Do Investors Value High Levels of Regulation?

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- However, one can also think of regulation as limits on the flexibility that firms have to operate.
- For example, disclosure may be costly to comply with, or seeking shareholder approval for investment decisions could impose costs of delay on firms.

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- However, companies have been fleeing such regulatory burdens.
- Collapse of international listings in the US since the passing of the Sarbanes-Oxley Act; many US companies have chosen to float on non-US exchanges.
- 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.

The Debate - Disclosure Regulation, Cross-Listings

- 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))
- Cross-listing in markets with higher legal and regulatory standards means governance benefits for cross-listers → lower cost of capital. (Stulz (1999), Karolyi (2006) surveys).
  - 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))

London

One Market, Two Regulatory Standards, Same Trading Technology

- 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.

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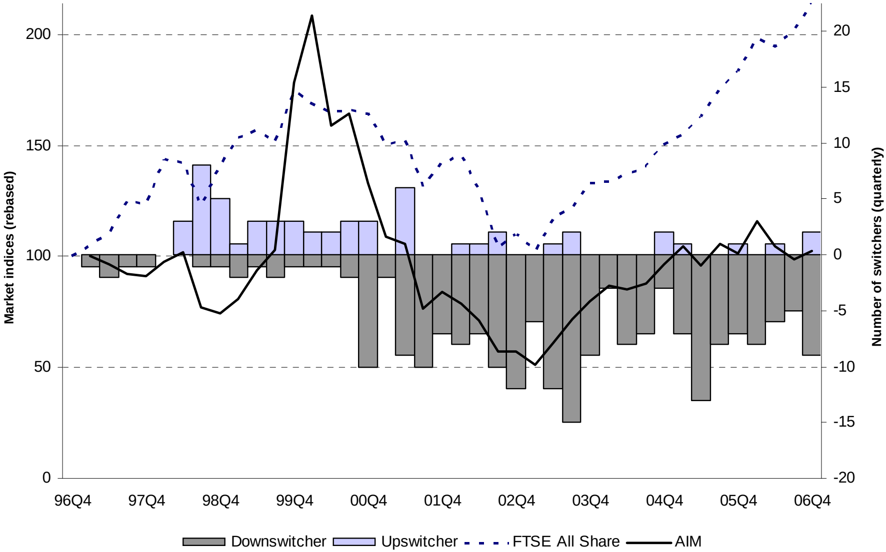
- Guardian, 2007. "London markets are said to have benefited from the regulatory regime in the UK which is not as stringent as the US where new rules - SOX - introduced after the collapse of oil company Enron are said to have become too burdensome."

The Evolution of the AIM Market

Year	Quoted Companies		New Admissions		Capital Raised (£m)		
	Total	…of which International	Total	… of which International	Initial Issues	Further Issues	Total
1995	121	3	123	3	69.5	25.3	94.8
1996	252	17	145	14	514.1	302.3	816.4
1997	308	22	107	7	344.1	350.2	694.3
1998	312	21	75	7	267.5	290.1	557.6
1999	347	22	102	6	333.7	599.8	933.5
2000	524	31	277	12	1,754.1	1,319.7	3,073.8
2001	629	42	177	15	593.1	535.3	1,128.4
2002	704	50	160	13	490.1	485.8	975.8
2003	754	60	162	16	1,095.4	999.7	2,095.2
2004	1021	116	355	61	2,775.9	1,880.3	4,656.1
2005	1,399	220	519	120	6,461.2	2,481.2	8,942.4
2006	1,634	304	462	124	9,943.8	5,734.3	15,678.1
2007	1,694	347	284	87	6,581.1	9,602.8	16,183.9
Total			**2,948**	**485**	**31,223.6**	**24,606.7**	**55,830.3**

Switching



Market indices (rebased)
Number of switchers (quarterly)
200
150
100
50
0
20
15
10
5
0
-5
-10
-15
-20
96Q4
97Q4
98Q4
99Q4
00Q4
01Q4
02Q4
03Q4
04Q4
05Q4
06Q4
Downswitcher
Upswitcher
FTSE All Share
AIM

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.

Regulatory Differences

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

Regulatory Differences

Panel B: Continuing Obligations

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

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)

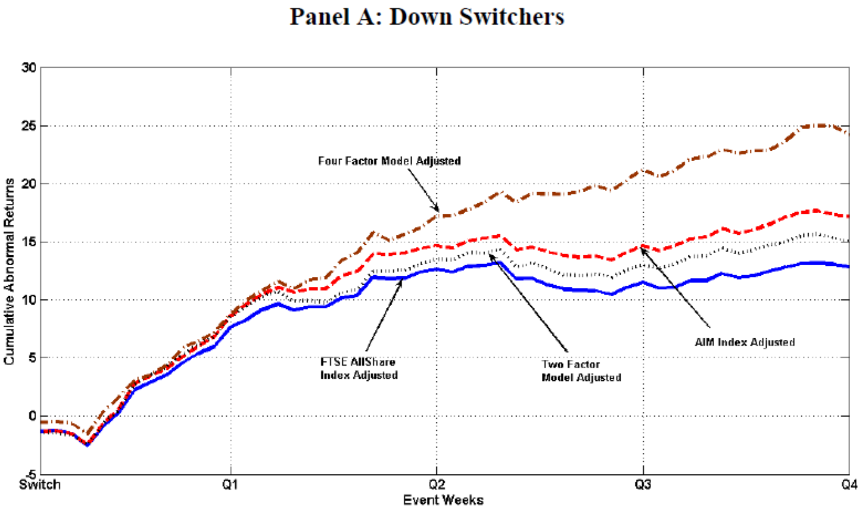
Panel A: Down Switchers

Raw Returns	**[-13,-2]**	**[-1,0,1]**	**[+2,+13]**
Cum. Raw Return	0.289	**-5.393**	0.160
OLS T-Statistic	*0.115*	*-3.636*	*0.073*
Cum. FTSE All-Share Return	1.238	0.145	1.581

Panel B: Up Switchers

Raw Returns	**[-13,-2]**	**[-1,0,1]**	**[+2,+13]**
Cum. Raw Return	3.990	5.363	9.828
OLS T-Statistic	*0.931*	*1.777*	*1.892*
Cum. FTSE All-Share Return	1.107	0.269	0.318

CARs Following Switch - Down



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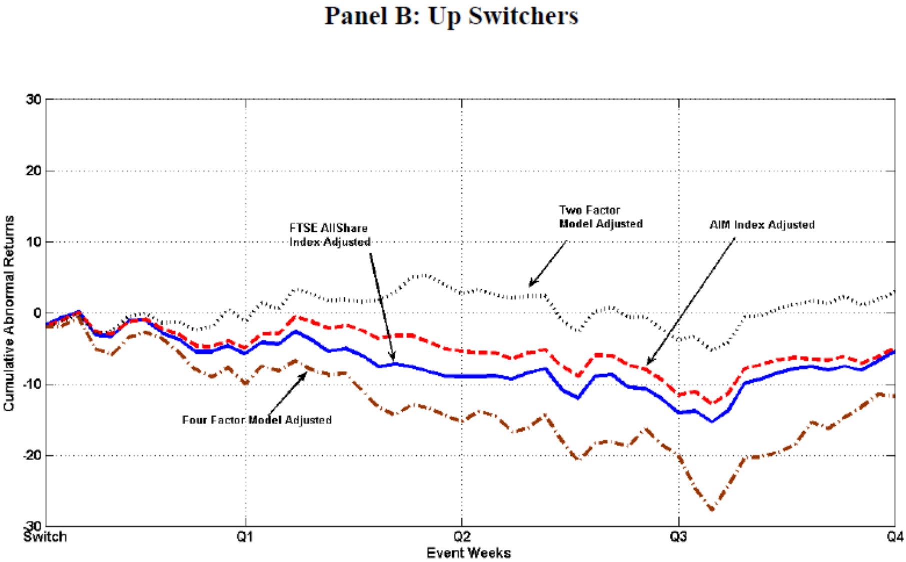

Robustness Checks

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

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- 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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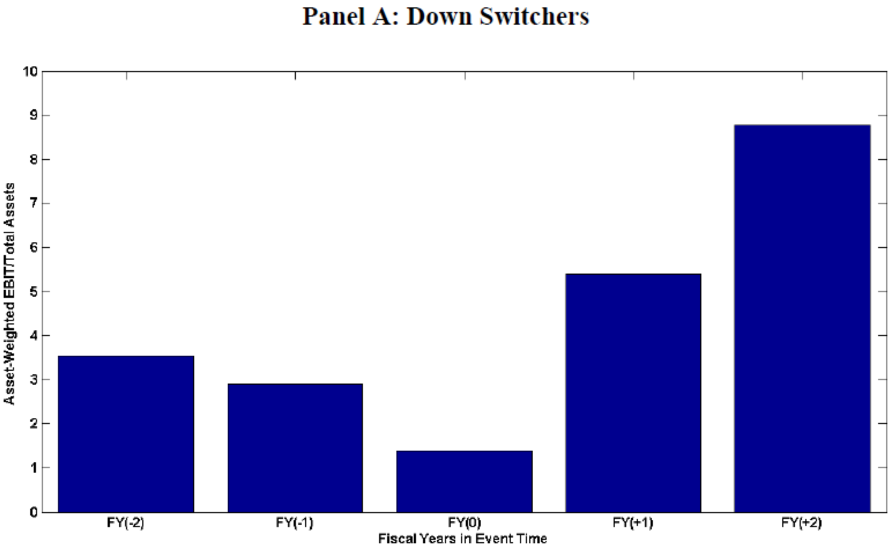
- Do we see this? Look at EBIT/Total Assets in event time.

Operating Performance - Down Switchers



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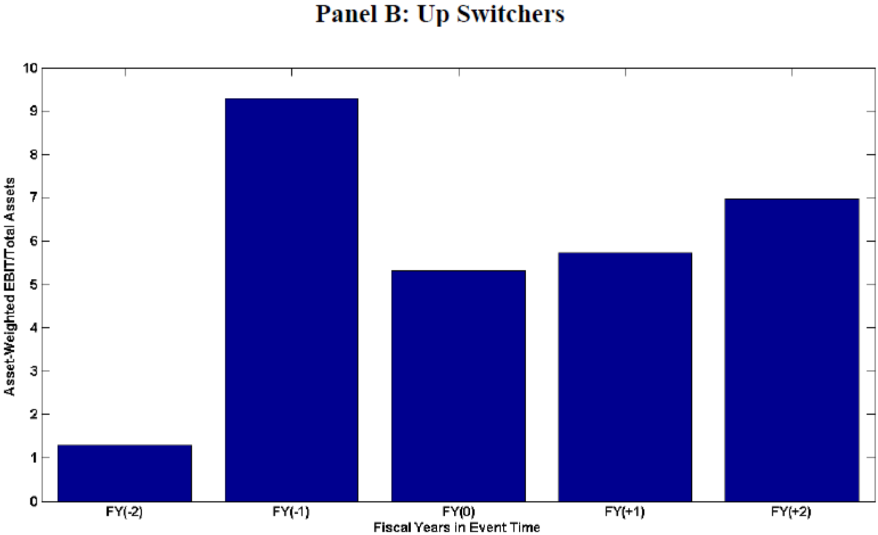

Forecasting ROA Improvements with the Bounce

	Down Switchers	
ROA(Fiscal Year +2)	OLS	WLS
Intercept	0.023	0.000
	0.178	*0.126*
ROA(Fiscal Year +1)	**0.245**	**0.162**
	3.749	*3.562*
ROA(Fiscal Year 0)	**0.211**	**0.290**
	2.348	*4.760*
ROA(Fiscal Year -1)	0.126	0.067
	1.720	*0.945*
ROA(Fiscal Year -2)	0.061	**0.167**
	0.802	*2.814*
log(Market Capitalization) (Fiscal Year 0)	0.002	
	0.161	
log(Market/Book) (Fiscal Year 0)	-0.002	0.007
	-0.198	*1.539*
CAR in Announcement Week	**0.298**	**0.213**
	2.796	*2.332*
CAR in 12 Months Following Switch (Drift)	1.595	**1.909**
	1.641	*2.695*
R-squared	0.422	0.407
Number of Observations	162	162

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- 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."