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Dear Sirs,

European Commission – Green Paper – Long-Term Financing of the European Economy

Introduction

We are the Quoted Companies Alliance, the independent membership organisation that champions the interests of small to mid-size quoted companies. Their individual market capitalisations tend to be below £500m.

The Quoted Companies Alliance is a founder member of European**Issuers**, which represents over 9,000 quoted companies in fourteen European countries.

Our ID number for the European Commission's register of interest representatives is 45766611524-47.

Response

We welcome the opportunity to respond to this consultation and the issues addressed in the green paper.

We believe that smaller, growing companies must be able to access public equity markets in order to grow and create employment. We agree with the Green Paper's analysis that in Europe historically there has been a heavy reliance on bank debt in order to finance SMEs' growth. At a time when bank lending is stagnant, we believe that there needs to be a shift towards more permanent capital – public equity.

However, over the past ten years, listings on UK equity markets have fallen, especially on the London Stock Exchange's Main Market (Please see Figures 1 and 2 below). While there is no single reason for this drop, we see the fall in itself as reason to explore whether or not Europe's equity markets are fit for purpose – i.e. providing a primary equity market for companies to raise finance and deliver value to the real economy.

Small and mid-size quoted companies make up a significant share of companies on UK equity markets. There are some 2,000 small and mid-size quoted companies in the UK, representing 85% of all quoted companies. These companies need equity markets to access finance and are fundamentally different from the largest, multinational companies, for example in the FTSE 100 index, in terms of their turnover, employees, types of investors, etc. As such, they require a different regulatory environment.

We believe that policymakers in Europe are starting to recognise this and are attempting to adjust the regulatory environment for small and mid-size quoted companies – for example through the 'SME Growth

Market' category in MiFID II and the proportionate disclosure regime for 'companies with reduced market capitalisations' and SMEs in the Prospectus Directive. However, there is no single definition of a 'quoted SME' and we are seeing a proliferation of definitions throughout various pieces of legislation, especially with regard to the European financial services directives.

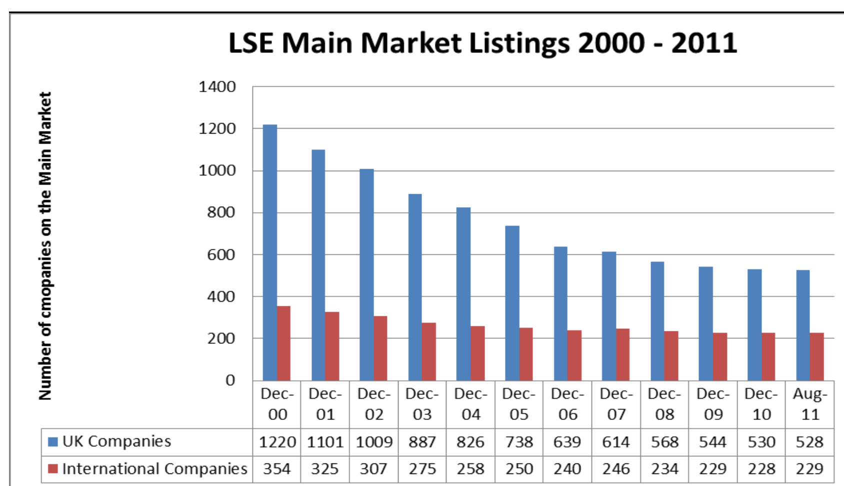
This is damaging and adds additional complexity for all market participants. Therefore, we believe that the first step in improving public equity markets for SMEs is to create a 'SME Asset Class' – a single definition of 'quoted SME' – so that regulations can be appropriate and more targetted for these growing companies. We discuss the creation of a SME Asset Class in more detail in our response to Question 12.

Our research indicates that 60% of UK small and mid-size quoted companies believe that equity markets are hindering their company's prospects. Smaller companies feel that equity markets are not fulfilling their intended purpose to help companies raise finance to grow, which inevitably is vital to Europe's economic recovery.[1]

In addition, 77% of UK small and mid-size quoted companies think that the amount of regulation impacting businesses will grow in the next 12 months.[2] We are concerned that much of the regulation that has been created or amended in the wake of the financial crisis will result in the costs of raising equity to increase for companies and thus negatively impact upon on their ability to raise finance, grow and create jobs. We discuss this in more depth throughout our responses to Questions 11 and 12.

We believe that action led by the European Commission to repair equity markets would provide small and mid-size quoted companies with the positive reassurance necessary to help this sector grow, which is essential to the Europe's economic recovery. We believe that the European Commission should create a working group to conduct a review to determine whether European primary equity markets are fit for purpose – in helping small and mid-size quoted companies grow and create employment. We discuss this in more depth in our response to Question 11.

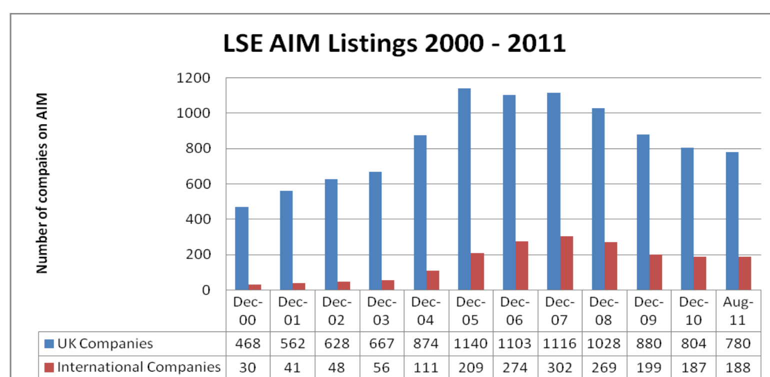
Figure 1 – London Stock Exchange Main Market Listings 2000 - 2011



	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Aug-11
UK Companies	1220	1101	1009	887	826	738	639	614	568	544	530	528
International Companies	354	325	307	275	258	250	240	246	234	229	228	229

[1] QCA/BDO Small & Mid-Cap Sentiment Index powered by YouGov, September 2011; a survey of 100 representative small and mid-cap quoted UK companies. This survey is carried out on a quarterly basis.
[2] QCA/BDO Small & Mid-Cap Sentiment Index powered by YouGov, January 2013; a survey of 137 representative small and mid-cap quoted UK companies. This survey is carried out on a quarterly basis.

Figure 2 – London Stock Exchange AIM Listings 2000 – 2011



	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Aug-11
UK Companies	468	562	628	667	874	1140	1103	1116	1028	880	804	780
International Companies	30	41	48	56	111	209	274	302	269	199	187	188

Source for both figures: *The London Stock Exchange Statistics – List of all companies, 2000 – August 2011 (available at: http://www.londonstockexchange.com/statistics/historic/company-files/company-files.htm). The following sectors are excluded from both figures: Banks, Company Bonds, Debentures & Loans, Non Equity Instruments, Preferences, Equity Investment Instruments, General Financial, Life Insurance and Non-life Insurance.*

Responses to Specific Questions

We have responded to those questions which we feel able to answer from a quoted company perspective and for which we can provide evidence.

1. Do you agree with the analysis out above regarding the supply and characteristics of long-term financing?

Yes, we generally agree with the analysis. However, we would note that the analysis downplays the impact of regulation on investors' behaviour and that, in light of the various legislative reviews that arose out of the financial crisis, this should be a key consideration in assessing the availability of equity finance and new IPOs in particular.

2. Do you have a view on the most appropriate definition of long-term financing?

We do not have a view on this. We would note that it is difficult to put a set timeframe on long-term – this often varies based on a company's sector.

3. Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channelling of financing to long-term investments?

We believe that the traditional role of banks in providing capital to growing companies is already reduced and will continue to reduce over the next few years due to a number of factors, including changes to banking regulation. As stated in our introduction, we believe that there needs to be a shift from relying on revolving bank debt finance to an ecosystem that builds on permanent, equity capital. It is of the utmost importance that policymakers explore how to enable this shift and allow small and mid-size companies to access public equity markets.

At the same time, banks will continue to play a role in providing capital to growing businesses. Therefore, it is important to ensure that any banking sector reforms do not prohibit or restrict the availability of banks to provide financing to SMEs.

4. **How could the role of national and multilateral development banks best support the financing of long-term investment? Is there scope for greater coordination between these banks in the pursuit of EU policy goals? How could financial instruments under the EU budget better support the financing of long-term investment in sustainable growth?**

We have no comments on this question.

5. **Are there other public policy tools and frameworks that can support the financing of long-term investment?**

We have no comments on this question.

6. **To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing ?**

We believe that institutional investors play an important role in the provision of permanent equity capital, especially to small and mid-size quoted companies.

We believe that certain types of insitutitional investors, for example pension funds, should be much more active in investing in small and mid-size quoted companies. Pension funds have been fleeing from equities in recent years. The UK Pensions Regulator has said that UK funds hold 43.2 per cent in gilts and fixed interest compared with 38.5 per cent in equities. This is the highest allocation of gilts and fixed interest since the Pensions Regulator started compiling data in 2006[3].

We believe that more can be done by national governments to incentivise insitutional investors to invest in small and mid-size quoted companies. For example, the abolition of the dividend tax credit for pension funds[4] in the UK in 1997 has resulted in the value of pensions being more uncertain and reliant only on the contributions of the employee and employer. At a time when governments are focused on encouraging people to save for their retirement and are faced with a pensions crisis, reinstating the dividend tax credit would be a welcomed action. We are recommeding that the UK Government reinstate the dividend tax credit for investments by pension funds in SMEs.

Furthermore, we believe that pension funds have increasingly been disincentivised from investing in small and mid-size quoted companies as a result of regulation. For example, the application of Solvency II to pension funds could mean that pension funds are less inclined to invest in SMEs as they are classed as risky investments. Making insurance companies and pension funds demonstrate solvency on a continuous basis inevitably makes them into short-term investors even though their liabilities are actually long-term.

We note that the European Commission has announced that its review of IORP Directive will no longer cover the solvency of occuptional pension schemes and we support this. Regardless, we believe that it is important for policymakers to consider how prudential reforms can affect behaviour and put pressure on funds to focus on the short-term, which does not support investment in growth companies and SMEs.

Lastly, we note that the Green Paper does not explore the role of retail investors in providing long-term finance for companies. Private, retail investors play a significant role in providing investment for small and

[3] http://www.ft.com/cms/s/0/c65e011e-28f5-11e2-9591-00144feabdc0.html#axzz2BpxbwwuF
[4] Pension funds in the UK received a tax credit of 20% on dividends received from UK companies.

mid-size quoted companies, in the UK and other European jurisdictions. We believe that in recent years policymakers have ignored this role in favour of a focus on 'investor protection'.

7. **How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?**

Please see our comments to Question 6.

8. **What are the barriers to creating pooled investment vehicles? Could platforms be developed at the EU level?**

We have no comments on this question.

9. **What other options and instruments could be considered to enhance the capacity of banks and institutional investors to channel long-term finance?**

We believe that there are a number of fiscal incentives that national governments could create to encourage long-term investment into smaller, growing companies. We have outlined in detail incentives for the UK in our Proposals for Taxation Reform: 2013 Budget[5].

We would note that EU state aid rules often act as a barrier to developing new or amending exisiting fiscal incentives in Member States. National governments are often reluctant to change fiscal incentives due to the long and complex process of having EU approval for a change to a scheme. We believe that the European Commission should reconsider both the application of state aid rules and the approval process of member states' schemes in order to ensure that these regulations are not a break to developing incentives that are vital for the growth of small and mid-size companies throughout Europe.

10. **Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicality of aggregate long-term investment and how significant are they? How could any impact be best addressed?**

Please see our comments to Question 6.

11. **How could capital market financing of long-term investment be improved in Europe?**

As stated earlier, we believe that public equity finance is vital to ensuring that Europe's growth companies can continue to grow and create employment.

We believe that there is an urgent need for the European Commission to have a joined up policy for helping small and mid-size quoted companies raise money through primary equity markets. We believe that the European Commission should create a working group to conduct a review to determine whether European primary equity markets are fit for purpose – in helping small and mid-size quoted companies grow and create employment. This review could explore:

- what changes to EU regulation and what EU initiatives could help deliver a better environment for small and mid-size quoted companies to raise equity on a primary equity market.

[5] http://www.theqca.com/about-us/responses/66112/quoted-companies-alliance-2013-budget-proposals.thtml

- the creation of a SME Asset Class, so that Commissioners, policymakers, regulators and market operators can easily facilitate proportionate and appropriate policy for growing companies, and so that investors can more easily allocate funds to these companies; and
- ensure that major European and national indices are constructed and calculated in a way that more accurately reflects constituents and their contribution to member states' economies and the European economy as a whole.
- what incentives investors – both institutional and private – have to invest their money in growing companies.

For more in depth analysis on these areas, please see our comments to Question 12.

12. How can capital markets help fill the equity gap in Europe? What should change in the way market-based intermediation operates to ensure that the financing can better flow to long-term investments, better support the financing of long-term investment in economically-, socially- and environmentally-sustainable growth and ensuring adequate protection for investors and consumers?

As mentioned in our introduction, we believe that vibrant and healthy public equity markets are essential to ensuring that small and mid-size quoted companies can continue to be the engines of growth for the European economy.

We have identified a number of regulatory and behavioural issues in public equity markets that make raising finance on these markets more difficult and less efficient and effective for SMEs, especially when compared to other forms of finance available to them (ie bank debt, venture capital, private equity, etc).

Some of these issues are caused by how market participants interpret regulations; some are caused by the current economic environment; and some are directly a result of how policymaking discourages SMEs from either seeking admission to a public equity market, raising finance on an equity market, and/or driving investment away from quoted SMEs.

We have identified issues below, outlined the problems and, wherever possible, highlighted possible policy solutions to alleviate these issues and, ultimately, make public equity markets more accessible for SMEs.

A. SME Asset Class

As noted in our introduction, there is no single legal definition of a small and mid-size quoted company. This is needed so that regulations can be targeted and proportionate.

Small and mid-size quoted companies are fundamentally different from large blue chip companies - in terms of their growth potential, size, turnover, market capitalisation, number of employees, percentage shareholding of investors, types of investors, etc. As such, they require a different regulatory environment.

Policymakers are starting to recognise this - and are attempting to adjust the regulatory environment for small and mid-size quoted companies. However, as there is no one single definition, we are seeing a proliferation of definitions throughout various pieces of legislation, especially with regard to the European financial services directives. This is damaging and adds additional complexity for all market participants.

Examples of definitions of SMEs in European Legislation

For example, the amending Directive of the Prospectus Directive (Directive 2010/73/EU[6]) defines a 'company with a reduced market capitalisation' as:

> *"company with reduced market capitalisation" means a company listed on a regulated market that had an average market capitalisation of less than EUR 100 000 000 on the basis of end-year quotes for the previous three calendar years.*

At the same time, the recent review of the Markets in Financial Instruments Directive (MiFID II) has attempted to create a new 'SME Growth Market' category, to try to define MTFs with a primary market function geared towards SMEs, such as AIM and the ICAP Securities and Derivatives Exchange (ISDX) in the UK. The majority of companies on a SME Growth Market must be an SME, which is defined in the Commission text of MIFID II similarly to that in the amending Directive of the Prospectus Directive:

> *"Small and medium-sized enterprise" for the purposes of this Directive, means a company that had an average market capitalisation of less than EUR 100 000 000 on the basis of end-year quotes for the previous three calendar years;*[7]

However, the European Parliament text of MiFID II, defines SMEs slightly differently:

> *'small and medium-sized enterprise' means a company that has an average market capitalisation of less than EUR 200 000 000;*[8]

EU recommendation 2003/361[9] also defines a SME based off a test on:

1. number of employees; and
2. either turnover or balance sheet total.

Table 1 - EU recommendation 2003/361 Definition of a SME

Company category	Employees	Turnover	OR	Balance sheet total
Medium-sized	< 250	≤ € 50 m		≤ € 43 m
Small	< 50	≤ € 10 m		≤ € 10 m
Micro	< 10	≤ € 2 m		≤ € 2 m

Defining a small and mid-size quoted company and market capitalisation

A common theme of all the above, varying definitions is the small size threshold set for a SME.

[6] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:327:0001:0012:EN:PDF
[7] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0656:FIN:EN:PDF
[8] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fNONSGML%2bREPORT%2bA7-2012-0306%2b0%2bDOC%2bPDF%2bV0%2f%2fEN
[9] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:124:0036:0041:EN:PDF

The US's Jumpstart Our Business Startups (JOBS) Act aims to ease the initial public offering process and reporting requirements for growth companies. Section 101 of Act defines an emerging growth company as a company with annual gross revenues of less than $1 000 000 000 during its most recent fiscal year as shown on the income statement presented under US GAAP. This is a much higher size threshold than any EU legislation provides for.

In Weild, Kim and Newport's report looking at US equity markets (September 2012), a small cap company is defined as a company with a market capitalisation between $500m and $2bn.[10]

If Europe's equity markets are to remain competitive in terms of attracting small, growth businesses, they need to provide a viable regulatory regime and listing regime similar to that provided in the US JOBS Act.

However, we recognise that one size does not fit all. A suitable definition of small and mid-size quoted company will vary for each member state. We need to have a flexible European economy that flexes for the different markets that are part of it and the companies that want to join the markets.

SME Growth Markets as a starting point

The proposed category of SME Growth Markets in MiFID II attempts to try to create a market structure for SMEs that is appropriately and proportionately regulated. However, it is possible only for multilateral trading facilities to qualify as SME Growth Markets and not regulated markets.

While we support the creation of a SME Growth Market category in European law, it does not address how to create an appropriate regulatory regime for listed SMEs (ie SMEs listed on a regulated market), which is why we recommend the creation of an over-arching SME Asset Class that is based purely on size of company rather than market.

Possible solutions:

- Create a single definition of small and mid-size quoted companies, which includes those companies on both regulated markets and primary market MTFs. The maximum threshold of a small and mid-size quoted company that could be applied by any member state should be any company with a market capitalisation below €1,000,000,000. Member states may choose to apply a lower threshold.

- Pension funds could be mandated to state what their investment policy is towards this group of companies.

- A specific SME Directive could be created which defines a small and mid-size quoted company and creates a regulatory regime for these companies which carves out various European regulations, making them more appropriate to facilitating growth of small and mid-size quoted companies on public equity markets.

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[10] Weild, David, Edward Kim and Lisa Newport. The trouble with small tick sizes: Larger tick sizes will bring back capital formation, jobs and investor confidence. Grant Thornton Capital Market Series. September 2012: http://www.gt.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/Trouble_Small_Ticks.pdf

B. Lack of analyst research on quoted SMEs

There is less research available on small and mid-size quoted companies than that which is available for large blue chip companies, which hinders their ability to attract and retain investors.

Forefactor, an independent market research organisation, conservatively estimates that 35-40% of all publicly traded companies worldwide have no sell-side analyst coverage and that small and micro cap companies suffer the most from this.[11] The key reasons that small and mid-size quoted companies do not attract as much coverage include:

- Large cap companies are more likely to generate higher investment banking fees;
- Typically, greater liquidity translates into higher revenue from trading commissions; and
- Many buy-side funds are bound by market cap restrictions on portfolio holdings.

All of this indicates that there is less incentive from a broker perspective to provide coverage for small and mid-size quoted companies. They simply do not gain much from covering them.

Weild and Kim (2009) also note that high quality investment research has fallen significantly in the past five years and, as a result, smaller companies have disproportionately suffered from this 'brain drain'.[12] Weild and Kim cite research from Integrity Research that estimates that 40% of sell-side analysts lost their jobs in 2008. They also cite research from FactSet Research Systems that shows that for an eight-and-a-half month period ended in May 2009, there were 2,200 incidents of analysts dropping coverage of a company. While Weild and Kim are looking at the US economy and equity markets, these findings resonate with the declining level of research in the UK.

In order to compensate for the lack of sell-side analyst coverage, small and mid-size quoted companies can turn to independent research providers. However, this is an added cost for the company, and so, the take-up of this has not been widespread. There has not been a reported drop in retainer fees charged by brokers and/or NOMADs as a result of this fall in research.

Small and mid-size quoted companies need more research coverage in order to retain current investors and attract new ones, which would stimulate increased liquidity in their shares.

Possible solutions:

- There should be minimum tick sizes for small and mid-size quoted companies – this could create a return for liquidity providers which could be reinvested in the provision of services.

- Companies that pay for independent research should be able to offset that cost against profits in any year for tax purposes.

- Companies that pay for independent research should have a higher threshold for a secondary public fundraising before they have to prepare a prospectus because there is more objective information in the public domain about the company.

[11] http://www.world-exchanges.org/insight/views/small-cap-analyst-coverage-under-radar-dilemma
[12] Weild, David and Edward Kim. *A wake-up call for America*. Grant Thornton Capital Market Series. Page 23-25. 2009 - http://www.gt.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/gt_wakeup_call_.pdf

- The European Commission could operate a pan-European database of all independent research.
- All SME Growth Markets should have a panel of research providers who cover every company on the market.

C. Raising the profile of public equity

A key issue preventing SMEs from accessing public equity is the lack of promotion of public equity as a viable form of finance, especially when compared to other financing options available to them.

Public equity is no longer fashionable. There is no a pervading positive culture towards equity finance as an option for SMEs from Government, media and society.

In our introduction we have shown how, over the last 10 years, the number of companies on equity markets in the UK has steadily fallen and on the regulated market has halved – from 1471 companies in December 2000 to 649 companies in December 2011.[13]

Compounding this is a general and pronounced lack of confidence in equity markets. In Issue 5 of the QCA/BDO Small and Mid-Cap Sentiment Index, 46% of small and mid-cap quoted companies cited lack of confidence in the market in general as the key aspect hampering their ability to grow.[14] With the outlook for equity markets so low amongst existing market participants, it is not surprising that potential market participants would be disheartened.

Moreover, there is a perception amongst the small and mid-size quoted company sector that regulation is ever-increasing. In Issue 3 of the QCA/BDO Small and Mid-Cap Sentiment Index, 78% of small and mid-cap quoted companies believe that the amount of regulation is likely to increase over the next 12 months.[15]

The role of private equity and the lack of companies seeking an IPO

In addition to poor market sentiment, public equity is often passed over as a financing option for SMEs due to other forms of available finance, such as private equity.

More than 70% of the amount invested by the 200+ member of the British Venture Capital Association (BVCA) in 2008 was comprised of private equity rather than venture capital (VC).[16] While this in itself is not necessarily negative, we are not seeing these private firms taking companies public when looking for an exit. In Europe, the number of VC-backed IPOs rose during the 1990s, peaking at 2000, and has now dropped to only a handful of them in 2008, 2009 and 2010.[17] This is magnified by the declining number of

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[13] These statistics refer to companies listed on the Main Market of the London Stock Exchange. See the introduction of this response for a detailed figure.
[14] http://bdoqcasentimentindex.co.uk/downloads/QCA-BDO-Small-and-Mid-Cap-Sentiment-Index-November-2012.pdf
[15] http://bdoqcasentimentindex.co.uk/downloads/QCA-BDO-Small-and-Mid-Cap-Sentiment-Index-May-2012.pdf
[16] The City's Role in Providing for the Public Equity Financing Needs of UK SMEs. City of London. March 2010: http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2010/The%20city%27s%20role%20in%20providing%20for%20the%20public%20equity%20financing%20needs%20of%20UK%20SMEs.pdf
[17] Trends in IPO Listings by SMEs in the EU. City of London. October 2011: http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2011/Trends%20in%20IPO%20Listings%20by%20SME%27s%20in%20the%20EU.pdf

VC exits more generally – EVCA data indicates that the number of exits in 2009 were only one third of the level seen in 2005 and 2006.[18]

While VCs seem to be holding their investments longer, they also seem to be favouring trade sales over IPOs as preferred route of exit. Trade sales in themselves are not inherently negative, but there is an increased danger of loss to the European economy in terms of economic opportunity, especially if there is a non-European company involved.

All of this points to a decline in potential companies that could be taken to the public markets, thus reducing the pipeline of small and mid-size companies that are seeking an IPO.

Government and industry efforts to raise the profile of public equity

We note that DG Enterprise is currently taking action to raise the profile of public equity as a financing option for SMEs.

DG Enterprise recently published a 'Practical guide to going public',[19] which we have supported the Commission in producing. This guide should help SMEs to evaluate the financing option of public equity and also help them to determine whether they are suitable for a public equity market.

DG Enterprise is also developing a European Small and Mid-Cap Awards, which will promote best practices and success stories on public equity markets, underscore the diversity of European capital markets and promote stock listings. We have been supporting the development of these awards through our partner organisation, EuropeanIssuers.

Possible solutions:

- The European Commission should promote equity finance to SMEs through increased education.
- The European Commission and national member states should explore whether there are aspects of the European tax system that favour private equity/venture capital finance in comparison to public equity.

D. Private client stockbrokers and model portfolios

In addition to institutional investment, it is important to increase retail investors' interest in the small and mid-size quoted company sector. However, there are a number of potential obstacles arising from regulations that lock these investors out of money raisings, thus cutting off a source of funding for these companies. This includes both European legislation, such as MiFID's definition of a professional investor, and also UK regulation, such as the Retail Distribution Review (RDR) and the conduct of business rules.

While the regulations themselves do not explicitly lock out retail investors from small and mid-size quoted company stocks, the result has been that private client stockbrockers have anecdotally moved away from

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[18] Trends in IPO Listings by SMEs in the EU. City of London. October 2011: http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2011/Trends%20in%20IPO%20Listings%20by%20SME%27s%20in%20the%20EU.pdf

[19] http://ec.europa.eu/enterprise/policies/finance/risk-capital/going-public/index_en.htm

recommending to their clients to put these stocks in their portfolios. This is partially due to increased risk of investigation from the regulator in a case where a small and mid-size quoted company fails. The end result is that retail investors who actively want to invest in small and mid-size quoted companies are often left to make that decision by themselves, with less information than would be available to them if they went through an advisor.

If these rules were adjusted so that retail investors could be more involved in the small and mid-size quoted company sector and have access to a higher-level of information about their investments in order to ensure investor protection, then there would be increased liquidity for these companies, which would make the market function more efficiently.

Company research and financial promotions

There is anecdotal evidence to suggest that companies struggle to get their company research distributed more widely due to restrictions and perceptions of the UK's financial promotion rules.

It has been suggested that companies are currently unable to publish broker-sponsored research that includes buy/sell recommendations on their websites, as it would be classed as a financial promotion in the UK. It has also been suggested that some companies are hesitant to publish independent research (which does not include a recommendation) on their websites for fear that it would be classed by the UK's competent authority – the Financial Conduct Authority – as a financial promotion.

We believe that the rules on publishing company research on websites should be explored and clarified to ensure that investors and potential investors (especially retail investors) have access to as much information as possible.

Possible solutions:

- The European Commission should explore the definition of a professional investor in MiFID and how this could enable targeted and risk-appropriate offerings to these investors.
- More in-depth research should be commissioned to explore how private client stockbroking firms classify investors and in particular the effect of MiFID on this classification.

E. Indices

Some European markets' indices, such as the UK's national indices, are heavily weighted towards large global companies that are headquartered in the UK and do not necessarily reflect economic contribution to that economy. Therefore, passive investment funds, such as Exchange Traded Funds, are skewed to investing in these larger global companies regardless of economic impact.

We have calculated that the top six companies by market capitalisation in the UK's FTSE All Share account for 30% of the index.

There are many "UK Funds" marketed to institutional and retail investors which, as a result of the index methodology applied, do not actually demonstrate investment in UK-centric quoted businesses.

By developing indices that are more focused on companies' contribution to member states' economies, further liquidity should flow into these companies as new funds are launched and marketed. This is not just a UK problem but should be seen as a European-wide opportunity.

Possible solutions:

- Industry should develop indices of companies more clearly aligned to the countries making up the European Economy and the European Commission should encourage and sponsor a debate on this.
- All SME Growth Markets should be required to have a range of representative indices which are freely available.

F. Secondary markets

Market makers play a key role in the UK's small and mid-size quoted company markets by providing liquidity. They ensure that there are continuous two-way prices by competing with each other in relation to:

- the size of their displayed quantity of buy/sell commitments in respect of shares (i.e. size); and
- their bid/offer spread (i.e. price)

Market makers compete in both price and size, thus giving investors certainty of execution at the best available price. This type of liquidity provision is not typically a feature of other European markets and is one of the pillars upon which the London public equity markets, particularly AIM, has been successfully built.

Recent EU legislation, such as the Short Selling Regulation and the Central Securities Depositories, has made it increasingly difficult and less attractive for market makers to continue providing prices in small and mid-size quoted company stocks. This could result in a rapid decline in liquidity in small and mid-size quoted company stocks, which would make it even more difficult for small and mid-size quoted companies to raise capital on UK public equity markets.

The Short Selling Regulations

The Short Selling Regulations, which came into effect in November 2012, included a more stringent "buying-in regime" for share trading which is centrally cleared. This new regime includes daily fines and an administration charge when short-sold shares have not been delivered for settlement by the required deadline.

Market makers often have to engage in short selling activity to provide liquidity. This is an essential feature of the UK small and mid-size quoted company market where there is likely to be an imbalance of buyers and sellers of stock for longer periods.

In liquid markets (FTSE 100 for example), market makers borrow stock to settle trades to cover the period until they can purchase the stock themselves, thus ensuring efficient settlement. In the small and mid-size quoted company market, however, stock borrowing facilities are either very limited or not generally

available. Therefore, a consequence of market-making in small and mid-size quoted companies is that market makers can inevitably have difficulty settling short-sold shares.

While the Short Selling Regulation has some exemptions for market makers, it does not offer an exemption from the 'buying-in regime', which over the medium-term could have a serious impact on the market for those small and mid-size quoted companies whose shares are centrally cleared (for example, traded on SETSmm).

The previous UK settlement regime, which is now superseded by the new regulation, recognised this unique feature of the small and mid-size quoted company market. There was a specific provision which allowed market makers to continue to provide this enhanced liquidity without being subjected to the rigid enforcement of a "one-size-fits-all" buying-in regime.

As market makers are now liable for fees and fines as a result of settlement failure, the regime may result in a significant change in behaviour and the withdrawal of some market maker liquidity. This could lead to market changes in a number of ways, including:

- An increase in transaction costs for investors through wider bid/offer price spreads;
- A decrease in capital commitment because market makers decide to make prices in smaller quantities than hitherto; and
- A resulting fall in trading turnover.

More generally, the new regime may also have a negative impact on small and mid-size quoted companies' ability to raise equity finance, if liquidity in a share falls.

While the UK interpretation of the legislation and London Clearing House's policy toward the buying-in regime has aimed to decrease the instances in which market makers are fined for settlement failure of short stocks, we believe that the regulation has still affected market makers' behaviour and anecdotally we hear that market makers are having to factor in the potential for fines when making decisions about which stocks to make markets in.

Central Securities Depositories Regulation

The Central Securities Depositories Regulation (CSDr), which regulates how all shares throughout Europe are settled, is currently still in its legislative process.

However, there is a real danger that the CSDr will go beyond the Short Selling Regulation and introduce fines for settlement failure in the case of both centrally-cleared, order book shares and non-centrally-cleared shares, which we believe would have an extremely detrimental effect on less liquid shares traded on UK public equity markets, particularly those of small and mid-size quoted companies.

At the moment, there is an amendment put forward in the European Parliament CSDr text which carves out 'SME Growth Markets' from the new CSDr settlement regime. However, this does not take into account the large number of small and mid-size quoted company less liquid stocks on regulated markets, such as the Main List of the London Stock Exchange. These listed small and mid-size companies risk having market

makers withdraw from providing liquidity in their shares, which will harm their ability to obtain finance and grow.

Markets in Financial Instruments Regulation

The UK retail market is in the most part characterised by on exchange trades agreed on a bilateral basis between brokers and market makers away from the exchange order book and not centrally cleared. This execution delivers numerous efficiency, cost and best execution benefits for retail clients. However, Article 28a in the European Parliament's text of the Markets in Financial Instruments Regulation (MiFIR) notes that all securities on a public equity market must be cleared by a Central Clearing Party (CCP), thus undermining the market maker model:

> *The operator of a regulated market, an MTF, or an OTF shall ensure that all transactions in equities and bonds that are concluded on a regulated market, an MTF and OTF are cleared by a CCP when a CCP accepts to clear that financial instrument*[20]

This will materially redesign this model in spite of there being no evidence of a failure during the financial crisis. The proposals would create significant additional cost for retail clients as well as reducing trading flexibility by preventing long dated settlement.

Possible solutions:

- European Commission and policymakers must take into account the role that liquidity providers play in various markets throughout Europe and ensure that any regulations do not harm their ability to provide trading capital for illiquid shares. Different markets with different local practices should be encouraged to coexist.

- The Short Selling Regulation should be amended to take into account the important role that liquidity providers play in small and mid-size quoted companies. In particular, the failure to provide any form of concession in relation to the settlement discipline provisions in Article 15 for market makers should be addressed.

- The Central Securities Depositories Regulations should be amended to take into account less liquid stocks that are listed on a regulated market. Article 7 of CSDr (settlement discipline) should be amended to provide flexibility for both cleared trades and for non-cleared trades where the buy-in will be administered by the trading venue.

- The final legislative text of the Markets in Financial Instruments Regulation should not include Article 28a.

G. Reviews of European financial services legislation

The way European reviews of financial services legislation are currently carried out prevents the creation of an appropriate regulatory regime for small and mid-size quoted companies.

[20] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fNONSGML%2bREPORT%2bA7-2012-0303%2b0%2bDOC%2bPDF%2bV0%2f%2fEN

Currently the regulations affecting quoted companies are split up into the various European financial services directives, such as the Prospectus Directive, MiFID, Transparency Directive and Market Abuse Regulation/Directive. These directives are under review at different times and areas of each sometime overlap, which creates definitional and timing problems.

A key example of this is the current ongoing review of MiFID II and the inclusion of a 'SME Growth Market' category in this piece of legislation. At the same time as the SME Growth Market category is being devised, the Market Abuse Directive is also being reviewed. Included in the Market Abuse Directive is a carve out that notes that companies on SME Growth Markets should not have to produce insider lists.

This approach is not ideal. Firstly, the SME Growth Market definition has not yet been agreed or put into law. As such, there is a risk of having directives and regulations that do not complement each other. Secondly, the regulatory regime for SME Growth Markets has not been developed yet and it uncertain as to which European markets will seek to become a SME Growth Market or which differences will exist in the regulatory regime between SME Growth Markets and regulated markets.

Possible solutions:

- The European Commission should coordinate legislative reviews more carefully.
- The European Commission and Parliament must take coordinated and decisive action to create a truly proportionate regulatory regime for small and mid-size quoted companies.
- As mentioned earlier, the European Commission could create a specific SME Directive, which defines a small and mid-size quoted company and creates a regulatory regime that makes various EU directives/regulations more appropriate to facilitating growth of small and mid-size quoted companies on public equity markets.

H. Balancing the tax treatment of raising equity and debt

Currently tax systems throughout Europe, and specifically in the UK, are skewed to encourage companies to raise debt finance rather than equity.

There is a specific entitlement to claim a tax deduction for costs incurred in raising debt finance, whereas the costs of raising finance through the issue of equity are not tax deductible. This represents an unnecessary and pronounced distortion in the tax system, which has been referenced in the recent Mirrlees Review[21] and raised in a number of debates surrounding the causes and consequences of the financial crisis.

For a small and mid-size company, this cost represents a disproportionately large percentage of funds being raised and is, therefore, a major disincentive to seeking a public equity listing. We estimated in 2008 that the cost of listing on AIM and raising equity would be between £400,000 and £650,000. We also estimated in 2008 that the cost of maintaining a listing on AIM cost a company between £100,000 and £150,000 per annum. We believe these costs to be similar to those being incurred currently.

[21] http://www.ifs.org.uk/mirrleesReview

Possible solutions:

- Member states should be encouraged to bring in incentives that level the playing-field between debt and equity, for example, through allowing listing costs to be tax deductible for small and mid-size companies and/or subject to an upper limit.[22] This would lower the cost of capital to SMEs seeking to access public equity markets.

I. Prospectus Directive

We believe that the aspects of the Prospectus Directive discourage small and mid-size quoted companies from listing on equity markets and, for those on a public equity market, from raising additional finance from existing shareholders.

We have seen a reduction in the number of offers to the public by companies in the United Kingdom, which is illustrated by the graphs below. We believe that this reduction is directly attributable to the increased costs and administrative burden of producing a prospectus since the introduction of the Prospectus Directive. Under the Prospectus Directive many issues to the public by these companies requires a prospectus to be approved by the competent authority. This is a process that can result in weeks being added to the timetable and which requires significantly more involvement from the accountants and lawyers to the company due to the additional disclosures required. Both of these factors increase costs to a point where we believe that the exercise ceases to be cost effective.

We welcome the European Commission's and Parliament's recent amendments to the Prospectus Directive, including the increase to the number of investors and the fundraising thresholds before having to produce a prospectus and the introduction of the proportionate disclosure regime for 'companies with reduced market capitalisations' and SMEs and the proportionate disclosure regime for rights issues.

However, we believe that these amendments did not go far enough to ensure that small and mid-size quoted companies can raise money efficiently on a public equity market, while still protecting investors. We recommend these further amendments:

- It is imperative that the financial limit above which a prospectus is required is raised. We support the ESMA Securities and Markets Stakeholder Group's recommendation that this is increased to €25 million.[23] The majority of further public fundraisings between 2000 - 2008 in the United Kingdom have been under €25 million, particularly on UK growth markets such as AIM and the ICAP Securities and Derivatives Exchange (ISDX). Increasing the threshold will relieve small and mid-size quoted companies throughout Europe of a very large administrative burden when seeking to raise funds and will reduce the cost of raising capital.

  If increasing the threshold across all member states is not appropriate, we would suggest that the relevant competent authority should be allowed to set its own threshold (subject to an overall framework, e.g. the minimum being €5 million and the maximum €25 million) below which it does

[22] See the Quoted Companies Alliance's Proposal for Taxation Reforms: Budget 2013: http://www.theqca.com/about-us/responses/66112/quoted-companies-alliance-2013-budget-proposals.thtml
[23] ESMA Securities and Markets Stakeholder Group – Report on Helping Small and Medium Sized Companies Access Funding: http://www.esma.europa.eu/system/files/2012-smsg-59.pdf

not require a prospectus and to the extent this exceeds the limit set by the Prospectus Directive the document may not be passported. This reflects the fact that, to our knowledge, very few small and mid-size quoted companies have sought to passport a prospectus.

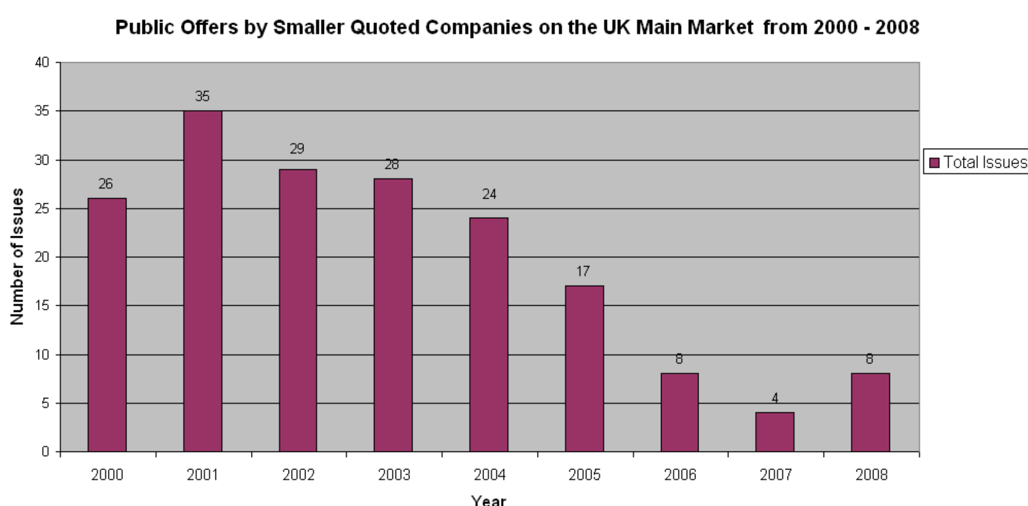
- We believe that offers to existing holders of securities should be exempt from the need for a prospectus. While we welcome the proportionate disclosure regime for rights issues, existing investors in these companies already have access to full information and are familiar with the company.

- We believe that small and mid-size quoted companies should be able to issue more than 10% of their share capital in any 12 month period before needing to issue a prospectus. It is very easy for a small and mid-size quoted company to trigger this requirement when doing various types of deals due to its size and could unduly influence a company's decision not to undertake a financing deal, which could prevent growth.

- We need a truly proportionate disclosure regime for 'companies with reduced market capitalisations' and SMEs. We do not believe that the current regime makes a public offer for a SME and company with reduced market capitalisation sufficiently cost effective and less burdensome, as originally intended in the level I amending Directive.

  We believe that there should be different disclosure obligations for a proportionate prospectus at IPO stage, where there may not be information available to the market, and one that is in relation to a subsequent public offer. This distinction would allow for the maximum cost saving to those SMEs and company with reduced market capitalisation already on market and those wishing to join a market.[24]

Chart 1: Public Offers by Small and Mid-Size Quoted Companies on the UK Main Market from 2000 – 2008



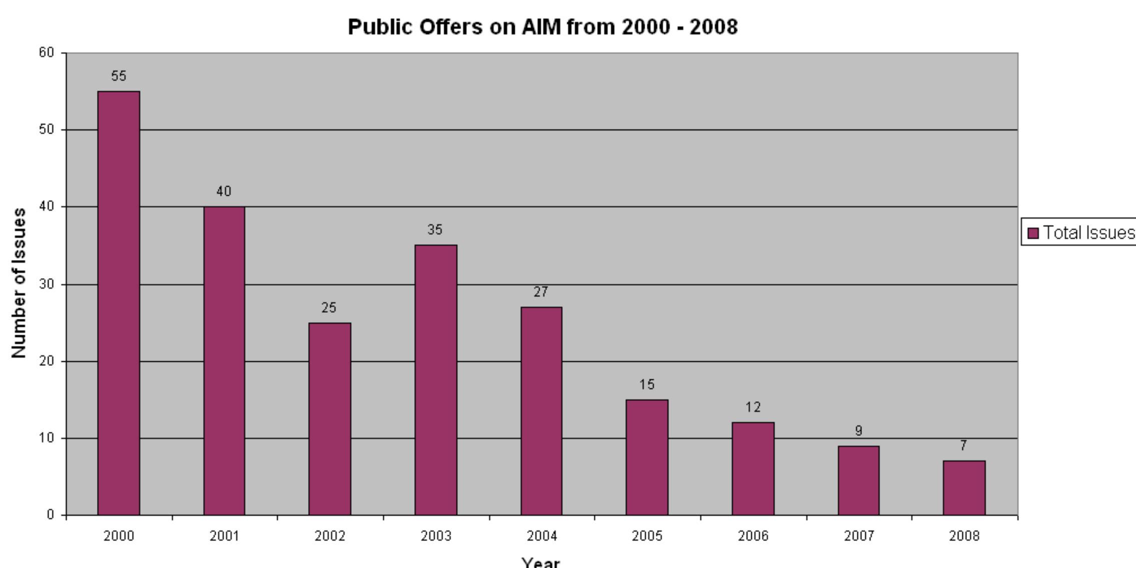
Source: The London Stock Exchange, *Further Issues Summary* (Available: www.londonstockexchange.com/en-gb/about/statistics/)

[24] Please see our response to ESMA for more detail on our proposals for a proportionate disclosure regime for companies with reduced market capitalisations and SMES: http://www.theqca.com/article_assets/articledir_93/46517/QCAResponse_ESMAPDTechnicalAdvice_Jul11Final.pdf

Notes:

'Total Issues' include the following types of further public transactions that would require a prospectus: Offer for Subscription, Open Offer, Placing & Open Offer, Placing & Offer for Subscription, Placing for Cash & Open Offer, Public Offering, and Rights Issue. In this chart, 'Smaller Quoted Companies' include those companies that had a market capitalisation below £100m at the time of the further issue.

Chart 2: Public Offers on the UK's Alternative Investment Market (AIM) from 2000 – 2008



Source: The London Stock Exchange, *Further Issues Summary* (Available: www.londonstockexchange.com/en-gb/about/statistics/)

Notes:

'Total Issues' include the following types of further public transactions that would require a prospectus: Offer for Subscription, Open Offer, Placing & Open Offer, Placing & Offer for Subscription, Placing for Cash & Open Offer, Public Offering, and Rights Issue.

J. International Financial Reporting Standards

We believe that International Financial Reporting Standards (IFRS) have introduced a great deal of increased cost and complexity without out very little added benefit for users, especially for small and mid-size quoted companies. We note that there have been many recent consultations from the IASB and other bodies on excessive disclosure and that there is a clear problem that needs to be addressed.

While we support the adoption of full IFRS for larger listed companies, we believe it is appropriate to recognise the difference in scale, and of resources available to small and mid-size quoted companies, which may have a capitalisation of just a few million pounds compared to their global listed counterparts capitalised at many tens of billions of pounds.

We therefore consider that both small companies listed on regulated markets and companies quoted on exchange regulated markets (such as AIM and ISDX in the UK) should have the choice to use IFRS for SMEs

or full IFRS, rather than having to use full IFRS as at present. We note that the ESMA Markets and Securities Stakeholder Group has recommended that the use of full IFRS should be optional for SMEs.[25]

IFRS for SMEs was produced to provide a simplified, self-contained set of accounting principles that are appropriate for smaller companies and are based on full International Financial Reporting Standards (IFRSs), developed primarily for listed companies. By removing choices for accounting treatment, eliminating topics that are not generally relevant to SMEs and simplifying methods for recognition and measurement, the resulting standard reduces the volume of accounting guidance applicable to SMEs by more than 85 per cent when compared with the full set of IFRSs. As a result, it potentially offers a workable, self-contained set of accounting standards to allow financial performance across international boundaries to be compared on a like for like basis.

The standard is available for any jurisdiction to adopt, whether or not it has adopted full IFRSs. Each jurisdiction must determine which entities should use the standard. Currently, the IASB states in the standard that it is not appropriate for publicly accountable entities to use IFRS for SMEs. However, there is an ongoing debate as part of the recent IFRS for SMEs review on whether this statement should be remove, which we support.

We also note that within the UK the new FRS102 standard has been based on IFRS for SMEs and it has been posited that this standard could be acceptable for use by some publicly accountable entities. We believe that allowing small and mid-size quoted companies to use IFRS for SMEs would provide a significant lessening of the financial reporting burden without significantly affecting the usefulness of financial reports. In fact it may make financial reports more useful.

K. PRIPS

Current amendments in the European Parliament seek to extend regulation aimed at packaged retail investment products to shares and bonds. This is another information disclosure obligation for companies which could have unintended consequences. We share the concern of the European Parliament to increase investor protection as well as supporting the aim of promoting investment into shares and corporate bonds. In order to meet these objectives, however, it is important to develop a proper framework which would be tailored to the specificities of shares and corporate bonds while not duplicating other disclosure requirements. Any such development should only take place after a period of full consultation, which has not been the case in the proposed extension of the Key Investment Document to shares and bonds.

L. Financial Transaction Tax

We believe that the proposed Financial Transaction Tax is a tax on equity, which raises the cost of capital for public companies and makes long-term finance more difficult to access. We do not support it and believe that, at the very least, it should not apply to trading in shares and bonds of small and mid-size quoted companies.

[25] ESMA Securities and Markets Stakeholder Group – Report on Helping Small and Medium Sized Companies Access Funding, page 17: http://www.esma.europa.eu/system/files/2012-smsg-59.pdf

13. What are the pros and cons of developing a more harmonised framework for covered bonds? What elements could compose this framework?

We have no comments on this question.

14. How could the securitisation market in the EU be revived in order to achieve the right balance between financial stability and the need to improve maturity transformation by the financial system?

We have no comments on this question.

15. What are the merits of the various models for a specific savings account available within the EU level? Could an EU model be designed?

We have no comments on this question.

16. What type of CIT reforms could improve investment conditions by removing distortions between debt and equity?

Please see our response to Question 12 – section H.

17. What considerations should be taken into account for setting the right incentives at national level for long-term saving? In particular, how should tax incentives be used to encourage long-term saving in a balanced way?

Please see our response to Questions 9 and 16.

18. Which types of corporate tax incentives are beneficial? What measures could be used to deal with the risks of arbitrage when exemptions/incentives are granted for specific activities?

Please see our response to Questions 9 and 16.

19. Would deeper tax coordination in the EU support the financing of long-term investment?

We have no comments on this question.

20. To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behaviour? What alternatives or other ways to compensate for such effects could be suggested?

We have no comments on fair value accounting per se, but please note our concerns on IFRS expressed in our response to Question 12 – section J.

21. What kind of incentives could help promote better long-term shareholder engagement?

We recognise that certain member states have measures in place, such as increased voting rights, in order to promote long-term investment and engagement. However, we believe that these options, ie increased voting rights and special dividends to long-term investors, should remain part of member states' company law.

We also believe that fiscal incentives designed to encourage long-term investment for both retail and institutional investors will naturally encourage a better quality dialogue between investors and companies.

22. How can the mandates and incentives given to asset managers be developed to support long-term investment strategies and relationships?

We support the development of stewardship codes, such as the UK Stewardship Code, for institutional investors and believe that they can help to faciliate engagement and dialogue between companies and investors.

In addition, asset owners and managers should be challenged to state how their investment policy meets the needs of their members and contributes to the long-term benefit of the European economy. The establishment of a SME asset class would help this to happen (please see our response to Question 12 – section A).

23. Is there a need to revisit the definition of fiduciary duty in the context of long-term financing?

We note that in the UK there is currently a review being carried out by the Law Commission to explore the fiduciary duties of investment intermediaries. We would recommend that any EU-level action in this area should be coordinated with this review. Whilst we welcome the consideration being given to the duties of persons acting as fiduciaries in the investment chain, the responsibilities themselves are consistent regardless of the hold period of an investment.

24. To what extent can increased integration of financial and non-financial information help provide a clearer overview of a company's long-term performance, and contribute to better investment decision-making?

25. Is there a need to develop specific long-term benchmarks?

Please see our response to Question 12 – section E.

26. What further steps could be envisaged, in terms of EU regulation or other reforms, to facilitate SME access to alternative sources of finance?

Please see our respone to Questions 11 and 12.

27. How could securitisation instruments for SMEs be designed? What are the best ways to use securitisation in order to mobilise financial intermediaries' capital for additional lending/investments to SMEs?

Please see our response to Questions 11 and 12.

28. Would there be merit in creating a fully separate and distinct approach for SME markets? How and by whom could a market be developed for SMEs, including for securitised products specifically designed for SMEs' financing needs?

Yes, we believe it is important to create a fully separate and distinct approach for small and mid-size companies on all types of equity markets throughout Europe – both regulated and exchange regulated

markets – through the creation of a SME Asset Class. Please see our response to Question 12 and in particular section A.

29. Would an EU regulatory framework help or hinder the development of alternative non-bank sources of finance for SMEs? What reforms could help support their continued growth?

In both the context of non-debt finance and public equity finance, any EU regulatory framework should allow different, competing markets for finance to flourish and co-exist. Such frameworks should encourage diversity rather than homogeneity so that investors and companies can have as wide a choice as possible. Overbearing regulation will kill innovation and restrict the development of alternative sources of funding for the engines of growth – small and mid-size quoted companies.

30. In addition to the analysis and potential measures set out in this Green Paper, what else could contribute to the long-term financing of the European economy?

Please see our response to Questions 11 and 12.

If you would like to discuss any of these points in more depth, we would be happy to attend a meeting.

Yours faithfully,

Tim Ward
Chief Executive