

6.2.1. Firstly, it calls upon the Commission to make concerted practical efforts to explain the workings of the Single Market, and so produce specific findings based on regularly documenting the practical consequences of EU measures.

6.2.2. Lastly, the Committee urges those Member State companies and entrepreneurs who consider it in their interest to establish themselves and operate in another market to roll up their sleeves, harness all their undoubted dynamism and exploit every opportunity they have to overcome by their own efforts as many obstacles as they can.

Brussels, 27 May 1998.

*The President  
of the Economic and Social Committee*  
Tom JENKINS

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**Opinion of the Economic and Social Committee on the 'Communication from the Commission — European capital markets for Small and Medium-sized Enterprises: prospects and potential obstacles to progress'**

(98/C 235/04)

On 13 May 1998 the European Commission decided to consult the Economic and Social Committee, under Article 198 of the Treaty establishing the European Community, on the above-mentioned communication.

The Section for Industry, Commerce, Crafts and Services, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 6 May 1998. The rapporteur was Mr Pezzini.

At its 355th plenary session (meeting of 27 May 1998) the Economic and Social Committee adopted the following opinion by 101 votes to one, with one abstention.

**1. Overall remarks**

1.1. The European Commission is to be congratulated on its positive and sustained efforts to stimulate the creation of European capital markets suitable for small and medium-sized enterprises (SMEs). Its actions were described in an earlier Communication 'Reporting on the feasibility of the creation of a European Capital Market for smaller entrepreneurially managed growing companies' <sup>(1)</sup>, on which the ESC did not deliver an opinion. These endeavours by the Commission responded to an earlier request by the Committee to 'carry out a feasibility study on the establishment of a recognized European capital market giving European firms, especially small firms, access to capital.'

1.2. In this follow-up communication the Commission has produced a constructive document. Nevertheless, there are certain points, such as the manner in

which EU securities legislation operates in practice, which have not received the detailed examination they deserve. There are others in which factors other than those put forward by the Commission are significant.

1.3. There are a whole range of other factors besides the adequate provision of finance which determine whether firms will grow to a significant size. It was decided that the most significant of these deserved examination in this opinion in order that a better overall assessment of the problems might be made. A number of the recommendations made arise from a fact-finding mission by the ESC to the USA made in November 1997. This was largely inspired by the reference to the US capital markets in the introduction to the Commission communication and by the encouragement to examine the US situation given by Commission President Santer in his speech at the Economic and Social Committee on 28 October 1997. As a result, this opinion covers a much wider field than the Commission communication, which merely deals with capital markets for SMEs.

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<sup>(1)</sup> COM(95) 498 final, 25.10.1995 .

1.4. A further criticism of the communication is that it fails to make clear that the new European capital markets are only of value to companies which, whilst technically SMEs (under 250 employees, less than ECU 40 million capital turnover and ECU 27 million on the balance sheet), are either of medium-size, particularly innovative start-ups, or firms that are particularly capital intensive.

1.5. In the USA, too, only some 2 % of companies at the most, albeit those with above average prospects for growth, attract external funding from informal private investors ('Business Angels') or venture capital funds. The Commission estimates that there are perhaps 20 000 firms at the most in the whole of the European Union which might go on to have their shares traded on a stock market at some point. They are, however, the firms that hold the promise of enjoying the highest rates of growth and creating significant new employment, good reasons for the Commission to have devoted such a degree of attention to their financing needs which have historically been less well catered for in Europe than in the USA.

## 2. Summary of the Commission document

2.1. The main objectives of the communication are to explore the potential barriers to the admittance to trading on capital markets of the shares of SMEs; to start a European-wide debate on the appropriate conditions for access to equity finance; to describe, and draw attention to the progress made by various initiatives to create new financial markets in the European Union such as 'EASDAQ' and 'Euro-NM'; to outline the actions the Commission is currently taking and intends to take in the future to overcome the barriers to the development of SME-orientated capital markets and ensure their smooth operation.

2.2. The communication identifies two main areas creating potential barriers to the development of these capital markets. The first relates to the attitudes, capacities and constraints originating within small and medium-sized enterprises themselves. In particular, the attitude of SMEs towards their financing, their expertise or lack of it in financial management, and the burdens which arranging an introduction on a stock market would place on them.

2.3. The second group of potential obstacles concern: the cross-border trading of shares on pan-European stock markets; particular currency related problems; differences in taxation and national accountancy practices; corporate governance and institutional investment. The Commission believes that in certain of these fields

the speedy and full application of existing European Union legislation would help. Finally, in the field of institutional investment and the free movement of capital, the Commission maintains that failure to remove discriminatory national restrictions could make the taking of infringement proceedings necessary.

## 3. Detailed comments on the communication

### 3.1. Introduction

Other than for the comments set out in section 1 of this opinion, the points made in the introduction are accepted.

3.2. Further progress in the development of SME capital markets in the European Union, and their prospects.

3.2.1. A number of capital markets more attuned to the needs of innovative and rapidly-growing companies than have been traditional stock markets, now exist in Europe. Two, EASDAQ and EURO.NM, have pan-European ambitions. The London AIM (Alternative Investment Market) currently appears to be more focused upon the United Kingdom.

3.2.2. The growth rates of companies seeking admission to these markets is likely to be far in excess of the 10 % cited in the second paragraph of page 2 of the Communication. When comparing sales in 1996 and 1997, three-quarters of the companies whose shares traded on the EASDAQ market experienced a growth in excess of 25 %. Nearly a third of all companies on the market showed a turnover increase of over 100 %.

3.2.3. The long-term success of these markets will depend on their admitting a sufficient number of innovative companies, as it is these who appear to particularly excite the interest of investors. Any initiatives to increase their numbers, particularly in fields such as biotechnology, would make a welcome contribution. Unfortunately, there is no completely reliable method of determining at an early stage which are the companies that are likely to grow rapidly and be successful in the long-term. What largely determines their eventual ability to attract external investment is the perceived quality of their management.

3.2.4. Efforts need, therefore, to be concentrated on encouraging more business start-ups and seeing that they have access to finance, together with timely advice, so improving management quality and reducing the current high rate of mortality, some 50 % within the first five years of existence according to the European Observatory for Small Business. There are already good schemes in operation within the EU which can provide

guidance when policies are being developed. One example is the 'Artigiancassa' financial facility in Italy.

3.2.4.1. Given that undercapitalization and inability to provide security for loans is common among new firms:

A loan guarantee facility for SMEs, with special arrangements for very small 'micro' loans, should be made available in all Member States. The means of delivery, whether through state organized schemes, or other mechanisms such as Mutual Guarantee Systems, would be for decision in the light of national circumstances. Given that many small enterprises do not adopt a limited company format, special attention needs to be given to their specific needs.

Guarantees might not need to have as high an upper limit as in the US Small Business Administration scheme (\$ 1 million, of which \$ 750 000 is guaranteed) but at least ECU 250 000 would seem appropriate. Properly run, these facilities should not be a great burden on the public exchequer. Loan defaults in the US are currently less than 2,5 % of the total guaranteed and fees charged to firms for the granting of loans would offset part of this. Based on the experience of Mutual Guarantee Systems, the so called 'Multiplier', which enhances the ability of consortia to underwrite loans, has a multiplier of 22. That is, with a 50 % guarantee and a hypothetical venture capital fund of ECU 100, it would be possible to grant a loan of ECU 4 400. This figure allows for an insolvency rate of 4 % and the cost of investigating credit worthiness.

3.2.4.2. A major reason for business failure is a lack of knowledge of the relevant sector and a lack of business and financial management skills. There is nothing magic about these and they can be imparted in the majority of cases providing the person giving the advice has the necessary business experience and counselling skills. The pity is that many of those most in need of advice seldom seek it.

Each Member State, with the cooperation of the appropriate private-sector organizations, should ensure that business mentoring on a one-to-one basis is available at reasonable cost to any self-employed person or SME proprietor or manager. Mentors should have had business experience and be members of a professional body (which could include national SME and craft organizations) able to ensure they receive proper initial and on-going training. Consideration should be given to making the seeking of

such assistance a condition for receiving a loan guarantee.

Whilst the establishment of such a structure will not be as cheap as in the case of the SBA Score programme, where mentors only receive out of pocket expenses, it need not be overly expensive. In the last full year of the United Kingdom Small Firms Service (1990), keeping 300 advisers in the field only cost around ECU 14 million. The attendant reduction in both business failures and ill-advised start-ups makes the establishment of such structures a first-class national investment. There is reason to believe that by extending this system, the business failure rate will fall considerably, perhaps even by 80 %.

3.2.4.3. Not all firms cease activities because of lack of finance or mismanagement. An unquantifiable number do so because they find regulatory burdens imposed upon them impossible to cope with. There must also be many who are deterred from starting a business because of the bureaucratic procedures involved. The European Commission and Member States recognize this, but action to address the problem needs to be speeded up.

In the USA new firms only need to make arrangements to pay social security contributions and register with the tax authorities. Member States should reduce start-up formalities to what they consider to be the bare essentials in a similar manner, while bearing in mind the different economic and social structures. They should also consider raising VAT registration exemption levels, as already permitted by the VAT Directives, so assisting the very small business.

The administration of firms paying very small amounts of VAT costs more than it yields, so this reform would have no budgetary cost, whilst giving new firms a breathing space before having to absorb what is for many a complex system, requiring them to pay for external advice in order to ensure compliance.

3.2.4.4. Unless considerable amounts of noise or harmful emissions are concerned it is easy to found a business in the USA and operate it from home. It has to be wondered whether firms such as Microsoft and Dell Computers, which both started in a garage, would ever have commenced operations in some parts of Europe.

There is a need for public authorities to pay more attention to substance rather than form when authorizing new start ups, and to simplify authorization procedures. Restrictions on starting a business

and operating it from a private home for a limited period should be relaxed where there is no question of public nuisance or inconvenience or harm to the environment or employees.

3.2.4.5. If a major objective is to encourage the creation of innovative firms, the US experience that their growth appears to take place most readily around universities or research centres needs to be noted. There are examples of such centres in Europe already, but not enough, neither are they yet sufficiently large.

Top priorities should be the encouragement of the establishment of more high technology business parks around universities and other research centres and the improvement of the overall quality of those that already exist, thereby increasing the chance of commercial application of scientific discoveries. In each case it is also vital to provide back-up, in the shape of venture capital funds.

There is a need for the Commission to examine current best practice in the Member States and to disseminate the results in order to encourage further developments.

3.2.4.6. US academics seem far more willing to establish or participate in businesses than their European counterparts. One reason may be a greater availability of early stage and seed capital (a gap now being addressed following the Heads of Government Extraordinary Council on Employment in Luxembourg), coupled with expert business advice. Another one may be cultural, with far more emphasis being placed on academic rather than worldly success in Europe.

An examination is needed into methods which would help make academics more aware of the possibility of developing commercial applications of their theoretical knowledge, particularly within a business in which they have a stake. It may be necessary to consider incentives, such as the provision of more funds for pure research to the departments of academics who respond positively. Member States should also loosen traditional restrictions which prevent academics from undertaking any type of commercial activity.

There will be practical problems to overcome, not least defining the ownership of intellectual property, particularly where the centres of learning involved are wholly funded by the state. Nevertheless, the existence of difficulties should not be made an excuse for inaction.

3.2.4.7. Another reason for less commercial application of research in Europe may be that it is

apparently easier and cheaper to patent discoveries in the US.

The intention of the Commission to produce early draft legislation aimed at creating a true European patent is warmly welcomed. The Council and the European Parliament are urged to rapidly consider and approve this legislation, along with the equally important draft Utility Model Directive.

3.2.4.8. In the more enterprise-oriented areas of the United States, entrepreneurs who go bankrupt are not made to shoulder so much blame. The federate state laws allow them to learn from their mistakes and to get their business back on its feet or start a new one.

Member States should examine their national legislation on bankruptcy and seek to amend it in order to limit the number of unnecessary bankruptcies and to give a greater chance of starting again to those who, though unsuccessful, acted in good faith.

3.2.5. Another factor which will determine whether or not these markets are successful is whether there will be sufficient interest from investors. So far, levels of interest by institutional investors appear encouraging, more questions arise in respect of private investors. One reason for the lack of interest in equities by individual European investors, referred to in the seventh paragraph of Section II, is certainly cultural. Europe is not an enterprise culture in the same way as is the USA. When it comes to investment, the security provided by fixed-interest investments has been traditionally more important than the potential for higher returns offered by equity investment. It can be anticipated that the creation of a single European currency will tend to change investor attitudes. Rates of return on government securities will tend to be lower, as will the amounts issued. This means that investors will need to consider alternatives.

3.2.6. Already, investor attitudes do seem to be changing and another factor in the apparent lack of interest in equities may have been a lack of opportunity. Recent evidence, including the success of privatization issues, shows that there may be a more pent-up demand than estimated. In any case, the majority of smaller private investors are likely to hold their stakes in equities indirectly, through collective investments and those made by insurance companies and pension funds. It is important that these institutional investors are not restricted in their investment policies by outdated national rules, which will become increasingly irrelevant in a single currency zone (see also point 3.4.1.2.5).

3.2.7. Growing companies are capital hungry and lack of funds frequently inhibits their rate of growth in Europe. This is less so in the USA where a greater variety of sources exist. In the USA informal private investors or 'Business Angels', who are frequently successful businessmen, are prepared to invest relatively substantial sums (said to be in the range of \$ 50 000 to \$ 100 000) in businesses with the potential for fast growth. In addition, the advice and contacts they can bring to the company are said to be as valuable as the money they invest. An encouragement they receive is that they are allowed to offset losses against tax payable on other activities under defined circumstances. Similar investors do appear to exist in Europe, but the picture is uneven and potential investors complain that it is difficult to locate suitable companies. The US Small Business Administration has recently tried to improve links in the US by establishing a national data base promoting contacts.

The Member States should examine how informal private investment might be encouraged, both through tax incentives and the establishment of contact networks, where these do not already exist.

3.2.7.1. When the informal private investor's participation is no longer sufficient, Venture Capital Funds should theoretically take over for the higher-growth firm, effectively bridging the gap until it has reached the point where a stock market floatation is possible. In practice, even in the USA, this only happens in the case of a very small number of companies as median investment sizes become increasingly large. The US Small Business Administration has endeavoured to fill some of the gap by providing guarantees for smaller venture capital investments.

The Council having acknowledged that a problem exists (Point 48 of the Luxembourg Conclusions), the Commission has reacted by tabling a draft proposal for a Decision permitting such guarantees to be given. This proposal will be the subject of a separate Opinion of the Economic and Social Committee.

3.2.8. A noteworthy feature of the American scene is the number of small companies that grow to medium-size. One reason may lie in the field of capital taxation, which was reduced in the US in the 1980s. Owners of a business are more willing to take the risks involved in growing rapidly if they are allowed to keep a substantial part of the results of success should they eventually float the company on a stock exchange or sell it. If they do not wish to do either, they may be interested in handing

it down to younger members of the family without incurring succession duties which bleed the company of finance it needs for trading and funding further expansion.

Member States should examine the effects of capital taxes and succession duties on SME growth and introduce reforms where necessary. This is something which the Committee has advocated on a number of occasions.

It is after all the total yield rather than the actual rates of these taxes which should be important to governments.

3.2.9. Another necessity is the provision of high-quality information, particularly on new share issues, to investors. For larger share issues this is a complex but practical possibility, but for smaller offerings this is currently made difficult where cross-border issues are concerned by two main factors. The first is the absence of a common definition of a public offer within the European Union. The second the restrictive manner in which the mutual recognition provisions of the Prospectus Directive<sup>(1)</sup> are being interpreted by the Member States. They are frequently requiring translations of what are massive documents, together with a considerable amount of additional information, together with the placing of expensive advertisements in national newspapers. This is perfectly legal, but forces issuers of 'SME stocks' to limit an Initial Public Offer of shares to one Member State, relying elsewhere on private placements of shares with professional investors. In addition, the widely differing national rules on advertising effectively exclude many private investors, either through ignorance or because only a private placement is taking place in their country of residence. These two factors have the unfortunate result of restricting liquidity in the after-market and reducing share prices. Unless these difficulties are overcome it will be virtually impossible to tap the pool of funds and interest in the shares of innovative SMEs that potentially exists in Europe. Neither will it be possible for the SME capital markets to provide funding for Europe's future commercial and industrial 'champions' in the way they otherwise could.

### 3.3. *Potential obstacles to the listing of SMEs on stock exchanges*

Five questions are asked by the Commission in this section of the Communication. They are addressed in the same order.

<sup>(1)</sup> 89/298/EEC (Council Directive coordinating the requirements for the drawing-up, scrutiny and distribution of the prospectus to be published when transferable securities are offered to the public).

3.3.1. Does a sufficient number of SMEs exist in Europe which are suitable and ripe for a stock market flotation, and if so, how can these be identified?

3.3.1.1. It would appear from the partial studies made to date, and mentioned in the Commission's Communication, that sufficient firms with the willingness and the potential exist, but whether many are yet ready, or even aware of the opportunities presented by a stock exchange flotation is less certain. Given that firms tend to be reticent about revealing their affairs to strangers, and there being much less information available in the public domain than in the USA, it is difficult to think of methods by which they might be identified. Perhaps professional advisers (bankers, lawyers, accountants) and organizations (chambers of commerce, etc.) might be induced to help in the identification of firms who are potential candidates for flotation.

3.3.2. Are owners of SMEs which are ready for flotation willing to accept the possible diminution of control which a public share issue is often taken to imply?

3.3.2.1. If they are not ready to accept the reality that they will suffer some diminution of control and will be answerable to a wider public than hitherto, owners of SMEs should not contemplate a flotation. In many instances a reluctance to accept this reality is a generational problem. As many of those who founded businesses after the second world war retire, those who succeed them seem much more willing to give up a certain measure of control in return for external funding and the greater opportunities for expansion that follow. Also, those that have been in receipt of venture capital, or have attracted informal private investment, have already become accustomed to outside scrutiny of their decision-making. The Commission's idea that more companies might come forward if there were publicly supported campaigns to bring home to suitable SMEs the advantages of flotation is worthy of further consideration, although advice about the most suitable market for the company and similar matters, clearly fall within the remit of a professional adviser.

3.3.3. Do SMEs have the willingness and financial skills necessary to meet the high financial information and transparency requirements of a stock market quotation?

3.3.3.1. The need to produce a high level of financial information in preparation for a flotation can constitute

a barrier to proceeding. Considerable effort is required, which must be coupled with the high cost of diverting management time from the development of the company. These requirements are, however, inseparable from the transparency required by both investors and market regulators. It is difficult to see how the Commission suggestion of making private companies adopt similar standards of financial transparency would address the problem. It would merely place an additional burden on companies not seeking and never intending to seek external equity finance.

3.3.3.2. As to the other suggestion, that financial training being provided for companies preparing a prospectus, it must be pointed out that it is the sponsors to the issue, not the company, who prepare the prospectus and the reporting accountants who satisfy themselves as to the accuracy and presentation of the figures. It is to be hoped that companies who had reached this stage would also have developed a reasonable level of financial expertise. Otherwise, they are likely to encounter problems in meeting the on-going obligations of a public limited company.

3.3.4. Do SMEs have access to the necessary specialist advice and support necessary to prepare an Initial Public Offering of shares (an IPO)?

3.3.4.1. Potential IPOs valued at less than ECU 100 million could well face a problem in that they are unlikely to be of interest to the larger investment banking houses. In some of the main financial centres smaller investment services firms do exist who are prepared to bring issues of quite a low value to the market, but this situation is not universal and difficulties in obtaining proper support and assistance could arise. This is of concern because one important factor determining whether or not investors are attracted to an issue is the name of its sponsor. It is, after all, they who act as filter/selector, trainer/preparer and on-going hand holder of SMEs coming to a stock market. It is to be hoped that Economic and Monetary Union, along with increased competition in the financial markets, will lead to the appearance of more investment firms prepared to take on smaller share issues, perhaps even outside their main country of establishment.

3.3.5. Are SMEs willing and able to bear the high cost of the process of a stock exchange listing, in terms of both an IPO and of the ongoing costs of a listing?

3.3.5.1. Costs of an issue are high, although the figure of 20 % of the funds raised quoted in the Communication

must refer to a very small issue. NASDAQ indicates a typical cost might range from 7% to 9% of the value of the issue. To offer special help with the costs of an IPO to SMEs making very small issues would not be of particular assistance as fees are not paid until after the new capital has been raised. In any case, stock markets are unenthusiastic about such issues, which tend to be illiquid after flotation and on-going fees charged hard to justify.

3.3.5.2. Some efforts are being made to meet the requirements of smaller SMEs, only a minority of whom are going to be high technology companies with international ambitions and two seem worthy of mention:

- the Union of Chambers of Commerce in Lombardy, Italy, has just established a second-tier capital market for companies with a capital of ECU 0,5 million upwards;
- the Irish Stock Exchange launched its 'Developing Companies Market' in January 1997. This provides a capital market with less onerous conditions than those applying to stocks on the Official List, including a requirement for only one year's accounts rather than three. Also, only 10% of the shares have to be issued to the public.

More initiatives of this nature creating 'nursery' capital markets, which are comparatively cheap to join, would seem to be required.

3.3.5.3. In addition to the two examples quoted in the previous paragraph, there is the longer-established German 'Freiverkehr' over-the-counter market, on which the shares of some 500 companies are traded.

3.3.5.4. The creation of an Internet market might, for the shares of smaller SMEs in particular, be one solution worthy of encouragement. In June 1997 the Australian Stock Exchange (AS) announced its intention to launch an 'Alternative Capital Market' in 1998 on which unlisted companies of any size would be able to seek investments via the Internet. The AS calculates that there are about 1 million SMEs in Australia, of whom 10% might have real potential for growth and 2% interested in seeking outside equity capital. Companies seeking to join the market would have to make use of 'sponsors' approved and supervised by the AS, who

would have to vet the information posted on the Internet by their client companies. Some mandatory information would have to be included, but nothing as complex as a prospectus would be required.

3.3.5.5. In the USA some companies are beginning to make offerings of shares via the Internet. A prospectus has to be produced and filed with the Securities and Exchange Commission but the companies themselves set share prices, leading to a lack of transparency in the after market. So far, it would appear that the majority of shares issued by this means have been sold to investors located in fairly close geographical proximity to the company.

3.3.5.6. A rather more sophisticated new form of issue, 'Public Venture Offerings', aimed at medium-sized companies, is now being offered in the USA, also via the Internet. Typical amounts raised are between \$ 5 million and \$ 10 million. A prospectus has to be filed with the Securities and Exchange Commission and with the regulatory authority in each of the States in which stock will be offered. The offer can then be advertised without restriction and be subscribed to by up to five institutional and an unlimited number of private investors. Stock cannot be traded for a period of 18 months from the date of issue. This form of funding is hard to tap, possibly because of its newness. Out of 2 000 firms expressing interest, one investment firm only agreed to launch offerings for four. Nevertheless, this appears to be a financing instrument with potential.

3.3.5.7. One problem to be faced if similar developments are to be encouraged in Europe is that of adequate regulation and the avoidance of fraud. Even the US Securities and Exchange Commission is not yet in a position to issue a set of rules, meaning that it may well fall to the Commission to be the first to comprehensively face this issue, hopefully establishing a framework of rules within which a meaningful, transparent and honest market in the shares of SMEs may develop.

The positive efforts made by the European Commission in the field of electronic commerce are acknowledged and supported. Building on this, the European Commission and the Member States are asked to launch consultations, preferably maintaining liaison with the US Securities and Exchange Commission, in order to devise a framework of rules appropriate to cover securities offered to investors by means of the Internet.

### 3.4. *Potential barriers to the cross-border trading of shares on SME capital markets*

#### 3.4.1. Points raised by the Commission

##### 3.4.1.1. Currency-related problems

The Commission view that these can only be solved by the introduction of the euro and the consequent impetus to cross-border trading in securities is endorsed. This will of course depend on the number of Member States participating from the outset and cannot be viewed in isolation from the performance of the EU economy.

##### 3.4.1.2. The regulation of securities trading at the EU level

3.4.1.2.1. The European Union has some 18 equity markets and 18 regulatory organizations. The USA has three principal or 'national' stock markets, all highly efficient and doing a good job for investors and companies. Since 1996, when Congress passed legislation which overrode State regulations where stocks traded on these markets were concerned, they have just one regulator, the Securities and Exchange Commission. At present, the fragmented European regulatory structure, together with the investment firms operating within it, cannot compete effectively with the US model.

3.4.1.2.2. Currently, EU legislation on financial services permits the free movement of capital and provides for the right of establishment. What is missing is any consistent interpretation of the rules by national regulatory bodies. This, together with the inconsistent manner in which the options provided for in financial services legislation have been exercised at the national level, are possibly the most fundamental problems remaining in relation to the organization and operation of stock markets in the EU. The single currency alone will not provide the solution — although it will be a start — as its full benefits will not be felt within the financial services sector under the current legislative and regulatory regime.

3.4.1.2.3. Particular problems exist in terms of the provisions of the Prospectus Directive when companies seek admission to a market outside their home Member State. The directive does not provide for the automatic mutual recognition of a prospectus prepared under the provisions of Article 12 in order to gain admission to regulated markets, even though this has been vetted by a competent authority. Some authorities are prepared to issue a certificate certifying they have vetted a

prospectus, others will not. Indeed the current patchwork of national regulatory arrangements, reflecting the different ways in which certain of the options contained in its articles have been perfectly legally transposed into the laws of the Member States does not make achieving mutual recognition under the terms of Article 21(1) of the Prospectus Directive as easy as it should be.

3.4.1.2.4. As pointed out in point 3.2.9, major difficulties also arise because of the requirement by some competent authorities for the translation of the prospectus and the addition of additional information specific to that Member State concerning local income tax aspects, financial organizations retained to act as paying agents for the issuer in that Member State, and the way in which notices to investors have to be published. In practice, they are placing an almost impossible burden on smaller issuers.

3.4.1.2.5. To allow such anomalies to remain will undermine some of the benefits of a single European currency as well as placing European capital markets at a disadvantage compared with those in the USA. Capital markets in the USA are not only efficient, they offer choice to companies and broaden opportunities for investors. The fundamental reason appears to be the regulatory climate, which ensures transparency and fosters competition. This in turn increases market size and reduces costs, both for investors and companies raising capital. Even though the European Union now has an overall framework of rules governing financial markets and services these are extremely complex, are supplemented by specific national provisions and policed by national regulators.

The European Commission and the Member States need to consider whether the present legislative and regulatory regime encourages the deepening of capital markets which is now essential and take appropriate steps to amend it, particularly the Prospectus Directive. This would not need major change to turn into an effective instrument, but would require some of the Member States to forego some of the legislative options they now enjoy, which were framed at a time when financial markets were far more national in character than they are now becoming. Whilst a European regulatory body, along the lines of the Securities and Exchange Commission, is unlikely to be created for the foreseeable future,



greater efforts are needed to ensure that enforcement at the national level is more coherent than is now the case.

### 3.4.1.3. Differences in national laws and practices

#### 3.4.1.3.1. Taxation

Whilst the Commission is correct in saying that double taxation agreements exist in most instances, this is not the case for all Member States, with two being particularly deficient in this regard. Nevertheless, it is apparently the lack of information about national peculiarities rather than the differences themselves which cause problems.

This deficiency is something that the Commission might consider addressing through the drawing up of a comprehensive guide, or encouraging its production.

#### 3.4.1.3.2. Accounting standards

The Commission view that these do not create a major problem is endorsed, although it would be helpful to analysts, who are the source of much public information on companies, if more accounts were prepared in accordance with international accounting standards. This is, however, something for stock exchanges to deal with through internal rules, not the European Commission. For this to work effectively, however, some Member States will have to amend national legislation, as already agreed in principle, in order to permit companies to use international standards. It is understood this is something they have undertaken to carry out and they are urged to do so speedily.

#### 3.4.1.3.3. Corporate governance

3.4.1.3.3.1. A Europe-wide debate on what would be a necessary level of corporate governance standards appears to have value, but there must be doubts about any solution based on legal provisions, particularly given the difficulty in framing either a directive which could gain agreement in the Council, or sets of national rules that would be at all coherent.

3.4.1.3.3.2. An initial difficulty is to adequately define corporate governance. The definition adopted by Ernst & Young in a report drawn up for the Commission as: 'all the rules on functioning and control that govern corporate existence in a given historical and geographical framework' is extremely broad. An attempt to translate this into legislation, particularly at the European level given the under developed nature of even the most basic concepts of corporate governance in some Member States, could prove an extremely complex undertaking. A danger is that the flexibility management needs in a

fast changing business environment would be unnecessarily restricted, further handicapping Europe in its attempts to compete with the rest of the world.

3.4.1.3.3.3. Even codes of conduct have to have an element of flexibility if they are not to prove unduly onerous for the smaller private company. One European stock market already lays down certain basic principles of corporate governance which companies whose shares are admitted to trading have to meet and continue to meet:

- the Board of Directors must have at least two independent members (which excludes all executives or employees of the company or its subsidiaries, a shareholder with a beneficial interest exceeding 20 % and any individual having a relationship likely to affect their independence of judgement);
- a Remuneration Committee, composed entirely of independent directors and operating in line with the best international practices when setting remuneration and incentive packages for directors and executives, must be established;
- an Audit Committee, with a majority of members being independent directors, must also be created and maintained;
- all related party transactions must be reviewed on an on-going basis, using a body with an independent majority, such as the Audit Committee, which should also review situations where possible conflicts of interest appear to arise.

3.4.1.3.3.4. If other European stock exchanges were to make similar binding rules, corporate governance problems in respect of public limited companies, at least as far as the overall conduct of executive directors was concerned, would be largely overcome. Other problems may manifest themselves in the future. Given the relative newness of this subject, there could be merit in adopting a step by step approach, only attempting to deal with abuses as they arise, preferably by means other than legislation.

#### 3.4.1.3.4. Institutional investment

Two fundamental reasons for a lower volume of funding available for venture capital investment in Europe is that there are less fully-funded pension schemes in existence and where they do, considerable constraints on their investment policies exist in some Member States. It is believed that the creation of more such schemes will become essential given the demographic problems facing Europe in the next century and in order

to maximize their performance these funds will need to be able to obtain the higher returns obtainable from making significant venture capital investments. The Commission position, underlying the importance of institutional investment for the success of these markets and the need for the removal of outdated and unnecessary restrictions on investment by pension funds, is endorsed.

Pension funds should, subject to proper safeguards which are strictly supervised, have freedom to devise investment strategies which are in the best interests of the members of such funds.

#### 4. Other significant points requiring consideration

##### 4.1. *The restricted concept of the 'Regulated Market'*

4.1.1. The legal concept of the 'Regulated Market' only applies in the case of the Investment Services and Capital Adequacy Directives, not to any of the other EU directives on financial services. This has a number of potential consequences:

- i) It would appear that shares admitted to trading could actually be classified as unlisted securities under certain circumstances, even though they had to meet standards of regulation and transparency as strict, or stricter, than those imposed by an 'official' stock exchange.
- ii) Should the classification of 'unlisted securities' be applied, financial services firms may have to accord them a nil weighting when calculating solvency ratios, so restricting institutional investment.
- iii) Investment firms dealing in UCITS (Undertakings for collective investments in transferable securities) may, under the provisions of national law following on from Directive No 85/611/EEC, have to carry out a 'due diligence' investigation of the regulated market concerned before making any investments in shares traded upon it.
- iv) Directive No 88/627/EEC on the information to be published when a major holding in a listed company is acquired or disposed of does not apply. This could lead to a situation where a substantial holding could be built up in a company traded on these markets, with the acquirer having no obligation to inform either the company or the market concerned.

4.1.2. It is presumed that the Commission regarded the designation 'regulated market' to carry with it an

assurance of the reliability of such a market. When coupled with the stringent rules imposed on firms whose shares are traded upon it, it is clearly inappropriate for rules to apply, or be judged by regulators to apply, which are more stringent than those applied to 'official stock exchanges'. The Commission is asked to examine how this anomaly might be overcome.

##### 4.2. *The US experience*

4.2.1. Whilst there are major economic and social differences between the USA and the European Union, there appear to be lessons to be learned from the former which could improve the situation of SMEs, particularly financially, but also with regard to management consultancy. This could assist the creation of more new firms and therefore jobs.

4.2.2. To adopt new initiatives or adapt existing structures in the light of those lessons would not mean that the whole of Europe would become a hive of entrepreneurial activity. Many areas in the USA certainly do not warrant that description. Growth in innovative industries and services (demarcating the two becomes increasingly difficult) seems to be concentrated in centres of excellence, largely based either around academic institutions or in areas such as that west of Washington DC.

4.2.3. Part of the reason for the high levels of new firm creation in the US is cultural, with a spirit of entrepreneurship, independence and flexibility more common in the population. Trying to inculcate a more entrepreneurial spirit in Europe through the educational system, something which the Commission apparently intends to foster, will take time, at least a generation.

4.2.4. Public policy in Europe must be directed to facilitating the creation of new businesses and ensuring that there is a lower death rate among firms in their first five years of life than in the USA and that more are given the opportunity to grow to medium size.

4.2.5. The objective must be to give SMEs, particularly those that are new, access to assistance. How it is delivered, whether through government agencies, contractors, or otherwise is a matter of choice for Member States, preferably after consultation with the social partners. They should, however, ensure that the 'displacement effect' is kept to the minimum. That is, assistance should not be granted in such a form that it provides an unfair short-term competitive advantage.

## 5. Analysis of the Commission's conclusions

5.1. It is impossible to challenge the Commission conclusions as set out in the Communication, except to say that the process of achieving the objective of a genuine SME equity culture in Europe may be a long process. This will be less so given a new and positive commitment from legislators and national regulatory authorities to reduce unnecessary barriers. In particular, it is essential that innovation in the securities markets is not retarded, or even stifled, by regulatory problems. It must always be borne in mind that the main purpose of securities' laws and that of regulators is to:

- regulate the relationships between share dealer and client so that the latter is not treated unfairly or exposed to the risk of fraud;
- protect investors more generally against fraud and market manipulation.

5.2. It is not to try to guard them against market risk or to protect specific national market interests, something that will prove increasingly difficult to achieve in today's global financial markets.

5.3. The primary economic role of the equity markets is to channel passive savings into productive investments. What the investment firms cannot do currently is to ensure the optimum level of liquidity in the market because of the restrictive attitude of national regulators and legislators in regard to the approval of prospectuses, the definition of a public offer and what qualifies as a 'Euro-security' (see Article 3(f) of the Prospectus Directive 89/298/EEC). The Commission should ensure that this Article of the Directive is correctly implemented at the national level.

5.4. What Europe needs in order to maximize levels of firm and job creation, aided by efficient financial markets as in the USA, but maintaining its distinct social identity, is:

- a greater flow of good companies seeking admission to stock markets. This means increasing total business numbers; making sure they do not suffer shortages of finance; have access to informed busi-

ness advice; do not have their progress retarded by unnecessary regulatory burdens; and can legally protect their innovations more easily;

- the encouragement of a greater flow of investment into equity capital at all stages of company development;
- the availability of 'nursery' equity markets, probably at the regional level, from which companies can move to larger national and pan-European markets when they have reached an appropriate stage of development, as well as the utilization of the possibilities offered by the Internet; and,
- the reform of European securities regulation in order to promote greater transparency and competition and to allow the efficient operation of a truly pan-European financial services sector.

5.5. It is recognized that in each instance some of the Member States may already have perfectly adequate mechanisms to address the problem raised, whilst more are likely to be introduced as a result of the Extraordinary European Council on Employment held in November 1997. The objective of these recommendations is to encourage the development of an overall framework that facilitates SME development and the creation of new jobs in all parts of the European Union through filling the gaps in the support framework that remain. This, in turn, will have positive effects on overall economic prosperity in the European Union, considering that most companies are SMEs. The form in which measures are introduced will depend on the traditions and structures in each Member State.

## 6. Additional comments

6.1. The Committee welcomes the positive policy developments outlined in the Commission Communication 'Risk Capital: A Key to Job Creation in the European Union' <sup>(1)</sup>. It also notes that the vast majority of suggested initiatives follow the same approach as in this Opinion. In endorsing the views contained therein, the Committee asks to be consulted on the continued evolution of policy in this area.

<sup>(1)</sup> COM(98) 522 final.

Brussels, 27 May 1998.

*The President*  
*of the Economic and Social Committee*  
Tom JENKINS