PART II - Comments on the 'Quick Wins'

contribution to the Green Paper "Building a Capital Markets Union" (CMU)

The Green Paper identifies five priority areas for short term action including the following:
1. Lowering barriers to accessing capital markets and reviewing the prospectus regime;
2. Widening the investor base for SME and improving credit information on SME;
3. Building sustainable securitisation;
4. Boosting long-term investment;
5. Developing European private placement schemes

Unfortunately none of these five priorities for the short term involves diirect investment by individual investors, except – but probably marginally – ELTIFs. However, the Commission itself rightly points out that "*households are the main source of funds to finance investment*" (Green Paper on the long term financing of the European economy). Therefore, a successful CMU must involve and attract individual investors. "*It makes no sense to create a fully integrated market for professional investors and maintain a separate less efficient and less integrated market for retail investors … The protection of investors should play a major role in building the CMU*" (Steven Maijoor, Chair of ESMA). Improving investor protection and clarifying choices for consumers must also take a prominent place in the CMU initiatives.

Regarding these five short-term priorities identified by the Commission, the ESMA SMSG would like to stress the following:

1. The Prospectus regime - lowering barriers to accessing capital markets

An effective overall funding environment in Europe must seek to:

- Ensure an appropriate regulatory framework for issuers that does not prove overly burdensome for them whilst still ensuring investor confidence.

- Attract a wider set of investors to smaller businesses who wish to grow by reducing the regulatory and fiscal burden on such SME investors

The SMSG 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. The ESMA SMSG believes that it is important to make it easier for companies to access capital markets. That said, the SMSG SME working group is not in favour of a reduction of disclosure requirements as such for SMEs under the Prospectus Directive. It rather believes that access can be made easier by addressing the following:

- 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.

- The Prospectus Directive should not be extended to MTFs, either in full or a lite version: MiFID II clearly distinguishes the functions of a MTF and a regulated market. The extension of the PD to MTFs would damage this distinction, which is vital to the financial ecosystem in the EU, allowing for SME-GMs to operate with a separate requirement for issuers to produce an admission document which "as a minimum, contains sufficient information for investors to make an informed assessment of the financial position and prospects of the issuer, and the rights attaching to its SME growth market securities" – consistent with ESMA's advice to the Commission.

- 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. To maintain a large investor base, translation into the national language is an important investor protection measure that should be kept.

- Text on the delegation of prospectus reviews to market operators deleted due to disagreement in the group. EU initiatives should seek to enhance the value of the Prospectus for investors while reducing burdens for SMEs. In its current form, the Prospectus – and in particular the "Summary Prospectus" - is not used by investors as it is written in legal jargon, from lawyers for lawyers, and therefore serves mainly to protect against liability. The language of an Prospectus should be clear, simple and easily understandable with the essential information. This means that e.g. general description of different types of risk unrelated to the specific company (textbook-like) should be avoided.

- Some members of the SMSG believe that the current limits for a Prospectus should not be raised. Others however propose increasing some of the thresholds, e.g. from €5m to €20m for equity.

- EU initiatives could also encompass looking at increasing the maximum number of investors allowed to be targeted by private placement to 500. Compared to the US, the European private market is lacking in depth and width, but is necessary to complement and eventually "feed" the public markets.

2. SME credit scoring - widening the investor base

Alongside investor interests for standardised credit data, a further focus must be put on taking the interests of small companies and small banks such as savings and cooperative banks into account, i.e. the ones having to provide such data. A European solution for company data needs to be designed in such a way that any provision of data takes place on a voluntary and not a mandatory basis, i.e. only when a company is interested in gaining access to larger and international investor groups in the context of funding measures via the capital markets. The use of standardized languages like XBRL for the a simplified comparable balance sheet could be an useful as well as the free access to all interconnected business registers.

In this respect, the SMSG also points to the importance of an easy-to-consult Central Rating Repository. Most investors are not aware of smaller, niche rating agencies. A Central Rating Repository would make the ratings by smaller niche rating agencies publicly available, and at the same time contribute to the lesser known agencies becoming better known.

Standardised credit scorings can help to reduce information asymmetries. Though at the same time highly redundant business models based on standardised credit scorings and ratings can lead to significant systemic risks. Therefore investors need also to take on responsibility themselves for adequate risk assessments of their exposure.

Another barrier is the lack of credit ratings in the market, and the consequent lack of competition and increase in costs. ESMA's own figures from Dec 2014 show that there are only 18 ratings agencies in EU, and just three of them have a >90% market share. Measures in the CMU to increase the competition for credit ratings agencies should be considered.

In addition to credit scoring, the investor base can be widened by considering the cost of research on SMEs (as for any type of company) is costly and investors are generally not eager to pay for it. This is why it is important to avoid taking new rules which could reduce substantially the delicate financial equilibrium of securities research especially on SMEs. 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.

3. Securitisation and corporate debt - building debt market financing for SMEs

When exploring the topic of fixed income market financing for SMEs, it is important to distinguish between small and medium companies.

It is also necessary to acknowledge the different roles played by bank, private placement and fixed income markets in financing small and medium sized companies in Europe as well as internationally. Taking this into account, it is possible to focus on the potential refinancing role of bank finance for both small and medium sized companies that bond markets can play through securitisation; and the direct financing opportunity that bond and private placement markets can provide for medium-sized companies. Further, in the context of the creation of new securities (e.g. private placements), the use of market infrastructures should be promoted, as they increase stability, by using safe, stable and reliable electronic systems, allowing e.g. for notary functions and reconciliation measures (i.e. ensuring integrity of the issue). Services provided by market infrastructures further facilitate an extensive international investors' reach: not only domestic investors are reached, but also investors on a European and global level may be reached. This reduces the "home-bias" phenomenon.

Alongside banks, companies operating in the real economy also make use of asset-backed securities to gain funding on the capital market. Such securities play an important role for companies, offering advantages – alongside being an attractive way of gaining funding – with regard to corporate indicators, credit line utilisation and reporting requirements not available when using other capital market products.

- **Refinancing of SME bank loans through securitisation**

Bond markets are poorly configured for the direct financing of small companies in comparison to retail banks. Banks have both flexible and standardised working capital and asset finance loan products, as well as local branch networks, credit teams for small corporates, regular contact with management and daily knowledge of cash flows. Conversely, the relative overall costs involved (including legal and due diligence) of a bond issue for smaller amounts can be uneconomic compared to the amount being financed. Similarly, the reporting requirements and administrative burden of a bond may be disproportionate for a small transaction. For investors, the size and irregularity of potential issuances of SMEs are also typically unappealing; the frequent absence of a credit rating can be a show stopper; and the structurally lower visibility of a smaller business a real difficulty.

It has been argued, including by the official sector (see 2014 ECB speech), that bond markets can play an important role in refinancing SME bank loans through securitisation (and covered bond) structures. This would be facilitated by the rehabilitation of securitisation post 2008 given progress on bank risk sharing and transparency (for example through the ECB's Loan Level Initiative.) Although this is correct in principle, the fact that pre-2008 SME loan securitisation was very limited in a securitisation market dominated by mortgage and consumer finance loans is often overlooked (see 2014 OECD Non-bank debt financing for SMEs). This is also the case in the much bigger US securitization market. One key reason is the lack of standardization of what are called "SME loans" on both sides of the Ocean.

Indeed, it could be argued that a more effective route is to concentrate on securitisation of more homogenous assets, e.g. mortgages or consumer finance such as credit cards. These are easier to achieve genuine risk transfer and would provide capital release for the bank, who in turn is able to reassign capital to SMEs. This should be coupled with a requirement that a significant proportion of this funding is to be released for SME growth companies. The Commission might want to assess a regime which would reallocate this capital.

Furthermore, there is often confusion between actual market based SME securitisation and Central Bank refinancing of such securitisations. Indeed the eligibility of SME loans as collateral for the LTRO and other credit operations of the ECB has created an important outlet for these assets. As a result as of end 2012, the ECB held €35 billion of SME related collateral. It is hoped that fixed income markets will progressively accommodate these transactions, but in practice SME securitisation appears very dependent on official sector credit enhancement mechanisms to make that transition away from Central Bank refinancing (see 2013 EIF report).

An important market initiative supports the post crisis rehabilitation of the use of asset backed securities and securitisation in the form of Prime Collateralised Securities (PCS). The PCS label aims to "enhance and promote quality, transparency, simplicity and standardisation throughout the asset-backed market". Pooling and standardisation of loans is needed to ensure transparency and comparability. It is also designed to help stretch the reach of securitisation to SME loans beyond its past widespread application to mortgages and consumer lending, but in practice this has not yet occurred.

In addition, transparency about the origination of loans and about the credit granting process of the originating financial institution would be meaningful information with regard to transparency of securitisations.

- **Corporate bond markets**

There have been a number of market driven efforts to open up bond markets directly to smaller companies drawing on what has been done in the equity markets and also generally targeting retail investors. There are three notable initiatives in Europe of this nature: the Initial Bond Offering launched by NYSE

Euronext in 2012, modelled on equity IPOs; the German Bond M market create by the Stuttgart Stock Exchange in 2010; and the LSE ORB market launched in February 2010.

There have also been initiatives to develop placements of debt securities for SMEs through shared SPVs (e.g. in France, the Micado France 2018 vehicle). These have however not been replicated on any significant scale.

In conclusion, debt capital markets can play a substantially greater role going forward in financing SMEs and medium sized corporates in Europe. This role can play out indirectly though the desired expansion of securitisation to SME loans to refinance banks. Its progress remains however highly dependent on central bank and official sector credit enhancement. The channelling of market finance, aimed at medium sized rather than small companies, can also happen directly through ongoing new initiatives - with the most recent and tangible being perhaps the ongoing drive to establish a pan-European Private Placement Market.

As far as the global corporate bond markets are concerned, they should become more attractive to individual investors, especially at a time of very low interest rates where retail bond funds will face a bigger challenge to offset fees to deliver a positive real return to investors. To achieve that, access, transparency and liquidity (at least for the larger bond issues) should be improved and be set at par with those of equity markets.

Finally, bonds need ratings, too, and efforts to increase the range and competition between ratings agencies will help grow this market.

4. Boosting Long-term Investments

In its 2012 advice, the SMSG had stressed that the implementation of CRD III and Solvency II have already contributed to the decrease in investment flows from banks and insurance companies into equities as well as to private equity and venture capital funds and other illiquid long term assets which begun in the mid-2000s. If pension funds covered by IORPD2 would also have to comply with Solvency II type of risk weightings, they will be required to hold additional liquid assets. This would not only have a negative impact on pension funds' ability to invest into equity and other long-term assets, but could over time lead to companies being faced with increased costs for pension benefits, as pension funds would find it difficult to generate the necessary long-term returns to match their long-term liabilities. Also the shift from Defined Benefit to Defined Contribution will continue to further impact on the investment strategies of pension institutions.

Rather, the group would like to see an increase in the level of equities and specifically the level of SME/VC that pension funds can hold. In the UK for example, in particular because of Auto-enrolment, savings are going into pension funds which cannot be accessed until at least age 55 (so long term products).

Similar end-results could be achieved through revisions of the AIFMD and the broadening of "eligibility criteria" for EuVECAs and EUSEFs and ELTIFs coupled with lower taxation of capital gains on longer-term investments made by private individuals in general.

5. Developing a European Private Placement scheme

For many years, mid-sized European companies have accessed the US Private Placement (USPP) market, making up a significant proportion of its nearly $50 billion of annual issuance. In 2013, European companies raised $15.3bn in this US market. In Europe itself, the popularity of private placements has accelerated since the onset of the financial crisis, with French and German domestic private placement markets (i.e. respectively the Euro PP and Schuldschein) providing approximately €15 billion of debt in 2013.

The German Schuldscheindarlehen Market has a remarkable volume: EUR 68.7 bn with new issuance in 2014 of EUR 11.7 bn shows that Schuldscheindarlehen are a set financing instrument for especially medium sized enterprises (ca. 60% are non-listed companies) which should be considered as reference when thinking about European solutions. Investors have a buy and hold perspective which is also reflected in the average maturity (5.3 yrs).

It's long track record with very low default rates and the required legal certainty makes the Schuldscheindarlehen an attractive asset class for investors. SMEs of sufficient size (as well as large sized companies) are able to engage in capital markets financing at relatively low transaction costs due to the very flexible level of required documentation (1-15 pages) also no external ratings are necessary. There is a growing demand from international investors as well as European issuers who are increasingly welcoming this lean documentation standard on account of the stable German legal framework.

These markets provide financing through the use of so called private placements, here defined as private issuance of medium to long term senior debt obligations (in bond or loan format), typically at fixed rate, by companies to a small group of investors. Private placements particularly benefit medium-sized and unrated companies by providing access to long-term debt finance which may not otherwise be available to them from the loan or bond markets This should not to be confused with other forms of debt market financing that have other characteristics and/or target issuers, but that may also be "privately placed" to individual or small groups of institutional investors as in the case for example of reverse enquiry EMTN transactions.

However, until now, there has been no pan-European private placement market. To address this, the International Capital Market Association (ICMA) has taken the lead in coordinating the work of the Pan-European Private Placement Working Group (PEPP WG) that currently includes, alongside major investors and other key market participants, the Association for Financial Markets in Europe (AFME), the Association of British Insurers (ABI), the European Private Placement Association (EU PPA), the French Euro Private Placement (Euro PP) Working Group and the Loan Market Association (LMA). There is also direct official sector participation with notably HM Treasury and the French Trésor, and the Bank of France.

This effort has gathered considerable support at the European level with the EU's Economic and Financial Affairs Council welcoming in a December 2014 press release such market-led efforts to develop a pan-European private placement market. It has also generated tangible results with the ongoing release of standardised transaction documentation. HM Treasury has also made a declaration contained in the 2014 Autumn Statement indicating that the UK would implement an exemption for withholding taxes for private placements. Most recently the PEPP WG has met key milestones in promoting the development of a pan-European private placement market with the publication of the following:

- Standardised documentation made available in January 2015 by both the Loan Market Association (LMA) and the French Euro PP WG (developed by the Euro PP Working Group, a French financial industry initiative). This documentation is designed to be complementary, and targeted at different market participants. It is now in use in market transactions.

- The Pan-European Corporate Private Placement Market Guide was released on 11 February 2015. It sets out a voluntary framework for common market standards and best practices which are essential for the development of the market.

In this context it must also be noted that the implementation of the AIFMD has in many member states implied a de facto tightening of the rules governing private placements of below threshold funds (whether EU or non-EU) to European institutional, semi-professional as well as private investors. This has made cross-border marketing of e.g. venture capital and private equity funds more difficult, in turn affecting the overall funding available for investment into SMEs.

As mentioned above, increasing the threshold to 500 investors from the current 100-150 investors could also help build an European private placement market in its full sense and not only limited to debt issuances by corporates, but also covering then private placements by eg below threshold AIFMs to professional and semi-professional investors.