REPORT TO ESMA

Securities and Markets Stakeholder Group – Report on Helping Small and Medium Sized Companies Access Funding

An own-initiative report by the Securities Markets Stakeholder Group to the ESMA Board of Supervisors

I. Executive summary

On 15th February 2012, ESMA's Board of Supervisors (BOS) requested the Securities Markets Stakeholder Group (SMSG) to present its views on the impact of regulation on Small and Medium Size Enterprises' (SME) ability to access funding. The SMSG responded to the BOS' request by setting up a dedicated working group and by agreeing on a mandate (see Annex I). The objective of the group is to give ESMA advice on how EU regulatory proposals impact the ability of small and medium sized companies to have access to funding (through private equity and venture capital funds or through capital markets by listing on an exchange) and how EU regulatory proposals impact investors' ability to invest in these companies. The advice of the group is targeted at ESMA but might also be relevant for other European Supervisory Authorities (ESAs).

As a first step, the group prepared this background report which also sets out a number of initial policy recommendations, some of which were also shared with the BOS during the joint meeting on 12th September 2012. When in this paper we use the acronym SMEs we mean a much broader group of small and medium sized companies than those confined in the EU Commission SME definition (see Annex II). This is because the original definition by the EU Commission was set up in the context of state aid and is thus very restrictive on e.g. size. The more recent use of this definition also in other contexts has some negative implications on SMEs.

The SMSG has chosen to look at SMEs as those companies having a market capitalization/enterprise value below 500 million.

The paper begins with a disturbing diagnosis: though SMEs account for two-thirds of total employment in the OECD countries, two-thirds of entrepreneurs perceive that it is difficult for young entrepreneurs to access financing. The paper then summarises the key statistics, describes the different stages of development and needs of SMEs and identifies issues that impact SME's ability to access funding.

The paper subsequently analyses the regulatory initiatives that impact the ability of SMEs to have access funding. The paper concludes that regulatory initiatives often have a negative impact on the ability of SMEs to access funding. For example, with regard to private equity and venture capital, AIFMD[1] will imply increased administration and reporting for SMEs and could affect their cost of capital. The implementation of the Solvency II Directive as well as the Capital Requirement Directive (CRD IV) will reduce the availability of investable capital for private equity and venture capital funds and thus onward flows to SMEs. The AIFMD and the proposed European Venture Capital Funds Regulation (EVCFR) and Social Entrepreneurship Funds (EuSEF) Regimes[2], aim to provide an EU-wide marketing passport to qualifying funds thereby enabling more investors to indirectly invest into SMEs. However, on balance, it remains to be seen if the benefits outweigh the costs.

With regard to Regulated Markets and MTF[3]s, the increased transparency following the adoption of MiFID[4] represents a challenge for SMEs, resulting in a suboptimal time allocation for SMEs' board and management and increased costs for accessing public markets. In addition, MiFID has also heightened the pressures faced by small and medium sized intermediaries with respect to their cost base. The latter were traditionally providing research activities and listing services to the SME sector. A decrease in the amount of research available for SMEs has negatively affected the liquidity of these shares on public markets. There is a risk that regulation extending to 'traditional' MTFs under the review of MiFID/MiFIR and MAD/MAR, may prove burdensome and not appropriate for SMEs. On the other hand, a level playing field is needed between MTFs and Regulated Markets, especially considering that both types of venues are now comparable in terms of trading volumes.

The paper then focuses on regulatory initiatives which impact the ability of investors to invest in SMEs. As a result of CRD III and Solvency II and the uncertainty they bring to investors, there is a decrease of investment flows from banks and insurance companies to equities in general as well as to private equity and venture capital funds. If pension funds covered by IORPD[5] would also have to comply with Solvency II type of risk weightings, they will be required to hold additional liquid assets. This will not only have a negative impact on pension funds' ability to invest into equity and other long-term assets, but may over time lead to companies being faced with increased costs for pension benefits, as pension funds find it difficult to generate the necessary long-term returns to match their long-term liabilities. With regard to Regulated Markets and MTFs, creating an SME market regime within MiFID II is a first step towards helping growing companies' access capital markets by gaining profile with the investor community within a European framework. The separate and distinct framework would allow for additional EU measures to increase investors' access to SMEs for example through Solvency II.

And last but not least, the paper sets out a number of policy recommendations cutting across a number of different policymaking areas, both at an EU level as well as at a national level. The SMSG is conscious that some of our proposals are clearly out of ESMAs remit, but we have deliberately chosen to take a broad perspective and holistic approach in our attempt to identify factors critical to the financing of SMEs and which address both the concerns of investors as well as the SMEs themselves.

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[1] Alternative Investment Fund Managers Directive (AIFMD).
[2] These regimes are currently being negotiated in the Trilogues.
[3] Multilateral Trading Facility (or MTF) is a specific type of European financial trading system.
[4] Markets in Financial Instruments Directive (MiFID).
[5] Institutions for Occupational Retirement Provision Directive (IORPD).

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1. Introduction

1.1 A short diagnosis

1. SMEs face a struggle to access the finance needed to grow their operations. According to an international study by Ernst & Young[6], this is a global issue that affects fast-growing emerging nations as much as developed countries. Almost two-thirds of the 1,001 entrepreneurs interviewed by Ernst & Young perceived that it is difficult for young entrepreneurs to access financing. This is very worrying as SMEs with less than 250 employees accounted, on average, for two-thirds of total employment in the OECD countries in 2007[7].

2. The study further found that private equity is becoming a viable option for smaller entrepreneurial businesses in fast-growing emerging markets.

3. The study also showed that public stock markets dedicated to SMEs have been launched in 14 of the G20 countries, and have been attracting an increasing number of companies over the last five years.

4. The advantages to companies of using the capital markets translate to higher economic contribution and employment. The markets provide businesses with a high degree of diversification of potential investors, the access to additional equity capital and the higher public profile and brand recognition that a listing can provide a company with. This can also help to attract talented senior management. However, in order to access capital markets a company generally needs to have a history, be able to show reasonable predictability of earnings and growth and be of a reasonable size and market cap so that there will be enough liquidity in the share to attract investors.

5. As different companies need different owners at different times during their life-cycles, it is in the interest of citizens, investors and future pensioners in Europe to ensure that there is an efficient and functioning ecosystem of different ownership and funding models for the different stages of growth of these companies (i.e. bank lending, venture capital and private equity as well as access to capital markets). These ownership and funding models are complementary.

6. However, for most countries debt remains the predominant form of SME financing, although the US stands out as offering a more diverse range of debt and equity finance mechanisms. Nonetheless, in many countries banks are increasingly shying away from financing SMEs.[8] This is discussed further in section 1.3 below.

1.2. Key statistics

7. There are approximately 23 million SMEs in the EU[9]. About 6,000 of these are listed on a Regulated Markets or MTF while some 25,000 are held through funds managed by 1,900 private equity and venture capital firms. The average holding of these companies by such funds is more than 4 years. In contrast, the average holding time of an institutionally held quoted share is 5-7 months in Europe.

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[6] White Paper by Ernst & Young "Funding the Future", 30 May 2012 http://www.ey.com).
[7] OECD (2011), Entrepreneurship at a glance 2011, OECD Publishing.
[8] Financial Times, June 1, 2012 "Global funding struggle for SMEs".
[9] Detailed SME statistics per country can be found in Annex III.

8. The 23 million EU SMEs are crucial for economic growth, job creation and exports. They currently account for two out of three jobs in the private sector and are responsible for more than half of the total value added by EU enterprises. In the period 2002 to 2010, they were responsible for 85% of net new jobs in the EU. As dynamic enterprises, they are significant contributors to innovation and breakthrough technologies. For example, UK SMEs account for 40% of live patents and are twice as likely to be in high technology sectors as their Chinese rivals.

9. A recent study by the Technical University of Munich[10] shows that, on average, private equity-backed SMEs had an annual growth rate of 7% over a four year period. For European SMEs the average growth rate is around 2%.

10. At the same time, companies quoted on AIM (The London Stock Exchange's market for smaller growing companies) have significantly outperformed the broader business population, showing a 37% growth in turnover and 20% growth in employment in the year following their IPO.

1.3. Impact of financial crisis

11. As a result of the global financial crisis, SMEs' own financial resources have deteriorated, leading to lower generation of internal cash flow and hence to greater external financing needs. This has lead SMEs to deleverage their own balance sheets and to create liquidity cushions to take into account the uncertainty in bank lending over the near future.

12. In the wake of the current financial crisis banks are generally, and to an even larger degree than historically, shying away from financing SMEs as they need to deleverage their balance sheet. This restricts credit to businesses even in those cases where companies generate a positive cash-flow which would allow for the servicing of debt. Smaller, younger and still developing companies are considered riskier, and banks prefer to concentrate their resources on lending to sovereigns (0% risk weighted), and larger companies, typically blue chip, where information asymmetries are smaller and where failure is less likely. In addition, banks have reduced cross-border lending which has led global companies to increasingly rely on their own domestic financial institutions further reducing the availability of debt capital for SMEs[11]. It should be noted however that access to credit by SMEs remains strong in Germany. According to IFO index and KfW there has been no credit crunch on SME financing. Funding conditions for SMEs, with exception of very small ones, have never been better. Especially small and medium intermediaries like the German co-operative and saving banks provide financing to SMEs.

13. As a result of the implementation of Basel III/CRD IV and Solvency II, banks and insurance companies face new tougher own funds requirements and greater liquidity constraints. This further reduces the availability of bank lending to companies and insurance companies to invest into equity causing an even greater crowding out effect for lending to SMEs compared to bigger companies and sovereigns. While larger companies may also be able to tap the corporate bond markets this option is typically not available for SMEs.

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[10] Return Attribution in Mid-Market Buy-Out Transactions – New Evidence from Europe, Professor Christoph Kaserer, Center for Entrepreneurial and Financial Studies, October 2011.
[11] Financial Times. May 4, 2012 " Banks look to farm out portion of SME loans".

1.4 How do SMEs currently raise capital and what governs their funding choices?

14. SMEs need capital to finance their development and maximise their innovation potential. As they progress through the business life cycle, they use a combination of financing sources including bank debt and external equity from business angels, venture capital or private equity funds and from the capital markets. In more recent times we have also, in some countries, seen variations of these models where newly born companies get immediately listed (like in Canada with TMX Venture Exchange). In others they can raise very small amounts, as a substitute to a bank loan, on an MTF (e.g. the 350 companies on the Polish NewConnect raising on average 900,000 euros).

15. Even if in most countries as we have seen debt remains the predominant form of SME financing before companies are able to generate profits and a positive cash flow, it is difficult to obtain loan financing from banks. In the early stages of their development, SMEs are typically dependent on equity financing. Initially capital may be provided by family, friends and eventually business angels. At a later stage, in order to professionalise and scale-up, growing and innovative companies will typically seek funding from venture capital and private equity funds. Once these funds have taken the SME onto its next level of development, they will look to the capital market and an Initial Public Offer (IPO) as one of their exit options.

Private Equity and Venture Capital

16. Before a company has reached the stage and size of being able to access capital markets, it still needs funding to sustain its growth and development. It will typically also be in need of more hands-on ownership and non-financial support to enable it to make the transition from an entrepreneur-led early stage company to a more professionally governed company with institutionalised processes in place, enabling it to scale up and take the next step in its development. For SMEs at this stage of development, venture capital and private equity funds can provide that type of long-term ownership which typically sets out a 3 to 7 year development plan rather than focusing on quarterly earnings.

Capital Markets

17. As mentioned above there are many advantages to using capital markets including the diversification of potential investors and the access to additional equity capital. Furthermore, company listing on an exchange will increase its profile and brand recognition, which can help to attract more senior management. However, in order to access capital markets a company generally needs to have a history (i.e. it needs to be able to show reasonably predictable earnings, growth, etc.). To attract investors the company needs a reasonable size and market capitalisation to have sufficient liquidity in its share trading post an IPO.

    Furthermore, it seems unlikely that bank funding will ever reach the same levels as those that existed prior to the global financial crisis as banks will be facing restrictions in the credit and liquidity they can provide (in light of Basel III, possibly the Volcker Rule etc.).

    Therefore, the need is to focus on how to encourage the broad base of investors to invest not only in equity but also in debt issued by smaller companies and how to structure a market so that investors can get reliable liquidity in their investments (irrespective of the way such debt is offered, i.e. by public offering or private placement, although private placement would be more suitable in case of smaller companies)."

1.5. Critical factors in determining funding choices

Information

18. Information is a necessary prerequisite for investment. Without sufficient information, no investments will be made. Investors will want to understand the company in order to be able to assess the risks connected with the investment. There is an ongoing need for information throughout the duration of the investment. The specific information needed depends both on the company as well as on the relationship between the company and the type of investors. Where the investment is private and made by an individual, the type of information can be negotiated directly between the investor and the company and can be disclosed to the investor confidentially. Where the company seeks public funding the required information must be disclosed to the whole market. For this reason stock exchanges used to have rules on prospectuses and continuous disclosure obligations. Today these are regulated by EU legislation. As it is difficult to determine precisely what information is needed in public markets, the obligations tend to be standardised, substantial, frequent and public.

Public trading and compliance costs

19. Complying with disclosure obligations is costly as the publicly traded company needs to divert internal resources in the form of manpower and attention to ensure continuous compliance. The stricter the regulation is, the higher the costs. Consequently, there is a threshold especially for small companies. The costs connected with providing one or more large investors with the information they require is usually low, because the information is limited to the specific information required by the investors and is only provided upon request. Disclosure obligations applicable to trading on a public market are usually considerably higher (as pointed out above). Furthermore, the publicity associated with being listed on a public market can have drawbacks because the continuous information on activities and performance, especially in adverse times, may have a negative impact on the company's standing and performance. It is not easy to determine the optimal level of disclosure obligations on public securities markets. If the standards are too strict, the resulting compliance costs may discourage listings by SMEs. If the standards are too lax, investors will not receive adequate information to protect themselves when making investment decisions in which case they run the risk of disappointment and ultimately outright fraud. Over time, several new securities markets have been launched to provide SMEs with funding while keeping disclosure obligations lenient, only to result in scandals that have hurt both investors and SMEs badly. Thus, it is necessary to find a balance which ensures adequate disclosure and investor protection without sacrificing investors' needs or burdening companies with excessive compliance costs. Besides regulating the scope and severity of disclosure obligations applicable to public securities markets, it is also possible to address the two sides that use these markets: the issuers and the investors. Securities markets may be divided to cater for different issuers, for example operating different markets or listings for large companies (blue chip or official listings) and SME (usually referred to as growth markets or second tier markets). Or, conversely, the investing public may be divided into professional investors, who are deemed sufficiently capable to access investment opportunities without substantial disclosures and investor protection, whereas retail investors are prevented similar access in order to protect them from the higher risks of this kind of investments.

Different types of investment at different times for different companies

20. Investment in a company can be tailor made to suit the individual investor's needs. However, a main distinction is made between equity and debt. Equity is seen as part of the company's capital and although it can be repaid on the rare occasion of the company's liquidation, its main purpose is to re-

main with the company and provide the investor with a share of the future profits of the company, usually paid annually as dividends. Debt is seen as a loan that is to be repaid, usually in instalments, and the investor is rewarded for the risk taken by an interest received on the loan. In case of insolvency, debt is paid before equity and in this respect debt is less risky than equity; although both forms of investment run the risk of default if the company cannot fulfil its obligations. As the reward of an investment will reflect the risk connected with the investment, the reward in form of dividend on equity is normally higher than the reward in the form of interest on a loan. In this respect, it should not matter whether a company obtains its funding by equity or debt; the relationship between risk and reward should be equal. Nevertheless, it does matter for a wide variety of reasons. One reason is tax, because most jurisdictions allow interest on debt to be subtracted from the financial results of a company before taxation, whereas dividends are paid out of profits that have been taxed. This asymmetry may distort the funding decisions of companies. Another reason is based on the fact that dividends are only payable from profits and retained earnings, whereas interest on debt must be served irrespectively of whether the company is profitable or not. For this very reason, start-ups which often have little or no profits in the first years are usually ill advised using debt as funding and should prefer to attract equity that is more patient in the sense that dividends are only payable once the company becomes profitable. However, this feature of the equity investment will usually be off-set by higher return requirements on the investment once the company is profitable, and to secure the investment the investor may also require control rights. Most start-ups are run by an entrepreneur who may be reluctant to give up control, or even to share it with an outside investor. However, the equity investment can be negotiated in such a way that these problems are overcome, e.g. by use of different classes of shares with different voting rights and rights for dividends. It is important that company law is flexible enough to accommodate the special needs of both companies and investors. Depending on the costs connected with providing investors with information, companies may try to attract equity investment from different sources. Very small companies may find it easier to have direct equity investment from (in a progression going from very personal to less personal) friends and family, business angels, and VC funds. Depending on the level of compliance costs, SMEs may also decide to go public and have their shares admitted for trading on MTFs or Regulated Markets.

2. Issues identified as impacting the ability of SMEs to have access to funding

21. While the objective of this paper as previously stated is to provide ESMA with advice on relevant EU regulatory proposals that impact the ability of SMEs to have access to funding, the paper will also point at a number of other developments and/or obstacles that have been identified in the process and how some of them are linked to specific regulatory proposals.

2.1 What are the main barriers for SMEs to access private equity and venture capital funds?

22. The European venture capital market has developed and matured. Contrary to what has sometimes been argued, currently it is not a problem for VC funds to have knowledge of entrepreneurs and investment opportunities as well as for entrepreneurs and other growing companies seeking VC-funding to find these funds. However, this is becoming increasingly difficult. The reasons why the two may not necessarily come to an investment agreement are usually related to the reluctance of some entrepreneurs/family businesses to give up part of their control or to differing opinions on valuations and commercial terms on co-ownership.

23. The most important barriers for SMEs to access private equity and venture capital funds are:

- **The reduced number of VC funds** - There is a shrinking number of active VC funds in Europe. This means that the supply of capital for which the SMEs compete is diminishing. With a shrinking number of funds it becomes increasingly difficult to build depth and expertise in managers and create clusters like the Silicon Valley in the US. Too much public money has over the years also been spread too thinly in Europe, not necessarily going to those managers with the most expertise but rather to local, regional or sectorial initiatives within Member States. This has not helped to build clusters of competence but rather reduced average returns across the sector making private sector investors in general weary of the asset class, thus creating a downwards spiral.

- **Restrictions to EU marketing activity** – Traditionally, venture capital and private equity funds have faced restrictions when marketing themselves to investors interested in indirectly investing into SMEs, across Europe. Various EU initiatives such as the AIFMD, the proposed European Venture Capital Funds Regulation (EVCFR) and European Social Entrepreneurship Fund (EuSEF)[12] Regimes have sought to address this issue and have aimed at introducing an EU passport to qualifying funds. However, the balance between costs and benefits of the passport remains to be seen. The impact of these directives could even be to reduce the number of new entrants thereby limiting onward flow of capital to SMEs. There is also a risk that global investors will prefer non-AIFMD-regulated private equity and venture capital funds for their indirect investment into SMEs as many may see an imbalance between additional costs and any perceived gap in investor protection. However, it can be hoped that certain other categories of investors, in particular those who rely on regulated products, will now invest in AIFMD regulated PE/VC managers and compensate for the flow of capital ultimately going to SMEs from categories of investors that may be lost.

[12] These regimes are currently being negotiated in the Trilogues.

2.2 What are the challenges ahead for SMEs to access venture capital and private equity funds?

24. In addition to the barriers mentioned above, the following challenges need to be considered:

- **Increased administration and costs -** The AIFMD (which will be fully applicable as from July 2013), aims at facilitating cross-border fund-raising for, among others, private equity and venture capital funds, thereby enabling more investors to indirectly invest into SMEs. However it will introduce additional reporting requirements for companies which are owned by private equity and venture capital funds ("AIFs"). While SMEs are to be excluded from the reporting obligations as set out in articles 26-30 of the AIFMD, due to the way SMEs are defined (see Annex II, paragraph 1), there is however a risk that SMEs held by the same AIF fall outside the scope of the SME exemption because they will be considered "linked enterprises". This concept of "linked enterprises" could also imply that these SMEs may lose the state aid to which they are currently entitled.

- **Increase in the cost of capital -** The AIFMD also imposes certain restrictions on dividends and capital structures on SMEs in certain jurisdictions, depending on how the Second Company Law Directive has been implemented for non-public companies in such jurisdictions.

- **The reduction of investible capital –** Solvency II and CRD IV limit the ability of institutional investors like insurance companies and banks to invest into long-term illiquid assets. As a result there is less investible capital available for venture capital and private equity funds, which limits the onward flow of capital into SMEs (this is further addressed under 3.2 below).

- **Restrictions on categories of investors** – The AIFMD will impose restrictions on marketing PE and VC funds to certain categories of investor like business angels, entrepreneurs and high net worth individuals who have traditionally been important contributors of both funding and know-how to early stage companies. This reduces the availability of funding to SMEs.

2.3 What are the main barriers for SMEs to access capital through Regulated Markets and MTFs?

25. Over the past years, European regulated trading venues have launched specific SME markets or segments to address the needs of smaller companies. However, the majority of these are struggling to attract companies. The main barriers to accessing these markets and segments are described below:

- **High cost of capital due to limited investor interest –** Companies incur various costs when going public including professional fees, administrative costs, regulatory costs and a discount on the offer of their securities. Once they are listed, they incur ongoing regulatory costs as well as trading costs. In addition, translation costs for some SMEs also prove burdensome. These costs should however not be assessed on a stand-alone basis. Companies are willing to pay the relevant professional fees and ongoing compliance costs as long as the benefits of accessing the capital markets outweigh the costs. This is measured through the level of investor interest generated and therefore the rate of return demanded by investors on the market. While some regulatory requirements under European legislation may be alleviated for smaller companies (e.g. quarterly reporting), such measures alone are not likely to help lower the cost of raising external capital. The main challenge is to diversify the pool of investors interested in investing in SMEs.

- **Lack of appropriate research coverage** – Traditionally, some market participants were cross-subsidising research on SMEs with revenues earned from their intermediation function in respect to blue-chips. However, such cross-subsidisation is nowadays rendered very difficult. As an example, the increased fragmentation resulting from the implementation of MiFID has heightened the pressures faced by small and medium sized intermediaries in respect to their cost base, the very ones that were traditionally most involved in SME research activities. The economic/business model of these intermediaries is not valid anymore. Therefore, because SME research is generally not in itself a profitable activity, most of these actors have tended to retrench from this field. This situation is particularly problematic, considering that SMEs, probably more than other larger types of companies, really need research and analyst support to attract investors.

- **Low liquidity** – While the number of quoted companies is slowly reducing due to de-listings, take-overs, mergers or shifts from public to privates, there has been an increase in trading in blue chip companies, mainly triggered by the low cost of trade execution[13]. In comparison to blue chips, SMEs' trading volumes tend to be limited. SME trading is usually characterised by lower levels of liquidity. This limited liquidity can be explained by a number of factors.

26. First, SMEs are intrinsically of a smaller scale than blue-chips, which often reduces their attractiveness to large, institutional investors. Second, recent market developments like the entry of high frequency traders have tended to reinforce the attractiveness of blue-chips, sometimes at the expense of SMEs in terms of trading.

27. As mentioned above MiFID has increased the fragmentation of the trading landscape due to an increase in competition. This increased competition has resulted in important pressures on the business model of trading venues, encouraging some of them to focus on the most profitable segments such as blue-chips trading, at the expense of other less profitable segments such as SMEs. According to recent figures, 13% of Europe's largest companies (i.e. which have a market capitalisation of over 1 bn EUR) account for 93% of Europe's market cap, 85% of the number of trades and 96% of turnover[14]. This is further illustrated by the fact that the great majority of new trading venues only offer trading in blue-chips.

28. At the same time, SME trading has not been the main priority of most of the new financial services participants, such as the high-frequency traders, which have emerged as a result of the increasing arbitrage opportunities created by the fragmentation of the trading landscape.

- **Higher transparency requirements impacting on SMEs' governance structure** - Increased requirements regarding transparency stemming from the implementation of MiFID, the Transparency Directive or the Market Abuse directive can represents a challenge for SMEs, resulting in a suboptimal time allocation for SMEs' board and management and ensuing increased costs. The smaller the company, the more disproportionate these are to the benefits of being listed. In addition, a more institutionalised ownership structure leads owners to increasingly vote with their feet, which in turn

[13] Grant Thornton Report. " A wake-up call for America

[14] Based on internal research by the Federation of European Securities Exchanges (FESE)

leads to a higher turnover of owners and hence often also to high rotation of new board members which then need to be brought up to speed, again taking time from management or requiring additional resources.

2.4. What are the main challenges ahead for SMEs to access capital through Regulated Markets and MTFs?

29. In addition to the barriers mentioned above, the following challenges need to be considered:

- **Benefits vs. costs** – Going forward it is critical that the benefits of being listed continue to outweigh the costs for those companies mature enough to 'stand on their own' and seeking a listing as a way of financing continued development and expansion.[15]

- **Finding the right balance between barriers to access capital markets and investor protection** – A possible way to counter the increasing challenges for SMEs to access capital through Regulated Markets and MTFs might be to create a European regulation which would give access to organised markets for SMEs with some lesser constraints than the Regulated Markets, while ensuring investor protection and minimising opportunity for regulatory arbitrage by larger companies. The SME market regime proposed under the review of MiFID seeks to achieve this.

- **The lack of systematic assessment of impact of EU law on SME funding** – There should be a systematic assessment on the impact of any EU regulatory proposal on the ability of SMEs to fund and grow their activities in order to avoid any unintended consequences.

[15] See Annex IV for examples of SME markets crated by Regulated Markets.

3. Issues identified as impacting the ability of investors to invest in SMEs

30. There is a need to consider what can be done to diversify and grow the retail and institutional investor base to support new business growth, without necessarily lowering the regulatory standards. Below we describe the issues that impact the ability of investors to invest in SMEs.

3.1. Impact on investors' appetite to invest in SMEs through access to private equity funds

- **Impact of EU regulation on institutional investors -** Private equity and venture capital funds typically raise funds from sophisticated institutional investors like pension funds, insurance companies, banks, endowments and funds of funds (which are typically funded by the same types of investors). Over the last four years pension funds accounted for over one third of all investments in European venture capital and private equity. This corresponds to more than 50 billion EUR of investment to European companies through private equity and venture capital managers. 85% of these companies are SMEs. Pension funds play a key role as global providers of long term capital. Therefore, EU regulatory measures impacting these investors' ability to hold long-term illiquid assets on their balance sheets have a direct impact on availability of long-term equity capital to SMEs in Europe.

  As an example, a decrease of capital flow from banks and insurance companies to private equity and venture capital managers has been noted due to the implementation of CRD III and Solvency II. If pension funds covered by IORPD also have to comply with Solvency II type of risk weightings in the future, they would be required to hold additional liquid assets of close to 1,000 billion EUR. This capital will be at the expense of something or someone. In this case it could be 'paid for' by a combination of lower allocations to private equity and venture capital, in turn leading to lower returns as a result of being forced to hold more short term liquid assets like government bonds. This in turn will put an additional constrain on many already underfunded defined benefit plans forcing the companies sponsoring these plans to pay in more capital, at the expense of their own working capital.

- **Effect of deleveraging and capital ratios measures -** Furthermore, policy makers and regulators must look at the long-term aggregated effects of measures aimed at short term deleveraging and strengthening of capital ratios. Risk weightings for different asset classes should be developed with due regard to use of correct indices and ratios relevant to each asset class.

3.2. Impact on investors' appetite to invest in SMEs through shares listed on MTFs and Regulated Markets

31. The increasing restrictions discussed in section 3.1 on institutional investors are also relevant to the investors in the equity markets. In addition, we believe the issues below have an impact on investor's appetite to invest in SME's through MTFs and Regulated Markets:

- **The creation of an SME market through MiFID II -** Creating an SME market regime within MiFID II is a first step towards helping growing companies access the capital markets by gaining profile with the investor community within a European framework. Therefore, the introduction of an EU label for SME markets is a welcomed development.

- **The need to ensure investor protection -** In addition, to increase investment flow into SMEs, it is crucial to ensure investor confidence. This is even more important for retail investors. The challenge would therefore be to find the right balance between a high level of investor protection and a reduction of obligations for issuers on those markets.

- **The importance of diversifying the investor pool -** Europeans are aging and well-capitalized pension funds, especially in certain countries (e.g. Finland) are no longer net investors in the market. Therefore, other types of investors are needed. One group that would have more potential is households (i.e. retail investors). In order to encourage retail investors to invest more in SMEs we need more emphasis on financial literacy. Having lighter rules for SMEs which depend on company size or market value can be confusing to retail investors since these measures can change. The proposed market abuse regulation (MAR) extends all the disclosure requirements (price sensitive information, insider lists, managers' transactions) requested for issuers on the regulated markets to all issuers admitted to trading on MTFs.

- **The importance of lowering the cost of capital -** In order to help lower the cost of capital there, is a need to reduce barriers to investing in small caps. When companies seek access to capital markets, they expect to raise capital as well as their profile at a reasonable cost. Ultimately, the value of the markets is measured through increased investor and stakeholders' interest. We therefore believe the cost of raising capital needs to be lowered by improving investor access to SMEs. This can for example be achieved through a review of the conduct of business obligations. In addition, progress can be made in the production and distribution of investment research and rating analysis to reduce information asymmetries.

4. Conclusions

32. Overall, it appears that the different regulatory initiatives and ensuing developments described in this paper have had negative impact on access to funding for SMEs. With regard to SME funding via private equity and venture capital, AIFMD may not only reduce the number of new funds investing into SMEs coming to the market but will also increase the burden of administration and reporting for SMEs held by such funds and could also imply an increase in the cost of capital for such SMEs. Solvency II and CRD IV will make it more difficult for insurance companies and banks to indirectly invest into SMEs via private equity and venture capital funds. While the AIFMD, the Venture Capital (EVCFR) and Social Entrepreneurship Funds (EuSEF) Regimes[16] aim to provide an EU-wide marketing passport to qualifying funds, thereby enabling more investors across the EU to indirectly invest into SMEs, the balance between costs, restrictive application and benefits remains to be seen.

33. With regard to Regulated Markets and MTFs, the increased transparency included in regulation such as MiFID represents a challenge for SMEs, resulting in a suboptimal time allocation for SMEs' board and management and ensuing increased costs of accessing public markets. In addition, MiFID has also heightened the pressures faced by small and medium sized intermediaries in respect to their cost base, the very ones that were traditionally the ones most involved in SME research activities. A decrease in the amount of research available for SMEs negatively affects the liquidity of these shares on public markets. There is a risk that regulation extending to 'traditional' MTFs under the review of MiFID/MiFIR and MAD/MAR, may prove burdensome and not appropriate for SMEs. On the other hand, a level playing field is needed between MTFs and Regulated Markets, especially considering that both types of venues are now comparable in terms of trading volumes.

34. Regulatory initiatives have also had a negative impact on the ability of investors to invest in SMEs. As a result of CRD IV and Solvency II and the uncertainty they bring to investors, there is a decrease in available capital from banks and insurance companies to equities in general. If pension funds covered by IORPD would also have to comply with Solvency II type of risk weightings, they would be required to hold additional liquid assets rather than longer term assets which would better serve their long-term liabilities.

35. With regard to Regulated Markets and MTFs, creating an SME market regime within MiFID II is a first step towards helping growing companies' access capital markets by gaining profile with the investor community within a European framework. The separate and distinct framework would allow for additional EU measures to increase investor's access to SMEs for example through Solvency II.

[16] These regimes are currently being negotiated in the Trilogues.

5. Policy recommendations to increase access to finance for SMEs

5.1. Introduction

36. An effective overall funding environment in Europe must seek to:

- Ensure an appropriate regulatory framework for issuers that do not prove burdensome for them and also wins investor confidence.

- Attract a wider set of investors to smaller, growing businesses by reducing regulatory and fiscal burden on SME investors.

The SMSG SME working group believes that EU policy makers can contribute to these objectives through EU legislation in several ways and that there is no 'one-size fits all' solution.

5.2. Securities regulation

37.

- **A distinct and separate SME market regime under MiFID II and MAD**

Such a regime would:
  - recognise the role such markets currently play in the EU funding environment;
  - ensure that changes to EU financial services regulation do not adversely impact small caps;
  - cater for a secondary market for trading shares of less liquid SMEs;
  - allow for further development of regulatory and fiscal EU policies to attract investors to this asset class.

The Commission's definition of an SME (for the purposes of this capital market regime) with a threshold of €100m is inappropriate. The group believes that policy makers should look at adjusting the threshold and suggests that it should be set at €500m. Disclosure exemption for very small issuers on MTFs. Consider introducing a floor in the SME market cap classification so that the smallest SMEs (primarily the "Ss" i.e. where company may be raising € 900,000) are not subject to costly listing and maintenance fees and would be admitted to trading "on demand only" on an MTF. ESMA should have a role also in the identification of such a floor. The proposed SME label with a separate and distinct legal framework would allow additional EU measures to increase investor's access to SMEs for example through Solvency II, EU state aid provisions, investment research rules, etc. It would also help improve investors' understanding of smaller companies and allow fund managers to adopt an investment strategy better adapted to smaller companies.

- **Improve the Prospectus Directive regime to make it easier for companies to access capital markets**

The SMSG SME working group is not in favour of a reduction of disclosure requirements for SMEs under Prospectus Directive. However:

- More flexibility is required for disclosure requirements applicable to SMEs. Regulators generally take longer to approve the prospectus of SMEs than to approve those of other companies. This can be particularly damaging to SMEs because the window for going public can be very short. This is more harmful to SMEs because of the relatively high fees.
- Costs - such as those incurred by the application of International Financial Reporting Standards (IFRS) - should be optional for SMEs.
- EU legislation should take into account the additional costs of translation. Today, many exchanges request the publication of the full prospectus and other documents in the national language even if an English version is available.
- Pre-IPO registration process - prior to the formal offer of securities – would help issuers take advantage of the relatively short term 'IPO window'. This could be encouraged through the existing PD framework which allows publication of a Registration Document prior to an offer of securities which would be supported by a Securities Note.
- Increase the consideration limit on offers subject to the Prospectus Directive regime from €5m (PD-Article 1(h)) to €25m in a 12-month period. This is similar to the provision in the Title IV in the JOBS Act which increases the exempt offering threshold from $5m to $50m. As a limited measure, this could be applied to SME markets only.
- Alternatively, the review of Prospectuses of companies seeking admission to SME markets could be delegated by the Home Competent Authority to the Market Operator and or key adviser. This would help lower the cost of capital for smaller companies while ensuring the existing framework for Regulated Markets is maintained.

- **Increase the availability of existing investment research and ratings information**

  Research on SMEs (as for any type of company) is costly and investors are generally not eager to pay for it. Provisions should be implemented to make existing research and ratings information available to a wider set of potential investors and thus help reduce information asymmetries associated with smaller companies. In some countries (i.e. UK, Canada and South Korea) the SME market is sustained by a market maker model based on spreads. Other models exist as well, as some market participants believe that the market maker model does not propose enough transparency.

- When SMEs decide to use rating agencies, incentives, also for corporate debt rating, could be considered as follows:

  - Reducing information asymmetries between issuers and investors and, as such, the risk premium demanded on loans of SMEs.
  - Protecting investors, through the provision of additional information about the additional risks they are incurring with these types of investments.
  - Reducing costs by allowing reduced capital requirements of credit institutions if ratings are issued by recognized External Credit Assessment Institution (ECAI).
  - Reducing costs by making the assets accepted as collateral in liquidity-providing operations to banks by the ECB, if the ratings are issued by recognized ECAI.

- **Reduction of the actual cost of access and maintenance of the listing (whether equity or debt) of SMEs**

- Consider an offer as public only when the number of investors is substantially higher than for other companies (e.g.: increasing this number from 150 to 300 in the case of SMEs and higher in the case of employee participation programmes).
- Reduce the costs charged by all parties involved in a listing of an SME's securities, for both the admission to trading as well as the maintenance of the listing.
- Reduce the minimum required capital to be listed (in value and percentage of share capital).
- Examine the possibility of placing bonds on retail networks such as Bond Manager by the issuer itself. This should take place under certain conditions including for instance mandatory rating and the mandatory provision of a prospectus. This would eliminate the need to use the network of a bank.
- Lighten the burden of publishing accounts: for example, requite semi-annual accounts (at least for the first years after being admitted to listing) and/or one or two months later than other firms (to allow a greater focus on these accounts by researchers, as they cannot pay attention to them while having to analyze published accounts of the largest companies in the market).
- Streamline governance criteria: e.g., do not require the separation of the function of Chairman and CEO.
- Examine and propose new business models for analyst to cover SMEs, possibly in cooperation between banks and exchanges.
- Streamlining reporting requirements and list of people with access to confidential information under MAD, not making them mandatory for SMEs, but allowing the regulator to request this information in case of need.

5.3. Investment Funds Regulation

38.

- **Exempt venture capital funds from the Alternative Investment Fund Managers Directive (AIFMD) to encourage them to gain scale**

The AIFMD does not apply to private equity and venture capital funds under €500m (as these funds are typically closed-ended and unleveraged; if not - the € 100 m threshold would apply) and is therefore not likely to impact the majority of European VC funds unless they need to opt-in in order to get access to the EU-wide marketing passport. However, the potential to be caught by AIFMD will deter funds from gaining scale which is ultimately needed to allow a fund to diversify and achieve attractive returns. US VC funds tend to be larger and therefore are able to back more enterprises and generate good returns. For example, Germany has only 4 independent VC funds >€100m compared to 227 in the US[17]. The SMSG is aware that the AIFM Directive was controversial and would like to stress that although this report points out several negative consequences of the Directive, the intention is not to challenge what is already valid EU law, but to highlight what we see as unintended consequences in respect of SME's that should and can be addressed by special measures directed as SME's while respecting the intended scope and purpose of the Directive.'

[17] Earlybird Europe Venture Capital Report – July 2011

- **EU Regulation applicable to institutional investors (such as Solvency II for insurance funds) and any future proposals to introduce similar regulation for pension funds must not place conditions that adversely impact the ability to directly or indirectly invest in small caps.** The capital and liquidity requirements under Solvency II are likely to exacerbate the tendency of institutions to only hold the largest and most liquid blue-chip equities or even only interest bearing instruments like government bonds due to the lower risk weightings for these than equities in general and deter any existing appetite for smaller companies. An appropriate exemption for investment in small cap securities should be implemented.

- **Review of UCITS directive to identify ways to attract dedicated UCIT funds for small caps.** For example, creating a new category of UCITS dedicated to investment in SME markets with specific conditions and ability to be marketed to retail investors. This would have the advantage of attracting retail funds to the SME sector through a vehicle which is subject to the well-established UCITS investor protection regime, and of avoiding the potential liquidity and other risks which might follow were retail investors to be encouraged to make investments directly in SME issuers.

- **The proposed European Venture Capital Funds Regulation (EVCFR) and Social Entrepreneurship Funds (EuSEF) Regime[18], which aim to provide an EU-wide marketing passport to qualifying funds thereby enabling investors across the EU to indirectly invest into SMEs, should allow for partial portfolio holdings in also listed SME markets.** We support the current proposal that includes holdings in SME markets as 'qualifying portfolio companies'. This will allow VC funds to appropriately consider their exit options (including via IPO) and provide them with the flexibility to follow portfolio companies even after IPO, as appropriate. Also the criteria of the MiFID definition of Professional Investor need to be adapted so as not to exclude traditional investors into VC funds like entrepreneurs and business angels who bring both funds and relevant experience, but none of which make 10 commitments to invest in a VC fund per quarter (not even the largest Institutions do) nor have necessarily worked in the financial industry.

- **Incentives to create investment funds specialized in shares and/or debt of SMEs**, for example through a more favourable tax regime and more flexible investment rules, possibly through closed-end funds, given the lower liquidity of the underlying assets.

5.4 Fiscal policy

39.

- **Review of EU State Aid risk capital guidelines to allow for effective incentive schemes to be adopted by Member States.** The guidelines should recognise the role of expansion capital as genuine risk capital.

  Tax reforms may be considered in order to encourage more long-term holdings (i.e. better pre-tax off-setting of gains and losses, and tax push forward if realisation proceeds are re-

[18] These regimes are currently being negotiated in the Trilogues.

invested). Creation of specific benefits to certain investors who can invest in SMEs, tax relief or personal internal revenue taxes lower on capital gains on securities of these companies, under conditions of maintenance of such securities over a minimum period of time and a maximum concentration by company (in value and in percentage of capital of each company). Exemption of certain investment rules imposed on certain investors in the case of investments in SMEs (e.g., minimum ratings, liquidity of securities, etc.). This would need to be balanced with any risk of misallocation of capital.

- **The Financial Transaction Tax, if introduced, should not apply to SME transactions.** Given that investors in smaller companies usually require a higher rate of return on investment, an additional tax would have a disproportionate increase in the cost of capital for smaller companies and is likely to deter investors from this asset class.

5.5 Other recommendations

40.

In addition, European legislators and regulators should take into account the following:

- **Improved EU coordination:** When considering new policy initiatives, the European Commission should apply a cross-directorate approach and consider how policy as well as other initiatives impact SME's access to finance and general endeavour optimal change for smaller enterprises.

- **Education of SMEs:** There is a continuing need to increase awareness and education of entrepreneurs to ensure they understand the different sources of finance available to them.

- **Research and ratings on SMEs:** EU legislation should include incentives to foster independent research and ratings of SMEs.

- **Review of categorisation of high net worth individuals/business angel type investors as 'retail':** The criteria to assess retail clients that request to be treated as professionals are not entirely relevant to early stage/small cap investors. This assessment increases the cost of investment and disenfranchises an important set of investors from small caps. A review would also help to ensure that appropriate exemptions are made for venture capital fund managers (and their end investors) in the AIFMD and the EU Venture Capital passporting scheme.

- **Creation of public support specific to these companies (for example, subsidized credit lines).**

- **Commissioning a comparative review of the EU and US high yield debt markets with a specific focus on providing investors access to smaller companies at mutually attractive terms.**

- **Developing a flexible EU "bankruptcy regime" (similar to the Chapter 11 provisions in the US).**

Adopted on 12 October 2012

Guillaume Prache

Chair
ESMA Securities and Markets Stakeholder Group

Annex I – Mandate of the SME Financing Working Group

Background

41. Following the decision at the SMSG meeting on 15th February, 2012 to set up a working group on access to funding/financing for small and medium sized enterprises ("SME"s), the working group has held two conference calls (29th March & 13th April) where members (as detailed below) defined the group's mandate, which was subsequently presented and approved by the full SMSG on 26th April. This paper reflects the outcomes of the discussions of the WG group as shared with the SMSG as well as the BOS during the meetings held in September 2012.

Outcome

42. Mandate and setting up of a Permanent Working Group.

43. The mandate of the group will be to monitor and give advice to ESMA on relevant EU regulatory proposals:

- That impact the ability of SMEs to have access to funding through venture capital and private equity funds (including additional regulatory and reporting burdens for such SMEs as a result of being controlled by such funds) or through listing on a MTF or a Regulated Markets (i.e. when financial instruments are admitted to trading on a Regulated Markets this triggers a list of legal requirements such as Prospectus, Transparency and Market Abuse Directives).

- That impact investors to invest in SMEs through access to venture capital and private equity funds as well as through shares listed on MTFs and Regulated Markets (including regulations impacting institution investors such as insurance companies, pension funds, banks, etc.).

List of SME Working Group members:

RAPPORTEURS - Judith Hardt and Anne Holm Rannaleet.

MEMBERS of the Group - Roland Bellegarde, Angel Berges-Lobera, Salvatore Bragantini, Pierre-Henri Conac, Peter de Proft, Jesper Lau Hansen, Pedro Braga da Cruz, Carmine Di Noia, Sari Lounasmeri, Jean-Pierre Pinatton, Xavier Rolet, Ludo Bammens & Adriana Tanasoiu.

Annex II – Definitions of SMEs – can “one size fit all”?

Two different definitions of SMEs are usually being used in different EU contexts:

1) Definition of EU Commission of 2003/361/EC

44. The current EU definition of “micro, small or medium sized enterprise” (“SME”) used e.g. in the Auditing and Accounting Directives, was adopted by the European Commission on 6 May 2003 and came into force on 1 January 2005 (Recommendation 2003/361/EC). This definition was intended to improve access to capital for SMEs, while ensuring that only those enterprises that genuinely require support are targeted by public schemes. The European Commission aimed to have “less and better targeted state aid”. Under article 2 of the Recommendation, the Commission categorizes micro, small and medium size entities (SMEs) as those enterprises which employ fewer than 250 employees AND which either have a turnover not exceeding EUR 50 million or an annual balance sheet not exceeding EUR 43 million.

45. Such definition allows the company to know in advance their status as an SME. This is important for its reporting obligations which are based on procedures which must be set more than one year in advance by a company. In addition, they have the advantage of not being questionable, because they are based on objective and measurable criteria.

46. However, the definition, which had been developed for the purpose of controlling access to state aid has however more recently been used in other contexts where it is less well suited and may have some unintended consequences, like under the AIFMD in relation to certain reporting obligations for companies owned by venture capital and private equity funds, as well as being discussed in the context of both the EVCFR (The EU-wide marketing regulation for venture capital funds) and the EuSEF (The EU-wide marketing regulation for social entrepreneurship funds), both currently discussed by Parliament and Council.

47. In addition, this definition is over 9 years old; hence is the monetary values of turnover and of the annual balance sheet still valid or should it be updated, at least by the accumulated inflation over this period?

2) MiFID, MAD and Prospectus Directive

48. The current definition in MiFID/MAD refers to the definition given in Article 2.1.f of the Prospectus Directive which is the exact same one as the definition recommended by the European Commission in 2005, and does not refer to market capitalisation. MiFID II proposes a new definition of SMEs based on a size threshold for the majority of companies on ‘SME markets’ (the proposed regime under MiFID II) being higher than the size of SMEs eligible for EU State Aid**.**

The challenges of only having one uniform SME definition

49. Drawing up a definition of SMEs is very difficult, because there are many aspects of their activities which have to be taken into consideration in defining their regime: first of all, distinction has to be made between listed SMEs and non-listed SMEs; moreover, as we can infer from the different definitions of SMEs contained in the European directives, each definition fits a different purpose. That’s why we say that, with regard to the possible definitions of SMEs, “one size **does not** fit all”. However when we look at SME's strictly from the market point of view, we look at listed companies or companies which wish to raise capital in the market through IPOs or debt listings. In that case the companies look at the initial costs involved plus the maintenance costs and various burdens. Those are justi-

fied if the investors are interested in investing in that issuer. And one of the key criteria for investors is the market cap and the amount of the float. If the market cap is too low, it reduces the number of potential investors. The fact that the market cap varies every day is not a problem since we speak of one threshold generally at the time of the IPO or debt listing to decide the kind of regulation applicable. No doubt that corporations have no problems in assuming more constraints if their market capitalisation moves far above the threshold after the IPO or debt listing. It will be a sign of great success. Many institutional investors consider already a market cap of EUR 200 million as being too small. For the purpose of this paper, the SMSG has chosen to look at SMEs as those companies having a market capitalization/enterprise value below 500 million in order to avoid capturing only micro-capitalisations.

3) Why the Commission's definition of an SME (under MiFID II) should be retained or even increased

50. The threshold at under €100 million is set at a level which allows smaller companies with the highest growth potential to access the capital markets; enables the European venture capital industry to have access to a more dynamic market environment for exits and further capital raising; and creates an asset class across Europe for a wider set of investors. Setting the criteria at too low a level would adversely impact investor perception of the SME markets as they would be regarded as only accommodating micro-cap, illiquid companies. This would reduce investor appetite and confidence and would further reduce the available liquidity of these markets. It would result in many growing companies choosing not to join public markets and seeking other, less public, forms of funding and would not provide the venture capital industry with the required exit environment. Over the longer term, this would be damaging to Europe's competitiveness in global financial markets and would adversely impact the contribution potential of its smaller, growing businesses to the economic recovery and future prosperity of the EU.

Annex III – SME representation and contribution to the EU

Number of enterprises by Member State - 2011						
Country	**Micro**	**Small**	**Medium**	**Large**	**Total**	**Member State small and medium sized enterprises as a % of total EU-27 enterprises**
Austria	90,225	5,121	907	142	96,395	0.4%
Belgium	404,860	27,678	3,996	862	437,395	2.0%
Bulgaria	259,074	23,380	4,582	722	287,756	1.8%
Cyprus	38,835	2,996	501	81	42,411	0.2%
Czech Republic	894,645	32,840	6,986	1,441	935,913	2.5%
Denmark	179,174	21,492	3,898	680	205,244	1.6%
Estonia	41,448	5,509	1,046	157	48,161	0.4%
Finland	205,460	12,722	2,241	613	221,036	0.9%
France	2,443,667	150,479	22,068	4,805	2,621,022	10.9%
Germany	1,577,596	260,550	45,223	9,384	1,892,753	19.3%
Greece	695,733	22,075	2,894	577	721,277	1.6%
Hungary	521,381	26,798	4,509	808	553,495	2.0%
Ireland	70,192	12,298	2,221	474	85,185	0.9%
Italy	3,535,676	186,757	19,088	2,904	3,744,422	13.0%
Latvia	61,790	8,579	1,513	203	72,086	0.6%
Lithuania	214,434	11,860	2,353	341	228,986	0.9%
Luxembourg	23,842	2,777	542	114	27,277	0.2%
Malta	37,740	1,244	254	54	39,293	0.1%
Netherlands	526,147	50,294	8,816	1,612	586,865	3.7%
Poland	1,508,322	42,477	15,450	3,406	1,569,653	3.7%
Portugal	989,430	38,679	5,508	792	1,034,409	2.8%
Romania	475,852	49,798	9,637	1,681	536,967	3.7%
Slovakia	51,726	18,358	1,912	502	72,497	1.3%
Slovenia	99,182	6,398	1,288	241	107,109	0.5%
Spain	2,236,609	144,062	17,438	2,871	2,400,978	10.2%
Sweden	553,519	27,614	4,898	1,014	587,043	2.0%
United Kingdom*	4,332,565	173,405	30,475	6,320	4,542,765	12.9%
EU-27	**22,069,124**	**1,366,240**	**220,244**	**42,801**	**23,698,393**	
as a % of total	93.1%	5.8%	0.9%	0.2%	100.0%	
Employment	41,834,998	26,606,705	21,885,128	44,249,739	134,576,569	
as a % of total employment	31%	20%	16%	33%	100%	
Average # of employees per enterprise	1.9	19.5	99.4	1,033.8	5.7	
Gross value added (€m)	1,425,340	1,223,467	1,159,647	2623497.1	6,431,951	
as a % of total GVA	22.2%	19.0%	18.0%	40.8%	100.0%	
Average GVA per enterprise (€m)	0.1	0.9	5.3	61.3	0.3	

Source: Annual Report on EU SMEs 2010/2011

*UK statistics source: UK Office of National Statistics, 2011

Annex IV – The US JOBS Act

51. The US recently passed the so called JOBS Act [see e.g. Economist articles referred to in the Annexed Bibliography]. Although the detailed provisions under the JOBS Act seek to alleviate US specific requirements that are not directly relevant / applicable to EU capital markets, the aim of the provisions is to help a wide population of smaller, growing companies access a wider set of investors. The EU can learn from the US experience. The main provisions included in the Act are the following:

- **"IPO On-Ramp"** - Provisions to benefit companies with annual revenues of up to $1 billion – a significantly larger threshold than companies eligible for any financial assistance from the US government (for example, under the US Small Business Act). This threshold recognises that any measures to facilitate smaller companies access the capital markets require a higher threshold than financial aid programs. In the EU context, this is analogous to the size threshold for the majority of companies on 'SME markets' (the proposed regime under MiFID II) being higher than the size of SMEs eligible for EU State Aid.

- **Threshold for shareholders/investors** - The current 500-shareholder threshold for SEC registration will increase to 2000 shareholders; in comparison, the EU exemption from producing a Prospectus applies to offers made to less than 150 investors (recently increased from 100). The 150 investor limit in Europe is too low, and contributes to low levels of liquidity in the secondary market, as many SMEs come to market with tightly held and narrowly distributed share or debt registers.

Annex V – The examples of the AIM (UK), Alternext (Belgium, France & Netherlands) and the Spanish BME/ Institute of Financial Analysts initiative

AIM

52. AIM is the London Stock Exchange's market for smaller, growing companies. A wide range of businesses including early stage, venture capital backed as well as more established companies join AIM seeking access to growth capital.

53. Over the 16 years of its existence, AIM has grown from ten UK companies worth £82 million in six sectors to over 1,100 companies worth £62.2 billion operating in 96 jurisdictions across 40 sectors.

54. There are key features on AIM that promote secondary liquidity and have been immune from cross subsidisation with the blue chip market, i.e. (regulation that permits market-making and creates economic incentives for dedicated market-making community to promote SME trading, research and distribution.

55. For example, AIM issuers have a choice of trading platforms to help them maximise liquidity. Over the years, the dedicated market maker support offered on the trading services has allowed a strong network of specialist firms that facilitate access to liquidity, capital and research for these companies to develop. With dedicated market maker support in a transparent environment, also the smallest companies benefit from guaranteed liquidity, which may not be available on a fully electronic order book. The London Stock Exchange, the operator of AIM strongly believes that trading solutions for small and mid cap securities need to consider the incentive and economics for advisers/brokers to provide the critical aftermarket support these companies require, particularly analyst coverage.

Alternext (Belgium, France & Netherlands) market

56. In 2005, Alternext was created to provide a listing and trading platform adapted to SMEs' needs and to provide investors with diversified investment opportunities, in a secured environment. Today, 180 companies are listed on this regulated platform, 165 in Paris, 13 in Brussels and 2 in Amsterdam, for a total market cap of €6.3 billion. Since its creation, €2.6 billion of capital have been raised on Alternext, €1.259 million at IPO. Whilst market capitalisation is €35 million on average, companies listed on Alternext are from a wide range of sectors (consumer services, technology, telecom, healthcare, etc.).

57. Alternext's listing and ongoing reporting requirements aim both at lowering SMEs' listing costs, and at providing investors with the security and information they need, ultimately contributing to increase the attractiveness of this segment. Typically, SMEs willing to go public on Alternext are assisted by an accredited listing sponsor, which will support the company in its preparation for listing and ensure that it fulfils its ongoing obligations when listed. In addition, each public offering on Alternext is approved by regulators. In parallel, a facilitated procedure is in place for SMEs seeking to raise capital through private placement, which access is limited only to qualified investors.

58. On the secondary market, the trading rules aim both at ensuring fair and orderly trading and at enhancing the liquidity of SMEs' securities. Trading is organised around a transparent central order book, and facilitated by liquidity providers. Alternext also provides for the possibility to execute block

trades off the order book, in order to protect investors against the risk of market impact. Orders and trades are closely monitored by the exchange's market surveillance team, which further reinforce investors' confidence and willingness to trade in these securities. Today, hundreds of investors from 16 countries mostly from continental Europe but also from the United States and the United Kingdom are active on this market. They contribute to and benefit from a high market quality, with low median bid-ask spread ratios (3%) and a low level of volatility over 180 days (46%). In terms of performance, the Alternext segment has proven to be highly effective: in 2011, the Alternext index has outperformed the CAC 40 indice by 10%.

BME/ Institute of Financial Analysts initiative

59. BME together with the Institute of Financial Analysts, promoted a project, named In-Research, offering a network on independent analysts to perform research services to quoted SME's, on a cost efficient basis and no conflict of interest, as the analyst is not selected by the SME but assigned by an independent commission running the network.

Annex VI - Summary of key findings from Grant Thornton US Study – A wake-up call for America

60. The Grant Thornton analysis of the US market ("A wake-up call for America") demonstrates that market structure changes implemented over the last decade are causing significant, secular declines in the number of publicly listed companies in the United States.

    The study reveals how low-cost trade execution has destroyed the ecosystem that once supported the small business economy, undermining job creation, economic growth, and U.S. competitiveness: Since 1991, the number of U.S. exchange-listed companies is down more than 22%, and when adjusted for real (inflation-adjusted) GDP growth, that percentage balloons to a startling 53%.

61. 360 new listings per year — a number we in Europe have not approached since 2000 — are required to replace the number of listed companies lost in the U.S. In fact, the U.S. has averaged fewer than 166 IPOs per year since 2001, with only 54 in 2008.

    Up to 22 million U.S. jobs may have been lost because of the broken U.S. IPO market.

Annex VII – Bibliography

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