Developing securities markets

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David Wright

Good afternoon, everybody. I have the great pleasure of welcoming Adena Friedman, who is the President and Chief Executive Officer of Nasdaq. We are delighted that you can be here.

We are going to talk about developing securities markets in Europe. We are now on the cusp of a new European political cycle of five years. How do we dynamise our capital and equity markets?

Adena Friedman

Thank you very much. It really is a pleasure to be here. It is probably good to remind the audience that Nasdaq is a wonderful market in the US but we also own and operate the markets in Denmark, Sweden, Finland, Iceland and the Baltics.

The role of capital markets is really to create jobs and economic opportunity for individuals and all the citizens of our countries, so it is very important to focus on the incentives needed as well as on the obligations that we put on companies, investors and intermediaries to make sure that you have a vibrant but well-protected system. In Sweden, Finland and Denmark, in particular, we have a market called First North, which is the small and medium-sized enterprise (SME) market. It has been an incredibly successful market in recent years and is mainly a retail market. We have had 200 initial public offerings (IPOs) in the last five years onto First North from across the Nordic region and we are starting to attract companies from other parts of the region as well.

What makes it work and how are we getting retail investors to come to this market? The first factor is that there is a strong equity and risk-taking culture in the Nordics that I think is somewhat unique in Europe and is very helpful for the development of the market.

But there are many incentives also. One of the newer incentives that have been created in the last seven years, and one which is definitely a catalyst of the success of First North, is the ISK savings account in Sweden. It is a very tax efficient savings account for retail investors, which allows them to put money into an account that has to be invested in public equities. These equities can be issued in Sweden but also in Europe. The annual tax is only 1-2% on total assets, which is marked every year. About two million accounts have been opened in Sweden in the last seven years. If you look at the trading activity and market cap of the SMEs in First North, it is almost all retail, so the ISK has definitely been a catalyst for investment in equities.

Moreover you need to develop the right market structure, so that you have sufficient capital coming into the market and also to create tight spreads, deeper liquidity and, therefore, a lower cost of equity capital for companies, which then incentivises them to go there to seek capital as opposed to the private markets. With that, we have a market-maker sponsor programme that allows a trading firm to sponsor the companies onto the exchange. They have a certain spread obligation but they also get some benefits as well. All of this creates an ecosystem that has become a great engine of growth for the region. We are really proud of it.

David Wright

Are there any issues with the availability of research for the small cap market?

Adena Friedman

Thanks for bringing that up. The one thing that we are finding challenging about MiFID II is that the research regime has changed for SMEs as much as it has changed for larger-cap companies. There is a declining amount of research happening in Europe in general on the back of the MiFID II obligations on unbundling, but it is really hitting SMEs the hardest. There are not that many institutional investors in these companies and they will not explicitly pay for research on SMEs, so many brokers have just stopped producing it, because they need incentives to do so.

What we have done on our side is to enter into a contract with Morningstar, who now provides research across all of the companies in the market. It is a generic, machine-learning-type analysis of companies, but at least it allows retail investors to get a basic level of knowledge. This is what we can do to help support research on SMEs but it would be better to have some exceptions in MiFID II rules around unbundling for SME research.

David Wright

Do you think the model of the Nordic markets could be replicated around the EU to dynamise capital markets and what would be the main ingredients?

Adena Friedman

I really do think it can be replicated but it is not something that happens overnight or even in a single political cycle. It is a matter of setting up some basic parameters over time.

First, not overdoing the disclosure obligations on small companies. These need to be lower than those on the main market, as is the case on First North.

The second element is creating incentives for individuals to invest in equities. I have seen statistics showing that the Nordics have 50% more equity ownership by retail than the rest of Europe. As I have mentioned previously, this is due to a combination of factors including cultural elements (a strong social network and a risk-taking culture), a high level of innovation among Nordic companies and also the ISK savings accounts, which has been a huge catalyst of growth in equities. This explains also why so many companies want to go to the equity market.

The last issue that I hear about a great deal, but which is a much harder problem to tackle, is insolvency rules. If you compare Europe and the US, not all is good in the US, but there are elements of the US system that encourage risk-taking and entrepreneurship. One of these is the ability to try something, fail and try again, which is a foundation of the US economy. Therefore I do believe that insolvency laws is something that Europe should really examine in greater depth.

David Wright

I agree with you, we have not advanced very much on this over the last 20 years. One other element that you mentioned when we prepared this conversation is the importance of a centralised repository of information for the market, such as the Electronic Data Gathering, Analysis and Retrieval (EDGAR) system in the US. Should implementing a similar system be considered in the EU?

Adena Friedman

EDGAR is a central repository that the US Securities and Exchange Commission (SEC) operates, into which companies have to submit every quarterly statement and every public announcement that is of material nature. It has become a huge central repository of financial information and disclosures from companies, which I believe is one of the key success factors of the US market. What happens with all the information in one place is that, first of all, the formats are the same and the language is the same. Also, technology companies can more easily come in and build algorithms that scrape information from these filings, and then make that information accessible to investors. Of course, investors can go find it themselves, but technology allows the creation of reports better adapted to investor needs.

In Europe, creating one place for every company to submit their information, using a common language and format such as International Financial Reporting Standards (IFRS) would simplify the access of investors to information about companies and the comparison of these companies. This information could also more easily go to each of the regulators. I am very supportive of this. It does not require sophisticated technology either.

David Wright

We are also seeing in Europe – as well as in the US – a big increase in private equity. For small firms, raising capital through the public markets is quite expensive today compared to private equity. Should we be concerned about this?

Adena Friedman

I would be the first to admit that the US market is not as vibrant as it could be. There are not as many small companies that go public in the US anymore. When we compare the small-cap market on Nasdaq and the First North market in Europe, First North works better. It has tighter spreads and deeper liquidity, and it has many more companies that come into the market at an earlier stage. More can be done to improve the market in the US, but a major factor is the amount of private money available. There are extremely low borrowing rates and ready access to vast amounts of private capital, particularly for technology and innovative companies. This puts public markets at a fundamental disadvantage.

If you are a small or even a mid-sized company and you are trying to raise capital to grow your business, are you going to take money from a long-term investor that does not require a huge amount of disclosure and allows you to grow and expand and, possibly, lose money for a long time, or are you going to raise money on the public market, where you may not be able to predict your financials easily and have a shorter-term investor horizon and a huge amount of disclosure obligations? I think you are going to pick the former.

We have work to do in the US to make the public markets more attractive. We have similar conversations in the US as in Europe around graduating companies more progressively to stringent disclosure obligations, which requires changing some of the proxy rules and other measures to make it less intimidating for smaller companies to go public.

David Wright

Do you think that type of graduation is enough in the current low or even negative interest rate environment?

Adena Friedman

Probably not. However despite the current monetary context, there are positive signs in the US market. It is worth noting that, last year, Nasdaq had 184 IPOs. This year, we have had more than 120 so far, so we are on track to beat last year's figure. More companies are going public because of the cycle. The public-equity markets are also very attractive at the moment, giving companies the same level of valuation they might get in the private market, even if they are pretty discerning. We are also seeing companies going public at a smaller size outside of tech.

However, we still have a long way to go to create the right balance between private capital coming from venture capital (VC) and private equity and public markets in supporting company growth and entrepreneurship.

David Wright

In the US, you also have a massive pension 401(k) market of roughly $20 trillion. Much of that finds its way into the equity markets. Europe does not have that, or much less. Would creating pan-European pension funds be an important driver on the demand side for growing the capital market?

Adena Friedman

I believe that the 401(k) market has been a huge driver of retail activity into the public markets in the US. Defined-contribution and defined-benefit plans are both as important and in the US we have both. The advantage of the European system is that you have giant public pension systems that can invest in their own market. The issue however is that they do tend to not invest in small companies, which require too many resources. However, you can incentivise public pensions to be more oriented towards domestic equity markets through tax incentives and other measures. Even if you had a small percentage of public pension money going into the SME market, it would represent a massive inflow of money for SMEs.

Some public and even private pensions also allow investors to segment a certain percentage of the money that they are entitled to invest themselves. This can be done within the existing system.

David Wright

I would now like you to imagine that you are the European Commissioner for Financial Services about to take office. What would be your priorities for developing capital markets in Europe?

Adena Friedman

There are three main issues that seem essential to me. First, is the development of an equity culture in the different EU countries and what the EU can do to influence individual nations to do this, which is quite challenging. This first requires creating the right incentives, because people do tend to respond to them. This is about focusing on savings accounts, on individual investment into equities and on motivating pension funds. Then you can tackle the harder issues such as insolvency rules in individual countries. The Commission can only write papers and comment on what works and what does not in this latter area.

The second aspect that I would focus on is market structure, and we do think that there is a great scope for improvement in equity market rules in Europe. MiFID II had good intent but the execution has been less than perfect. We have seen no increase in lit volume on the exchanges and just a repurposing of dark trading into the systemic internalisers (SIs), which does not benefit anyone. The spreads are not getting tighter, there is no additional liquidity going into the markets and this is just making them more complicated.

A third aspect is that we still do not have the level of disclosures on a post-trade basis that we think is necessary to incentivise retail investors to come into the market. We are supporters of a post-trade consolidated tape that includes every trade – SIs and dark pools as well as lit venues – so that a basic disclosure of the last trade that happened can be created. It would also provide a consolidated view to investors and an experience closer to that of a single European market.

David Wright

You could do a pretty good job here, Adena. Thank you very much for being with us. I found this very instructive and I hope these ideas and the experience of what is happening in the Nordic markets can be taken on board when the European Commission launches work on what we can call Capital Markets Union II. Thank you very much for being with us. ■