WFE Response to the Financial Stability Board – The Effects of Financial Regulatory Reforms on SME Financing

www.world-exchanges.org

Introduction

The World Federation of Exchanges (WFE) welcomes the opportunity to provide input to the Financial Stability Board's assessment of the effects of financial regulatory reforms on the financing of small and medium enterprises (SMEs).

The WFE is the global trade association for regulated exchanges and clearing houses. We represent over 250 market-infrastructure providers, spread across the Asia-Pacific region (~37%), EMEA (~43%) and the Americas (~21%). With extensive experience of developing and enforcing high standards of conduct, WFE members support an orderly, secure, fair and transparent environment for all sorts of investors and companies wishing to raise capital and manage financial risk. We seek outcomes that maximise financial stability, consumer confidence and economic growth. We also engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in an internationally integrated financial system.

WFE exchange members are committed to improving the range of financing options available to SMEs. Across the WFE's member exchanges, there are multiple dedicated SME platforms. While the specifics of the platforms vary, most are characterised by tailored initial listings requirements and ongoing disclosure requirements aimed at meeting the needs of earlier-stage, smaller companies than might otherwise struggle to access public equity markets. In addition to providing listings platforms, many of these market operators also provide pre- and post-listing support for SMEs, and alternative financing platforms that provide access to debt capital, or offer mechanisms to connect firms with private equity/venture capital investment.

The WFE, through its dedicated SME Working Group, has conducted extensive research into various aspects of SME markets, including challenges faced by SMEs and others in the financing ecosystem. This includes:

WFE Report on SME Exchanges*[1] *(March 2016 produced with the support of the World Bank World Bank Group's Finance and Markets Global Practice):

SME Financing and Equity Markets*[2] *(February 2017, produced with the support of an Advisory Group that included WFE member exchanges and representatives from securities regulators)

Small and Medium Sized Enterprises and SME Exchanges*[3] *(July 2017, produced in conjunction with the Milken Institute)

Family Firms and Listing: Opportunities for Public Capital Markets*[4] *(February 2018)

WFE SME Markets – Key Datapoints and An Overview of WFE SME Markets*[5] *(October 2018)

The WFE collects monthly IPO data from across its membership as well as annual lists of listed companies. This allows market-level analysis of the types and size of companies coming to market at an entity level, as well as the funds raised at the point of listing. We also collect annual data on key market statistics relating to WFE member SME platforms. We believe this data allows for more granular analysis of the market financing piece of the SME funding puzzle and we would happy to work with the FSB on this analysis.

Exchanges strive to facilitate capital formation and enable access to capital, while providing appropriate levels of investor protection. This extends, as is evident from the number of exchanges that operate dedicated SME offerings, to providing mechanisms to enhance SME access to finance. Exchanges also recognise that they are a part of the financing ecosystem which interacts with other financing mechanisms, intermediaries and investors and that addressing the SME financing challenge requires an ecosystem approach.

Our comments should be viewed in this context: while we seek to promote more effective provision of SME finance through regulated markets, we recognise that exchanges are not the sole solution to SME funding challenges and that other actors and associated types of financing such as banks, private equity and venture capital firms amongst others, all have an important role to play. The focus must therefore be on ensuring that all parts of the ecosystem are able to perform their function as it relates to different aspects of SME finance.

---

[1] Available here: https://www.world-exchanges.org/our-work/articles/wfe-report-sme-exchanges
[2] Available here: https://www.world-exchanges.org/our-work/articles/wfe-report-equity-market-financing-smes
[3] Available here: https://www.world-exchanges.org/our-work/articles/wfe-milken-institute-sme-exchanges-report-18-july-2017
[4] Available here: https://www.world-exchanges.org/our-work/articles/wfe-family-owned-businesses-listing-report
[5] WFE SME Markets Key Datapoints – October 2018 and An Overview of WFE SME Markets

Questions

1. What have been the main trends in SME financing (i.e. types of financing, volumes, prices and maturities) since the financial crisis? How do these trends differ across jurisdictions (e.g. advanced vs emerging market economies) and sectors (e.g. high-tech vs traditional firms), as well as by firm size (micro vs small vs medium-sized firms) and age (e.g. start-ups vs mature firms)?

We note the observation in the consultation that SME access to finance has improved. While this may be the case in some jurisdictions, feedback from some of our members suggests that for many SMEs, securing financing remains challenging particularly for companies without a profit history or assets that can be used as collateral. In China, for example, to deal with high cost and unavailability of financing for SMEs, efforts have been made to expand direct financing channels for SMEs (see our response under Question 5).

In relation to the nature of the companies accessing public markets, while some of our member markets have noted a marked shift towards technology companies (for example, in China, the percentage of certified high-tech companies across the Shenzhen exchange markets was at 73% at end December 2018, up from 33% before 2004) in other markets (such as Malaysia) technology companies remain a minority (20%) of the companies listed on the market. In Norway, while technology companies are using the market for financing, this is not to the exclusion of other types of companies. In South Africa, many small businesses are in the retail or services sectors.

The point is frequently made, but it is worth making again, that there is no single, consistent, global definition of an SME. For policy purposes, national jurisdictions may define micro, small and medium enterprises, usually with reference to the number of employees, turnover and/or assets. These definitions may or may not align with how providers of finance define SMEs for purposes of extending credit or listing on a market. The matter is further complicated when one looks across jurisdictions – what is considered an SME in the United States, may be a large company in Sri Lanka. We do not think it is necessary to arrive at a globally consistent definition, but rather definitions should be clearly aligned with specific objectives.

Regarding trends:

- While there seems to be certain consensus that considerations such as tailored listings requirements and manageable costs are a given, what is appropriate and strikes the right balance between issuer access and investor protection will likely vary from one market to another.
- The definition of an SME tends to be jurisdictionally specific, so its market of operation and the broader policy environment and objectives will determine what the SME exchange looks like and what it attempts to do.
- The structure of the market/platform will depend on the ecosystem in which the exchange operates. Thus, in jurisdictions where capital markets are under-developed, the exchange may have to play a much larger role in vetting companies and monitoring their ongoing compliance than in markets where there are a broad swathe of high-quality intermediaries.
- There is a need for an enabling ecosystem, which can prove particularly challenging in markets where there isn't natural, pre-existing demand for equity market capital or where the traditional ecosystem has been eroded. Exchanges cannot address this problem on their own.

See the WFE Report on SME Exchanges[6] (produced with the support of the World Bank World Bank Group's Finance and Markets Global Practice) for further detail

2. What have been the main drivers of the observed trends in SME financing in recent years? How do they differ across jurisdictions, sectors, size and age of firms?

In our SME Financing and Equity Markets paper[7] (*February 2017, produced with the support of an Advisory Group that included WFE member exchanges and representatives from several securities regulators)* we used survey data from listed and unlisted SMEs,

[6] Available here: https://www.world-exchanges.org/our-work/articles/wfe-report-sme-exchanges
[7] Available here: https://www.world-exchanges.org/our-work/articles/wfe-report-equity-market-financing-smes

retail and institutional investors, and intermediaries. We concluded the following were necessary for the creation of an effective equity financing environment for SMEs:

- A well-established regulatory and supervisory framework for the SME exchange
- A mechanism supporting SMEs to prepare disclosure documents - for companies, the process of listing and ongoing compliance with listings requirements can be burdensome, costly and time consuming, and may act as a disincentive to listing. Companies therefore value support and assistance in complying with their requirements.
- A mechanism enhancing liquidity of SME stocks (e.g., a market-maker requirement)
- Research and analysis on SME capital markets activity

Some other important findings from the research, are as follows:

- Obtaining access to finance is an important reason for listing but the decision to list on a stock exchange goes beyond corporate finance considerations.
- Listed companies are less likely to be borrowing constrained than unlisted companies i.e. the fact of listing may actually enhance access to other forms of finance (see a discussion on the reasons for listing in the WFE / Milken research).
- Companies – at least in some jurisdictions - may not know enough about listing to make an informed decision about the relative costs and benefits.
- Market intermediaries that service the SME market do so for a variety of reasons, but not necessarily because it is profitable to do so.

In our Small and Medium Sized Enterprises and SME Exchanges[8] (July 2017, produced in conjunction with the Milken Institute) we found:

- Reasons for listing include access to benefits beyond simply finance, but associated with listing, such as "positioning the firm for growth"; "diversifying the investor base"; and enhancing the "credit-worthiness of the firm".
- While financing is not the only objective, it is an important one and many firms who choose to use public equity markets, do so because it represents a lower cost of capital than the alternatives.
- Companies reported a positive experience in the areas of "impact on visibility and reputation", "effect on financial performance and profitability" and "corporate social responsibility". However, in areas such as time and costs of aligning financial record keeping and reporting with listings requirements; level of liquidity of the stock; volatility of the stock price; and time and costs associated with meeting ongoing listings requirements, they found listing more challenging than expected.

3. Have financial regulatory reforms such as Basel III affected bank financing to SMEs (e.g. in terms of loan volumes, prices, maturities and collateralisation)? If so, how? How important have been their effects vis-à-vis other types of bank lending and compared to the main drivers identified in question 2?

4. How does the impact (if any) of financial regulatory reforms vary across banks operating in different geographies and with different size and business models?

5. What other G20 financial reforms or other domestic financial regulations (if any) may have impacted financing to SMEs and how?

In the aftermath of the crisis, several jurisdictions sought to introduce regulation that would enhance access to capital, including for SMEs. We list three that are particularly critical.

US: In the US, this took the form of the Jumpstart Our Business Startups (JOBS) Act of 2012. Much has been written about the declining number of listed companies in the US. In a recent report on Financial Markets, the US Treasury notes that "since the financial crisis, the annual number of IPOs averaged 188 – far less than the average of 325 during the period before."[9] Regulators

[8] Available here: https://www.world-exchanges.org/our-work/articles/wfe-milken-institute-sme-exchanges-report-18-july-2017
[9] US Treasury - A Financial System That Creates Economic Opportunities - Capital Markets, October 2017, pg 22

continue to explore ways to enhance accessibility and use of public markets. Some of the more recent recommendations coming out of the US Treasury include through further reduction of regulatory burden and improved market access to investment opportunities and promoting robust secondary markets in equity and debt (noting that secondary market trading mechanisms may need to be adjusted to cater for smaller cap companies).

China: In 2018, Chinese Premier Xi Xinping announced the creation of the Science and Technology Innovation Board. The Board will (amongst other initiatives) allow qualifying companies to be listed under a registration system (a relaxation of the current listings approach in China) to attract more of these companies to list. The Shanghai Stock Exchange is in the process of implementing this Board which will for example, allow companies to list who do not have a profit history, assuming they are a qualifying company as defined by the rules of the Board.

EU: We refer you to the submission of our colleagues at the Federation of European Securities Exchanges who provide feedback on EU-regulation and proposals regarding barriers to be addressed.

6. Have financial reforms prompted a shift in the provision of SME financing, e.g. between banks and other financial institutions (substitution effects)? If so, how?

Most recently, the WFE analysed equity-focused SME platforms operated by its member exchanges. We find that there has been an increase in the number dedicated SME platforms, particularly in the last ten years. Among the platforms reviewed, seventeen were established between 1990 and 2007 (seven in the 1990s and 10 between 2000 and 2007 inclusive). However a further 18 were established in the ten years since the financial crisis (2008 to mid-2018).[10] As at end 2017 (the last year for which we collected full year data) over 16,000 companies had listed on these platforms since their inception, raising nearly US$400 billion. We also note however, that there is a fair degree of variability across these platforms and jurisdictions, across all metrics, highlighting the point that while there are certain globally-applicable principles, the specific challenges and solutions will be jurisdiction-specific.

To cite some specific examples:

China: Experience is that listed SMEs have easier access to different types of refinancing, including public issuance (i.e. public secondary offering, share rights issuance), non-public issuance (private placement) and equity-fixed income products (preferred shares, convertible bonds).[11] Convertible bonds have become more popular over the past three years, and have become one of the major refinancing products. From 2016-2018, SME Board companies raised RMB 34.79 billion via convertible bonds, up from RMB 2.98 billion, accounting for 26% of the SME Board refinancing value. In 2018, the first two companies issued preferred stocks, raising RMB 12.48 billion. Corporate bonds are growing steadily, and preferred stocks become one of the choices.

Norway: sense that stricter capital and liquidity requirements for banks has resulted in some shift away from bank financing to use of bonds and possibly equity. See that smaller/earlier stage tech companies are relying on private equity/venture capital. Limited use of crowdfunding in the Norwegian market.

7. Are there any other issues or relevant factors that should be considered as part of the evaluation?

Based on our research, we believe there are certain core principles that are more broadly applicable to enhancing SME use of public markets, and thereby access to finance and other benefits associated with listing. These are as follows:

- Market regulators/policymakers should identify ways to **reduce costs associated with listing**: The decision to list (or otherwise) entails a cost-benefit analysis for the firm. The costs of listing cover both the direct costs of fees paid to the exchange (which are often greatly reduced for SME markets) and intermediaries, but also the indirect costs associated with initial and ongoing compliance with listings requirements. Mechanisms to reduce costs should therefore focus on addressing the complexity and scale of the requirements of listing and maintaining a listing. Companies should only be required to disclose information that is directly relevant for purposes of informed investor decision-making. In some markets it may be desirable to revisit the frequency of reporting. There may be opportunities to streamline and automate disclosure compliance.
- There should also be a focus on identifying ways to **enhance the information that is available about listed SMEs**. This entails focusing both on finding ways to improve the quality of SME disclosure (which does not necessarily equate to MORE disclosure, but rather more accurate, more efficient and relevant disclosure) and encouraging more independent, third-party coverage of

[10] These include only more traditional equity market platforms and do not include dedicated debt offerings and other initiatives such as those aimed at facilitating venture capital/private equity investment.
[11] This is borne out by WFE research.

SMEs. Many WFE member exchanges have, as part of their dedicated SME offerings, introduced measures to improve the availability of information about listed SMEs to attempt to address this, but this should be seen as a supplement rather than a substitute for good-quality, independent research analysis.

- **Addressing barriers to use of public markets**. These may include institutional investor mandates that limit the ability to invest in small cap companies, and tax structures that preference certain types of finance above others.

- Looking at **secondary market trading mechanisms** to assess whether these impede the attractiveness of markets for SMEs. As highlighted in WFE research, all market participants recognise that some level of liquidity is necessary to enable effective investor participation and accurate price formation (which impacts secondary capital raising). A one-size-fits all model may not be suitable for smaller cap companies and alternative trading mechanisms that serve to concentrate liquidity, may be desirable.[12]

  Liquidity is also achieved through greater investor diversity. Enabling broad market participation (while recognising investor protection objectives) may therefore assist in addressing the liquidity challenges.

- Investing in **effective market education**, for both companies and investors: WFE research highlighted that in some instances companies are not aware of the range of financing options that are available to them, and/or the implications of particular financing choices. In other instances, companies that come to market may not understand what is required of them as a listed company and not invest sufficiently in the requisite governance, financial compliance and investor relations functions to achieve the best outcomes from their listings experience. Again, many WFE member exchanges have dedicated pre- and post-IPO programmes that focus on these issues, but achieving larger-scale outcomes may require broader support.

  In relation to investors, broad-based financial literacy that educates particularly retail investors is an important part of creating a thriving ecosystem. Again, many WFE member exchanges have their own financial literacy programmes but these could be amplified through the support of national regulators.

[12] For example, the Science and Technology Innovation Board will introduce “after-close fixed-price trading” which they hope will contribute to the liquidity of the market.