This is a note to guide the discussion at the Financial Roundtable meeting.

The meeting will be held from 10:00 AM to 13:00 PM on Thursday 23 October 2014, and will take place at the OECD Headquarters in Paris, Château de la Muette, in the Conference Centre; entrance at 2 rue André-Pascal, 75016 Paris. More information about the venue, including a list of hotels in the vicinity, can be found at www.oecd.org/conferencecentre.

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A. Meeting background and overview

1. The OECD Committee on Financial Markets (CMF) comprises officials from OECD central banks, finance ministries and other financial authorities, who meet biannually to review structural, institutional, regulatory, and market developments in financial services in OECD countries and emerging economies. As part of these meetings, there is a meeting with representatives of the financial services sector – the OECD Financial Roundtable. The Roundtable allows for off-the-record discussions on specific topics between Committee members and selected representatives of the financial services sector. This note provides a brief overview and questions to guide the discussions for the Roundtable on “Public SME Equity Financing – exchanges, platforms, players.”

2. Half a decade since the start of the financial and economic crisis, growth remains sluggish and banking sector problems are still inhibiting a more strongly footed recovery in OECD economies from taking hold. As banks are deleveraging, capital markets will have to play a bigger role especially in financing long-term investment, including in infrastructure, small- and medium-sized enterprises (SMEs) and knowledge-based capital, which are key contributors to economic growth and job creation. This is also being recognised in OECD’s work on institutional investors and long-term investment (www.oecd.org/finance/lti), a project that also feeds into efforts at G20 level in this area. Besides infrastructure, SME financing is an important component of this work.

3. Being heavily reliant on traditional bank lending, SMEs are faced with important financing constraints in a deleveraging environment, when credit availability from banks is more restricted. For SMEs, admission cost and listing requirements in main markets may be discouragingly high, and a perceived reluctance of institutional investors to invest and the absence of a level playing field between equity and debt financing (e.g. tax treatment) have impeded the fostering of SME public equity financing. With momentum building behind alternative non-bank sources of financing for SMEs, now may be the right opportunity for SME equity capital markets and other equity financing stakeholders to take the lead in the discussion with the official sector, towards the common objective of fostering SME equity financing and thereby facilitating growth of the real economy.

4. Against this background, we propose the discussion to take place in two rounds focused on the following topics:

   • Round 1 (approx. 1h30: 10:00-11:30): Status quo of SME equity financing: Developments, drivers and impediments, discussing (a) the impediments to equity financing; (b) the experience with SME participation in public equity markets; and (c) the optimal trade-off between standardised and tailored-made platforms.
     
     (Coffee break, 15 min)

   • Round 2 (approx. 1h15: 11:45-13:00): How to foster SME equity financing, discussing (a) the impact of market practices and regulations; (b) the role of an ecosystem (market making, network
infrastructure, advisory, etc.) to cater to SMEs’ specific needs; and (c) how to incentivise institutional and retail investors to participate in SME equity markets, also drawing on experiences with other forms of non-traditional equity financing.

5. Some questions for discussion are proposed in the following sections, and references at the end provide further reading and information.

B. Round 1: Status quo of SME equity financing: Developments, drivers and impediments

1. Background

6. The share of SME financing provided through capital markets is currently very small, despite the fact that public/organised exchanges and other platforms offer an attractive and abundant long-term financing source. Equity capital is critical to growth and infrastructure investment and the development of small IPO markets and, together with securitisation and other non-bank financing instruments, could encourage appropriate allocation of risk and risk taking, and thus support a quicker, more sustainable rebound of economic growth.

7. A number of equity markets targeting smaller listings have been established in different parts of the world (e.g. the Alternate Investment Market in London, TSX Venture in Canada, HK GEM in Hong Kong, Mothers in Japan, Alternext/Euronext and Alternativa in Europe, AltX in South Africa). Such markets offer more flexible listing criteria, eased disclosure requirements and comparatively low admission costs so as to cater to SMEs’ inherent characteristics. Public listing of SME equity through primary and secondary issuance has the potential to provide funding for a company’s growth and can increase the availability of, and improve conditions for, subsequent debt financing. Existing SME owners can realise their capital gains and tap a wide investor universe, including retail investors and sophisticated long-term institutional investors.

8. Nevertheless, important obstacles to the wider use of public equities for SMEs (by issuers and investors alike) remain to be resolved. Difficulties facing SMEs seeking public equity financing are not limited to the respective cost burden (admission fees, advisors and broker commissions), red tape and reporting requirements (e.g. Prospectus Directive¹ in Europe). Loss of confidence to go through the offering process, fear of being exposed to share price volatility, aversion to sharing sensitive information but also lack of education around the process of listing and life after an IPO are other reasons explaining the reluctance of SMEs in joining equity capital markets. In addition, entrepreneurs tend to be unwilling to relinquish any share of ownership or control of their business (as is the case with VC investments) or accept potential lock-in periods upon listing.

9. On the investor side of the market, equity investors seeking to provide equity financing to SMEs are confronted with information asymmetries, leading to potentially high monitoring costs relative to the level of investment, possibly unfavourable or onerous regulatory frameworks (particularly on a relative basis) and investor protection considerations. Low levels of liquidity in SME growth markets (somehow inherent in the SME asset class) act as one of the main deterrents to investment in public SME equities. Promotion of SME listed shares to retail investors might be one of the ways to enhance market liquidity.

10. Equity (but also bond) capital markets remain fragmented and not highly attractive to SMEs and mid-caps, especially in Europe, with low levels of cross-border investment in such securities. Despite undisputable efficiencies that are to be gained by standardising and unifying regional markets, the

¹ Article 4 of Directive 2010/73/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market.
existence of separate platforms might have strong merits in terms of financial stability and risk management (“fail-safe mechanisms”) – increasingly important in today’s interconnected financial system.

11. There is a role for governments and regulators to make efforts to promote the financing of SMEs through equity markets. Improvements in the economic incentives for equity financing, and in turn in the rate of SME capital formation, could be used to help foster innovation and job creation. The cost of going public needs to be reasonable and tailored to the size of the SME. Policy measures to reduce the bias against equity financing, such as relevant tax treatment of equity and/or incentives for the use of equity financing – both for issuers and for investors – need to be considered by policymakers (see the example of the UK). Trading (tick size) incentives for smaller cap stocks and the possibility of allowing such companies to choose their tick size might boost investment in SME equities. The creation of an active retail investor market could enhance liquidity of SME listed shares, provided that appropriate mechanisms are in place to defend against sales practice abuses which may occur. Given that SME platforms are inherently different from large cap markets, it might be preferable for their regulation and infrastructure to evolve separately from large cap markets (as is the case under MIFID).

2. Selected issues for discussion for Round 1

a) How important is the bias favoring debt instruments against equity financing for SMEs? Is enough being done by regulators/policy makers to address such bias? How to level the playing field between equity and debt financing?

b) What has the experience been with SME participation in public equity markets? What are the impediments limiting their access? Is there a role for the government in supporting those markets by providing the right incentives for SMEs to IPO?

c) How to define the optimal trade-off between standardised and tailored-made platforms? How to balance the need for more liquid and deeper (e.g. Pan-European) equity markets against tailored-made domestic exchanges that comply with local regulatory/legal/tax/other rules thus lowering access cost for local SMEs?

C. Round 2: How to foster SME equity financing?

I. Background

12. Listing in SME growth markets benefits in most cases from more flexible or somehow “lighter” regulations than main markets require. Nevertheless, there are numerous instances where rules and regulations may obstruct the flow of funding to SMEs. The right balance between administrative and regulatory burden and due diligence needs to be achieved such that the flexibility provided to SMEs does not result in weak investor protection or compromised integrity of market participants (e.g. Nomads), weak corporate governance or insufficient transparency. The same holds for recent market practices that may inhibit the development of SME equities, such as high-frequency trading or a focus on low cost trading execution, by definition incompatible with SME listed shares.

13. The relative low volume of shares traded on growth markets compared to main markets and the limited free float that small caps regularly offer (retained stakes by management and owners) as well as buy-and-hold strategies limiting day-to-day trading are all problematic, particularly when seeking to attract

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2 According to an OECD study (Weild et al., 2013), GDP growth rates only predicts 10% of small IPO activity while economic incentives explain 70% of it.

3 Tick sizes as a percent of share prices for sub $500 million market value companies probably need to exceed 1% of share price to fuel investment (Weild et al., 2013).
institutional investors. The existence of well-functioning market-making systems is instrumental to the fostering of SME markets, particularly given their importance for professional and institutional investors.

14. There is a role for policymakers to ensure that ecosystems comprising of market makers, small cap and SME equity research, brokers, sales, ratings and specialised SME banks are in place to foster the development of SME financing through growth markets. It is important for policymakers to incentivise (economically and otherwise) market participants in a way that diverts them from competition based on price of trade execution, which is arguably toxic to SME markets (e.g. tax incentives, higher commissions, higher tick sizes). Pure for-profit models for growth platforms can have perverse incentives (e.g. promotion of highly liquid stocks to electronic order book markets) and cannot ensure sustained capacity to bring SMEs to the market and, equally importantly, support them in the aftermarket.

15. The existence of said ecosystem will in turn be useful as a platform for the development of other, non-traditional SME equity instruments such as equity private placements, equity crowdfunding, listed funds (with potential co-funding and risk sharing between the private and public sectors), corporate venturing, which can all, in turn, rely on that same ecosystem. Lack of vibrant SME IPO markets and aftermarket ultimately creates negative feedback loops that risk stunting the growth of private market innovations including aforementioned non-traditional SME equity instruments.

2. Selected issues for discussion for Round 2

a) To what extent do certain market practices (such as high-frequency trading) and regulations (such as the Volker rule and prop trading limits) impact investor participation in SME equity markets? How do these affect investment flows to listed SMEs?

b) Is the absence of an ecosystem that can cater to SMEs’ specific needs an impediment to their willingness to list? How important is market making? Is there a role for policy makers in facilitating the infrastructure and networks of participants? What’s the role of advisory intermediation / third party financial advisers (Banks, Nomads), how is it expected to develop and what would their optimal role be in order to foster the SME public equity markets?

c) How can institutional and retail investors be induced to participate in SME equity markets? What role can public policy play in catalysing such participation? Are passive investment strategies, such as indexing, a way to attract long-term institutional investors to SME listed equities, particularly given information asymmetries and high transaction costs relative to the size of the investment?

d) What has been the experience with other non-traditional equity financing, such as Special Purpose Acquisition Companies (SPACs) or other listed/non-listed vehicles targeting SME equities, equity private placements, crowdfunding, corporate venturing? What’s the role of long-term and institutional investors in such SME equity investments? Is there a role for the government to catalyse and support overall equity investment in SMEs?
D. Selected references


