Listing Act and DEBRA: prospects and priorities for SME equity markets

1. Equity financing trends and drivers

1.1 The equity funding gap and related trends and challenges

The Chair introduced the session by emphasizing the limited size of EU capital markets and the risk averseness of investors compared to other regions. This may result in a lack of availability of financing for European companies, particularly for small and medium-sized enterprises (SMEs) potentially impeding innovation and more broadly economic growth.

An IFI representative noted that reports produced during the pandemic by the International Monetary Fund (IMF) and the Association for Financial Markets in Europe (AFME) concluded that there is an equity gap in Europe of €300-600 billion, which is very significant. This concerns corporates of all sizes. It is unlikely that these figures will have changed very much, because most companies increased their level of indebtedness during the pandemic. The need for equity is very significant, particularly for financing the digital and green transitions. In addition, firms need a strong capital base to obtain additional financing. The current changes in the macroeconomic environment, with rising interest rates and inflation, will further affect company economics in the near future.

An industry speaker stressed that, with reindustrialisation and sovereignty objectives following the Covid crisis, financing needs are expected to increase. The higher interest rates will also increase funding costs, which will further widen the funding gap. Non investment grade private companies in particular that finance themselves on the bond markets will face a much higher financing cost. Over the last 5 years, financing costs in the high-yield market decreased significantly, reaching 3%, while the average rate 20 years ago was around 9%.

A policy-maker observed that the restructuring of supply chains towards Europe with current geopolitical developments should lead to European SMEs playing a larger role, with related financing needs. The green and digital transformations also play an important role in this discussion, because they can only be funded with equity or, more broadly, with risk financing, including hybrid equity.

An investor representative emphasized that the funding of SMEs needs to be enhanced because those are the companies that can make the difference in the future in terms of growth, innovation and sustainability. Attracting retail investors to SMEs is essential, because research demonstrates that it is the retail investors who drive the market and set the prices in the market. Large institutional investors mainly use index replicating techniques, rather than stock picking and invest with a great deal of conservatism and heard behaviour. Therefore a combination of retail investors and SME issuers is vital for innovation. In addition, equity investments providing higher returns in the longer term are necessary to help retail investors prepare for their retirement.

An industry representative observed that the demand for equity among retail investors has significantly decreased in France since the beginning of 2022, when considering the volumes handled by retail e-brokers. Many retail clients who were quite active during Covid are leaving the market. Market volumes are quite low at present, leading to high volatility. The current situation in the debt market is also challenging, with rates and spreads increasing, but this is not a retail market.

An official stressed the importance of taxation for the growth of equity markets. In Estonia, for example, the equity gap is not that big in aggregate. That is due to a taxation system that fosters the provision of equity to SMEs by not taxing profits before dividends are paid out. The levels of capital raising by SMEs in public and semi-public markets in Estonia in recent years and particularly in 2021 are encouraging. Causality is difficult to identify however. Factors may include the macro environment and the increased maturity of the market.

1.2 Current IPO and listing trends

The Chair noted that there is a widespread general decrease in public listings in many regions of the world, Asia being a notable exception, with more than 30,000 listed companies having delisted globally since 2005. Concerning Europe, a recent article in the Financial Times reported that, for the first time, there are more initial public offerings (IPOs) and equity financing deals of Chinese companies in Europe than in the US, but these deals happened mainly in London and Switzerland.

An industry representative added that there have been fewer IPOs in the EU in 2022 due to the current macroeconomic environment and mounting geopolitical risks. It is expected that there will be 20 to 30% fewer SME IPOs in 2022 compared to 2021. The decrease will likely be more significant for larger corporate IPOs, which need the support of global markets that are more impacted by macroeconomic and geopolitical risks. SMEs are more local and local investors focus more on the situation of the individual companies.

An industry representative stated that their bank, a major European bank, is very active in IPOs, for large companies and SMEs, in France, Belgium and Italy. A strong correlation has been observed between market volatility and the number of IPOs over the last 20 years. When market volatility is above 25%, the IPO market generally disappears. Another issue that has to be taken

into account in the context of the EU Listing Act, is the significant level of competition in the listing market. The UK is reviewing its regulations to increase its competitiveness after Brexit, for example introducing shares with multiple levels of voting rights. In the UK market alone, €125 billion have been raised in the last 10 years, corresponding to around half of the total achieved in the EU and the depth of the UK market is increasing. Nasdaq in the US is also an important competitor for listings in the tech, biotech and health sectors. Advancing quickly on the Listing Act in order to enhance the competitiveness of the EU listing market is in the interest of EU sovereignty.

An IFI representative mentioned that the tech sector, which has grown extremely fast in recent years, is experiencing value adjustments which will affect the IPO market. This first happened in the US and is now coming to Europe. A further issue to consider is that 75% of fast-growing scale-ups in the EU are refinanced by US investment funds, with most going on to file for IPOs on the US Nasdaq at a later stage. Some initiatives have been launched to address this issue such as the Scale-up Europe programme that was agreed under the French EU Presidency.

An industry representative observed that a similar issue within the EU hinders the development of local SME markets. The larger companies with deals exceeding €300 million usually list in London or one of the main EU financial centre with the support of global banks, which takes resources out of the local EU markets and limits the development of local market ecosystems.

2. Obstacles to listing for SMEs in the EU and potential areas of progress

Several panellists highlighted the challenges that SMEs face when going public.

An industry representative observed that, while listing fees are lower for SME IPOs, the costs of legal advice and intermediaries are proportionately very high. In addition, cross-border IPOs are difficult to implement for local SMEs, because prospectuses and documentation have to be drafted in English and the cross-border execution of order can be challenging. Some other issues include the Market Abuse Regulation (MAR), which should be simplified to make compliance easier for smaller issuers and brokers. A common definition of SMEs is also needed at the EU level.

An official agreed that the costs of intermediation and the ecosystem are relevant when considering measures to support further listing. In Estonia, the increase in market activity coincided with a decrease in legal advisory fees, partly due to regulation and also to an improved maturity of the legal advisory market.

Another industry representative emphasised the obstacles related to the fragmentation of the EU securities market. Specifications for equity markets differ from country to country, increasing complexity. For example, payment for order flow is allowed in Germany but not in France. Cross-border post-trading is also very inefficient in Europe and increases transaction costs. As a result, clients prefer to buy US shares on Nasdaq or NYSE. Further issues are the lack of research on SME stocks and the fact that the development of index products is reducing the transparency of equity markets in general.

An IFI representative noted that governance issues also hinder equity financing for SMEs. 60% of SMEs are family companies. Many SME managers are not in favour of equity financing, particularly from external shareholders, because of the dilution of capital controls it entails.

An investor representative agreed that while there are obstacles to the development of SME equity markets on the supply and demand sides, the supply side presents more structural challenges, because of the unwillingness of many SME owners to share control. Also, listing is complex and costly for SMEs. On the demand side the availability of capital is not a major problem in Europe, because there is a high level of savings and an interest in investing in SMEs. The problem mainly relates to information asymmetry with insufficient analysis and research on the smaller companies and risk averseness.

The industry representative emphasized that the availability of research on SMEs is an issue that needs to be tackled by the Commission. Building trust in the market is also essential. Investors, especially retail investors, are concerned about the possibility for SMEs to be taken over or bought out, which is quite frequent and may have major impacts.

3. Objectives of the upcoming Listing Act and priorities for supporting SME listing

The Chair noted that there is no 'silver bullet' for improving SME equity financing and listing. The Listing Act needs to explore a range of actions.

An industry representative emphasized the importance of an ambitious Listing Act for achieving the objectives of the Capital Markets Union (CMU). The Listing Act should however not result in lowering the disclosure standards of the market, in order to maintain investor trust. The diversity of local interpretations of regulation and of market practices needs to be reduced in order to facilitate and simplify listing on equity markets in the EU. The EU market also has to develop a more mature and deeper investor base for IPOs. In particular, cornerstone and anchor investors are necessary to reduce execution risk. Ensuring insurance companies can invest more in equity would be a key measure. The retail distribution channels also need to become more efficient, and pension and insurance holdings by individuals should be encouraged. In addition, specialized investment funds investing in SMEs should be developed. If there were some incentives to direct asset manager funds towards SMEs, asset managers would have more scale to invest in this segment. The

industry speaker added that evolving towards one common insolvency law in Europe is also essential for the CMU. In addition, while equity is discussed a great deal, the debt capital market is also very important in this regard.

A second industry representative stated that strong support is needed to improve the functioning of SME markets. Government support is the most effective but it is dependent on the level of political commitment to the development of capital markets. The Swedish SME market was very successfully developed with the creation of a retail saving account and effective tax cuts. But the measures taken in Denmark by the public authorities were less ambitious e.g. with less tax incentives and as a result the SME market did not develop in the same way. Stock exchanges can also support SME markets. The profitability of SME markets is usually limited, but stock exchanges cross-subsidise them with other revenue coming e.g. from data services, because SME listing represents a long-term growth potential for the exchanges. That is why it is vital to preserve and strengthen local stock exchanges and ecosystems. The consolidated tape project of the MiFIR review proposal is a challenge in this regard because it may take revenues away from the exchanges that could be used for supporting SME markets.

A regulator suggested three main areas on which the proposals of the Listing Act could focus for developing SME listing.

A first area is providing investors with appropriate information in a way that does not put an unnecessary burden on issuers. Prospectuses are a first issue. They have been reviewed several times and alleviations have been introduced. The latest changes date from 2021, when a short recovery prospectus was created, but it has not been a success with only 19 issuers having used this format. Further areas of improvement were identified in an ESMA peer review of the way that prospectuses are handled by national competent authorities (NCAs). In the French SME growth market for example, prospectuses are not mandatory for IPOs below €8 million. While eliminating prospectuses in this market seems difficult, it should be up to the stock exchange to define what kind of information memorandum is needed. However, some exchanges are reluctant to take on this responsibility. Equity research on SMEs is a second issue. Its availability has been diminishing in Europe, in part due to MiFID requirements to unbundle research and trading costs, but the problem is also that stock exchanges and brokers do not earn enough money when they organise SME listings. Broker equity research has been increasingly replaced by issuer-sponsored equity research, which creates potential conflicts of interest, but is the only viable solution at present. This kind of research is classified under the MiFID regulation as marketing documentation. Conflicts of interest should be more prominently disclosed and rules should also be proposed to ensure the independence of equity analysts drafting this research. For example, a code of conduct was established in France, which could be used as a basis for defining standards at EU level. The proportionality of disclosure requirements is a third issue. At present, disclosure requirements apply only to listed entities, but some disclosures, for instance those relating to non financial reporting, should apply according to activity and size criteria rather than the listing of the entity. Listing should not automatically lead to additional disclosure.

A second area that needs considering in the Listing Act concerns voting rights. Founders often want to retain decision-making power, especially for innovative companies. It should be possible to provide a multiple voting structure for shares in every European country, as is the case at present in the UK and certain EU member states. Finally, market abuse rules, which have been debated in Europe for many years need adjusting, the regulator believed. The same definition of inside information applies to users of this information and to companies providing it, which is not always the case in other jurisdictions. Another definition could be useful for companies, leading to a more restrictive distribution of confidential information.

An investor representative suggested that solutions to make SME markets more attractive should mostly concentrate on the investor side. Issuer focused solutions to reduce the administrative burden associated with listing, such as lowering regulatory requirements will have limited impact, because the main obstacle to listing is in most cases the fact that owners want to remain in control of their company and do not want significant changes in terms of governance. The investor representative was moreover opposed to rules allowing multiple voting rights because a balance must be struck between former and new owners of companies and the 'one share, one vote' principle must be maintained.

The measures for developing SME listing must therefore consider the interests of investors, the investor representative stated. In addition they should foster a combination of institutional investors who can perform a detailed assessment of companies and of a wide group of retail investors. The aim is eventually to achieve a more effective capital allocation in Europe and to diversify the funding of European firms. This requires making the SME market more attractive for retail investors in particular, developing a real equity culture and also providing an adequate framework for individual savers to invest. There are a number of obstacles to overcome. Most retail investors prefer investing in larger companies which seems safer and is less costly or in investment funds, which offer more diversification. A business case for getting SMEs into ETFs, which are a less costly vehicle for investing in equity markets, could help to stimulate the market. Building investor trust is important as well. If companies are not properly managed or fail to prevent fraud, investors need to be able to seek redress. Currently, in Europe, it is only possible to do that at national level. A pan-European collective system of redress is needed.

A third industry representative suggested that improving the cost and efficiency of SME markets, in particular at the post-trading level, is essential, possibly with a consolidation of the EU post-trade infrastructure and the use of more blockchain technology. This however is in the field of private initiative. Enhancing the transparency of SME markets is also important,

which requires moving towards common specifications for SME markets across the EU.

The Chair summarised that there are issues on the supply and demand sides, but SMEs can be an important asset class, even for retail investors, for both equity and debt. This must be taken into account in the Listing Act and also in other initiatives to support the funding of SMEs.

4. The DEBRA proposal and expected impact on the debt-equity bias

A policy-maker noted that taxation also plays a role in the development of equity markets. The current debt-equity bias in terms of taxation makes debt financing more attractive for companies, since interest expenses are tax deductible. The debt-equity bias i.e. the difference between the cost of capital for debt and equity, is high in the EU, at an average of 1.8 percentage points in 2021, with a range of 0.1 to 3.1 across member states[1].

Companies should be able to make the trade-off between debt and equity funding without tax rules influencing those business decisions. This would provide a better basis for businesses to take on the risky investments that are needed for the green and digital transitions in the coming decade. Six member states have already taken action to address this issue: Italy, Belgium, Cyprus, Malta, Poland and Hungary. While the measures differ in policy design, all provide for tax allowance on equity. These actions prompted the European Commission to develop a common approach. The Debt-Equity Bias Reduction Allowance (DEBRA) proposal seeks to rebalance the costs of debt and equity financing in order to achieve higher equitisation levels and discourage excessive debt accumulation, while limiting the budgetary impact for member states. This is achieved by combining a tax allowance on new equity with a limitation of the deductibility of interest expenses to a period of 10 years[2].

The review of existing notional interest deduction regimes by the EU's Code of Conduct peer review group clearly shows the importance of a comprehensive and robust anti-abuse framework as well. In particular, anti-abuse rules should target, amongst others, cascading of allowances through equity, using a mix of intra-group loans and participations, and re-categorisation of old into new equity. The DEBRA proposal provides a robust and complete anti-abuse framework to avoid such unintended use of the allowance.

DEBRA will apply to all non-financial companies, as the financial sector is already subject to regulatory requirements that prevent under equitisation. Discussions on the DEBRA proposal have just begun, the policy-maker concluded. EU Member States are supportive of the objectives of the initiative. The main challenges to overcome are the relative complexity of the measures and the difficulty of getting DEBRA to the top of the political agenda in the current environment.

An investor representative welcomed the proposal to address the current fiscal bias, which perpetuates overreliance on bank funding and upholds leverage. Transitory provisions should however be considered to ensure that the time to market of DEBRA does not have unintended consequences, i.e. incentivize companies to delay expansion of their equity, in anticipation of the entry into force of DEBRA. This would be contrary to policy objectives. The policy-maker confirmed that there will be grandfathering for all equities.

A regulator agreed that addressing taxation issues is essential for the development of capital markets. Care must however be taken with these measures not to provide bad incentives for equity listings, because otherwise it is private equity investors who will benefit from these measures, rather than the general public. An industry representative added that while the objectives of DEBRA are relevant, there should be caution about attracting vehicles to listing solely for fiscal benefits, bearing in mind the negative example of certain special purpose acquisition companies (SPACs[3]).

An official commented that, although DEBRA looks like 'low hanging fruit' from a distance, from closer it is clear that a complex construction is needed to address the debt-equity bias. Whether this is worth it is not yet certain. If DEBRA was confirmed implementing it as a regulation would be necessary, in order to achieve sufficient consistency. The policy-maker mentioned that the specificities of certain tax systems, such as the one in Estonia will be addressed at Level 2.

An official concluded that DEBRA addresses a structural issue in the market and it is the right time to solve it. The proposal must be appropriately calibrated, given ongoing developments at the macro level.

1. Research suggests an impact coefficient of the corporate income tax (CIT) rate on the debt-asset ratio of about 0.27. This means that for the weighted average CIT rate in the EU (26%), the debt-equity bias is responsible for a 7 percentage-point higher debt-to-equity ratio on average.

2. Under DEBRA, a notional interest rate allowance would be granted on new equity for a period of 10 years, based on the year to-year increase of equity. The time dimension of the allowance approximates the average maturity of debt, striking the balance between limiting the fiscal costs of the allowance and providing some planning horizon and stability for investors. The equity allowance would be calculated with a notional interest rate based on the currency specific European Insurance and Occupational Pensions Authority (EIOPA) risk free rate, plus a risk premium of 1 to 1.5% for SMEs. This top-up in the risk premium approximates the difference in the EU average of financing costs between SMEs and larger firms. On the debt side, the deductibility of net interest payments (interest paid less interest received) would be limited to 85%.

3. A special purpose acquisition company (SPAC) is a company without commercial operations and is formed strictly to raise capital through an initial public offering (IPO) or the purpose of acquiring or merging with an existing company.