ESMA Securities and Markets Stakeholder Group

Report

Access to public capital markets for SMEs

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Table of Contents

I. Preliminary remarks ____ 3

II. Long term trends and recent developments ____ 5

II.1. Equity issuance ____ 5

II.2. Corporate bond issuance ____ 7

III. SMEs Growth Markets ____ 10

III.1. Background ____ 10

III.2. Objectives of SME growth markets ____ 11

III.3. Prospective SME growth markets ____ 12

III.4. Opportunity to help SMEs on public markets ____ 12

III.4. The need for an end objective ____ 13

III.5. Parameters for success ____ 13

IV. Corporate bonds issued by SMEs ('Mini-Bonds') ____ 14

IV.1. UK ____ 14

IV.2. Germany ____ 15

IV.3. France ____ 15

IV.4. Spain ____ 15

IV.5. Italy ____ 15

IV.6. Lessons learned ____ 16

V. Conclusions and recommendations ____ 17

Abstract

Access to finance for SMEs continues to concern policymakers at the national and European level. Each funding source has comparative advantages and disadvantages. Consequently it is important to ensure that SMEs have access to different funding sources (business angels, venture capital and private equity investors, public markets). Diversification of funding sources is also important to avoid the risk of over-reliance on a single funding source.

One of the CMU objectives is to lower barriers to public capital markets access. This Report builds on the previous work done by the SMSG in the area of access to finance for SMEs in October 2012 and in May 2015 to adopt a focused approach and to address two topics related to public capital markets: SMEs Growth Markets and corporate bonds issued by SMEs. Private placements, which are also relevant for smaller companies, are not covered in this Report.

MiFID II introduced SME growth markets as a sub-category of MTFs. The Commission, as part of the CMU Action Plan, is committed to review the regulatory barriers to small firms for their admission to trading on public markets and to ensure that the regulatory environment for the SME Growth Markets is fit for purpose. This Report points out that the concept of SME Growth Markets is not yet fully developed and in operation. As there are various parameters that could be applied to judge the positive development and ultimate success of SME Growth Markets, the Report highlights the need to clearly define success parameters and recognizes that no single measure of success would be sufficient.

Corporate bonds issued by SMEs ('mini-bonds') may prove to be an additional useful financing tool for SMEs (also partly substituting bank lending) provided that they offer – in a transparent way - an attractive risk/return tradeoff to investors as well as affordable financing for firms. The corporate bond market for SMEs in Europe appears to be highly fragmented: different regulatory frameworks and degrees of maturity of public bond markets coexist. The Report notes that credit risk assessment of mini-bonds may be an issue. Retail investor protection is a source of concern. Restrictions to professional investors only might be considered. Indirect investment in mini-bonds through institutional investors investments might lessen investor protection concerns.

The Report also raises additional issues that are related to the SMEs funding. Unintended consequences may arise from the MiFID II provisions on investment research, especially on the liquidity of small cap stocks. The new Prospectus Regulation generally achieves its purpose of introducing rules designed to facilitate access to capital markets financing for SMEs. The new Prospectus Regulation is however missing an important element to ensure continuous growth for SMEs: the ability to easily move from an SME Growth Market to a regulated market.

I. Preliminary remarks

One of the Capital Markets Union (CMU) objectives is to deepen financial integration and increase competition: "more cross-border risk-sharing, deeper and more liquid markets and diversified sources of funding

will deepen financial integration, lower costs and increase European competitiveness."[1] Aligned with this, CMU also seeks to help to mobilise capital in Europe and channel it to all companies, including Small and Medium Enterprises (SMEs). As of 2014, SMEs in the European Union accounted for 99.8% of all enterprises in the non-financial business sector, employing almost 90 million people - 67% of total employment – and generating 58% of the sector's value added.[2] Yet access to capital market financing for SMEs within Europe remains limited, with a heavy reliance on bank lending.[3]

The objectives of strengthening EU capital markets set by the CMU are more relevant and urgent now particularly in a post-Brexit environment, as the share of bank financing in the EU is expected to increase without the UK. An immediate priority, particularly in the Eurozone, should be to enhance the role of market-led financing of the economy, while developing resilient, liquid and safe markets. Efforts might also be devoted – and are, in fact, devoted – to the promotion of underdeveloped capital market products like securitisation, private placements, infrastructure financing, green and social impact financing, while preserving investor protection.

In October 2012, following a request by the ESMA's Board of Supervisors (BOS), the Securities and Markets Stakeholder Group (SMSG) adopted an own-initiative report on 'Helping Small and Medium Sized Companies Access Funding' (ESMA/2012/SMSG/59). In May 2015 the SMSG adopted a second paper to contribute to the discussion on the CMU (ESMA/2015/SMSG/017).

This Report builds on the previous work done by the SMSG in the area of access to finance for SMEs. The structure and the conclusions of the previous SMSG's documents are still very valid in our view. Consequently, this Report adopts a focused approach and addresses two topics related to public capital markets that we deem are currently particularly relevant: SMEs Growth markets, a new category of multilateral trading facilities that are being created under MiFID II (Art. 4 (1) No. 12 and Art. 33) and will apply from 2018, and corporate bonds issued by SMEs. The structure of the Report is the following: after a description of long term trends and recent developments in public equity and debt markets, first we discuss the objectives and the challenges of the SMEs Growth Markets concept and then we examine European experiences of corporate bonds issued by SMEs (also known as 'mini-bonds'). A closing Section contains our conclusions and recommendations.

The focus of this Report is on market-based funding for SMEs for two reasons. First, the diversification of funding sources in Europe is still far from optimal. According to the 2017 ECB Survey on the Access to Finance of Enterprises (SAFE), market-based sources of finance such as equity and debt securities account only for respectively 10% and 3% of the total funding of SMEs[4]. Second, heavy reliance on bank funding exposes SMEs to stress in the banking system. Dependency on bank-based financing decreased following the financial crisis but still remains high on average. Following the financial crisis, the dependence on bank financing in the euro area has decreased, accounting for 50% of total financing in the period from 2002-

[1] European Commission, 2015, 'Action Plan on Building a Capital Markets Union', COM(2015) 468 final, Brussels, 30.9.2015.

[2] European Commission, 2016, 'Annual Report on European SMEs 2014/2015', Brussels, 15.4.2016.

[3] OECD, 2015, 'Opportunities and constraints if market-based financing for SMEs', Paris, September 2015.

[4] European Central Bank, 2017, 'Survey on the Access to Finance of Enterprises in the euro area', Frankfurt, May 2017.

2016. From 2002-2008, banking lending accounted for 70%. This evidence is mainly driven by big corporates' access to non-banking funding, such as corporate bonds[5].

II. Long term trends and recent developments

This Section provides a sketch of some trends in market-based finance both on the equity and on the bond areas.

II.1. Equity issuance

Figure 1 shows that IPO activity in Europe is lower trending and volatile in the period 2006-2016. Access to public equity markets occur in waves, depending on macro-economic, firm-specific and institutional factors.

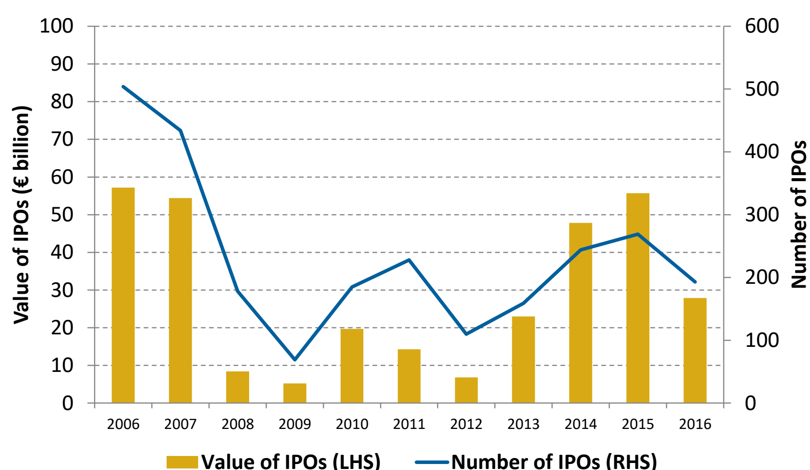

Figure 1 - European IPOs (source: EC)

As regards macro-economic conditions, waves occur because firms try to time the IPO to profit from relative overvaluation of their shares and because they are tempted by previous successful IPOs. Academic research in this area, like Ditmar and Ditmar (2008),[6] challenges this conclusion suggesting that IPOs waves are related to the fact that equity issues occur more frequently in the early stages of the business cycle when cash flow is likely to be too low. This feature contributes to the explanation of the observed cyclicality in the IPO market.

As to firm-specific factors, in a survey of Chief Financial Officers (CFOs) from 12 European countries, CFOs view enhanced visibility, financial flexibility and funding for growth as important universal factors (Bancel

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[5] European Commission, 2017, 'Economic Analysis on the Mid-Term Review of the Capital Markets Union Action Plan', Brussels, June 2017.

[6] Dittmar, A. K., & Dittmar, R. F., 2008, 'The timing of financing decisions: An examination of the correlation in financing waves', *Journal of Financial Economics*, 90(1), 59-83.

and Mittoo 2009)[7]. Another important (and common) explanation for going public is to facilitate subsequent acquisitions.

Concerning institutional factors, institutional settings and market functioning are also important factors for institutional investors when considering an IPO investment. Liquidity, regulatory environment and high corporate governance standards are usually considered as key decision criteria.

Looking at long-term trends worldwide, IPO activity has decreased in advanced economies. Over the period 1995-2014, IPO activity in advanced economies decreased significantly (see Figure 2) with the number of IPOs and amount raised in 2014 shrinking by 63% and 57%, respectively compared to the average in the period 1995-2000.[8] The opposite trend is noticeable for emerging markets spurred by IPO activities of Chinese companies, accounting for 62% of all capital raised on emerging markets since 2008.

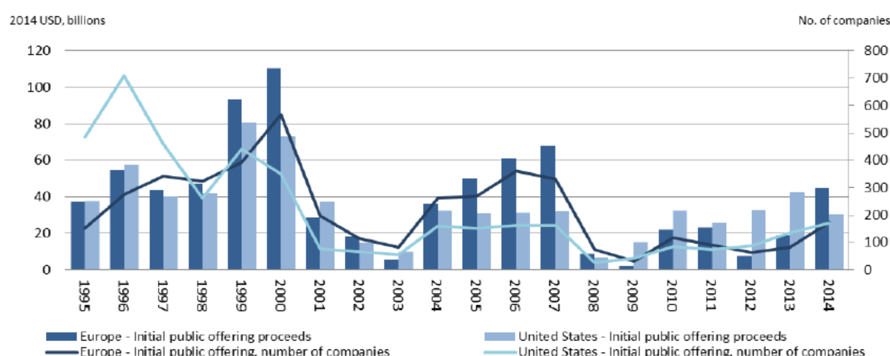

Figure 2 - IPOs by US and European non-financial firms (source: OECD)

The breakdown of IPO activity based on the market capitalisation of the issuing firms (see Figure 3) clearly shows that large firms account for most of the total deal value. In 2016, they account for 66% of total deal value compared to 24% and 6% for mid- cap and small-cap firms. In addition, the number of IPOs is also much more volatile for smaller firms compared to large firms, illustrating that the IPO market for smaller firms is less stable and more vulnerable to shocks.

[7] Bancel, F., & Mittoo, U. R., 2009, 'Why do European firms go public?', *European Financial Management*, 15(4), 844-884.

[8] OECD,2015, OECD Business and Finance Outlook 2015, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264234291-en.

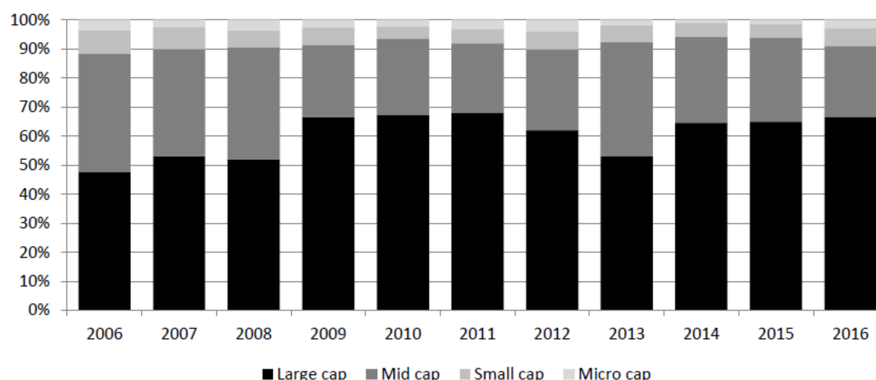

Figure 3 - Breakdown of IPO activity according to firm market capitalisation (source: EC)

In quantitative terms there is a clear IPO gap for SMEs. However this does not imply that equity markets are to be relevant for all SMEs. SMEs are confronted with high fixed costs of becoming listed compared to the deal size. The Federation of European Securities Exchanges (FESE) estimated that in 2015 the costs vary from 10 to 15% of the amount raised from an initial offering of less than EUR 6 million to 3 to 7.5% from more than EUR 100 million.[9] On top, recurrent compliance costs after listing (e.g. information disclosure) have to be taken into consideration as well.

II.2. Corporate bond issuance

Corporate bond issues increased and have mitigated the effect of bank lending constraints at least for large firms. Compared to 2006, the number of corporate bond issuances in Europe has nearly doubled in 2016 to 788, representing a volume of EUR 240 billion in 2016. This trend mirrors the evolution witnessed in advanced economies were non-financial corporate bond amounts nearly doubled from 2000 to 2014. The strong increase in issuing activity following the 2008 financial crisis suggests that in this period debt securities had some degree of substitution effect for shrinking bank lending.[10]

This finding is confirmed by world-wide data. In the aftermath of the 2008 financial crisis, the use of corporate bonds has become an increasingly important source of finance for non-financial companies both in advanced and emerging economies. In many cases, corporate bonds have provided an opportunity for companies to replace existing debt with cheaper borrowing and also to refinance their existing bank loans in times of reduced bank exposure to the non-financial corporate sector. Figure 4 shows the total global amount of proceeds received by non-financial companies from public and private bond issues during the last 15 years. The annual amount of money non-financial companies raised through bond issues increased from an average of USD 828 million in the 2000-2007 period to an average of USD 1,473 million in the post-crisis period.

[9] FESE (Federation of the European Securities Exchanges), 2015, EU IPO Report: Rebuilding IPOs in Europe. Creating jobs and growth in European capital markets. European IPO Task Force, March 2015.

[10] European Commission, 2017, 'Economic Analysis on the Mid-Term Review of the Capital Markets Union Action Plan', Brussels, June 2017.

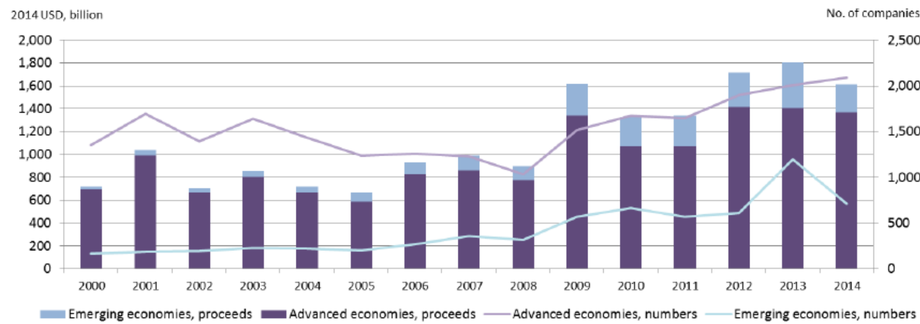

Figure 4 - Corporate bond issuance by non-financial firms (source: OECD)

The number of first time bond issuers increased significantly in the 2008-2010 period.[11] In addition, the risk profile of bonds changed, with riskier bonds being issued after the 2008 financial crisis. The value of corporate bond and stock markets as % of GDP equals 12% and 56% for the EU (10% and 51% for EU27, respectively), compared to 31% and 112% for the US. United Kingdom figures hold the middle between US and EU27 figures with corporate bond and equity markets equal to 18% and 78% of GDP (Wright and Bax 2016)[12].

The corporate bond market is still dominated by large firms. Figure 5 shows that public bond issues by firms with an asset size of USD 250 million or less decreased from 7% in 2000 to only 2% in 2014. In addition, the median value of bond issues has increased as well. Contrary to large firms, SMEs reacted to the shrinking availability of bank financing by relying increasingly on internally generated funds and alternative financing like trade credit

[11] OECD,2015, OECD Business and Finance Outlook 2015, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264234291-en.

[12] Wright, W., & Bax, L. (2016). What do EU capital markets look like post-Brexit? New Financial. http://newfinancial.eu/wp-content/uploads/2016/09/2016.09-What-do-EU-capital-markets-look-like-post-Brexit-a-report-by-New-Financial.pdf.

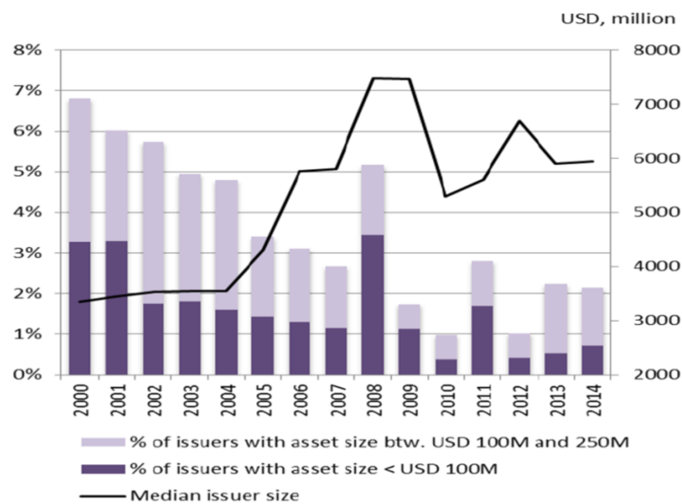

Figure 5 – Size of non-financial firms issuing bonds in advanced economies (source: OECD)

SMEs have a number of structural disadvantages when considering bonds issuance, similar to those for equity issuance (higher information asymmetries; more uncertainty surrounding their creditworthiness; limited track record; lower visibility; high issue costs). However, with respect to equity issuance, corporate bonds issuance faces lower constraints as firms issuing debt do not need to change their capital structure or to alter their shareholding structure. By contrast, such changes occur when firms issue equity on public markets.

Equity and bond markets are intertwined. Figure 6 shows the number of IPO firms issuing bonds around the IPO date. Initial access to equity markets facilitates subsequent access to finance (equity, bond, and bank financing) as well as mergers and acquisition (M&A) activity. There is also a positive feedback effect: more developed equity markets would lead to more developed bond markets.

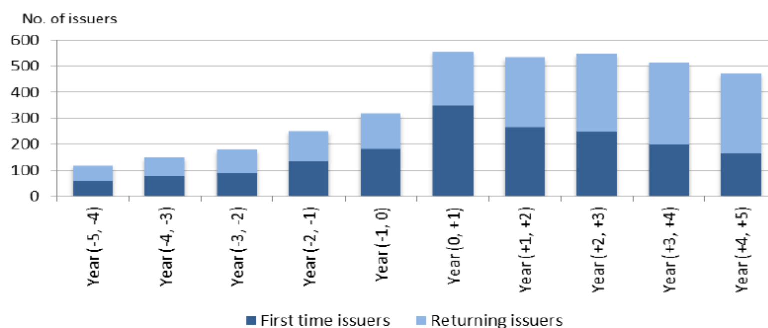

Figure 6 - Number of IPO firms issuing bonds around the IPO date (source: OECD)

III. SMEs Growth Markets

III.1. Background

"...in most OECD countries more debt is typically associated with slower growth while more stock market financing generates a positive growth effect." OECD Economic Policy Paper, June 2015 No 14

Multilateral trading facilities (MTFs) were introduced under MiFID in 2007. They were defined as "a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non -discretionary rules – in a way that results in a contract."[13] They were intended to inject competition in share trading across the EU.

The European Commission's 2008 Small Business Act for Europe[14] called for rules that were designed with the aim of reducing administrative burdens on SMEs. It looked to adapt current legislation so that it met the needs of issuers on markets for SMEs and to facilitate access to finance for those issuers.

As part of its subsequent Capital Markets Union Action Plan[15], SME growth markets were launched in MiFID II by the European Commission and are defined as MTFs that are registered as an SME growth market in accordance with Article 33 of MiFID II[16].

This article and the delegated regulation[17] set out the requirements for an operator to register as an SME growth market and include:

a) At least 50% of its issuers whose financial instruments are admitted to trading are SMEs at a time when the MTF is registered as an SME growth market and in any calendar year thereafter;

b) Appropriate criteria for initial and ongoing admission to trading of financial instruments of issuers, which should be objective and transparent;

c) An appropriate operating model for the performance of its functions that ensures the maintenance of fair and orderly trading in the financial instruments admitted to trading;

d) Rules that, where appropriate, require an issuer seeking admission of its financial instruments to trading on the MTF to publish an appropriate admission document – drawn up under the responsibility of the issuer and clearly stating whether or not it has been approved or reviewed and

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[13] Directive 2004/39/EC (MiFID): http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32004L0039&from=EN.

[14] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52008DC0394&from=EN.

[15] Action Plan on Building a Capital Markets Union, European Commission: http://ec.europa.eu/finance/capital-markets-union/docs/building-cmu-action-plan_en.pdf.

[16] Directive 2014/65/EU (MiFID II): http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2014_173_R_0009&from=EN.

[17] C (2016) 2398/F1 (Delegated Regulation): https://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2398-EN-F1-1.PDF.

by whom;

e) Issuers, persons discharging managerial responsibilities (PDMR) and persons closely associated with PDMRs – as defined in MAR – must comply with the relevant requirements applicable to them;

f) Rules that define the minimum content of the admission document, so that investors have sufficient information to make an informed assessment of the financial position and prospects of the issuer, and the rights attaching to its securities;

g) A requirement that the issuer states, in the admission document, whether or not, in its opinion, its working capital is sufficient for its present requirements or, if not, how it proposes to provide the additional working capital needed;

h) Arrangements for the admission document to be subject to an appropriate review of its completeness, consistency and comprehensibility;

i) A requirement that its issuers publish annual financial reports within six months after the end of each financial year and half yearly financial reports within four months after the end of the first six months of each financial year;

j) Mechanisms that ensure prospectuses are disseminated to the public, and that admission documents, financial reports and information defined in Article 7(1) of MiFID II are publicly disclosed by issuers, either via its website, or via a direct link issuer's website where the information is published; and

k) Ensuring that the regulatory information remains available on its website for a period of at least five years.

III.2. Objectives of SME growth markets

There isn't a single point of reference that explicitly defines the objective of SME growth markets, or how their success can be measured or assessed. Nonetheless, a number of recitals and other forms of technical advice indicate that:

- The objective of SME growth markets should be "to facilitate access to capital for smaller and medium-sized enterprises and to facilitate the further development of specialist markets that aim to cater for the needs of smaller and medium-sized issuers."[18]

- Creating a new sub category of SME growth market within the MTF category "should raise their visibility and profile and aid the development of common regulatory standards in the Union for those markets. Attention should be focused on how future regulation should further foster and promote the use of that market so as to make it attractive for investors, and provide a lessening of administrative burdens and further incentives for SMEs to access capital markets through SME growth markets."[19]

- SME growth markets should not have rules that impose greater burdens on issuers than those applicable

[18] MiFID II, Recital 132.

[19] Ibid.

to issuers on regulated markets.[20]

- "One of the aims of MiFID II is to facilitate access to capital for SMEs and the development of specialist markets catering specifically for the needs of SMEs. To that end MiFID II envisages establishing a regime for the registration of MTFs offering facilities to SMEs as 'SME growth markets' (SME-GMs), where they meet certain criteria specified by MiFID.

  This new category of MTF shall raise the visibility and profile of specialised SME markets and shall establish common pan-European standards while at the same time providing sufficient flexibility to be able to incorporate the existing current range of successful markets operating in that field.

  The requirements to be met by a SME-GM shall, according to MiFID II, take into account the need for the requirements to maintain high levels of investor protection to promote investor confidence in those markets while minimising the administrative burdens for issuers on the market so striking the correct balance between those two principles."[21]

III.3. Prospective SME growth markets

As the concept of an SME growth market is not fully developed and in operation, it is difficult to provide a definitive list of how many existing markets will seek to become an SME growth markets.

European Economics has identified around 40 potential SME growth markets among the EU's MTFs. Of these, Germany and the United Kingdom account for eight and five potential SME growth markets respectively. Five EU member states have no candidate SME growth markets, whilst 14 EU member states have just one prospective SME growth market.[22]

At the same time, Veil and Di Noia have commented that the following factors will affect SME growth markets' long-term success: "The long-term success of the 'SME growth market' trademark will crucially depend on the ability of this multi-level assessment system to signal high quality listing standards. Whether eligible MTFs will rush to display that label or will rather refrain from doing so by taking advantage of their freedom not to seek registration as SME growth markets (Recital 134 MiFID II) is difficult to predict, as the market perception of operators' credibility may depend on a number of variables. While any attempt to forecast the success of SME growth markets would be a high-risk exercise, the question does offer an opportunity to analyse some dynamics for listing."[23]

III.4. Opportunity to help SMEs on public markets

The introduction of SME growth markets is an opportunity to look at many aspects of capital market

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[20] Delegated Regulation, Recital 112.

[21] ESMA technical advice on MiFID II.

[22] Data Gathering and Cost Analysis on Draft Technical Standards Relating to the Market Abuse Regulation, European Economics (February 2015): https://www.esma.europa.eu/sites/default/files/library/2015/11/cost_analysis_u_for_final_report_on_mar_technical_standards_0.pdf. Also cited in Impact Assessment of the Delegated Regulation (EU) No 600/2014 – As regards to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions, pp. 111 – 123: http://ec.europa.eu/finance/securities/docs/isd/mifid/160518-impact-assessment_en.pdf.

[23] Di Noia, C., & Veil, R., 2017, 'SME growth markets', in 'Regulation of the EU Financial Markets MiFID II and MiFIR', edited by Busch, D., & Ferrarini, G., Oxford University Press.

structure from the point of view of SMEs. We understand that the Commission is discussing which pieces of legislation are disproportionate with respect to SMEs and where the SME growth markets concept can be used to exempt such companies from any overly onerous requirements. This is a welcome approach.

These could include items relating to market making, clearing and settlement rules and prospectuses arising in various regulations and directives such as MiFID II, MAR, the Transparency Directive, the Prospectus Regulation, the Short Selling Regulations and CSDR. The aim should be to develop a distinct and separate regime for SME Growth Markets, which is less complex than the regimes for regulated markets (as already recommended by the SMSG in its 2012 report). By looking at the different aspects of market structures, SME growth markets could achieve their full potential in energising SMEs to grow and contribute more to the EU economy.

III.4. The need for an end objective

We believe that consensus regarding what this policy initiative's desired outcome is crucial to being able to put the building blocks for success in place. The aim of the concept needs to be carefully set out, so that the Commission, ESMA, national competent authorities (NCAs) and SME growth market operators can test their thinking and interventions against what is the desired outcome.

For example, ESMA has the opportunity to embrace this concept and – through regulatory convergence, peer review and its influence – to ensure that NCAs also respect and embrace the concept. As already noted, neither the European Commission nor ESMA specify objectives or targets beyond general intentions. It is obviously not ESMA's role to define the policy of SME growth markets.

Interventions to exempt SMEs from certain pieces of legislation as mentioned above are very helpful but establishing defined success measures may well lead to other non-legislative interventions arising from areas other than DG FISMA[24].

III.5. Parameters for success

SME growth markets should be able to operate through a number of different models. Harmonisation in this area must take into account the need for SME growth markets to retain flexibility as to the specific market model and eligibility criteria. Harmonisation should not mean homogenisation: no single model will work for all European markets, as they all have different investment cultures.

Yet recognised measures of success are typically limited. De Sousa, Beck, van Bergeijk and van Dijk note: "Nascent markets differ markedly in their success, as measured by number of listings, market capitalization [market cap to GDP], and trading activity [turnover]. Long-term success is in part determined by early success: a high number of listings and trading activity are necessary, though not sufficient, conditions for long-term success. Banking sector development at the time of establishment and development of national savings over the life of the stock market are the two most reliable predictors of success."[25]

Nonetheless, some of the criteria to evaluate whether progress is being made could include:

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[24] The Directorate General for Financial Stability, Financial Services and Capital Markets Union.

[25] Albuquerque de Sousa, Jose Alexandre, Beck, Thorsten, van Bergeijk, Peter A. G. & Van Dijk, Mathijs A., Nascent Markets: Understanding the Success and Failure of New Stock Markets (November 16, 2016). Available at SSRN: https://ssrn.com/abstract=2870392

- Issuer demand to join SME growth markets;
- Investor demand and the quality of investor protection on each SME growth market;
- Intermediary uptake – for example, the number of brokers, accountants and lawyers registering to operate on each SME growth market;
- Access to SME growth markets for issuers and investors across EU member states;
- Total money raised at IPO and by further issues on each SME growth markets and overall;
- Availability of investment research;
- Relative liquidity improvements over time; and
- Jobs created following an IPO.

There are also various parameters that could be applied to judge the positive ongoing development and ultimate success of this concept. These might include:

- Timescale to judge success – both short and long-term;
- The number and geographic spread of SME growth markets created across the EU27;
- The number of listings on all and each SME growth market;
- Market capitalisation of all and each SME growth market; and
- Number of IPOs of all and each SME growth market.

Any parameter of success would need to be clearly defined. No single measure would be sufficient. The resulting indicators of success could include some overarching measures such as seeking to create a larger pan-EU network of SME growth markets; increased job creation by SMEs in the EU; increased economic growth by SMEs in the EU and the Eurozone; more stable European financial markets; and enhanced EU competitiveness vis-à-vis the rest of the world.

IV. Corporate bonds issued by SMEs ('Mini-Bonds')

To answer the call for larger market-based funding sources for SMEs in Europe, a few countries have experimented with bond financing. In fact, different markets across Europe are targeted to corporate bonds issued by SMEs. Although also relevant for SMEs funding, private placements of bonds are not covered in this Report.

IV.1. UK

One of the oldest mini-bond market was introduced in the United Kingdom. In 2010 the London Stock Exchange activated a platform to trade bonds in retail size (from £100 up to £10,000) known as 'Order book for Retail Bonds' (ORB). A market maker is required to provide liquidity. Admission requirements are the same as those for the main market. Other options for UK SMEs wishing to issue bonds are: unlisted bonds

and bonds placed through crowdfunding platforms. In 2015 debt-based securities were used to raise £6.2 million from crowdfunding platforms[26].

IV.2. Germany

German experience in this area seems to be very significant, although probably not very successful. In May 2010 the Stuttgart Stock Exchange launched the Bondm market, a segment dedicated to the issuance and trading of corporate bonds issued by SMEs, open to both institutional and retail investors. Liquidity in the secondary market is supported by a Quality Liquidity Provider (QLP), who is expected to offer continuously bid and ask quotes during trading hours. Bonds can be issued with no intermediary acting as underwriter using an electronic channel named 'Bondm subscription box'.

From May 2010 and November 2014, a sizeable number of defaults occurred, with negative effects on investors wealth and the reputation of the market, which was eventually shut down. Mietzner, Proelss and Schweizer (2016)[27] point out that the number of actual default is much larger than those implied by the rating assigned to the mini-bonds. This created a favorable opportunity for lower quality firms to acquire cheaper funding.

IV.3. France

Corporate bonds issued by SMEs in France are traded in two regulated markets (B and C segments at Euronext) and one MTF (Alternext). They are all open to professional and retail investors. Minimum issue size is €10 million on Euronext and €5 million on Alternext. Rating is a requirement if the issuer is not a listed firm. The last three financial reports must be audited. In 2016 the French government passed a regulation to allow the placement of bonds through crowdfunding platforms.

IV.4. Spain

In 2013 Bolsa y Mercados Españoles (BME) set up a market to trade small cap bonds named Mercato Alternativo de Rent Fija (MARF). Only professional investors are allowed to trade. Minimum trading size is €100.000. An advisor to assist the company during the issuance process is required. Rating is not required. A liquidity provider is also not required.

IV.5. Italy

In 2012 the Italian government introduced new regulations to enable unlisted companies to issue debt instruments commonly known as 'mini-bonds'[28]. Mini-bonds are eligible for listing and subject to the same tax regime as bonds issued by listed companies. Investors are exempt from tax withholdings on interest earned. Issuers are allowed to deduct the interest paid for up to 30% of EBIT. Issue size may be as low as €20m. Mini-bonds aim to be *pari passu* with banks, with financial covenants in line with the banking ones.

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[26] Zhang, B., Baeck, P., Ziegler, T., Bone, J. & Garvey, K., 2016, Pushing Boundaries. The 2015 UK Alternative Finance Industry Report, University of Cambridge.

[27] Mietzner, M., Proelss, J., & Schweizer, D., 2017, Hidden champions or black sheep? The role of underpricing in the German mini-bond market, *Small Business Economics*, 1-21.

[28] Mini-bonds were introduced in Italy by Law Decree no. 83 of 22 June 2012 converted with Law 134/2012 (the so–called Development Decree).

In 2013 Borsa Italiana set up the ExtraMOT PRO as an MTF to trade mini-bonds, as well as other debt securities. Only professional investors, as listed in the Annex II of the MiFID I, have access to ExtraMOT PRO. Figure 7 shows the number and the value of mini-bonds issued in Italy in the last five years.

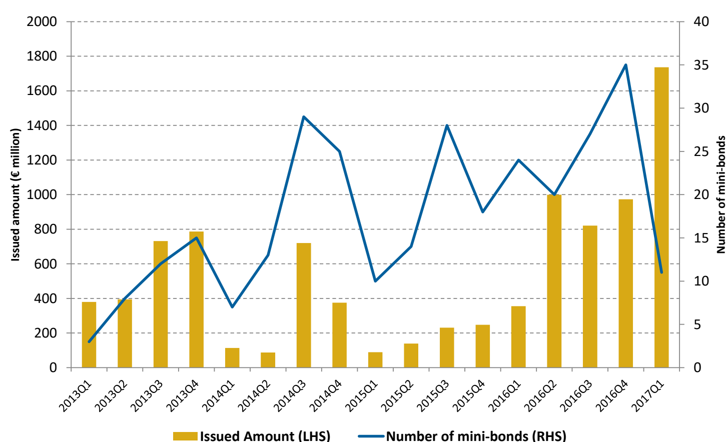

Figure 7 - Italian mini-bond issuance activity

IV.6. Lessons learned

A well-functioning market should provide appropriate incentives to issuers, investors and intermediaries. Issuers should be able to get funding they need paying the right price, which means – from the perspective of the investor – to receive fair investment returns, give the associated risk level. Market intermediaries, through underwriting, research and secondary-market activities, also play a crucial role.

Mini-bonds may prove to be an additional useful financing tool for SMEs provided that they offer an attractive risk/return tradeoff to investors as well as affordable and flexible financing for firms. As for the risk dimensions, mini-bonds are exposed to market, liquidity and credit risk. All bonds face these risks, but credit risk is most critical for relatively unknown, smaller companies.

Retail investor protection is a source of concern. Mini-bonds might have attracted many retail investors over the past two years with projections of high returns, in an environment where such yields are hard to find among traditional securities. The German experience shows that ratings did not perform very well. Restrictions to professional investors only might be considered.

The corporate bond market for SMEs in Europe appears to be highly fragmented. Different regulatory frameworks and degrees of maturity of public bond markets coexist across Member States. On the regulatory dimension, rating is required in some jurisdictions. On the maturity dimension, issuance of debt securities is considered irrelevant for SMEs in the Central Eastern and South-Eastern Europe (CESEE) region.[29]

[29] European Central Bank, 2017, 'Survey on the Access to Finance of Enterprises in the euro area', Frankfurt, May 2017.

The role of banks in lending might actually raise a conflict with respect to the role of banks in mini-bonds issuance. Banks may act as arrangers and advisors to firms issuing mini-bonds. However, unconventional monetary policy measures may crowd-out mini-bond issues. Targeted Longer-Term Refinancing Operations (TLTROs) offered by ECB provide long-term loans to banks and offer them an incentive to increase their direct lending to firms, which may somehow discourage banks to support mini-bond issues. Not surprisingly, independent (i.e., non bank-owned) brokerage firms often act as advisors for mini-bond issuances.

Another potential issue is liquidity. Mini-bonds are not actively traded. This is not a surprise given the buy-and-hold attitude of the mini-bond investors. Bond market liquidity is under the scrutiny of European institutions. The EU Commission's Expert Group on Corporate Bond Market is expected to deliver recommendations about market liquidity for corporate bonds in November 2017.

V. Conclusions and recommendations

Access to finance for SMEs continues to concern policymakers at the national and European level. The need to reform the architecture of capital markets in the EU so that they are capable of supporting job creation and generating sustainable economic growth has been accelerated by the UK's vote to the leave the European Union.

Opportunities in this respect have already been lost as the Market Abuse Regulation (MAR) – which came into effect on 3 July 2016 – has preceded MiFID II, which has been delayed until January 2018. For example, MAR exempts SME growth markets from certain requirements, such as maintaining insider lists. However, with the concept of SME growth markets being defined by MiFID II, exemptions cannot currently be used until MiFID II comes into force.

Unintended consequences may arise from the MiFID II provisions on investment research, especially on the liquidity of small cap stocks. A new action called for the CMU's 'SME listing package' is the assessment of the impact of MiFID II level 2 rules on listed SME equity research. MiFID II requires investment research to be paid for in one of two ways: from a fund manager's own account, which may be recoverable by raising fees, or via a ring-fenced client research-payment account. MiFID II prevents research from being paid for directly using dealing commissions. In an unbundled world, based on execution-only commission rates where payments for research are separated, research coverage of small cap stocks might suffer. Small cap research might have been in fact cross-subsidized over time by large cap research. The lack of research might impair stock liquidity and, ultimately, price efficiency.

Low levels of liquidity in SME markets have consistently inhibited investment in public SME equity. Many SMEs lack the confidence and the know-how to both navigate the offering process and contend with share price volatility. In June 2017, the European Commission sought to inject new impetus into the Capital Markets Union by outlining a set of new actions through a communication on it mid-term review[30]. The objective is to complement existing initiatives included in its original Action Plan. Yet, going forward, it will be crucial for the European Commission to present well-defined, measurable parameters of success, in order for it to be able to accurately assess whether it has effectively harnessed the potential SME growth markets and whether they are truly fit for purpose in the European financial ecosystem.

A new action called for the CMU's 'SME listing package' is the use by Member States of EU funds to partially

[30] Communication on the Mid-Term Review of the Capital Markets Union Action Plan: https://ec.europa.eu/info/sites/info/files/communication-cmu-mid-term-review-june2017_en.pdf.

finance costs borne by SMEs when seeking admission of their shares on the future SME growth markets. Such a measure, although it does go in the appropriate direction, can hardly make a crucial difference in terms of access to the funds that SMEs may need. A flexible and proportionate approach may instead be needed for successful SME growth markets. This is actually a priority action set out in the CMU mid-term review of June 2017: targeted amendments to relevant EU legislation could be implemented to deliver a more proportionate regulatory environment to support SME listing on public markets.

Direct investment in corporate bonds issued by SMEs might give rise to investor protection issues. The assessment of credit risk exposure for mini-bonds has proved to be challenging. In this respect, the institutional investors specialized in mini-bond investing might be well placed for a sound assessment of the embedded credit risk as well as to provide retail investors with a diversification effect otherwise prevented.

The new Prospectus Regulation generally achieves its purpose of introducing rules designed to facilitate access to capital markets financing for SMEs. Attention was paid to lowering the administrative burden and costs, which can be disproportionately high for these companies, with measures such as allowing a broader use of incorporation by reference and cross-referencing in the prospectus documents. The new Regulation increases the thresholds under which a prospectus is not required (i.e., under €8m and fewer than 150 persons per Member State, other than qualified investors) and also introduces simplified rules for secondary issuances as well as specific rules for the SME Growth Markets prospectus.

The new Prospectus Regulation is however missing an important element to ensure continuous growth for SMEs: the ability to easily move from an SME Growth Market to a regulated market. We encourage ESMA and the Commission to consider ways to facilitate the transition of companies from SME growth markets to the regulated markets, taking into account the time that a company has been on an SME Growth Market and the observance of the reporting requirements under the SME Growth Market rules as well as other directives and regulations (e.g. Market Abuse Regulation). Additionally, the new Regulation has, in some aspects, missed the opportunity to simplify and adequately adapt the rules to the needs of SMEs. For instance, the summary requirements regarding risk factors and financial information are onerous for SMEs. Lastly, the exemptions granted in the new Regulation might be adjusted to include a large number of SMEs (raising the threshold to, e.g., €20m and 200 natural or legal persons).