

SME equity funding: Listing Act and ESAP proposals

1. Current state of SME equity funding and listing in the EU

1.1 Opportunities and challenges associated with SME equity funding

The Chair stated that small and medium sized enterprises (SMEs) are the basis of the EU economy and need adequate financing but there are conflicting trends in the market. A massive number of companies – more than 30,000 globally – have delisted from the markets since 2005, with higher figures in Europe and the US than in other regions. At the same time, the equity market structure has positively evolved in the EU in recent years, e.g. with a relative success of multilateral trading facilities (MTFs) that are likely to support SME access to equity markets.

A policy-maker agreed that improving the financing of SMEs remains a key objective, given their importance for the EU economy, which is higher than in other jurisdictions. The right financial tools are needed to support the growth of these companies and notably an improvement of their access to market-based funding. A survey conducted by the Commission together with the ECB in 2022 on the access to finance for enterprises in the EU showed some surprising results however. Only around 11% of EU SMEs reported that equity funding is important for them. That reflects the current overreliance of SMEs on bank lending in the EU. Further diversifying the financing of SMEs is essential, particularly for the more innovative companies.

There have been quite a few fluctuations in the SME equity funding market recently, due in part to the macro environment, but the main issue is that SME markets remain underused, the policy-maker stressed. Market financing was very limited in 2020 due to the Covid crisis. Firms turned more to credit lines from banks, as they were often guaranteed by the state. 2021 saw a significant increase of private equity (PE) and venture capital (VC) funding, together with a record number of SME IPOs following the creation of SME growth markets, but that boom was short lived and in 2022 market funding declined again. Rising interest rates could have favoured equity funding, but at the same time the economic uncertainty and volatility due to Russia's invasion of Ukraine and rising inflation impacted negatively equity primary and secondary markets.

An official observed that there is huge potential in the growth of innovative SMEs in the EU, and particularly in the Central and Eastern Europe (CEE) region. It is essential to fuel investment to these companies. According to some calculations, the growth potential of SMEs in a country such as Slovakia is almost four times Slovakia's GDP.

1.2 Main drivers and obstacles to SME equity funding

A civil society representative noted that the situation of SME equity markets is quite heterogeneous in Europe. Strong growth has been seen over the last 20 years in the Nordic countries, mainly due to a high level of retail participation and investment culture. This had led to an increase in household wealth particularly in Sweden and Denmark. In Denmark household financial assets represent 426% percent of GDP, while in Romania, where most assets are held in cash and bank deposits, they are limited to 79%. In the Nordics, up to 80% of household financial assets are held directly or indirectly in capital market instruments, with a strong role played by investment funds, insurers and pension funds. This shows that retail participation can create a virtuous circle or a vicious cycle depending on the countries. A second aspect to be considered is that the increase in company listings is also often correlated to the interest in investing among the population and the proportion of households actively participating in the markets. If this dynamic is not created then there will be fewer listings, and vice versa. The statistics showing that half of the trading on the Nordic stock markets in SME shares is done by retail investors is telling in this regard.

The civil society representative also observed that the strength of relationship banking in many parts of Europe can be an obstacle to the further development of capital market financing. Banks want to preserve their relationship with SMEs and the corresponding revenue streams coming from interest income. This means that they do not always encourage their customers to increase equity and bond financing or to go public, because the amount of fees for supporting the listing of a company is probably lower than the income that they can gain from more traditional financing activities.

An industry representative added that the high cross-border transaction costs within the EU are another obstacle to the development of SME equity markets. This contributes to a home bias in the purchasing of stocks in most member states and when retail investors buy foreign stocks they usually prefer US stocks to other EU stocks because of the high execution costs. These costs are due mainly to post-trading which is fragmented, with multiple infrastructures and no legal harmonisation across the EU. With regard to SMEs more specifically, a further issue is that the investments of retail investors in IPOs have not always been profitable in the past notably because of the lack of liquidity. Investors who have lost money on IPOs will not invest again in those kinds of stocks.

A policy-maker observed that barriers to the investment in SME stocks also have to do with information asymmetries, the higher costs of investing in SMEs compared to large caps and also the reluctance of company owners to open

up their capital to external investors, in order to retain full control over their business.

The Chair summarized that there are supply and demand drivers to be considered related to the access of SMEs to equity markets and to the demand for SME stocks. Sweden has been particularly successful in putting these different drivers into play resulting in a high number of listed companies and significant market cap and retail participation. There are also external factors to consider such as the macro environment, monetary policy and the availability of alternative source of financing.

2. Legislative proposals to improve equity funding

2.1 Proposals made in the context of the Listing Act and ESAP initiatives

A policy-maker stated that some new initiatives have been proposed by the Commission to support SME financing, as part of the Capital Markets Union (CMU) action plan. These include the recently published Listing Act and the European Single Access Point (ESAP) initiative, which aims to facilitate the access to financial and non-financial information on companies across the EU.

The objective of the Listing Act, the policy-maker explained, is to facilitate the listing of companies, especially SMEs but not only, with improvements of the legal framework in terms of proportionality and simplification. Proposals have been made to better adapt listing requirements to companies of different sizes. Adjustments are also proposed in terms of transparency. While transparency is very beneficial, providing an extensive amount of information can be very cumbersome for smaller companies and first time issuers. The Commission has proposed a streamlining of prospectus requirements to alleviate the burden for first-time issuers and also those who are tapping public markets repeatedly. There is also the objective of making the approval process of new prospectuses shorter and more effective and predictable. A second objective of the Listing Act is to improve the proportionality of the market abuse framework, while preserving its effectiveness. The sanction regime could be made more proportionate, when it comes to non-core infringements in particular, because the risk of being caught with the current rules due to negligence or unintended actions may discourage smaller issuers. A third aspect of the Listing Act is a new proposal of multiple vote share structures, aiming to address the reluctance of some company founders or controlling shareholders to give power away and allowing them to retain some decision making powers in the company if it is listed on public markets.

A civil society representative noted that with regard to the proposal to establish a so-called cross market order book

supervision in relation to market abuse, there is a risk of an uneven playing field, because bilateral trading venues are not in the scope. That needs to be taken into account.

The Chair summarized that the proposals of the Listing Act and ESAP could make it easier not only for SMEs but for all companies to access capital markets and to seek additional market funding through an improved entry point to company information. These proposals build on similar measures that have already been implemented in some OECD countries and EU member states.

2.2 Expected benefits from the Listing Act and ESAP proposals

A civil society representative stated that from their perspective, the proposals of the Listing Act are a significant step in the right direction. If appropriately implemented, these measures, together with the other proposals of the CMU action plan, could help to enhance retail investment culture and generate more listings, creating a virtuous circle for the development of capital markets in the EU. The proposal to implement a multiple voting rights regime, which seeks to achieve a minimum harmonisation of national laws in this area – allowing company owners to retain decision-making powers in their company while raising funds on public markets – is particularly important. Sweden, Finland and Denmark have such regimes in place and this has contributed to the listing of companies and the growth of capital markets in these countries. This should therefore be extended to all EU countries and the current fragmentation of national rules should be tackled. This is important in particular for encouraging family-controlled companies to consider listing. In Germany, 90% of companies and 43% of companies with sales of more than €50 million are family companies. In these companies, the fear of losing control is usually one of the main factors why they do not list. The proposal to streamline prospectuses is also very welcome, as this may help to significantly reduce the costs and burden for issuers.

An official observed that the Listing Act and ESAP are key elements of the CMU, which is a key driver of future growth in the EU and is needed to react to the US Inflation Reduction Act. A stronger integration of EU capital markets is needed to make better use of economies of scale in the financial area and more active capital markets are needed to provide the investments required for the green and digital transitions. As shown by the mandate given to the Eurogroup by the Eurozone leaders following the March 2023 Euro Summit to further develop the CMU and the op-ed article signed in March 2023 by the chairs of several European institutions¹, there is a strong momentum behind the CMU initiative.

The ESAP and the Listing Act are addressing both the demand and the supply sides, aiming to find a new balance between investors and issuers and develop synergies between the two, the official noted. Another positive feature of the Listing Act proposal is that it

1.Channelling Europe's savings into growth – Op'ed article signed by the Presidents of the European Council, European Commission, Eurogroup, ECB and EIB – 9 March 2023.

addresses the whole listing process from the pre-IPO to the post-IPO phase. Concerning the pre-IPO phase, there is already a general approach on the multiple-voting rights regime and the Council is ready for negotiation. This measure could be extended beyond SME growth markets. For the IPO stage and the improvement of prospectuses, the main issue is achieving sufficient proportionality. Defining the appropriate threshold for streamlining prospectuses that allows a preservation of investor protection still needs to be done. A range can be defined where all member states can feel comfortable. There are also some legal questions to tackle in relation to the language used. Finally, concerning the post IPO stage and the market abuse aspects, these are more technical questions so there is no political obstacle to these measures. A further positive measure of the Listing Act for countries such as Slovakia is to make it easier for SMEs to access the market infrastructure of countries with more developed capital markets. ESAP will also address the fragmentation of cross-border information, providing another added value for smaller member states and markets in terms of visibility.

2.3 Issues to be further considered

An industry representative suggested that more could be done to reduce capital market fragmentation in the EU. The Listing Act is a step in the right direction in this regard, but more could be done in the post trading area in particular, with more harmonisation and integration in the settlement space. The framework applying to market-making also needs to be further harmonised to avoid market fragmentation. It is currently difficult for companies listed in different European exchanges to have the same market maker in order to maximize efficiency and liquidity and diminish costs. The ESAP should also encourage more cross-border trading, but the precise status of the project needs to be clarified. A further issue to consider concerns the research unbundling rules of MiFID II, the industry speaker stressed, that require unbundling brokerage commissions and investment research fees. Currently there is an exemption from the unbundling rules for issuers whose market capitalisation does not exceed €1

billion. The proposal has been made to increase the current threshold of €1 billion to €10 billion, but this remains a complex rule to implement.

A social society representative supported the recommendation to increase the threshold for unbundling requirements to €10 billion, but noted that the debate about this threshold is irrelevant in many EU markets where the large majority of companies have a market cap smaller than €1 billion. Beyond this measure there is a need to encourage independent research. There are several examples of market-led initiatives that are worth considering. For example, there is a research institute supported by the stock exchange in Spain, which is providing independent research on companies that do not benefit from sufficient coverage. Such initiatives should be encouraged.

An official agreed that more harmonisation is needed in European capital markets. Many heterogeneities remain to be tackled. For example, there are different distribution models and different levels of access to capital across member states. There are also some actions of the CMU action plan that are particularly relevant for the CEE region and that still remain to be implemented. The first is Action 5 of the CMU action plan, which proposes to implement a process for directing SMEs to alternative providers of funding in cases where they have not obtained requested financing from a bank. This is something which is already used in the UK and can be replicated in continental Europe. The second action is Action 7 concerning financial literacy, competencies and education on which more focus is needed in the next stages of the CMU, because support from the wider public is needed for the success of the initiative.

A policy-maker added that the Commission has been working on the setting up of an SME IPO fund for quite some time that should provide additional support measures for SMEs and enhance their confidence in capital markets. The project is moving forward with the recent completion of a call for expression of interest for fund managers.