreign companies, will take a disproportionate share of exits).

Hence, we recommend the following steps to specifically help SMEs access capital markets:

### 1) INCENTIVES

- Positive tax incentives are needed. If Europe wants more investors to look at SMEs, incentives are needed, and tax incentives are among the most effective.
- FESE urges the Commission to study this issue carefully as we believe that incentives on taxation for the smaller and most dynamic companies will be a key instrument.

### 2) PUBLIC FUNDING:

- The European Commission is already committed to providing funds for private funds such as private equity and venture capital funds that invest in SMEs.
- Continuing to focus on private equity only is too narrow; SMEs need both private equity capital and public markets.
- We recommend the following principles to be put into action:
  - Funding for venture capital should only focus on early phase SMEs.
  - Funding should be made available for SME IPOs to help attract private investors.
  - Public funds could act as a domestic anchor for investors by funding a ‘fund of listed SMEs’, incentivising other domestic and foreign funds to join in.

### 3) RESEARCH

- The EU should set up public/private partnerships to produce and disseminate high quality and credible research on SMEs.
- Assuming good research exists, it still needs to be widely available. Therefore the second suggestion would be to create or provide funding for an EU-wide information/guideline website for SMEs. The website could serve potential investors for SMEs listed on European Markets. (We gratefully acknowledge the important steps already taken in this regard).

#### *Question 27)*

*How could securitisation instruments for SMEs be designed? What are the best ways to use securitisation in order to mobilise financial intermediaries' capital for additional lending/investments to SMEs?*

We believe that securitisation can be useful in some cases, but a more harmonised mandatory framework is needed to avoid the problems of the past and to ensure that a link exists between the local lenders and the SMEs. Hence, as for securitization in general, we recommend:

- Transparency vis-à-vis the securitized assets
- Transparency regarding the trading of the assets
- Mandatory minimum ‘skin in the game’ to ensure that the originators of the assets have proper incentives

*Question 28)*

*Would there be merit in creating a fully separate and distinct approach for SME markets? How and by whom could a market be developed for SMEs, including for securitised products specifically designed for SMEs' financing needs?*

We welcome the goal of improving the visibility and investor reach for SMEs by attributing a SME Growth Market label to those MTFs that respond to a common set of criteria as was proposed by the Commission in the MiFID Review. At the same time, SMEs should remain free to seek a listing on the exchange (RM or MTF) they believe is the most beneficial to them and their stakeholders.

As we have stated earlier, if the SME Growth Market regime is designed flexibly enough (being voluntary, and not taking away the ability of the market operators to adapt their platforms to their target companies' and investors' needs), then we have no objection to the regime in principle.

Having said that, it is questionable whether the introduction of a SME Growth Market label will significantly improve SMEs' access to capital markets. We are concerned that the introduction of a SME Growth Market will not address the fundamental issues surrounding SME access to finance, these being supply and demand. Great care must be taken with the design of the infrastructure for SME-specific markets, in order to maximise investment scale and proximity. For a viable public listing market, SMEs must want to list (supply), and investors must want to invest (demand). As is in any market place, supply and demand must meet at an optimal point that delivers a low cost of capital to companies while being an attractive investment option for investors. Currently, the market is much smaller than it could be primarily because investor demand is too small. Scarce resources and effort should therefore be allocated to the development of investor demand.

The MiFID II proposal (Article 35.7.) also contains a provision allowing the shares of companies listed on SME Growth Markets to be traded on other SME Growth Markets without the consent of the issuer. We believe this will lead to a fragmentation in the liquidity of the SME stock which, coupled with a lack of market research and consolidated market data, will produce price discrepancies across the venues on which the SME stock was traded and result in a loss of investor confidence in the price formation process.

This will be compounded by the strong 'home bias' of investors in SMEs, where the proximity of the investor to the issuer is key. Therefore the trading of SME stock on other SME Growth Markets should only occur with the explicit consent of the SME issuer.

*Question 29)*

*Would an EU regulatory framework help or hinder the development of these alternative non-bank sources of finance for SMEs? What reforms could help support their continued growth?*

As was mentioned above, we are not convinced that creating a separate regulatory framework for SME markets would help SMEs to access to finance without the necessary actions taken to guarantee investor demand.

Any regulatory changes must be balanced with investor needs and ensuring a high level of investor protection. The quality of regulation relating to companies' initial and ongoing disclosure duties has a direct impact on their image and attractiveness to investors. Improvements in this area can be achieved through appropriate changes to legislation regulating the duties of issuers (prospectus and Transparency directives) and of market participants (Market Abuse Regulation).

Lighter reporting requirements for issuers should be complemented with greater flexibility in the means by which ongoing disclosure requirements are fulfilled.