FESE

A Roadmap to Develop Smaller Capital Markets within the CMU

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FESE Members fully support the goal of the Capital Markets Union (CMU) to strengthen the European economy and ensure easier access to markets for companies, notably small and medium-sized (SMEs) ones which are the backbone and engine of the economy. To ensure the success of CMU, FESE believes that it is key to boost the development of smaller capital markets where the majority of the companies are SMEs and the investment gap still remains broad. For example, in the Central and Eastern European (CEE) region[1], the average stock market capitalisation accounts approximately for less than 20% of GDP as compared to an average of 75% of GDP in the EU28.

FESE is a keen supporter of the development of local capital markets and has recently set-up an internal workstream dedicated to smaller markets.[2] Our membership has identified and analysed the main challenges faced by these markets, as follows:

- Lack of proportionality and resources;
- Lack of an equity culture;
- Lack of attractive stocks (few top performers, corporate governance issues, etc.) paired with a lack of harmonisation of investments rules;
- Lack of quality capital, especially related to innovation and intangible assets (research, skilled workforce, financial education, advisory services, etc.) - markets are dominated by SMEs without an adequate ecosystem to cater for their needs, especially form an investors side;
- Lack of post-trade infrastructure;
- Lack of private pension schemes and missing capital market orientation;
- Low weighting market in international portfolios due to the low local market classification results, lack of research coverage and of trust of the local legal framework.

Overall, we believe that the measures proposed by the European Commission in the context of the CMU Action Plan are a step in the right direction. In particular, those measures that are aimed at supporting SME listing. However, in order to have a fully integrated CMU, it is essential to better support smaller markets. The development will positively contribute towards the strengthening of European competitiveness on a global level. FESE encourages policy makers at both European and national level to continue working together towards creating the best opportunities for making capital markets successful as a place for companies, especially SMEs, to access capital and create growth.

Concretely, FESE would like to suggest the following principles and recommendations, in order to reduce burdens and barriers for both companies and investors. Some of these recommendations are tailored for smaller markets, while others are valid for all markets, independently from their size or level of development.

1. Ensure a coordinated development of ecosystems

The local dimension, especially for smaller markets, is essential to cater for the specific needs of their companies which are mostly SMEs. Regulators and policy makers should explore how to **facilitate capital market convergence and derive full benefits from an EU integrated diversity of national eco-systems**, particularly in areas such as market infrastructure, taxation, and supervisory coherence.

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[1] This includes: Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic, Slovenia, and the three Baltic countries.
2 For FESE internal purposes, smaller markets are defined either as (i) markets focused on SME and mid-caps or (ii) markets in jurisdictions defined to have emerging or frontier market classification in commonly used frameworks.

2. Deliver a proportionate regulatory framework

For smaller markets, the regulatory burden can be sometimes overwhelming. More precisely, the 'one-size-fits-all' model, mostly used in the context of EU level legislative frameworks, is less proportional for smaller markets and brings excessive and disproportionate requirements for services providers, thus making the overall market less competitive.

For instance, due to the full application of the Market Abuse Regulation to MTFs, issuers on these specialised markets need to apply the same requirements as the main markets. If we take the example of Poland, the average market capitalisation of a company listed on NewConnect is around 1.2 million EUR, while MAR provides, for offences of insider dealing and market manipulation, a maximum fine of 5 million EUR for natural persons. Member States can also impose even higher maximum administrative fines. This discourages smaller companies who face raising compliance costs and hence prefer to de-list and to resort to private equity.

Therefore, we encourage EU regulators to:

- Run a **comprehensive assessment of the impact of the various legislative files which might differ based on the size and maturity of the markets**.
- Consider forms of **technical assistance to support the implementation of EU laws** at national level. Such support should have a very practical dimension (e.g. take the form of roadmaps and instructions) and should be tailored to specific needs of the countries concerned. This would help mitigate the regulatory burden and could enable focusing more on business, rather than on the implementation of the EU legislation.
- **Propose longer deadlines for transposition and implementation** to give more time to market participants to get ready for the changes.

3. Develop an equity culture in Europe for both investors and entrepreneurs

3.1 For retail investors

3.1.1 Foster financial education

According to a report published by the European Commission in April 2018, less than half of European households (43%) invest in any type of financial product with the notable exception of Sweden – where more than 60% of households invest. In line with their rather conservative nature in terms of investment, the vast majority of Europeans (80%) have savings to act as a buffer for emergencies and unpredictable expenses.[3] Furthermore, a study run by S&P shows how financial literacy rates vary widely across the European Union and are particularly low in the Central, Eastern and South-eastern Europe (CESEE) countries.[4]

Such low levels of financial education are a great impediment to a successful CMU. Citizens who lack basic financial concepts are not well equipped to make informed financial choices regarding saving, investing, and borrowing. Promotion of markets must go hand in hand with measures to sustain confidence in markets. In the coming legislative period, efforts should focus on improving financial literacy on the basis of facilitating access to direct investments. In this regard, we would suggest:

- **Elaborate EU-wide and/or EU-funded national educational campaigns** promoting financial literacy and equity culture. Also, public-private cooperation should be encouraged.
- **Consider new technologies that could enhance investors participation**, e.g. by allowing for an ease and useful disclosure of issuers' information. This would enhance availability of EU data and research by standardising and improving data collection, to enable both companies and investors to understand comparative costs and benefits of different services provided by capital market participants.

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[3] 'Distribution systems of retail investment products across the European Union – Final Report', April 2018 (here)

[4] Standard & Poor's Ratings Services Global Financial Literacy Survey, November 2015 (here)

3.1.2 Re-build trust in the financial sector

Consumer protection is an important factor to rebuild financial services users' trust and ensure the development of capital markets. Consumer protection requires a robust legal framework and competent government institutions implementing and enforcing it. Therefore, we believe it would be worthwhile considering the creation of **central courts dedicated to the capital market**. Faster and more adequate rulings require more specialised attorneys and judges. Regaining trust in the market requires setting an example of quick and efficient prosecution of embezzlers and other wrongdoers.

3.1.3 Review pension systems and allow direct investments in bonds and equity

Pension savers should be allowed to invest directly into low-cost, long-term instruments such as equities, bonds and low-cost equity index funds. Therefore, a **review of the pension legislation**, both at national (2nd and 3rd pillars) and EU levels (e.g. PEPP proposal and pension funds rules) is necessary. Also, **financial incentives**, e.g. tax breaks, should be promoted to enable long-term direct investment.

3.1.4 Review the impact of MiFID II on equity research

From a retail investors' perspective, at EU level, a review should be undertaken to **assess the impact of MiFID II's inducement rules for equity research conducted on SMEs**. There is some evidence that coverage is diminishing as a result of the regulatory requirements for research to be independent. While the regulators' intention was commendable, the consequences might be that less research, enabling investment in SMEs, is carried out.

<u>3.2 For institutional investors</u>

3.2.1 Undo the tax bias toward debt

We encourage EU policy-makers to consider the different characteristics of public equity and debt markets when undertaking capital markets regulatory initiatives. In particular, some of the current fiscal arrangements in place act as a barrier to the development of public capital markets in Europe.

We understand that taxation is the competence of the Members States. Nonetheless, Member States should be encouraged to use tax policies to stimulate long-term investing of listed equity of smaller companies and to ensure the fair treatment of debt and equity financing. We encourage Member States to **review fiscal incentives against equity financing** in Europe given the high potential positive impact such changes could deliver for the overall attractiveness of European public capital markets.

The European Commission should also conduct an impact assessment on the cost of capital arising from the current tax bias against equity investments. Currently, in many European countries we either observe a lack of positive tax incentives, or the presence of significant disincentives, whereby the tax system is more favourable to debt issuance than to equity. **To orient more investor flows into listed equity, bond and derivatives instruments, new or existing tax and regulatory disincentives that suppress investor demand should be avoided. And tax exemptions for any type of longer-term investment products should be encouraged**.

3.2.2 Facilitate investments from institutional investors

The regulatory limitations for the investments from institutional investors should be reviewed. We call upon regulators to adopt a **cross-cutting approach and analyse the various sectorial regulations,** e.g. Solvency II, IORPs, etc**. that could prevent or limit investing in smaller markets and SMEs by institutional investors.**

3.2.3 Increase the visibility of smaller markets for institutional investors

It is essential to bring many of the smaller EU markets on the radar screen of investors to develop them further. This increased visibility will have in the longer run the effect of improving liquidity.

Smaller markets are particularly impacted by the effects of passive investing, meaning the inclusion in a broad market index, which has become increasingly important. It should therefore be considered that the classification of countries according to their development does not always reflect that certain conditions might be fulfilled through the participation to the Single Market and the application of the EU legal framework. In addition to the current methodologies, we would favour, where reasonably applied, a **regional approach** in assessing the economic development of smaller markets.

3.3 For entrepreneurs

3.3.1 Promote a risk-taking culture among entrepreneurs

From an entrepreneurs' perspective, key to influencing an equity culture is education. In order to promote public markets as an alternative funding source, and open it up to SMEs in particular, it is necessary to better coordinate the pre-IPO phase. Many FESE Members already assist companies looking to raise capital (for example: BME 'Pre-Market Environment'; Boerse Stuttgart 'Nordic Pre Market' (for the Nordics) and 'VentureZphere' (for Germany); Deutsche Boerse 'Venture Network'; Euronext 'FamilyShare', '#IPO Ready' and 'TechShare', etc.). The companies taking part in these programmes are future IPO candidates and dependent on funding for further growth. Such initiatives provide the following services:

- Connecting SMEs to investors and helping them gain access to professional services;
- Stakeholder coordination and management;
- Due diligence and prospectus writing, investment case development;
- IPO roadshow support and financial PR and marketing services.

Smaller markets lack resources to run on a continuous basis such large-scale educational initiatives. Therefore, public support is key and this could take the form of:

- **Regulatory initiatives, for example in the context of the upcoming InvestEU framework, to support exchanges in their public good and educational activities.** This support could be used at different levels of market education: educating large companies about transparency and corporate governance, educating SMEs about listing in an SME market (benefits and obligations, establishing corporate governance and investor relation functions – longer lasting programs).
- **Promote the use of the EU structural funds to support listing of local SMEs**, e.g. creation of an 'IPO Fund' to tackle the investment gap, coverage of part of the listing and transaction costs, co-investments by state funds – currently state funds focus only on private-equity style investments.

3.3.2 Support a friendly business environment

As stressed in the report of the Vienna Initiative[5], a friendly business environment is key to ensure a prompt development of capital markets. In this regard, we would support further **harmonisation of insolvency, accounting and taxation rules**. FESE already stressed the importance of a favourable tax treatment to boost retail investors' participation in capital markets, but this is key also for companies. The tax regime which applies to listed companies, including SMEs, plays an important role in the decision of companies to list. A fair tax treatment, in the form of lower taxes (Corporate Income Tax) and easier tax procedures, would incentivise companies to go public and would help maintain on the stock market those companies which are already listed.

In conclusion, there is a clear need for more far-reaching initiatives if the EU truly wants a fully integrated union in its capital markets, which would act as an attractive alternative to bank financing for channelling funds to firms.

[5] Vienna Initiative 'Report by the Working Group on Capital Markets Union', March 2018 (here)