# EC PROPOSAL
## for a Regulation amending MAR and the Prospectus Regulation as regards the promotion of the use of SME growth markets

# AMAFI's Feedback

Association française des marchés financiers (AMAFI) is the trade organisation working at national, European and international levels to represent financial market participants in France. It acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI's members operate for their own account or for clients in different segments, particularly organised and over-the-counter markets for equities, fixed-income products and derivatives, including commodities. Nearly one-third of its members are subsidiaries or branches of non-French institutions.

For over two years, AMAFI has been paying close attention to progress in the Capital Markets Union (CMU) initiative and within such initiative, to the proposals which aimed to support SME listing on public markets. AMAFI considers that the question of the listing of SMEs is crucial at the moment when Europe sees its model of financing the economy give a much wider place to market financing. The challenge is to allow companies to finance their development at different stages of their growth. And thus create value and jobs within the EU.

Having contributed to:

- the two European Commission (EC) consultations of May 2015 on its Green Paper on Capital Market Union (*AMAFI / 15-28*) and on the review of the Prospectus Directive (*AMAFI / 15-27*) in which a proportionate disclosure regime was proposed for small and medium-sized companies,
- the three ESMA consultations on Prospectus of September 2017 (*AMAFI / 17-61*) which included a consultation on the content and format of the EU Growth Prospectus *(ESMA31-62-649*),
- the EC consultation of February 2018 on "*Building a proportionate regulatory requirement to support SME listing*"(*AMAFI /18-12*),

AMAFI is now keen to give its feedback on the three following provisions of the "***Proposal for a Regulation of the European Parliament and of the Council amending Regulations (EU) n° 596/2014 and (EU) 2017/1129 as regards the promotion of the use of SME Growth markets***" (the "Proposed Regulation" or the "Proposal"):

- Article 1 (1) which concerns **market soundings**
- Article 1 (2) which concerns **liquidity contracts**
- Article 1 (4) which concerns **insider lists**.

In addition, AMAFI notes and regrets that the Proposal does not address the issue of the financing of research which is a key component to attract SMEs to public markets. The MiFID II qualification of research services as "inducements" which came into force at the beginning of the year is likely to weaken an already fragile economic research model for SMEs in the coming years.

## I. Feedback on Article 1(1) regarding market soundings

Article 1 (1) of the Proposed Regulation proposes to add a **paragraph 1a to article 11 of MAR** stating that:

***" 1.a** Where an offer of securities is addressed solely to qualified investors as defined in Article 2(e) of Regulation (EU) 2017/1129 of the European Parliament and of the Council*, communication of information to those qualified investors for the purposes of negotiating the contractual terms and conditions of their participation in an issuance of bonds by an issuer that has financial instruments admitted to trading on an SME growth market shall not constitute a market sounding and shall not constitute unlawful disclosure of inside information. That issuer shall ensure that the qualified investors receiving the information are aware of, and acknowledge in writing, the legal and regulatory duties entailed and are aware of the sanctions applicable to insider dealing and unlawful disclosure of inside information".*

**AMAFI fully agrees with this proposal** but only to the extent that it acknowledges that <u>communication of information to qualified investors for the purposes of negotiating the contractual terms and conditions of their participation in an issuance of bonds shall not constitute a market sounding</u> and shall not constitute unlawful disclosure of inside information. This statement is the accurate result of the analysis appearing in Recital (5) of <u>what is a market sounding</u>, as defined in Article 11 of MAR (i.e. what is the purpose of the communication of information in that case: "*gauging the interest of potential investors as regards a pre-defined transaction*") <u>as opposed to what is the purpose of the communication of information during the negotiation phase of a private placement of bond</u> ("*structuring and completing the entire transaction*").

**AMAFI disagrees however with the restriction** contained in the above **proposed Article 1a** which limits the consequence of the analysis mentioned above to issuers having financial instruments admitted to trading on an SME growth market. Of course, AMAFI understands that the scope of the Proposed Regulation is strictly confined to SME growth markets and companies listed on those trading venues but nevertheless **this restriction is not acceptable and not appropriate for the following reasons**:

(i) If the Proposed Regulation is strictly confined to SME growth markets, it proposes to modify a European Regulation <u>(MAR) which, by no means, is restricted to those markets</u>. Therefore, including a new paragraph (1a) in Article 11 of MAR setting a principle applicable only to issuers having financial instruments admitted to trading on SME growth markets could only be legally acceptable if – and only if – the justification for such special provision were specific to this type of issuer. BUT THIS IS NOT THE CASE.

(ii) Indeed other types of issuers (other than those having instruments traded on SME growth markets) are involved in transactions which <u>have exactly the same characteristics</u> (offer of securities addressed solely to qualified investors in which the communication of information to such qualified investors is also done for the purpose of negotiating the contractual terms and conditions of their participation in an issuance of bonds by the issuer). If the proposed Article 1a were kept as such, that would mean that for those issuers, such communication would implicitly be considered as a market sounding (or at least there would be a doubt for them.

This would make no sense both from a legal and operational standpoint:

- From a legal standpoint

As indicated above, since the analysis is rightly conducted on the basis of the nature and purpose of the communication of information in the negotiation phase of a private placement of bonds, and since the conclusion of the analysis is that it is not a market sounding, then a proposed added paragraph should necessarily apply to all types of issuers which enter into similar negotiation processes for the same goal of achieving a private placement of securities. Otherwise, how could it be legally justified that the same facts are not characterized as a market sounding for issuer A but are characterized as a market sounding for issuer B?

- From an operational standpoint

It should be recalled that in a 2017 report prepared by the BCG and Linklaters entitled "*Identifying market and regulatory obstacles to the development of private placement of debt in the EU*" and published by the European Commission in December 2017 (the Report), 3 pages were dedicated to the "*Regulatory Obstacle to the Further Development of the Euro PP Market"* identified as the uncertainty relating to the application – or not – of the market sounding regime to these transactions consisting in the private placement of debt with a negotiation process. The conclusion (on p. 149 of the Report) is as follows:

*"MAR in respect to market sounding rules needs to be clarified at EU level to confirm that Euro PP transactions (i.e. not a public or syndicated bond issue and not an EMTN) do not fall within the scope of article 11 and therefore that market soundings provisions do not apply to Euro PP transactions. Ultimately, market participants would like this issue to be addressed by a specific new piece of legislation.*

*This clarification is needed to be sure that the market sounding regime does not impede prospective investors to participate in the structuring of Euro PP transactions that can take several weeks or months to structure. There are other more appropriate risk mitigators that are applicable to Euro PPs to achieve the same goal: inside information (which may be communicated to potential investors during the negotiation of a Euro PP transactions) remains subject to MAR. What is more, Euro PP requires a formal non-disclosure agreement to manage any confidential and/or inside information shared previously to any exchange".*

This shows without doubt that the above "regulatory obstacle" applies **to all transactions consisting in a private placement of debt** – known in France as ***"Euro Private Placement or Euro PP***" transactions" and in the United Kingdom as "**European Corporate Debt Private Placement or ECPP"** transactions.

Therefore, it would be totally inappropriate (in addition to being legally wrong) to address this issue – moreover in a piece of European legislation (MAR) having a broad scope – only for one category of issuers, while the issue addressed concerns a much broader range of issuers. In fact this type of transactions is an alternative means of financing used by a variety of issuers, a significant part of them being outside the scope of the SME or SME growth market definition. Therefore, **any positive solution** to this difficulty **should be extended** to all private placements of debt when investors are involved in the negotiation**, irrespective of where the issuer concerned trades its financial instruments.**

<u>For the above reasons, AMAFI considers that **§ 1a of Article 11** of MAR, which Article 1(1) of the Proposed Regulation proposes to add **should be amended as follows**:</u>

*“ **1.a** Where an offer of securities is addressed solely to qualified investors as defined in Article 2(e) of Regulation (EU) 2017/1129 of the European Parliament and of the Council*, communication of information to those qualified investors for the purposes of negotiating the contractual terms and conditions of their participation in an issuance of bonds by an issuer ~~that has financial instruments admitted to trading on an SME growth market~~ shall not constitute a market sounding and shall not constitute unlawful disclosure of inside information. That issuer shall ensure that the qualified investors receiving the information are aware of, and acknowledge in writing, the legal and regulatory duties entailed and are aware of the sanctions applicable to insider dealing and unlawful disclosure of inside information.*

<u>For the same reasons, AMAFI considers that the proposed **Recital (5) should be modified** as follows</u>:

*(5) According to Article 11 of Regulation (EU) No 596/2014, a market sounding comprises the communication of information, prior to the announcement of a transaction, in order to gauge the interest of potential investors in a possible transaction and the conditions relating to it such as its potential size or pricing, to one or more potential investors. During the negotiation phase of a private placement of bonds, ~~SME growth market~~ issuers enter into discussions with a limited set of potential qualified investors (as defined in Regulation (EU) 2017/1129 of the European Parliament and of the Council and negotiate all the contractual terms and conditions of the transaction with those qualified investors. The communication of information in that negotiation phase of a private placement of bonds aims at structuring and completing the entire transaction, and not at gauging the interest of potential investors as regards a pre-defined transaction. **<u>Therefore it is not a market sounding and consequently market sounding rules should not apply to those transactions. Furthermore,</u>** imposing market sounding on private placements of bonds ~~can thus be~~ **<u>would be</u>** burdensome and act as a disincentive to enter into discussions for such transactions for both issuers and investors. In order to increase the attraction of private placement of bonds ~~on SME growth markets~~, it should be made clear that those transactions ~~should be excluded from~~ **<u>do not fall within</u>** the scope of the market sounding regime, provided that an adequate non-disclosure agreement is in place.*

<u>The reasons for the modifications proposed by AMAFI are the following:</u>

- As mentioned above, <u>all issuers</u> of private placements of securities with negotiation should be concerned by the proposed measure;

- Given that the legal analysis, mentioned above, of what is a “market sounding” under Article 11 of MAR leads, and rightly so, to the conclusion that, in a private placement of securities, there is <u>no market sounding</u>, the logical consequence can only be that Article 11 of MAR – which deals exclusively with market sounding – cannot apply to those transactions, whoever is the issuer;

- Consequently, it would be more accurate to state that those transactions <u>do not fall within</u> the scope of the market sounding regime rather than talk about “exclusion” or “exemption” which suggests that it is an exception to a general rule of applicability;

- Undoubtedly, the market sounding regime is burdensome and acts as a disincentive to enter into discussions for such transactions, but this is true <u>for all issuers and for all potential investors</u>, notably because of the very heavy obligations imposed on the “*persons receiving market soundings*” which have a deterring effect for the potential investors who might otherwise have been interested in entering into a negotiation process with the issuer with a view to concluding such a transaction.

This is the reason why it was indentified, notably in the Report mentioned above, as a "“*Regulatory Obstacle to the Further Development of the Euro PP Market”*, for all issuers and for all potential investors. And this is the reason why the EC's attention was brought to that situation and a clarification was/ is being sought. But the legal reason for the proposed §1a is not because the market sounding regime is burdensome but because, in the type of transactions described in such §, there is no market sounding.

## II. Feedback on Article 1(2) regarding liquidity contracts

**AMAFI fully supports the EC Proposal in so far as it recognizes the benefits of liquidity contracts**, as opposed to market making arrangements. As indicated in Recital (6), liquidity mechanisms are of two types: market making and liquidity contracts and there are benefits attached to the latter which are not attached to the former. Indeed:

- Market making is an activity carried out on the market maker's own funds. As such, this activity is based on the market maker's ability to generate a sufficient income in relation to the resulting risk in a context where the prudential cost of this activity has significantly increased since the financial crisis. This requirement has two consequences. The first one is that it increases the cost (which reflects the margin taken by the market maker to pay for the risk it takes) at which the investor can buy or sell the shares: The second consequence is the fact that the risk taken must be worth the cost. For shares with a low liquidity, it means that it will be very difficult for the market maker, unless it receives a very high remuneration – but this will not be attractive for investors – to cover the cost of its risk: in fact, the less liquid are the shares, the less interested the market makers are in trading in such shares. Ultimately, without active market makers to increase the liquidity at an acceptable price for investors, it is the cost of capital for issuers which is higher;

- Liquidity contracts are based on different principles. As indicated in Recital (6), "*A liquidity contract involves a contract between an issuer and a third party who commits to providing liquidity in the shares of the issuer, and on its behalf*". To carry out its mission, the third party – a market member – deals with funds and shares made available to it by the issuer. As such, it does not support any financial risk on its own funds: It must be careful to use the assets entrusted to him in the best way to increase the liquidity on the market, while ensuring that it can act over the long term, and of course this third party acts independently from the issuer from whom it receives no instructions.

  There are **several benefits attached to liquidity contracts**, as shown by a market study conducted by AMAFI:

  (i) The existence of a liquidity contract leads to a reduction in the volatility of stocks, by more than 25% for stocks with a free float below EUR 200m, and in the region of 10% for stocks with a free float between EUR 200m and EUR 5bn,
  (ii) The existence of a liquidity contract leads to a reduction in the bid-offer spread of stocks, by more than 50% for stocks with a free float below EUR 200m, and in the region of 20% to 40% for stocks with a free float between EUR 200m up to EUR 5bn,
  (iii) Market making agreements do not provide such benefits in terms of volatility and bid-offer spread reduction, especially for SMEs.

**AMAFI disagrees however with three aspects of the EC Proposal**:

(1) The Proposal should not be limited to issuers listed on SME growth markets

Indeed, if liquidity contracts are particularly important for issuers listed on SME growth markets, they are useful for all issuers irrespective of their capitalization and certainly for a large variety of issuers which are not "SMEs" as defined in MiFID and/or are not listed on an SME growth market[1]. It would be very detrimental to such other issuers and to the liquidity of other markets to restrict the proposed measure to SME growth markets as this would be a sign that the authorities consider that liquidity contracts are not important for other types of issuers and other markets.

As mentioned above in relation to market soundings, if the Proposed Regulation aims only at promoting the use of SME growth markets, in fact it proceeds by way of amendment to a piece of European legislation (MAR) which has a much broader scope. Therefore, inserting a provision applicable only to issuers having financial instruments admitted to trading on SME growth markets in MAR could only be legally acceptable if – and only if – the justification for such special provision were specific to this type of issuer. This is not the case either for liquidity contracts.

(2) The proposed template should only apply to liquidity contracts which are not entered into in the context of a national accepted market practice

AMAFI fully agrees with the objective pursued by the EC as mentioned in Recital (6) which is to enable the issuers concerned to "*enter into a liquidity contract with a liquidity provider* ***in another Member State in the absence of an accepted market practice*** *established at national level. The Union framework on liquidity contracts…* ***should however not replace but rather complement existing or future accepted market practices****. Competent authorities should* ***keep the possibility to establish accepted market practices*** *on liquidity contracts to* ***tailor their conditions to local specificities*** *or* ***to extend such agreements to illiquid securities other than SME growth market shares****".*

However, AMAFI considers that the Proposal is not fully in line with this objective. In fact, it contradicts this objective when it provides in the proposed paragraph 12 that the said issuers shall be authorized to enter into a liquidity contract provided all of the conditions listed thereafter are met, including the compliance with the new template mentioned in (b) and in paragraph 13.

Indeed:

EITHER a liquidity contract is established pursuant a national accepted market practice and in such case, it must comply with such practice but should not have to comply with the proposed template. It should be recalled that compliance with the national accepted market practice implies necessarily that the criteria set out in Article 13 (2) of MAR are met but it should be noted that the EC recognizes also that such national practice allows Member States to "*tailor their conditions to local specificities or to extend such agreements to illiquid securities other than SME growth market shares*";

OR, "*in the absence of an accepted market practice established at national level",* issuers will nevertheless be able to enter into liquidity contracts established "*in accordance with the template*" referred to in paragraph 13, as the purpose of such template is "*not to replace but rather complement existing or future accepted market practices****".***

[1] For instance, in France, out of the 414 liquidity contracts presently in effect under the accepted market practice, roughly 55% concern issuers, excluding very large caps, with an average market capitalization above EUR 200,000,000 and/or which are listed on the regulated market.

From a legal standpoint, that means that the condition mentioned in paragraph 12(b) (i.e. the liquidity contract must be established in accordance with the new template mentioned in paragraph 13) should not apply to the liquidity contracts entered into pursuant to a national accepted market practice.

Consequently, AMAFI proposes that paragraphs 12 and 13 be amended as follows:

"12. "***In the absence of an accepted market practice established at national level***, *an issuer ~~whose financial instruments are admitted to trading on an SME growth market~~ shall be authorized to enter into a liquidity contract……..".*

13. "*In order to ensure……setting out a contractual template to be used* ***in the absence of an accepted market practice established at national level*** *for the purposes of entering into a liquidity contract to ensure compliance with the conditions set out in Article 13…."*

In addition the word "SME growth market" should be removed each time it appears in each of these two paragraphs.

(3) The principles applicable to such template should be defined at Level 1 and not left to ESMA to propose

Indeed AMAFI is worried to see that it is planned to give ESMA the duty to develop draft implementing technical standards on the basis of which the EC will issue a delegated regulation.

So far, ESMA has not demonstrated a sufficient understanding of the issue at stake, particularly with regard to the economic issues involved and to the benefits of a liquidity arrangement for the issuers concerned and for the market. The reason for that is probably that (i) because the structure of their financial market place, 24 NCAs have no clear idea of the various positive aspects of liquidity contracts or have a strong interest in supporting the market making model in effect in their country and as a result consider that they have no real need in that respect, and (ii) for the remaining four authorities, only one (France) has developed this technique with real intensity for a long time.

The best example of the resulting lack of understanding of the issue at stake is the Opinion (*ESMA70-145-76*) ESMA has issued on 25 April 2017 which, following only a legal approach, does not take into consideration the economic aspects of the practice. In spite of the fact that, strictly speaking, this Opinion is not binding, in practice it has *de facto* very damaging consequences since departing from the *criteria* imposed, even with no legal basis, in such Opinion (the limits regarding volume, price and resources) leads to a negative opinion regarding the market practice concerned.

AMAFI believes therefore that if a mandate is given to ESMA to develop such implementing technical standards, the framework for such template – i.e. the principles on which such standards will be proposed, should be set at Level 1 by the Commission so as not to leave too much freedom to ESMA. In line with the objective stated in Recital (6) (and as mentioned above), it should be clearly stated that the proposed template should only apply in the absence of an accepted market practice established at national level, since it is recognized that such national practice may very well, with the general framework of MAR, tailor such practice to "*the local specificities*" of the market for which it is intended.

## III. Feedback on Article 1(4) regarding insider lists

AMAFI acknowledges the fact that insider list requirements are burdensome for issuers and other stakeholders and therefore understands the Proposal to replace the current alleviation provided by MAR to SME Growth Market issuers by a less burdensome "list of permanent insiders". However, this alleviation will only be granted to SME issuers and not to persons acting on their behalf or for their account ("*such as accountants, lawyers, rating agencies*" but that should also include investment firms advising such issuers on financial transactions with potential inside information) which shall remain under the obligation to draw up, update and provide to the NCA upon request their own insider lists in accordance with Article 18(1) to 18(5).

In that context, AMAFI believes that the Proposal would actually transfer both the burden and the liability solely on those persons (and first and foremost on investment firms), of drawing up those insider lists in lieu of SME issuers. This is unfortunate since the objective of MAR with insider lists was precisely to make the issuer responsible for managing the risks around the circulation of "its" inside information and will increase the liability and the obligations of investment firms when dealing with SME issuers, not to mention personal data issues they might face when they would add relevant staff from the issuer on the list.

Therefore, since insider lists seem to be considered as being not as relevant for SME Growth Market issuers, AMAFI would question why the requirement remains for the persons acting on their behalf or for their account and suggests to remove this part from the proposal text, as follows:

""*4. In Article 18, paragraph 6 of is replaced by the following:*
*"6. Issuers whose financial instruments are admitted to trading on an SME growth market shall be authorised to include in their lists of insiders only those persons who, due to the nature of their function or position within the issuer, have regular access to inside information.* ***Similarly,*** ***a****ny person acting on behalf of, or for the account of an issuer admitted to trading on an SME growth market issuer* ~~*remains subject to*~~ ***are exempted from the*** *requirements set out in paragraphs 1 to 5*."

In any case, that should not be an issue since the Commission noted in the context of the proposal that "*The impact on the capacity of National Competent Authorities to detect insider trading would be minimal as they rarely rely on insider lists in practice*". Incidentally, one can question the merit of such insider lists on a wider context of all issuers considering that affirmation.

## IV. THE EC should also address the research issue

The entry into force of MiFID II / MIFIR at the beginning of 2018 has considerably modified the economic model of the production of research or financial analysis for equity markets. The former and largely used "bundled model" (research fees are compensated together with execution fees) is no longer possible. Henceforth, research has to be paid by asset management companies independent of the transactions they carried out with their brokers.

It must be noted that under the previous regime, the coverage of SMEs was far from being satisfactory. As an example, for the French market (Euronext Paris) the average coverage (number of analysts) was the following in 2017.

| Market Capitalization | Average number of analysts |
|---|---|
| < 10 MEUR | 0.03 |
| > 10 MEUR and < 150 MEUR | 0.87 |
| > 150 MEUR and < 1000 MEUR | 2.96 |
| > 1000 MEUR and < 5000 MEUR | 9.2 |
| > 5000 MEUR | 20 |

*Extract from a Bloomberg data base*

There is a large consensus among issuers, asset management companies and research providers that, given the new rules, the total amount paid for research will dramatically diminish in the coming years and accordingly the supply of research. This will particularly affect the supply of research for SMEs because research providers will no longer be able to finance research on SMEs in a context where cross-subsidization (between large and small capitalizations, sectors of activities ..) is not possible.

However, research plays a central role to attract companies, and especially SMEs on public markets. Indeed, the return on equity required by investors (and therefore the cost of capital for the issuer) mainly depends on the quality of information available. This is particularly true for SMEs where information is more complicated to gather and to assess compared to larger capitalizations. Financial analysts are the main actors for providing information to investors. Moreover, secondary market liquidity, which is also a component taken into account by investors to evaluate the cost of capital, is linked to the coverage of an issuer.

According to a study made by three French academics who analyzed 583 French SMEs between 2000 and 2015, the correlation between the coverage and the cost of capital on the one hand, the coverage and the secondary market liquidity on the other hand is positive[2].

Given that, AMAFI considers that the “Proposal” should also comprise amendments to MiFID II in order to introduce more proportionality in the inducement regime, adapted to the SME Growth Markets.

[2] Rôle des analystes sur l’attractivité et la liquidité des PME-ETI (*Rapport auprès de l’Observatoire du financement des entreprises par le marché, 1er février 2018*).