Do Investors Value High Levels of Regulation?

Tim Jenkinson and Tarun Ramadorai

SBS, OMI, Oxford, CEPR

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Abiding by corporate governance standards.
Having to seek approval or permission for corporate actions.

However, one can also think of regulation as limits on the flexibility that firms have to operate.

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Lightly (or privately) regulated market segments have become more popular: Alternative Investment Market segment in London; Alternext market launched by Euronext; First North, part of OMX.
High disclosure → fewer opportunities for managers to steal.
(Mahoney (1995), Shleifer and Wolfenzon (2002), LaPorta et. al. (2005))

But mandatory disclosure seems to provide little new information to shareholders. (Stigler (1964), Benston (1973), Jarrell (1981), Simon (1989), and Mahoney and Mei (2006))


But regulators don’t seem to prosecute foreign issuers even in blatant cases of tunnelling. (Licht (2001, 2003), Siegel (2005), Karolyi (2006) survey).

US markets captured 50% of global IPOs in late 1990s, but around 8% in 2006, post SOX. (Zingales (2006)).

But cross-listing premium on US markets seems unaffected by SOX. (Doidge, Karolyi, Stulz (2007))
The London Stock Exchange (LSE) has two market segments. The Main Market (MM) comprises companies that have satisfied the formal listing requirements of the UK Listing Authority (UKLA).

- A “Regulated Market” as defined by European securities laws.

The Alternative Investment Market (AIM) comprises companies that have not satisfied the requirements of the UKLA.

- Not a “Regulated Market” as defined by European securities laws, but rather an “Exchange Regulated Market”.

The two market segments have the same trading technology.
AIM Controversy

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### The Evolution of the AIM Market

<table>
<thead>
<tr>
<th>Year</th>
<th>Quoted Companies</th>
<th>New Admissions</th>
<th>Capital Raised (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>... of which International</td>
<td>Total ... of which International</td>
</tr>
<tr>
<td>1995</td>
<td>121</td>
<td>3</td>
<td>123</td>
</tr>
<tr>
<td>1996</td>
<td>252</td>
<td>17</td>
<td>145</td>
</tr>
<tr>
<td>1997</td>
<td>308</td>
<td>22</td>
<td>107</td>
</tr>
<tr>
<td>1998</td>
<td>312</td>
<td>21</td>
<td>75</td>
</tr>
<tr>
<td>1999</td>
<td>347</td>
<td>22</td>
<td>102</td>
</tr>
<tr>
<td>2000</td>
<td>524</td>
<td>31</td>
<td>277</td>
</tr>
<tr>
<td>2001</td>
<td>629</td>
<td>42</td>
<td>177</td>
</tr>
<tr>
<td>2002</td>
<td>704</td>
<td>50</td>
<td>160</td>
</tr>
<tr>
<td>2003</td>
<td>754</td>
<td>60</td>
<td>162</td>
</tr>
<tr>
<td>2004</td>
<td>1,021</td>
<td>116</td>
<td>355</td>
</tr>
<tr>
<td>2005</td>
<td>1,399</td>
<td>220</td>
<td>519</td>
</tr>
<tr>
<td>2006</td>
<td>1,634</td>
<td>304</td>
<td>462</td>
</tr>
<tr>
<td>2007</td>
<td>1,694</td>
<td>347</td>
<td>284</td>
</tr>
<tr>
<td>Total</td>
<td>2,948</td>
<td>485</td>
<td>31,223.6</td>
</tr>
</tbody>
</table>

Ramadorai (SBS, OMI, Oxford, CEPR)
Focus of This Paper

- Do equity investors value high levels of regulation?
- Focus on LSE firms that opted to switch from the MM to AIM, and vice versa.
- Chairman and Chief Executive of Arbuthnot Banking Group on decision to switch: “AIM... offers a lighter regulatory touch... it will provide some relief from the regulatory onslaught that is costing us £1.25m a year – a lot for a company whose profits last year were £5.5m.” (Financial Times, July 14, 2005).
- Decision to switch to AIM, until very recently, did not require shareholder approval.
- We examine the valuation impacts of the announcement to switch, and the post-switch returns of firms.
### Panel A: Admissions requirements

<table>
<thead>
<tr>
<th>Main market</th>
<th>AIM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum 25% shares in public hands</td>
<td>No minimum shares to be in public hands</td>
</tr>
<tr>
<td>Normally 3 year trading record required</td>
<td>No trading record requirement</td>
</tr>
<tr>
<td>Pre-vetting of admission documents by the UKLA, or another recognised EU authority</td>
<td>Admission documents not pre-vetted by Exchange or any listing authority</td>
</tr>
<tr>
<td>- admission takes several months</td>
<td>- admission can be achieved within 2 weeks</td>
</tr>
<tr>
<td>Minimum market capitalisation on entry (£700K)</td>
<td>No minimum market capitalisation</td>
</tr>
<tr>
<td>Sliding scale admission fees: e.g. £16K, £49K, £142K respectively for £10m, £100m and £1bn market cap at issue</td>
<td>Nominated adviser required at all times</td>
</tr>
<tr>
<td>Flat rate admission fee: £4K</td>
<td></td>
</tr>
</tbody>
</table>
### Panel B: Continuing Obligations

<table>
<thead>
<tr>
<th>Main Market</th>
<th>AIM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior shareholder approval required for substantial acquisitions and disposals</td>
<td>No prior shareholder approval for transactions</td>
</tr>
<tr>
<td>Sponsors needed for certain transactions</td>
<td></td>
</tr>
<tr>
<td>Companies are subject to extensive continuing obligations as required by the UKLA</td>
<td></td>
</tr>
<tr>
<td>Sliding scale annual fees: e.g. £8K, £8K, £20K respectively for £10m, £100m and £1bn market cap</td>
<td>Flat rate annual fee: £4K</td>
</tr>
</tbody>
</table>
Event Study

- Extract weekly data from Datastream for all switching firms.
- Do not consider firms with substantial accompanying transactions requiring shareholder approval (e.g., takeovers, reverse takeovers).
- News searches on all companies to identify the first announcement.
  - In the year prior to the actual switch date.
  - Factiva: newspapers, newswires, and the Regulatory News Service (RNS) of the LSE.
- Switch date sourced directly from the LSE.
Risk Adjustment

- Construct weekly RmRf, SMB, HML and UMD from stocks in FT-AllShare using Datastream.
- Risk adjust using betas estimated in pre-event year - separately for announcement and switch.
- Correct the betas for non-synchronous trading.
- Alternative risk adjustment:
  - Betas on both MM and AIM.
  - Simple market-adjusted returns using MM, AIM.
- Standard errors nonparametrically corrected for heteroskedasticity and cross-correlation in event time. Results robust to autocorrelation.
### Announcement Effects

Penalized (Rewarded) for Down (Up)

#### Panel A: Down Switchers

<table>
<thead>
<tr>
<th>Raw Returns</th>
<th>[-13,-2]</th>
<th>[-1,0,1]</th>
<th>[+2,+13]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cum. Raw Return</td>
<td>0.289</td>
<td>-5.393</td>
<td>0.160</td>
</tr>
<tr>
<td>OLS T-Statistic</td>
<td>0.115</td>
<td>-3.636</td>
<td>0.073</td>
</tr>
<tr>
<td>Cum. FTSE All-Share Return</td>
<td>1.238</td>
<td>0.145</td>
<td>1.581</td>
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#### Panel B: Up Switchers

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<thead>
<tr>
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<th>[-13,-2]</th>
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<th>[+2,+13]</th>
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<tbody>
<tr>
<td>OLS T-Statistic</td>
<td>0.931</td>
<td>1.777</td>
<td>1.892</td>
</tr>
<tr>
<td>Cum. FTSE All-Share Return</td>
<td>1.107</td>
<td>0.269</td>
<td>0.318</td>
</tr>
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</table>
CARs Following Switch - Down

Panel A: Down Switchers
Robustness Checks

- Remove [-1,0,1] weeks around every index deletion and addition during the announcement and switch periods.

Indices: FTSE AIM, FTSE Fledgling, FTSE Small Cap, FTSE All Share, FTSE 250 and Hoare-Govett Small Companies. Major small company indices in the UK.

Remove all firms with announcements of capital restructuring, share issuance, listing rule violations, acquisitions or disposals at any time during the event window.

Changes in taxation – tax treatment for AIM firms is different – redo results in each sub-period of differential tax treatment.

Changes in ownership – inspect institutional and individual ownership changes around switches.

No substantial changes in the results with any of these changes.
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Do we see this? Look at EBIT/Total Assets in event time.
Panel A: Down Switchers

Operating Performance - Down Switchers
Panel B: Up Switchers

Asset-Weighted EBIT/Total Assets

Fiscal Years in Event Time

FY(-2)  FY(-1)  FY(0)  FY(+1)  FY(+2)
### Forecasting ROA Improvements with the Bounce

<table>
<thead>
<tr>
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<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>OLS</td>
<td>WLS</td>
</tr>
<tr>
<td>ROA(Fiscal Year +2)</td>
<td></td>
<td>0.023</td>
<td>0.000</td>
</tr>
<tr>
<td>Intercept</td>
<td></td>
<td>0.178</td>
<td>0.126</td>
</tr>
<tr>
<td>ROA(Fiscal Year +1)</td>
<td></td>
<td>0.245</td>
<td>0.162</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3.749</td>
<td>3.562</td>
</tr>
<tr>
<td>ROA(Fiscal Year 0)</td>
<td></td>
<td>0.211</td>
<td>0.290</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2.348</td>
<td>4.760</td>
</tr>
<tr>
<td>ROA(Fiscal Year -1)</td>
<td></td>
<td>0.126</td>
<td>0.067</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1.720</td>
<td>0.945</td>
</tr>
<tr>
<td>ROA(Fiscal Year -2)</td>
<td></td>
<td>0.061</td>
<td>0.167</td>
</tr>
<tr>
<td></td>
<td></td>
<td>0.802</td>
<td>2.814</td>
</tr>
<tr>
<td>log(Market Capitalization) (Fiscal Year 0)</td>
<td>0.002</td>
<td>0.161</td>
<td></td>
</tr>
<tr>
<td>log(Market/Book) (Fiscal Year 0)</td>
<td>-0.002</td>
<td>0.007</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>-0.198</td>
<td>1.539</td>
</tr>
<tr>
<td>CAR in Announcement Week</td>
<td></td>
<td>0.298</td>
<td>0.213</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2.796</td>
<td>2.332</td>
</tr>
<tr>
<td>CAR in 12 Months Following Switch (Drift)</td>
<td>1.595</td>
<td>1.909</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>1.641</td>
<td>2.695</td>
</tr>
<tr>
<td>R-squared</td>
<td></td>
<td>0.422</td>
<td>0.407</td>
</tr>
<tr>
<td>Number of Observations</td>
<td></td>
<td>162</td>
<td>162</td>
</tr>
</tbody>
</table>
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- Even if these companies self-select to switch markets, this is important. Bottom line seems to be that we should let them; i.e. not impose heavy-handed regulation.
- Privatising regulation means regulatory ‘default’ is passed on:
  - "Oct 28, 2007: Nabarro Wells & Co has been fined £250,000 ($520,000) and publicly censured by the LSE. It said the fines were imposed because Nabarro Wells failed to undertake the necessary level of due diligence to assess the appropriateness of certain companies for admission to AIM; to make due and careful enquiry into whether certain AIM companies’ admission documents complied with the AIM rules on the appropriateness of certain companies for admission to AIM."