DEVELOPING AND CONNECTING SECURITIES ECOSYSTEMS

1. Developing securities ecosystems at the domestic and EU levels

1.1. Balance between domestic and cross-border development

A regulator noted that the capital market union (CMU) initiative has two main objectives. First, developing capital markets in the EU. Capital markets are small in many European countries, which reduces their attractiveness and capacity to fund the economy. Second, further integrating and connecting domestic capital markets, as the differing legal systems and corporate structures that exist at present across the EU mean they are largely national. This will provide additional opportunities to savers and issuers such as SMEs and also help to improve risk mitigation across the EU.

Further developing and integrating EU capital markets is challenging because the right balance and sequence needs to be found between local and pan-European development in order to achieve positive impacts. There is always the risk that a pan-European market-opening measure may weaken existing domestic capital markets but at the same time it is necessary to connect local markets, once they have started developing, in order to achieve sufficient development at the EU level.

An industry representative agreed that building the CMU is valid, but SME equity financing must be built first on a national basis with the development of local capital-market ecosystems. Once they are functioning, a cross-border layer across the EU can be added to bring extra benefits. Post-trade must also be addressed, as the present market structure does not support cross-border listings for SMEs. It is costly to handle the extra friction that a company incorporated in a given EU country experiences when listing in another one. The CMU must be stepped up by the incoming Commission, taking into account existing best practices across Europe.

Another regulator noted that securities ecosystems include companies, investors, infrastructures and intermediaries, and emphasized that there is still a great deal of friction in the matching of financing supply and demand among them. An ecosystem is usually domestic, but there should also be the objective to develop a European ecosystem as a local ecosystem.

1.2. Capitalizing on best practices at the EU level

An industry representative stressed that effective capital-market ecosystems for SMEs already exist, particularly in the Nordic region, showing that the CMU objectives in terms of developing local capital markets are achievable. Finland, Sweden and Denmark have a little more than 1,000 companies listed, of which 600 are small-caps; 350 small-caps are on the junior market, which is an MTF (multi-lateral trading facility) with its own rulebook and half of the 600 companies on the regulated market are also small-caps. This SME market in this region survived the financial crisis and is still successful despite tough regulations such as MiFID II and the Market Abuse Regulation (MAR).

The Nordic region is the only one, when looking at the EU and US, to have had a net increase in the number of listed companies since the latest crisis. The junior market is also growing quickly. This example shows how effective capital-market ecosystems can develop with different regulations and a proportionate regulatory regime and currently there is an initiative underway with the US to promote these practices. The US market indeed no longer encourages SMEs to go public. Recent initial public offerings (IPOs) such as Facebook, Lyft and Uber concern huge companies funded by venture capital and private equity until they went public.

The industry speaker underlined that within the Nordic region, development has been particularly strong in Sweden over the past 10 years and even before the financial crisis. Best practices from Sweden are now being used in Finland and Denmark, where progress has been more difficult.

Another industry representative agreed that the net increase in the number of public companies on the Nordics market is remarkable given the opposing global trend. Around 75,000 companies were listed globally in 2000; by 2017, there were fewer than 35,000. This must be addressed by public-policy decision-makers. A question however is to identify which issuers can best drive SME issuance forward.

2. Priorities going forward

2.1. Refocusing the CMU on a smaller set of investor and SME-related objectives

An industry representative was struck by the diminishing confidence in CMU progress and comments made by speakers in another session of the Eurofi seminar, that SMEs do not need capital markets because there is sufficient bank funding. The EU regulation recently proposed by the Commission regarding SME growth markets however mentions the need to reduce dependence on bank lending and facilitate the raising of capital as major objectives. These sceptical comments show that it is time to re-evaluate how this can be done. Having thousands of listed companies in Europe is difficult to achieve in the short-term, but the objective of developing capital markets and better balancing capital market and bank financing for stability reasons needs to be pursued, possibly with a different action plan.

The CMU agenda must be reset to emphasise two main lines of action, the industry speaker suggested: investor protection and a proper understanding and development of ecosystems. SME markets and the main blue-chip markets are not different, they are part of the same ecosystem and the same rules should apply.

Another industry representative considered that a great deal has been done to design and implement the CMU over the last five years with an action plan containing 33 different measures covering all possible areas identified at the time. Most of the corresponding legislative texts have been delivered, although some are still to be implemented. Continuing the momentum requires a focus of the CMU on a smaller set of priorities.

The speaker suggested three main priorities going forward. First is a focus on SMEs. SME markets have done well in some parts of the EU, but overall Europe is not as good at growing companies as the US. The causes of that need to be rectified, whether it is proportionality or a lack of strong local markets across the EU. The US JOBS Act[1] can possibly provide inspiration also. Second is looking at the pools of capital that exist in Europe and those that need developing. The current CMU action plan focuses mainly on growing existing pools of capital with measures related to securitisation and Solvency II. Going forward the objective should exist of developing new pools of capital, for example with the further development of pension funds. The Pan-European Personal Pension (PEPP) project was an attempt to do that and more should be done in that space. Pensions are indeed the area where there is the biggest gap with the US in terms of savings, with private-pension savings in Europe of about a quarter of the US. Within Europe, the gap is even bigger, as private pension funds in the smallest member state are 200 times smaller than in the biggest. That equates to trillions of euros to invest. It will not change overnight but must be improved. The UK has made a start so it is relatively ahead in Europe. Over the last five years, it has moved to auto-enrolment into private pension systems, with 7 million new pension savers investing £10 billion more than would otherwise have been. It is not enough but it is a good start to build on. The third aspect is the global dimension of capital markets. The UK has hundreds of European companies listed and raising funds there, but connections are also needed to global markets, where much of the growth and investment will come from over the coming years.

A regulator agreed that developing pension funds and life-insurance in Europe will lessen fiscal burdens and create investment capacity. Only few countries in Europe have prefunded systems and they are mostly where the most active capital markets are: northern Europe, the Netherlands and the UK. Going from pay-as-you-go to more prefunded systems would improve fiscal sustainability and help to foster the development of capital markets for everyone's benefit, including a broader ownership among European citizens of European corporates.

Another regulator noted that building effective securities ecosystems is complex, as it requires a combination of individual measures relating to the four core categories of market participants: savers, intermediaries, infrastructure and issuers. Measures must create potential for all four.

Developing securities ecosystems first requires increasing the diversity of investors and participants, the regulator suggested. Greater diversity helps to increase market volumes and cover the costs of building the ecosystem and also provides more stability with a broader variety of investors. That means increasing retail-investor participation and also attracting cross-border participants and foreign investors with different characteristics, skills and expertise.

A second area is addressing barriers to cross-border investment, which stem from differing fiscal and legal requirements across member states that increase the costs of these transactions. This explains the low participation of investors in cross-border capital markets in the EU rather than geographical distance. Tax is a fundamental barrier, as income on securities is taxed twice at present in many cases, in the country of the security's issuance and in that of the investor. This makes little sense in a single European market, especially when compared to the single taxation in goods markets. Post-trade barriers are a second issue that impacts long-term investment because these barriers affect securities during the whole period that they are held. The third type of barrier is securities account structures. Eight to 10 EU countries have account structure requirements, such as mandatory segregated accounts, which in effect prohibit direct investment by other countries' retail investors. Slovenia is an example. Eliminating these barriers requires in particular a high degree of standardisation and interoperability at the level of infrastructure.

An industry representative added that investors see the EU as fragmented, which creates the perception that EU equity markets are relatively illiquid and lack a centralised regulatory regime for capital formation. Capital formation should be a key focus of the CMU going forward to build a stronger ecosystem.

2.2. Tackling the unintended consequences of EU securities regulation for SMEs

An industry representative suggested that introducing more proportionality for SMEs in all EU capital market legislations i.e. MiFID II, EMIR and MAR should be a key priority for the next steps of the CMU (CMU 2.0). Another industry representative however considered that investor protection should not differ between main markets and SME markets. Differentiating rules destroys confidence and can be dangerous. There is only one ecosystem and problems need to be addressed as a whole.

A regulator considered that growing regulation at the EU level still leaves many differences in the implementation at local level, as well as creating unintended consequences of regulation.

Regulation is often seen only as a cost, but if it is appropriately defined and implemented it is an asset and compliance must be seen as an investment. Some aspects such as investor or issuer education to convince participants to go to the market can be dealt with without regulation, but developing SME capital markets and efficient market infrastructure needs an appropriate European regulatory framework.

Some mistakes have been made in developing securities regulation over the last 20 years, the regulator felt, including extending the scope of the new market-abuse regulation (MAR) with insufficient care. This regulation is about market abuse, insider trading and market manipulation, and also provides a framework for price-sensitive information and disclosure obligations. Having the same disclosure obligations for smaller and bigger companies does not make sense and needs to be reviewed.

The new Prospectus Regulation coming into force is another example. It seems a mistake to add a simplified version of the prospectus to the existing layer of hundreds or thousands of pages, especially for SMEs. This should be replaced with more palatable information requirements, especially for retail investors, considering that many SME issuances mainly target retail investors and do not correspond to the needs of most institutional investors or asset managers who require larger issuances and more liquidity.

A third issue is the unintended consequences of MiFID II for research. Some countries have seen a decrease in research, others such as Italy have developed automated research based on numbers and less analysis. Those rules must be rethought and better calibrated.

In addition to tackling these problems, regulation should be used to better match investments with the appropriate investors and ensure a sufficient level of diversification. For example, more sophisticated investors are needed for less liquid and longer-term, riskier securities or for crowdfunding, not necessarily professional investors but ones with revenues exceeding €70,000 and net assets above €100,000. The European Long-term Investment Fund (ELTIF) is a way of facilitating this match as it is open to retail investors, with interesting compulsory diversification rules. With ELTIFs, retail investors can go for illiquid, longer-term securities or infrastructure, which helps to develop long-term investment.

Recreating a stakeholder group at the Commission-level that existed in the past would also be useful in this perspective because member states' National Competent Authorities cannot deal with all issues.

2.3. A programme of research to support CMU work going forward

An industry representative suggested that research on capital market development in the EU is needed to support the CMU work, gathering evidence and driving the thinking about the next steps. That should be an objective for the incoming Commission, with industry playing a role. The low-hanging fruit have already been picked, so finding new ideas will be more challenging. There are many pieces of research on different components of the CMU but little on the future steps of the whole initiative. The main reasons for the limited progress in the development of capital markets in the EU are also still largely unknown.

Another industry representative agreed that studies and research should be used to develop a CMU 2.0, which is a good idea, possibly underpinned by big data analyses. One possible area of study would be to evaluate the amount of equity that has been extracted from public markets by mergers and acquisitions and the activity of private-equity and venture-capital firms' over the last few years and the impacts and underlying reasons of this.

3. Essential drivers of the development of EU capital market ecosystems

Detailed comments were made on two major drivers of the development of EU capital markets.

3.1. Developing retail participation

A regulator emphasized the importance of retail investor participation because even if they are only a small part of the market they are the "canary in the coalmine". If the canary dies, there is a problem. If the canary sings loudly and is buoyant, this usually means that other market participants are happy and developing well. If SMEs do not go to the market, the same reasoning applies.

An investor representative considered that developed local securities and equity ecosystems need a robust local base of individual investors. An appropriate investor base is also needed to develop IPOs in Europe. It is key to the CMU project's success for two reasons. The first reason concerns liquidity in equity markets: academic research, such as that from Edhec Business School, shows that individual investors are mainly contrarian, in contrast to institutional investors, who are mostly momentum-investors. Even a small base of individual investors helps.

The second reason to nurture a local base of individual investors and share ownership is that retail investors have a relatively bigger role in the small and midcap markets than in the overall markets. Euronext statistics show that the share of retail investors in the primary market for IPOs and secondary market for small and midcaps is 20% compared to 10% overall.

The investor representative also emphasized that employee share ownership is a powerful way to develop retail investment. Following a proposal by Better Finance, the Commission added an action on employee share-ownership to the initial list of 33 CMU objectives defined in 2015. A pilot project conducted in 2014 by the Commission concluded that there was a need to promote awareness of employee share-ownership, especially in countries where it does not exist. If employee share-ownership in the EU reached the level of the US, it would be multiplied by 6 which would add $2 trillion of market capitalisation and unlisted SMEs' share ownership would multiply by 100 (from $13 billion to $1,300 billion). This can be a key driver of EU capital markets. UK studies also show that a majority of people exposed to employee-share-ownership open brokerage accounts and buy other shares.

3.2. Developing the IPO market in the EU

An industry representative considered that developing the IPO market is a major opportunity for the EU and also for global capital markets because a robust, healthy IPO market, particularly for SMEs, is a key building block for a strong EU securities ecosystem.

IPOs have a positive social impact. IPO issuers are job creators, and companies that raise capital, particularly SMEs, contribute to underlying economic growth. Studies show that 90% of companies see economic revenue and employment growth after going public, so it is critical from a public-policy perspective. It is even more important when considering that over two-thirds of the EU's workforce is employed by SMEs.

IPOs are also an attractive asset class of investment. They have outperformed benchmarks by 500 to 700 basis points through multiple cycles on a global basis and provided institutional and retail investors and issuing companies' employees with significant premium or alpha investment performance.

There are several challenges to address regarding this market in the EU. IPO volumes are down some 70-80% over the last 10 to 15 years due to regulatory costs and complexity. European issuers are also looking outside the EU, as shown by Spotify, which is a missed opportunity for the EU.

The EU should consider creating an IPO and capital-formation taskforce to study existing practices at the global level, assess their impact and make recommendations. There is potential for cross-border regulatory collaboration between the EU and other jurisdictions on this. Examples of innovation or progressive reform around the world relating to IPO issuance include the US JOBS Act, which focuses on emerging growth companies. The success of IPOs in the Nordics is another example that should be expanded at the EU level. There are also on-going IPO initiatives in the UK and Hong Kong that are worth assessing.

1. The Jumpstart Our Business Start-ups (JOBS) Act is a U.S. piece of legislation that was signed into law by President Barack Obama on April 5, 2012, that allays some SEC regulations on small businesses. It specifically targets "emerging growth companies" which are defined as issuers with "total annual gross revenues" of less than $1 billion during their most recently completed fiscal year and includes measures to facilitate capital raising by these companies notably via IPOs and crowdfunding.