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COMMUNICATION FROM THE COMMISSION

European capital markets for Small and Medium-sized Enterprises: prospects and potential obstacles to progress

CONTENTS

I. INTRODUCTION

One of the financial problems faced by many fast-growing European Small and Medium-sized Enterprises (SMEs) is the difficulty in raising on European capital markets the external equity capital they need for expansion. The European Commission has already taken up the issue of access for European SMEs to capital markets: its progress to date was summarised in a Communication of 25th October 1995[1], which noted that the absence of provision of SME capital markets in Europe has led an increasing number of European companies to seek flotation on US stock markets, especially the NASDAQ market[2], and has also restricted the opportunities for European venture capitalists to exit from their investments. New SME capital markets are to be encouraged not only because of the directly beneficial effect they could have in allowing firms to access long-term finance, but also for the positive role they could play in stimulating the European venture capital industry, and financial services in Europe.

The 1995 Communication also summarised the role played by the Commission in the financing of a feasibility study by the European Venture Capital Association (EVCA) into the possible creation of a European capital market for growing SMEs, and in the creation of the European Association of Securities Dealers, which arose out of that study. The positive conclusion of the EVCA study influenced, directly or indirectly, the creation so far of two private sector financed projects for the creation of a European capital market for growing internationally-oriented SMEs. These two initiatives, described in that Communication, are the EASDAQ market (European Association of Securities Dealers Automated Quotation), and the Nouveau Marché/Euro-NM initiative.

These encouraging and promising initiatives were made possible by the liberalisation brought about by Community legislation, in particular the Investment Services Directive[3], which allows securities traders to deal anywhere in the Union on the basis of a "passport" provided by the regulator in their home Member State, and opens up regulated EU securities markets to "remote membership" for traders located in other Member States. However, the Communication noted that while the existing body of European law, once fully in force, should allow the creation of these markets, a number of possible obstacles had been identified which might hamper the efficiency of their operations.

The Industry Council of 6th and 7th November 1995 asked the Commission "to go deeper into the conclusions of its Communication and report on ways to overcome the various obstacles currently existing in the Member States, including obstacles inhibiting the channelling of funds of institutional and private investors, in order to support the creation of secondary European capital markets for SMEs, taking into account the national systems and experiences already under way." The European Parliament, in a resolution of 4 July 1996[4], welcomed the Commission's Communication, and the initiatives it described, but noted that for the new markets to be successful, a number of issues, including liquidity, regulation, and possible protectionism, needed to be addressed.

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[1] COM (95) 498 final, entitled "reporting on the feasibility of the creation of a European Capital Market for smaller entrepreneurially managed growing companies".
[2] See also the Commission's Green Paper on Innovation, COM(95) 688 final.
[3] 93/22/EEC, of 10.5.1993.
[4] A4-0168/96

This further Communication therefore sets out to respond to those requests by defining better the potential obstacles to the efficient operation of these new capital markets for growing SMEs. First of all, however, it describes recent developments in the creation of SME capital markets in Europe, and discusses their perspectives; it then outlines the many barriers of attitude and capability regarding stock market flotation which can hinder SMEs from seeking a flotation; finally, it deals with more specific barriers to cross-border trading in equities in general, and on SME capital markets in particular, for example, in the regulatory and legal fields.

II. FURTHER PROGRESS IN THE DEVELOPMENT OF SME CAPITAL MARKETS IN THE EUROPEAN UNION, AND THEIR PROSPECTS

Since the publication of the previous Communication, the two European initiatives already referred to, Euro-NM and EASDAQ, have continued to make progress, as have plans for national SME equity markets.

These markets are for SMEs which need capital in order to grow, either in greater amounts or at a lower cost than banks will provide, because of the risk associated with smaller growing companies. Where successful, these SMEs, often based on new technologies, can attain very high growth rates - well over 10% per year - and some of them may well become the champions of tomorrow, although others will fail. It is thus in the nature of things that many SMEs listed on such markets will become large companies at some point, while not necessarily giving up their listing. An SME stock exchange is therefore not necessarily one which only lists SMEs; it is one which, compared with other exchanges, normally concentrates its Initial Public Offerings on firms at an earlier stage of their development.

The French Nouveau Marché began trading on March 20 1996, and by the end of 1996 eighteen companies were listed (including two non-French ones), with a total market capitalisation of over 220 million ecu. The Nouveau Marché intends to become an Europe-wide equities market, and to this end has linked up with other recently-established nationally-based SME stock markets, the Nouveau Marché of the Brussels Bourse, and the Neuer Markt of Deutsche Börse A.G., together with the Amsterdam Stock Exchange's *Nieuwe Markt*, to form a network of markets called "Euro-NM". Euro-NM is a European Economic Interest Group, which aims to promote synergies by harmonising rules and regulations, integrating commercial and technical activity, and carrying out common marketing.

The EASDAQ market is a private initiative, independent of any existing stock exchanges: over ninety financial institutions from twelve countries (including most Member States) are participating in the project as shareholders. The market opened on September 30 1996; the first Initial Public Offering took place on November 27 1996, and several more have been made since. EASDAQ's target is 20-30 such flotations in its first year of operations, and a total of several hundred companies listed after five years.

However, it is not only at the European level that plans are being made for SME capital markets. Within the Member States, a number of nationally-based markets are either in operation or in the planning stage. The "Neuer Markt" of Deutsche Börse A.G., the

Belgian Nouveau Marché, and the Amsterdam Stock Exchange's *Nieuwe Markt*, which are all participating in the Euro-NM network, have already been mentioned. In the UK, the London Stock Exchange's Alternative Investment Market has been operational since mid-1995 and has over 160 companies quoted, with a market capitalisation of over ECU 3.5 billion. The Vienna stock exchange recently announced a special programme, entitled FIT, to allow SMEs easier access to a listing; FIT is due to start in mid-1997. In Italy, there are plans to create a new market called METIM (*Mercato Telematico delle Imprese Medie*); it will have a national and local orientation, and will be focused on family companies as much as technological ones. In Ireland too there are plans for a new SME stock exchange.

The Commission strongly welcomes all of these initiatives. As only a relatively small proportion of SMEs considering a stock exchange flotation will be sufficiently international to warrant a listing on a Europe-wide exchange, these national SME capital markets will play an essential role in providing SMEs with improved access to equity finance. SMEs which have reached a stage in their development where a stock market listing is appropriate need to have a choice of stock markets - national or international - according to their specific needs. The new competitive climate in European investment services will oblige markets to focus more closely on services to their clients, and one welcome consequence of this is the development of capital markets providing a better range of services to SMEs than was hitherto the case.

The perspectives for these various markets depend on a number of factors, including the extent to which the potential obstacles described later in this Communication are overcome. The development of a greater "equity culture" in Europe will also be important, in particular where high-risk high-potential-return investments, such as SME equities, are concerned. Evidence from the United States shows that equities of growing SMEs outperform the national stock market indices, and in Europe, equities in general have consistently produced better returns than bonds. Yet despite the evidence European investors, unlike US investors, tend to favour bonds over equities, and blue-chip equities over SME equities, in order to reduce the perceived risk. Some welcome exceptions do exist however: in Sweden 35% of private financial assets is invested in shares, compared with 17.5% in the UK, 10% in France and 5.5% in Germany; in the USA the figure is 21%[5].

The new SME capital markets also have the opportunity to learn the lessons from the second-tier capital markets of the late 1980s. One of the most important of these is that sufficient liquidity is an essential prerequisite for success. Low trading volumes can produce high volatility in share prices, and deter investors from fear of being caught in the "mouse trap" of being unable to sell their shares because of low demand. Ensuring sufficient liquidity will therefore be one of the main challenges faced by the new SME capital markets; this can only be achieved with a high level of regulation and transparency.

The advanced information technology used will also be a key factor for success: a combined information, trading, clearance and settlement system providing a quick efficient and "seamless" service is much valued by investors, and the new SME capital markets have all put a great deal of effort into their computer systems. Choice of trading system

[5] Source: German Federal Ministry for the Economy.

(quote-driven, order-driven or auction, for example) is also important, as different systems are more suitable depending on the size and urgency of a transaction.

Nevertheless, the experience of NASDAQ in the United States shows that it can take a number of years for a new market to become highly successful. The new SME capital markets, European or national, are private for-profit ventures, and much will depend on their commercial decisions and skills, and their cost. For in the single market for investment services, stock exchanges must compete with each other on the basis of the service offered to the customers, firms and investors. Investor protection and full disclosure of information will also be important in establishing confidence in the new markets. Nonetheless, it is believed that these markets have a good chance of success, as they fill a gap that was previously unsatisfied in the provision of finance to SMEs and opportunities to investors.

III. POTENTIAL OBSTACLES TO THE LISTING OF SMEs ON STOCK EXCHANGES

Despite the great potential for growth of the new European SME capital markets, with the likely beneficial effect on the financing prospects of European SMEs, some problems do remain, which could slow down progress or reduce its effect. Many of these potential difficulties lie in the attitudes of SMEs towards their financing, their expertise in financial management, and the burdens which a stock exchange listing would place on them.

These problems can be broken down essentially into five questions:

i) Does a sufficient number of SMEs exist in Europe which are suitable and ripe for a stock market flotation, and if so, how can they be identified?
ii) Are owners of SMEs which are ready for a flotation willing to accept the possible diminution of control which a public share issue is often taken to imply?
iii) Do SMEs have the willingness and the financial skills necessary to meet the high financial information and transparency requirements of a stock market quotation?
iv) Do SMEs have access to the necessary specialist advice and support necessary to prepare an Initial Public Offering of shares (an IPO)?
v) Are SMEs willing and able to bear the high cost of the process of a stock exchange listing, in terms both of an IPO and of the ongoing costs of a listing?

To the first question, the answer is almost certainly yes. It is not only young high-technology companies which might be quoted on small cap stock market for the first time, but also more mature family companies facing a succession issue, for example. Well over 500,000 companies exist in Europe with over 20 employees and an average turnover of over 5 million ecu[6], and even if only a few percent of this total are suitable for a stock market listing, this would give a figure of 10-20,000 companies; this fits EASDAQ's assessment of 15,000 companies in Europe potentially suitable for listing[7]. These companies, although only a small minority of all SMEs, have the greatest job-creation potential. Another indicator of the existence of suitable companies for a public share issue

[6] Source: *Enterprises in Europe*, Fourth Report, 1996. Figures for European Economic Area.
[7] EASDAQ quoted in the *Frankfurter Allgemeine Zeitung*, 24.9.1996.

is the numbers of European companies choosing to be quoted on NASDAQ. About eighty European companies are now listed there.

One possible problem consists in identifying those companies which are and those which are not suitable for a listing. Many companies may incorrectly believe that they could not have access to the financing they need by means of a public offer of shares; evaluating the potential of a company for "going public" is a skill that directors of SMEs do not always possess, and they may be deterred from specialist external evaluators because of the cost. Here there could be lessons to be learnt from practice in the USA, where there is over twenty years of experience in evaluating firms for quotation on NASDAQ.

It is suggested that one possible solution to this problem could be the preparation of some form of European auto-assessment methodology, to help SMEs evaluate their aptitude for a stock market quotation. This might involve the study of experience in the USA and elsewhere, the drawing-up of a guide, available in different language versions and adapted to the conditions of the different Member States, to help SMEs evaluate themselves. Such an activity would need to be carried out by an appropriate expert body.

Another possible limiting factor on the number of potential SME flotations on stock markets is unwillingness among company owners to dilute or lose their control over the company to the benefit of new shareholders. This is an understandable attitude; however, if the alternative is to rely on expensive bank loans, forgo expansion of the company, or make a trade sale, a public share offering may be the best option (if the company is ready for it). Moreover, a stock market listing does not necessarily imply the sale of a controlling majority of shares in a company; also, entrepreneurs may not be aware of the range of types of shares that exists, some even without voting rights.

Financial institutions will naturally try to persuade companies identified as potential market flotations, and this should make more companies aware of the possibilities open to them. These activities, coupled with expert independent advice, should help overcome unwillingness by owner-run companies to make a public share offering. But if this does not turn out to be the case, there could be a justification for public support in this area, in the form of campaigns to bring home suitable SMEs the benefits of flotation.

It may also happen that a company does not want to be quoted on a public stock exchange because of the stringent transparency rules, mainly in the field of financial information. Or, it may be willing to release such information but not have the resources to produce the necessary accounts. Here, cultural and legal factors have an influence, as the amount of financial information required from private and public companies varies considerably between Member States, but in almost all cases, a stock market quotation considerably increases the requirements. An additional cost factor is that flotation on one of the new European SME stock markets may involve a company needing to produce accounts according to rules different from those usually used in its home Member State (for example International Accounting Standards), thus making additional documentation necessary[8].

[8] See section IV.iii.2.

The promotion of a culture of financial transparency across Europe, including for private companies, could help the situation in reducing the gap in financial reporting requirements between publicly-quoted companies and others. Beyond this, financial training will certainly be needed for companies preparing a prospectus for a share offer. It is becoming widely accepted that reducing the financial information requirements imposed on SMEs wishing to issue shares publicly could be counter-productive, as it would make potential investors less likely to invest in those companies.

Even if all these factors have been overcome, bringing a company to market is a long and complicated task which requires the involvement of an expert financial intermediary, usually a investment bank. These financial skills may not exist to the necessary extent everywhere in the EU to satisfy the potential demand from SMEs, especially if the new SME markets fulfil their full potential and there are many companies wishing to be quoted. Although providing such financial services should clearly be left to free competition between financial intermediaries in the long term, if their relative shortage looks like hindering the progress of SMEs wishing to float, it may become necessary to stimulate the development of such skills by selective training and information, especially between Member States with more highly-developed capital markets, especially SME markets, and other Member States.

However, expert support services tend to be costly: bringing a company to a stock market flotation is an expensive business. The French Nouveau Marché estimates that the legal and accountants' fees linked to the listing process can represent up to 13% of the funds raised, and the fees of the compulsory adviser/market-maker can come to 7% of the capital raised[9]. Increased competition between financial intermediaries such as investment banks will hopefully reduce these costs in the future, but currently, public intervention is sometimes made within the Member States to help SMEs meet them: for example, the French *Agence Nationale pour la Valorisation de la Recherche* provides, under certain circumstances, reimbursable advances to companies to cover part of the cost of a stock market Initial Public Offering (IPO). In many cases the cost of an IPO can be transferred to the new shareholders, thus reducing the overall cost, but there are still also the ongoing costs of a stock market listing (subscription charges, legal and accountancy fees, audit fees and so on).

IV. POTENTIAL BARRIERS TO THE CROSS-BORDER TRADING OF SHARES ON EUROPEAN SME CAPITAL MARKETS

In a number of areas, potential obstacles exist which could hamper the cross-border trading of shares on European capital markets. Some of them could deter individual or institutional investors from investing in markets in countries other than their own; some of them are problems faced directly by the markets themselves or by intermediaries. These barriers apply, of course, to all European capital markets; however, they could prove particularly acute for European-level SME capital markets, for which cross-border transactions might constitute a very high proportion of their turnover. Although many

[9] Source: Courier ANVAR, June 1996

potential barriers may become apparent in the future[10], only those which have already been identified as potentially important are discussed below.

IV.i. Currency-related problems

Currency risk is often cited by securities dealers as one of the most important barriers to their participating in cross-border transactions. Although the risk can be hedged through derivative products, this adds to the cost of the transaction. Also, for institutional investors exchange rate changes can distort fund performance information and act as a deterrent to investment. Besides, the currency-matching requirements imposed by national governments on institutional investors are only possible because of the existence of different currencies. Currency differences make the development of interpenetration between national markets more difficult and thus reduce the liquidity of markets.

The introduction of a single currency is therefore an essential prerequisite for a truly integrated European securities market in general, and for the new European capital markets for growing SMEs in particular to fulfil their full potential. The single currency will increase the transparency of capital markets and the comparability of investor information, reduce investor risk, and make cross-border transactions easier, quicker, and cheaper. It will improve the liquidity of European capital markets and, through its strength and stability, attract inward investment in European equities. Indeed, European capital markets are one of the areas of the European economy that have the most to gain from the rapid introduction of the euro.

IV.ii. The regulation of securities trading at the EU level

It was primarily the advent of the single market in the securities field on 1 January 1996, with the entry into force of the Investment Services Directive (ISD)[11] and the Capital Adequacy Directive (CAD)[12], which made possible the creation of new European capital markets for growing internationally-oriented SMEs. Thus, in many ways the successful future operation of these new markets is dependent on the complete and accurate transposition and application by the Member States of the single market legislation on securities trading, in order to establish genuine and fair competition between securities markets. The Commission will play an active role in monitoring the application of these directives, and in helping to resolve any interpretative questions that may arise.

Questions concerning the practical application of the Directives will require close co-operation between the regulatory bodies of Member States; a hypothetical example would be if an investment firm authorised in one Member State were to commit serious misconduct in a another Member State. Co-operation between national regulatory bodies in the securities field is already strong, being legally underpinned by specific requirements in Directives such as that covering stock exchange listing particulars. In 1995 the Commission adopted a proposal for a Directive on the setting up of a Securities Committee[13], which would replace the existing High Level Securities Supervisors

[10] See "*Legal and tax issues arising from cross-border dealings on EASDAQ*", European Venture Capital Association and European Association of Securities Dealers, 1996.

[11] 93/22/EEC, of 10.5.1993.

[12] 93/6/EEC, of 15.3.1993.

[13] COM (95) 360, 17.07.95.

Committee, and have competence in respect of both the Investment Services and Capital Adequacy Directives, but this still awaits approval by the Council in co-decision with the European Parliament.

The Directive setting up a Securities Committee will, when adopted, bring into being a Committee which will assist the Commission in the exercise of technical rule-making powers under the ISD and the CAD. The Securities Committee will also be a useful advisory body which the Commission can consult when envisaging new initiatives in the field of securities markets. It will not have any role in the day-to-day regulation of securities, which remains the responsibility of national regulators. Co-operation between regulators is requested under securities market directives, and this is given practical effect by the drawing-up of bilateral agreements between regulators, called "memoranda of understanding".

Investing in SMEs involves high risks, and potentially high returns. It can reduce overall risk, if carried out as part of a strategy of diversification of investments and if the investments made are sufficiently spread. The objective of regulation of SME capital markets, as of other capital markets, is to establish transparency and thus to protect investors, not from investment risks, but from any abuse by firms, market participants, other investors or the markets themselves.

In the longer term, more wide-reaching regulatory issues look certain to arise. Given the current trend of market developments, with internationalisation of trading and the use of novel trading systems other than traditional stock exchanges (including so-called Proprietary Trading Systems and possibly the Internet), it appears possible that regulatory authorities may face an increasingly difficult task in enforcing existing legislation. Also, with the spread of cross-border electronic trading it could become increasingly difficult to decide when and where trades are actually performed, and the question of which regulatory body is competent could become harder to determine. These issues, if they do arise, will need to be monitored and evaluated for their implications on securities market regulation.

IV.iii. Differences in national laws and practices

In the newly-established single market for securities, and especially on European capital markets for growing SMEs, more and more transactions will involve two, three or more Member States. Differences in national laws and practices could act as a disincentive to such transactions.

National legislation in the three areas discussed below may have an important incidence, direct or indirect, on cross-border trading in shares on SME capital markets.

IV.iii.1. Taxation.

The first of these is the tax area, where foreign investors can find themselves at a disadvantage compared with investors based in a Member State. For example, both capital gains tax and withholding tax on dividends varies enormously between Member States. Double assessment for tax between EU countries will usually be avoided through double taxation treaties, though this can necessitate additional administrative procedures. Net income can depend on whether the country of origin of the shareholder operates a credit or an exemption system with regard to dividends originating outside the country. However, as investors in high-risk, high-return SME markets will probably be seeking capital gains rather than dividend revenue, it is hard to know to what extent these differences will influence their investment decisions.

In certain Member States, specific tax reliefs exist to encourage investment in equities. For example, schemes whereby losses made on investments in unquoted private companies (up to a ceiling) can be set against overall tax liabilities exist in several Member States, and in France and the United Kingdom the relief is maintained even if the company subsequently lists on the Nouveau Marché or AIM respectively. In all such cases where specific national tax reliefs exist, it would be desirable for them to be extended to cover investments made on other European capital markets (at least for companies incorporated in the Member State concerned); this would avoid possible tax discrimination between different firms from the same Member State, according to which stock market they choose to list on.

In April 1996 the Commission produced a discussion paper for the ECOFIN Council, "Taxation in the European Union"[14], which noted that as regulatory and economic barriers to the establishment of the Single Market are progressively removed, taxation is rightly perceived as an increasingly important residual factor preventing the full realisation of the Single Market and its goals of sustainable growth and a high level of employment. Tax disadvantages linked to cross-border financial transactions were identified as a factor complicating the lives of citizens. The Council decided as a result to set up a high-level group to examine ways of making progress on these and other tax issues affecting the single market. The Commission's report on the work of this group was published on 22 October 1996[15]. It concluded that action is necessary to eliminate the existing barriers to cross-border income and capital flows; subsequently, the Dublin European Council of 13-14 December 1996 endorsed the setting-up of a permanent group to take a strategic overview of tax policy, and to co-ordinate national tax policies, while respecting the principle of subsidiarity.

IV.iii.2. Accounting standards.

This is another area in which national differences could discourage investors, although research[16] suggests that large investors are used to dealing with accounting differences and that other factors have greater influence over their decisions. The International Accounting Standards Committee is currently attempting to produce a core package of accounting standards for adoption by IOSCO (the international securities regulators' body) in 1998; in its Communication of November 1995 "Accounting Standards: a new strategy vis-à-vis International Harmonisation"[17], the Commission declared its intention to become involved in this work. The first priority of its strategy is to enable large listed companies to produce only one set of consolidated accounts that can fulfil the requirements of the EU Accounting Directives and those of International Accounting Standards (IAS). A task force set up in November 1995 has concluded that with the

[14] SEC(96) 487 final, 20.03.1996.
[15] COM(96) 546 final.
[16] *The European Equity Markets*, European Capital Markets Institute, 1996
[17] COM (95) 508 final

exception of two minor matters, European companies can prepare their consolidated accounts on the basis of existing IAS without conflicting with the Accounting Directives. Its report will constitute the basis on which each Member State will decide whether and to what extent companies can apply IAS when they wish to do so. In the meantime capital markets wishing to attract business, and firms wishing to attract investment, must decide which accounting conventions and practices to adopt, within the limits imposed by national rules.

IV.iii.3. Corporate governance

Corporate governance, in its widest sense, involves the rights and duties of the management of a company towards its shareholders and other stakeholders, and the mechanisms which the latter have for controlling the activities of the management. The composition and powers of the board of directors and the information which they must provide are important aspects of corporate governance. Protection of minority shareholders is another, and it is mainly in this area that corporate governance issues are relevant to the new SME capital markets, as it is possible that absence of shareholder protection could discourage investors from investing in firms listed on such markets. The directors of companies being floated on these new markets may be inexperienced in shareholder relations, and national differences in such matters as conceptions of the directors' duties and the structure of the board of directors (single-tier and two-tier boards, for example) will further complicate matters for investors.

In Europe, shareholder interest in governance is increasing, and institutional investors are also taking greater interest in the internal management of the companies in which they invest. Institutional investors based outside the EU, especially in the United States, are also sensitive to corporate governance issues. The Commission welcomes the renewed emphasis in several Member States on good standards of governance, and believes that a Europe-wide debate on appropriate corporate governance standards would be helpful.

In addition to national and European legislation on corporate governance, stock exchanges may decide to impose supplementary corporate governance requirements on companies wishing to be quoted on them, and such standards can play a part in competition between exchanges. Beyond this, it remains to be seen whether a clear set of European corporate governance principles would be useful, and if so, what form it might take and what content it would have. In its recent Green Paper on statutory auditing in the EU[18], the Commission pointed out that it might be useful to issue a Recommendation at EU level on possible ways to improve the present system of corporate governance.

IV.iv. Institutional investment

Institutional investors, including collective investment funds, insurance companies and pension funds, will be a key in determining the success of the new European capital markets for SMEs (although individual investors will certainly play an important role too). On US stock markets institutional investors own 31% of shares, with pension funds

[18] COM(96) 338 final, 24.07.1996..

owning 24%; in the UK the figures are 59% and 51% respectively, in Germany 22% and 12%, and in Italy 11% and 1%[19].

Pension funds in particular are set to undergo much growth in coming years: the pressure on unfunded social security pension schemes in many countries due to an ageing population and unemployment, are likely to lead to a great expansion of provision for retirement through funded pension schemes. One report[20] estimates that pension fund assets might increase by up to nine times, to over 10,000 billion ecu, by 2020. These funds will be looking for new investment opportunities, which will inevitably lead to the new SME growth markets being closely analysed by pension funds, and by other institutional investors, for such opportunities.

However, the freedom of such funds to invest freely is currently limited by a number of restrictions in Member States. Many of these restrictions are normal and justifiable prudential requirements (and in addition, many funds have their own internal risk-diversification rules, such as restrictions on investments in unlisted securities, which fund managers must respect). But many nationally-imposed restrictions, such as certain prohibitions on foreign investments, or obligations to invest in government bonds, are discriminatory. Some requirements to invest in matching currencies may be excessive and not necessarily prudential. Such restrictions can lead to investors obtaining sub-optimal returns on their investments, and can also lead to distortions: for example, a pension fund may find itself unable to invest in a company from the same Member State simply because it is quoted on a foreign market.

As European capital markets for growing SMEs are by their nature international, and because they will need substantial institutional investment in order to succeed, these national restrictions on investment could have a disproportionately higher effect on them than on other capital markets. The abolition of these restrictions is essential, not only in the interest of pension fund contributors and of companies seeking equity funding, but also for the completion of the single market and the application of the Treaty provisions on the free movement of capital. The Commission has now written to certain Member States asking that they take steps to remove discriminatory restrictions not authorised by the Treaty of Rome[21]. Failure to act could result in infringement procedures before the Court of Justice. In addition, efficient capital markets will be one of the subjects covered in a Green Paper on pension funds, currently being prepared by the Commission.

V. CONCLUSIONS

As a consequence of the difficulties faced by European SMEs in accessing capital markets, they are largely undercapitalised: only 10% of European SMEs surveyed in 1996 were financed by external equity, while 49% had long-term loans, and 54% had overdrafts[22]. Firms take many more years on average in Europe to be floated on a stock

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[19] Source: *Corporate Governance in Europe*, Centre for European Policy Studies, 1995

[20] Source: *European Pension Funds: their impact on European capital markets and competitiveness*, European Federation for Retirement Provision, June 1996

[21] Article 73 forbids restrictions on capital movements, except proportionate ones base on prudential grounds.

[22] Source: Grant Thornton Business Survey 1996

exchange than in the United States. The initiatives for European SME capital markets over the last few years, are therefore opportune and necessary, although they constitute only part of the solution. A start has been made towards a structure of SME-oriented capital markets, European and national, which can fill this important gap in SME financing and provide attractive investment opportunities. New technologies, and a high level of transparency, should enable these markets to attract new investment, but the rapid technological advances also raise issues concerning how best to regulate capital markets.

The establishment of these new markets has been made possible by EU single market legislation in the field of securities trading, essentially the Investment Services Directive (ISD), which removed former insuperable obstacles to the establishment of fully European markets, such as the existence of national monopoly markets with restricted access for foreign dealers. Nevertheless, a number of potential difficulties remain, which could hinder the access of SMEs to equity capital, and the development of markets designed to respond to their needs. Many are questions for individual stock exchanges to decide as part of their strategy. Those dealt with here - problems of access for SMEs to stock exchanges in general, and potential obstacles to cross-border trading in shares on European capital markets for growing SMEs - may require intervention, either at the level of the European Union or that of Member States, and this Communication suggests some lines of action.

Improving access for SMEs to equity capital via listing on a stock exchange, and tackling the possible hindrances to this within SMEs themselves, is one of the objectives of the Commission's Third Multiannual Programme for SMEs, adopted by the Council on 9 December 1996[23]. The Multiannual Programme also includes the exploration of innovative financial instruments for SMEs, and in this context the Commission intends to study the feasibility of other means of SME financing through securities, including for example the issuing of bonds.

The improvement of access for SMEs to equity finance, both through the development of suitable SME-oriented capital markets, and through helping SMEs overcome the inherent difficulties which can prevent them being floated on such markets, will have a strongly beneficial effect on the European economy, and on the level of employment. Increased access to equity finance would produce a chain reaction of positive effects for companies: it would allow them to invest in research and expansion; by decreasing debt-equity ratios, it would make banks more willing to supply further debt finance; by improving the opportunities for venture capitalists to exit their investments it would free up venture capital for investment in start-ups and young companies. There would also be wider economic benefits: better opportunities for European investors, especially pension funds, thus alleviating current difficulties in funding pensions; more inward investment to Europe from elsewhere; the development of financial services in Europe.

For all these reasons the Commission believes that the opportunities provided by the creation of national and European capital markets for growing SMEs should be maximised. All efforts should be made, including the measures described or suggested in this Communication, to further the establishment of a genuine SME equity culture in Europe.

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[23] 97/15/EC. Official Journal L 6/25 of 10.1.1997.

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