# Primary and secondary equity markets in the EU

Executive Summary

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Written by Oxera Consulting LLP
*November – 2020*

**EUROPEAN COMMISSION**

Directorate-General for Financial Stability, Financial Services and Capital Markets
Directorate B - Horizontal policies
Unit B1 – Capital markets union

*European Commission*
*B-1049 Brussels*

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## Motivation and approach

The European Commission commissioned Oxera Consulting LLP to study the functioning of primary and secondary equity markets in the EU. The main objectives of this study are to contribute to the evidence base needed to further advance the Capital Markets Union (CMU), with policies that provide a better environment for listing of companies of different sizes by addressing potential economic and technical barriers related to the EU primary and secondary equity markets. Moreover, the study assesses the prospects for market development and considers the future architecture of EU equity markets.

For the study, we (Oxera) have collated original data, held and recorded structured interviews with a wide range of relevant stakeholders, analysed this material and identified its implications for a CMU, before developing a set of policy recommendations for the Commission.

Public equity markets provide substantial social benefits, offering an effective way to share risk and allocate capital efficiently between savers and borrowers. They discipline firms' valuations and organisational behaviour. Initial public offerings (IPOs) enable firms to raise funds as they grow, and offer an exit route for early-stage investors.

However, our analysis shows that Europe's public equity markets have fallen behind in global terms. Its markets are much smaller than those in the USA, despite having a similar-sized economy, and are smaller than Asia's markets when measured by market capitalisation relative to gross domestic product (GDP).

Given all this and the relative decline of public equity markets in the EU, we identify policies that can help their development, while remaining vigilant to the possibility that private markets could be more efficient in some cases. Most importantly, we identify the need to develop markets policy in the round rather than issue by issue. This is because measures designed to pursue one goal might impede pursuit of another goal. There are many trade-offs to consider and there are dependencies between primary and secondary markets. After analysing the primary and secondary markets in-depth, we suggest strategic paths for how the Commission might best deliver a CMU.

## Primary markets

Primary markets are a type of platform, on which the buyers and sellers are investors and investees in equities. Platforms need to attract buyers and sellers, and succeed as more buyers and more sellers join. Balancing the interests of investors and investees was therefore important in our analysis, which focuses on:

- regulation (section 3);
- reasons for listing and de-listing (section 4);
- economics of listing for small firms (section 5);
- cross-border listing in the EU (section 6);
- reasons why large unlisted firms may not seek to list (section 7);
- the IPO process (section 8).

Our analysis shows that the number of listings in the EU-28 declined by 12%, from 7,392 in 2010 to 6,538 in 2018, while GDP grew by 24% over the same period.[1] Large financial centres (Frankfurt, Paris and London) saw declines in listings. 8,000−17,000 large companies in 14 EU

[1] Oxera analysis based on data from stock exchanges—see section 2.8 of the main report.

member states are eligible to list but not seeking to do so.[2] We have been witnessing the partial eclipse of the public corporation.

**Key issue 1: what is driving the decline in listings?**

The decision to list depends on the net benefits to a firm of going public outweighing any negative impacts. The top benefits to listing identified in our analysis are the exit route for existing shareholders, facilitation of acquisitions, and access to additional equity. Listing also signals commitment to governance standards—hence many Asian and African firms list in the UK or USA.

Feedback from market participants indicates that the initial and ongoing costs of becoming a public company have risen considerably in recent decades, and widened the gap between public and private companies. The costs of listing are direct (fees) and indirect (agency costs, under-pricing, risk management, litigation, and regulation). We estimate the total financial cost to be in the region of 5–15% of gross proceeds, and typically more for those raising smaller sums. These costs matter, as we see in sections 4 and 5.

Increased M&A activity along with the development of private equity markets are identified as the major driving forces for the decline in listings. Data from the major EU exchanges indicates that delistings have predominantly been driven by increased M&A activity. Some of these delistings have been the result of acquisitions by already listed companies. However, there have also been delistings as a result of private equity firms acquiring listed companies and some technical delistings.

Even though regulation is not the primary driver of the decline in listings, there is room for future modernisation and streamlining of the listing rules. The regulatory costs associated with listing are particularly relevant for smaller issuers, for which alternative private funding options may be more readily available.

The main reasons cited in our issuer survey and structured interviews for voluntarily choosing to delist include the challenges associated with meeting regular financial reporting requirements; the time and cost associated with compliance and administration; annual fees paid to advisers, brokers and exchanges; and requirements to disclose sensitive information.

**Key issue 2: what can policymakers do to encourage EU listings?**

Firms not listing also brings social costs. Public markets exert market discipline on firms' valuations and organisational behaviour. They also support the democratisation of wealth creation; for example, while pension funds and insurers can invest in private companies, the general public typically cannot. As companies, especially in high-growth disruptive industries, choose to stay private for longer, investors limited to public markets miss out on an increasingly large part of the economy. Also, passive investors using indices have access to increasingly fewer companies, and, as a result, see smaller returns on their investments.[3] The key policy question is therefore: what can policymakers do to encourage the development of public equity markets in the EU?

First, we note that not all the drivers of the decline in listings are controllable by policymakers, and set these out in the report:

[2] Oxera analysis, based on Orbis data—see section 7 of the main report. The 14 member states are listed in section A1.3 of the main report. 8,000 excludes unlisted companies owned by corporates.
[3] See section 1.2 of the main report for more detail.

- readily available private equity funding;
- continuing low interest rates and the availability of low-cost, debt-based finance;
- tax issues, particularly the bias towards debt over equity in many countries;
- the complexity in disclosure documentation that is due to market practice (e.g. advisers trying to mitigate litigation risk) and increases investor search costs.

**Key areas for policymakers**

The study identifies five key areas for policymakers to consider.

1. **Revisiting the rules around disclosure to reduce the imbalance between private and public companies**—for example, by evaluating the incremental benefits of disclosure requirements for secondary listings, of quarterly and half-yearly reporting requirements, and of the private company exemption from Environmental Social and Governance reporting. As some reporting requirements are imposed by exchanges not by regulators, we note that there is a role for a co-ordinating authority such as the Commission, with the support of others, to ensure that the overall set of requirements is in the public interest. Policies to support the development of SME growth and other junior market segments are also important, as they reduce the minimum efficient scale for listing. We describe some of these in section 5.
2. **Encouraging flexibility in the use of dual-class shares** where national rules or practices prevent this. One approach is to allow dual-class shares on a time-limited basis, through sunset clauses, to encourage more family-owned firms to seek a listing on public markets. Among the 14 EU member states analysed in-depth in the study, 5,000 family-run companies above €50m in size remain unlisted[4]—this could be a significant source of new listings.
3. **Promoting institutional investor participation in IPOs**—by reconsidering regulatory costs or restrictions on pension funds and insurance companies, and possibly other financial firms, investing in public equity markets. The Commission's review of equity capital charges under Solvency II is important here. The Commission could also prompt member states to reconsider national restrictions on pension funds.
4. **Improving corporate governance standards to keep down agency costs**. Here, the appropriate policy response depends on the context. In countries where ownership is fragmented, the aim should be to reduce impediments to blockholder control. In markets where there is already concentrated ownership, the aim should be to prevent exploitation of outside shareholders. It is healthy to have competition between different forms of company ownership in the Single Market—policymakers should not take away all benefits of a family-run business, but should aim to stop expropriation of outside shareholders.
5. **Attracting retail investors, a potentially large source of capital, to invest in public equity markets**. Book-building has reduced the role of retail investors in IPOs, but policymakers could require book-builders to use technology to make a small proportion of allocations directly available to retail investors. This would not compromise price formation as it is driven by institutional investors. For smaller stocks, policymakers could explore whether lighter regulation could catalyse the development of investment vehicles focused on SMEs.

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[4] Oxera analysis, based on Orbis data—see section 7 of the main report.

### Secondary markets

Secondary equity markets are where investors buy and sell shares. A well-functioning equity market provides liquidity and a reliable price-formation process. These market functions allow investors to (re)allocate their asset holdings at low cost, enabling them to manage their financial risks according to their preferences. More efficient secondary markets also lower the cost of raising capital for issuers in the primary markets.

We find the following trends in trading activities in EU equity markets.

- Equity trading in the EU (including the UK) has been fairly stable.
- There is significant home bias in equity trading. A large share of the cross-border trading activity comes from other EU member states.
- Cross-border trading is mostly concentrated among stocks in large financial centres. Consolidation of some exchanges and the growth of alternative trading platforms has mostly occurred in Western Europe, while equity trading in Central and Eastern Europe has remained more independent, with the exception of Nasdaq Baltics.
- Insurers and pension funds account for 30% of domestic investment in large and mid-size financial centres, compared to 9% in small financial centres.

Our analysis indicates that increased competitive pressure has led to the following.

- Lower trading fees
- More choice for traders and investors

The benefits from competition have been felt mainly in the large and well-established financial centres. Smaller financial centres—such as those in Central and Eastern Europe—have not yet seen the benefits from new entry.

### Key issue 3: what can policymakers do to encourage EU equity trading?

Given the trends observed in secondary markets, we advise that policymakers embrace the choice and innovation taking place in equity markets, while being mindful of protecting price formation.

Our analysis indicates that, despite an increase in trading fragmentation, implicit costs of trading have not increased (i.e. market liquidity has not decreased). This is because traders have access to the necessary technology to search for the best available option to execute their trade. Although market depth has reduced, traders deal with this in a variety of ways to minimise market impact and implicit costs. However, it remains important to monitor liquidity, using a range of measurements (including implementation shortfall to capture market impact), on a regular basis across EU markets, to establish a well-rounded view of the development.

While there has been an improvement at the aggregate EU level, liquidity is still a major concern for SMEs and small financial centres. Two recent developments have further challenged SME liquidity: new rules on unbundling of trade execution and research fees may have a negative impact on small companies, which generally receive much lower research coverage than large ones; and the increasing popularity of passive investment (specifically ETFs) has benefited liquidity in large-cap stocks rather than small caps.

### Local capital markets

Our analysis indicates that most of the competition benefits from MiFID I have been felt in the large financial centres, rather than small financial centres.

The absence of larger pan-European CCPs operating in smaller financial centres makes it commercially less attractive for brokers to trade in stocks domiciled in smaller financial centres and for new trading platforms to enter.

**Key areas for policymakers**

Oxera's study identifies five key areas for policy focus specifically aimed at improving liquidity for SMEs and local capital markets.

1. **Investigating the role of the EIF and/or EBRD to act as an anchor investor to crowd in additional investment in each region**, and supporting the development of the local ecosystem for services, such as fund management, equity research, and IPO advisers.

2. **Attracting more institutional investment into local capital markets**: reviewing restrictions on their ability to invest in equity; investigating the commercial barriers to the adoption of indices in these markets; and requiring classification of the relevant countries as 'emerging' or 'frontier' to enable their inclusion in the relevant indices.

3. **Promoting open access and interoperability links between CCPs, or facilitating cross-border mergers at the market infrastructure level**, and more broadly, supporting the development of pan-European infrastructure and ecosystem.

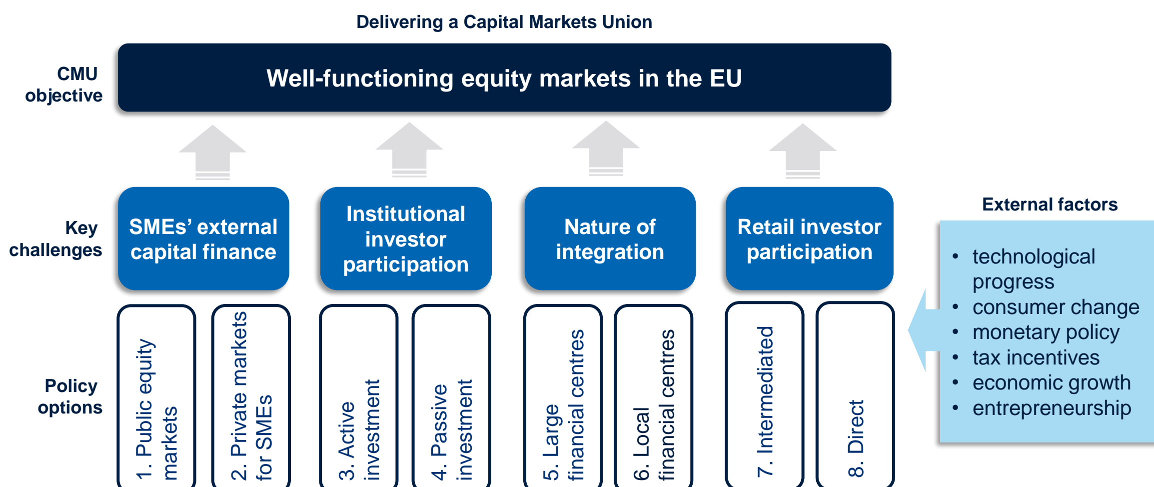
4. **Encouraging more investment in SMEs**: options include supporting the creation of fund structures to facilitate the investment of diversified pools of SME stocks; policies to promote the provision of equity research; and promoting the use of tax incentives for investing in small stocks.

5. **Strengthening corporate governance** to build public trust in equity markets and raise standards in jurisdictions where local requirements are in practice weaker.

**How might the Commission best proceed to deliver a CMU?**

We have identified four key challenges to achieving the delivery of a CMU. Each challenge could be addressed in a different way depending on the political direction of the EU. Combining each of the four key challenges with two alternative options for delivering the CMU results in eight possible development paths. Each path has different implications for the prioritisation of policy action, and there are important choices for the Commission to make in terms of which development path, or paths, to follow. This is discussed in detail in section 14. Some policies support more than one development path and may therefore have a high pay-off in terms of developing capital markets. However, it is not certain that these policies will produce the greatest net benefits overall. The Commission should consider the operation of the EU's equity markets in the round, to identify a set of policies that, overall, will produce a successful market design.

**Development paths to deliver CMU**




Source: Oxera.

Adoption of new technologies can improve market outcomes, and competition is a critical driver of that adoption. Therefore, the Commission's policies need to be tilted towards promoting competition wherever this will not entail major risks. Regulation needs to be flexible enough to allow the industry to benefit from the new technologies, keeping in mind the unique economic features of the market.

Events, such as Brexit and COVID-19, need not distract the EU from achieving its CMU vision. They might necessitate specific market-monitoring, but policymakers need to remain focused on ensuring that equity markets carry out their primary function of providing the finance to enable the European economy to flourish, and to calibrate any response to Brexit and COVID-19 in light of overall market data and other evidence.

The Commission should in any case launch an annual market-monitoring exercise using data on primary markets, SME access to funding, liquidity performance, levels of trading and post-trading integration. The wealth of evidence in this report can be used to select the most useful data. If the data indicates that markets are not growing or integrating, the Commission could launch an in-depth analysis of the relevant markets with a view to enhancing their functioning. In particular, the nascent equity markets in mid-sized and small financial centres would benefit from close monitoring, with high-quality data collected for future policy interventions if required.

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This study has been conducted by Oxera in cooperation with national and European trade associations, intermediaries, issuers, investors, financial market infrastructure providers, advisers, governments and the academic community. Assistance has also been provided by staff members of the European Commission, national financial services authorities and regulators, EBRD, ESMA and IOSCO.

Oxera is grateful to all the many people involved in the study, whose cooperation, contribution and dedication over several months have made it possible. Any errors, however, remain those of Oxera.

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Luxembourg: Publications Office of the European Union, 2020

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PDF ISBN 978-92-76-08003-9 doi:10.2874/833943 EV-02-19-413-EN-N

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