Corporate Governance and Fragmentation of Financial Markets: adapting to the emergence of the unregulated market

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1. INTRODUCTION

'A listing on a stock exchange used to be the solution for companies if they wanted to grow and generate equity. A listing, after all, meant better access to capital as well as attention from the financial world and the media. During the internet hype around the turn of the century companies waited in line for a listing. But at the moment the interest of small and mid cap firms to list on the Amsterdam stock exchange could – and this is a euphemism – be higher. The blue chips of tomorrow have basically not been coming to the stock exchange for years. And in my opinion this is how both companies and investors are missing chances. After the bursting of the internet bubble in 2001 and the financial crisis that followed a few years later, the stock exchange apparently lost its appeal. The transparency requirements for a listing became a lot stricter after the internet hype and various accounting scandals, such as Shell and Ahold. Of course one needs to protect the investor against such practices, but the need to create more rules has gone overboard a little, if you ask me. If this continues, there will soon be no more investors for small and mid cap firms, simply because there are so few of these companies that are willing to engage in a listing. For example, the prospectus requirements now resemble a compliance document more than an investment proposal. On top of that, the rates for small caps on Euronext are high. Together with the prospectus requirements, the costs of a listing is therefore simply too high for smaller companies'[1]

These are the concerned words recently voiced by a columnist in a leading Dutch financial newspaper. In his writing he calls for the stock market to become appealing again for potential listing companies. Stricter regulations that increase listing costs for companies have made listing on a stock exchange less attractive. He stresses that a listing on a stock exchange is close to unfeasible especially for small and mid cap companies because of the high costs involved. To the extent that for some companies access to public equity is simply not an option. If these strict regulations are at the core of the unappealing image of the stock exchange, one could logically reason that simply lowering the requirements would be a solution to this apparent problem. This did not go unnoticed in the financial world and in the past decade unregulated markets have made their appearance. These venues in the unregulated market, in the shape of Alternative Trading Systems (ATSs) and low tier listing venues,

[1] Maarten Hartog 'Maak van de beursnotering weer een ondernemers nirwana' (translated), Financieel Dagblad November 14th 2011. Available at: http://fd.nl/beleggen/columns/maarten-hartog/214299-1111/maak-van-de-beursnotering-weer-een-ondernemers-nirwana

provide a cheaper way to get access to public equity. It appeared to be that these new types of exchange venues became an attractive alternative for listing companies.

Facilitated by globalization and technological innovations the market for international listings is changing. Companies now have the ability to list on an exchange venue that is more suitable to their specific needs, without the limitations of a border. These developments lead to a competition between exchange venues, but there is also discussion over whether or not this leads to a regulatory competition between jurisdictions. The unregulated market is gaining in popularity by taking globalization and technological developments into consideration as well as the need for companies to raise capital while maintaining a healthy balance with the listing costs.

The aim of this paper is to establish to what extent Corporate Governance standards are applicable in the unregulated market and to establish a desirable Corporate Governance regime in the unregulated market. In order to come to these conclusions a thorough analysis will be made of the role of Corporate Governance in listing choices of companies. This will be done by analyzing academic literature on cross listing and Corporate Governance, as this will give an insight in the decision making process of listing companies. Following I will elaborate on market fragmentation and the reasons for market fragmentation. By doing so the emergence of the unregulated market can be explained. In order to gain a better understanding of the workings of the unregulated market, I will provide an analysis of low tier listing venues and ATSs. The final chapter contains an analysis of the application of Corporate Governance in the unregulated market and the Corporate Governance needs of the unregulated market. A connection will be made between the cross listing theories and the listing choices of actors in the unregulated market. Prior to my conclusion I will contribute to the ongoing discussion regarding regulatory competition in Corporate Governance with respect to the subject matter.

2. CORPORATE GOVERNANCE AND LISTING CHOICES

- **Corporate Governance in International Financial Markets**

Corporate Governance is of importance to financial markets in order to assure 'timely and accurate disclosure of relevant information to the market' which 'enhances investor confidence and thus contributes to the development of deep and liquid financial markets.[2] The

[2] J.M. Mendoza, p. 264

importance of Corporate Governance in the investment market is also stressed by the Organization for Economic Co-operation and Development (OECD). According to the OECD the interplay between exchange venues and Corporate Governance becomes evident in various ways. First of all the exchange venue on which companies decide to list determines the applicable Corporate Governance standards.[3] It needs to be noted here however that this is solely the case if one assumes that the connecting factor for the applicable Corporate Governance standards is based on where the company is listed. This means that the Corporate Governance standards of the exchange venue itself are applicable or the Corporate Governance standards set by the authority of the country in which the exchange venue is situated. Another connecting factor could be the country in which the company has its seat.[4] This was at issue in the Air Berlin PLC case. Air Berlin set up a British PLC with registered seat in the UK and de facto head office in Germany as full partner of the German KG. This new structure was considered to be a way to circumvent German Corporate Governance regulation which, under German law, only apply to German companies.[5] According to German law, the German Corporate Governance standards were not applicable as it used the seat of the company as connecting factor, whereas according to the UK the company was listed on a regulated exchange in Germany and therefore the UK Combined Code would not apply either. This lead to the undesirable outcome that Air Berlin was not subject to any Corporate Governance Standard at all. Regardless, Air Berlin still applies Corporate Governance standards. They voluntarily comply with the provisions of the UK Combined Code to a certain extent: '*However, the company has not complied with certain provisions of the Combined Code that are not required by German corporate governance standards and are not customary in the German market.*'[6] Even though it exceeds the scope of this paper discuss this case in detail it is important to keep in mind that using the exchange venue as connecting factor for the application of has not been fully adopted by every country. Thirdly, Corporate Governance plays a role in the exchange industry to the extent that the level of Corporate Governance standards corresponds with the degree transparency and shareholder protection. Roughly speaking, by lowering the Corporate Governance standards transparency and shareholder protection will decrease. The level of shareholder protection

[3] H. Christiansen, A. Kolderstova, p. 2

[4] Where the company has its seat is based on whether the company in question applies the real seat method or the incorporation method. However, this exceeds the scope of this thesis.

[5] Corporate Governance and Company Law News, available at http://www.worker-participation.eu/Company-Law-and-CG/News/Corporate-Governance-and-Company-Law-News12

[6] AirBerlin Annual report 2009, available at http://gb22.swberichte.eu/index.php?id=902&L=2

reflects the image of the exchange venue itself with regards to its credibility. The question that arises however is if the level of Corporate Governance standards is the key factor for companies when they decide to engage in a listing? I will discuss whether or not this is the case in a later chapter.

The aim of this paper is not to give an empirical analysis of what the effect is of strict Corporate Governance standards versus less stringent Corporate Governance standards on (cross) listing companies. The effect of stringent Corporate Governance standards on firms operating in different investment markets has been subject of previous research, therefore it is for now sufficient to take notion of the fact that good Corporate Governance is associated with high market valuation and operating performances.[7] However, it is necessary – with respect to the subject matter of this paper - to have an understanding of the academic debate and theoretical framework regarding Corporate Governance and the listing choices of companies. In the academic literature concerning Corporate Governance in international investment markets the point of discussion has mainly focused on why firms decide to list on a certain venue. Or more specifically, the debate has revolved around the question what the role of Corporate Governance has been in the decision making process of listing companies. This has been especially the case for firms that engage in cross listing as these companies choose a specific exchange venue for specific reasons as opposed to or in addition to their home stock exchanges. Below I will therefore elaborate on the role of Corporate Governance in cross listings.

- **Cross Listing**

This paper aims to make an analysis of Corporate Governance in the unregulated market. Since Corporate Governance regulation in the unregulated market is significantly less stringent than it is in the regulated market it raises the question to what extent Corporate Governance remains a deciding factor when choosing an exchange venue. In the past extensive research has been done on the role of Corporate Governance in cross listing on regulated exchange venues. Cross listing can be regarded as a strategic choice of a company to list its shares on a foreign exchange.[8] The overall assumption in academic literature is that strict Corporate Governance standards attract issuers, and thus also cross listing companies. Paradoxically, we now find an emergence of exchange venues with less stringent Corporate

[7] L.F Klapper, p. 723
[8] L. Gagnon and G.A. Karolyi, p. 1

Governance standards. Is there an explanation for this contradicting development or was the assumption on the role of Corporate Governance never true in the first place? An assessment the bonding theory, the signaling theory and the market segmentation hypothesis regarding cross listings may provide us with an answer.[9]

A company can engage in a cross listings through either an Initial Public Offering (IPO) or through a dual listing.[10] The main motives for cross listing are to gain access to a greater pool of capital, increase trading volumes and to be subject to better Corporate Governance rules to protect investors.[11] It is this last reason on which the academics focused when they developed the different theories. By means of a brief overview of these theories the decision making process of companies to list on a certain exchange venue can be assessed. This is of importance for the subject matter because in order to gain a better understanding of the role of Corporate Governance in this decision making process. Moreover it provides the basis for a later chapter to determine whether Corporate Governance is of equal importance to listing companies on the unregulated market.

Bonding theory

The bonding theory is based on the assumption that one of the main reasons for companies to cross list on a different market is to become subject to different, often stricter, Corporate Governance standards. By adhering to these higher standards, the cross listing company supposedly has more credibility and is therefore more attractive to investors.[12] J. Coffee, one of the main proponents of the bonding theory explains it as follows: '*by voluntarily subjecting themselves to higher disclosure standards and a greater threat of enforcement the partially compensate for weak protection of minority investors under their own jurisdiction's laws and thereby achieve a higher market valuation.'*[13] In other words, the choice of a company to list on a specific venue depends on the Corporate Governance regime. When companies engage in a cross listing there are legal implications regarding the laws and regulations they have to comply with because those are the rules in that country for that venue. This can be exemplified with the use of cross listings in the United States, since this is where the vast majority of cross listings take place. The legal implications for companies that cross list in the

[9] J. Coffee 2002, p. 1780
[10] L. E. Ribstein, p. 100
[11] L. Gagnon, G.A. Karolyi, p.2v
[12] J. Coffee 2002, p. 1757
[13] J. Coffee 2002, p. 1757

United States are three folded; first of all they become subject to the enforcement powers of the Securities and Exchange Commission (SEC), secondly investors can benefit from the available legal remedies of the United States that are far more accessible than in most other countries and thirdly, cross listing companies need to comply their financial statements with the Generally Accepted Accounting Principles (GAAP).[14] However, besides these legal implications, the cross listing company benefits most – according to the bonding theory – from the stringent Corporate Governance regulations. An exchange with strict Corporate Governance regulation is regarded as a system with a high investor protection, which supposedly attracts investors.

Signaling theory

Companies may decide to cross list in order to send out certain ‘signals’ to the market. The signal that the company wants to send varies. A company could signal by means of a cross listing that it has significant growth prospects for example.[15] In general one could say that the bonding theory is based on becoming subject to a different legal regime whereas the signaling theory is not necessarily.[16]

Market segmentation hypothesis

The market segmentation hypothesis is, as opposed to the bonding and signaling theory, based on liquidity. When a company cross lists abroad it naturally attracts more investors from that country. Due to increased analyst and media attention investors in the host country can be reached, which could also explain why companies from a country with a Corporate Governance system similar to the system of the host country would cross list in a different country anyway.[17] The market segmentation hypothesis also suggests that ‘cross listing may be an attempt to overcome barriers to cross-border capital flow that encourage market ‘segmentation’, or different prices in different markets.’[18] Market segmentation can be of importance to companies because a more dispersed ownership decreases the risks among investors.[19]

[14] J. Coffee 2002, p. 1780
[15] L. Ribstein, p. 109
[16] L. Ribstein, p. 111
[17] L. Ribstein, p. 111
[18] L. Ribstein, p. 111
[19] L. Ribstein, p. 111

For the scope of this paper it is of importance to take a closer look at what type of companies make use of cross listing. Empirical research shows that mainly major multinational companies cross list.[20] Also it is evident that the country in which most companies decide to cross list is the United States.[21] Even though cross listings do not take place as often as they used to anymore, the United States is still the main destination for cross listing companies. Bearing in mind the purpose of this paper it is important to note that the characteristics of cross listing differ significantly from international listings in the unregulated market. I will discuss this in a later chapter.

- **The decline of cross listings**

Cross listings have known a period of great success but this success has stagnated in the first decade of this century. The reason for the decline in cross listings is said to be the deregulation of the stock exchange industry. Deregulation caused an increase in international trading by making it easier for investors to own and trade in foreign stocks and easier for companies to offer their stocks on a foreign exchange.[22] Not only has the growth of cross listings stagnated, moreover, companies that were cross listed are now delisting from the secondary exchanges they were cross listed in.[23] It has been established that the lower costs of the unregulated market has altered the course of cross listings.[24] Simplified international trading, lowered the need for traditional cross listings. After all, companies could now trade internationally without being subject to the high listing and trading costs inherent to complying with the Corporate Governance standards of the new exchange venue. Without an official cross listing, the applicable Corporate Governance rules are not directly applicable to the company, yet the company does have access to a greater pool of equity. In other words: the advantages of a foreign market without the regulatory burden. The next question now becomes however what the importance is of Corporate Governance and what is left of the cross listing theories?

In the final chapter I will reassess the cross listing theories. By doing so it can be determined whether or not these theories regarding strict Corporate Governance standards are universally and indefinitely applicable. Moreover, if they are applicable to listings in the unregulated

[20] L. Ribstein, p. 100
[21] L. Ribstein, p. 100
[22] L. Gagnon, G.A. Karolyi, p. 1.
[23] L. Gagnon, G.A. Karolyi, p. 22.
[24] J.M. Mendoza, p. 263

market. Also when knowing how to factor in the importance of Corporate Governance into the listing choices of companies, it can be determined what type of Corporate Governance system is most suitable to the type of companies listing on the unregulated market.

3. FRAGMENTATION OF FINANCIAL MARKETS

In the last two decades the investment market has been subject to structural changes. These changes made a difference in the organization of the investment market, but also affected the Corporate Governance systems in the various markets and how Corporate Governance is enforced.[25] This changing landscape is characterized by trade fragmentation. Whereas the market used to be dominated by one or a few stock exchanges in each country the market now has diversified. Companies considering a listing on an exchange now have a plethora of venues to consider. All of which with its corresponding Corporate Governance policies.

- **Reasons for Trade Fragmentation**

Technological innovations have had a major influence on international trading. Besides that demutualization and therefore professionalization of exchange venues have had a tremendous impact on the landscape of exchange venues.[26] Below I will discuss the factors that have contributed to the fragmentation of the trade exchange landscape. Accordingly it can be established how this relates to the emergence of the unregulated market and the Corporate Governance regulation in these markets.

Technological developments

Several factors have lead to fragmentation in the trade market, so there is not one single cause for the changes in the exchange industry. However, the driving force behind the different factors leading to market fragmentation has been the rapid development in information technologies. This enabled cheaper and faster exchange services by means of electronic trading platforms one the one hand and simplified trading though electronic communications.[27] Technological innovations spurred globalization in general and, specifically for our subject matter, also the globalization and internationalization of trading. Paradoxically, this caused a decrease in cross listings, not because companies refrain from

[25] H. Christianssen, A. Kolderstova, p. 1
[26] H. Baum, p. 685
[27] H. Baum, p. 685

listing in another country, but instead because international trading and retrieving equity from foreign investors was now made possible without having to engage in a cross listing.

Demutualization

Demutualization is defined as follows: 'the process of converting exchanges from non-profit, membership owned organizations to for-profit, investor owned organizations.'[28] This leads to a fragmentation of the stock industry because the now publicly traded firms are forced to compete with a wide range of different trading venues.[29] Inherent to the demutualization of stock exchanges is the listing of a stock exchange itself. The potential conflict of interest with this development has been a concern among regulators.[30] This concern is based on the traditional role of a stock exchange as a regulator and monitoring compliance of listed companies with their own rules as well as with legislation and securities regulation.[31] Because of this ambiguous position of demutualized stock exchanges, various measures have been taken in order to minimize the conflict of interest. These measures include the seperation of functions of stock exchanges, where the regulatory and monitoring functions are carried out by a subsidiary of the stock exchange. This however does not entirely settle the issue as a subsidiary can not be regarded as indepenent.[32] Other jurisdictions have therefore opted for transferring regulatory and monitoring responsibilities of the stock exchange to independent regulatory bodies. An example of this is the Financial Service Authority (FSA) in the UK, which now bears the responsibility for listing and disclosure rules as well as enforcing these rules.[33] In a later chapter I go into further detail on the approach of the Alternative Investment Market (AIM) in the UK which relies on the private sector for regulatory and monitoring responsibilities.[34] .

With stock exchanges having an objective to make profit, they will need to find a way to become more attractive to potential issuers in order maintain their competitive edge. This competition could have an impact on the level of Corporate Governance. According to the OECD this is because '*the incentives faced by exchanges to establsih and maintain high regulatory standards might weaken as they weigh the risk of deterring listings altogether or*

[28] L. Gagnon, G.A. Karolyi, p. 23
[29] R. Macey & O'Hara, p. 564
[30] H. Christianssen, A. Kolderstova, p. 1
[31] H. Christianssen, A. Kolderstova, p. 4
[32] H. Christianssen, A. Kolderstova, p. 6
[33] H. Christianssen, A. Kolderstova, p. 13
[34] J. Gerakos, M. Long, M. Maffet, p. 2

losing them to competing market places.'[35] This implies, in my opinion, that stock exchanges take into consideration that listing companies favor lower listing costs over a stringent Corporate Governance regime. This is remarkable as this is contrary to the bonding theory.

Demutualization disproportionally affects small and mid cap firms, because '*as exchanges in Europe and the United Stated demutualize, their incentive structures adjust to a revenue-seeking model, excluding some risk-laden small firms seeking to raise low amounts of equity through a public issuance*'.[36] This means that besides the disproportionally high regulatory burden imposed on small and mid cap companies, it also becomes harder to get access to the regulated market because of the profit making objectives of demutualized exchanges.

Disintermediation

Disintermediation is a result of the technological innovations in the exchange industry. Traditionally the trade venues functioned as an intermediary between the investors and listed companies. The stock exchange was a physical place where stocks were traded. However, due to a revolution in the communications infrastructure, exchange venues now are not necessarily a physical place anymore. Rather, they are a virtual place where stocks can be exchanged electronically.[37] This disintermediation becomes evident in two ways. Disintermediation, not only results in traditional stock exchanges facilitating electronic trading, besides the traditional way of trading, it also results in electronic trading platforms actually replacing the traditional stock exchanges.[38] With this new form of trading, new exchange venues arise and the stock exchange as we know it loses its monopoly in the market, leading to a fragmented market.

Corporate Governance after Corporate Scandals: Sarbanes-Oxley Act

The structural changes discussed above made it possible for exchange venues to develop trading mechanisms that provided a platform for companies to engage in a listing without the heavy regulatory burden of the regulated market. Thus far the structural changes in the market have been discussed. However, besides the structural changes there have been other factors that have lead to a more fragmented trading landscape. One of these factors is the way

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[35] H. Christianssen, A. Kolderstova, p. 14
[36] J.M. Mendoza, p. 283
[37] H. Baum, p. 683
98-696-936
[38] H. Baum, p. 683

regulators responded to the corporate scandals in the beginning of the 21st century. In the aftermath of corporate scandals such as the Enron case in the US and the Parmalat case in the EU, policy makers rapidly developed strict Corporate Governance standards. The effect of stringent Corporate Governance standards can be exemplified with the effect of the implementation of the Sarbanes-Oxley Act (SOX) in the United States. There was an apparent need for a corporate equivalent of checks and balances in order to protect the investor. In the US, the Security and Exchange Commission (SEC) implemented SOX, including a set of stringent Corporate Governance standards, for listed companies in the regulated market. SOX put a significant strain on the listing costs of companies. Especially foreign listed companies in the US were at a disadvantage as the corporate structure of these companies often did not fit the mold that SOX was based on.[39] The implementation of SOX therefore made it far less attractive to list on a US market as the costs for complying with the stringent Corporate Governance standards increased. Listing on an exchange with a stringent Corporate Governance regime of course can be beneficial to a company as well. For some companies the benefits of a listing on a US market, such as market segmentation and a greater pool of equity and lowering the agency costs outweigh the increase in listing costs. For other, often smaller companies on the other hand, the high listing costs refrains them from listing on a venue with such restrictions. Consequently, the heavy regulatory burden mostly affects the small and mid cap firms. For these companies a listing on the unregulated market where they can gain access to equity and possibly a foreign market, yet without the high listing costs, could be a more suitable solution.

Assuming that the bonding theory is applicable to cross listings, one could continue to reason that Corporate Governance is indeed the key factor in deciding on what exchange to list their company. Building upon this assumption, it is not compatible that after the implementation of a higher regulatory burden cross listings would decrease. Especially with regards to foreign issuers, it is evident that SOX created an obstacle for potential issuers that many were not willing to overcome. It is too simplistic to state however that the implementation of SOX has been the main reason for the decline in cross listing and fragmentation in the trade market. As seen above, SOX was implemented in a time where a structural shift took place towards demutualization, deregulation and globalization. It is safer to say that all these factors combined have contributed to the decline in cross listings as well as to trade fragmentation.

[39] Coffee 2002 p 1764

4. THE UNREGULATED MARKET

- **Low Tier Listing Venues**

Lowering the Corporate Governance requirements and by doing so reducing the listing costs seems to be an effective way to attract new listing companies. Reducing the regulatory burden that listing companies would normally have to adhere to appeals to companies that have to bear the weight of the disproportionally high burden. It will always take a cost/benefit consideration of each individual company, but the companies affected the most with the higher regulatory burden are the small and mid cap companies.[40] De facto this may preclude them from listing on a traditional stock exchange. In some instances this can be seen as a direct result of the implementation of stringent Corporate Governance regulation such as in SOX, but there has been another development that accelerated the growth of the unregulated market. A decline in private equity funding caused what is referred to as a 'public equity funding gap'.[41] After the dot-com bubble at the turn of the century, the corporate scandals at the beginning of this decade and the financial crisis in 2008 it has been increasingly difficult for companies to be financed through private equity. This could explain why small and mid cap firms, which often used to be funded through private equity, now resort to public equity in order to get access to capital. The traditional stock market, however, mostly accommodates large multinational companies that can bear the high regulatory burden. Small and mid cap companies on the other hand may for this reason not be able to resort to public equity. Low tier listing venues therefore might provide the right platform for small and mid cap companies to get access to equity. An advantage of funding through public equity, as opposed to funding through private equity, is that companies will be less dependent on one or a few private investors. Public equity investors are likely to be more dispersed lowering the risk for investors, and at the same time creating a more dispersed voting climate which makes companies less dependent on one or a few investors, even though the number of investors on low tier listing venues are relatively low as opposed to investors on the regulated market.

The changes in financial markets urged the stock exchanges to adapt. Besides increasing Corporate Governance standards in the regulated market, stock exchanges also created Corporate Governance regimes tailored to small and mid cap firms: low tier listing venues.

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[40] J.M. Mendoza, p. 280

[41] J.M. Mendoza, p. 280.

The OECD explains the emergence of low tier listing venues as part of a stock exchange initiative to improve overall Corporate Governance.[42] Through low tier listing venues the stock exchanges seek to facilitate small and mid cap firms in order to provide them with access to public equity.

The low tier listing venues are a often subsidiary of a regulated stock exchange.[43] For example: NYSE AMEX is the low tier listing venue of the NYSE in the United States and NYSE Alternext is the European equivalent of NYSE AMEX in Europe. AIM, the Alternative Investment Market, is the unregulated counterpart of the London Stock Exchange (LSE). Thus far AIM is the most successful low tier market. Because of its success, AIM will be used in this paper to exemplify the functioning Corporate Governance in the low tier market. It unfortunately exceeds the scope of this paper to elaborate deeply on why specifically AIM has been so successful as opposed to its equivalents. Interrelated events that contributed to the succes of AIM are a successful marketing campaign, the growing importance of London as a financial center, an independent regulator (the FSA) and the ever increasing listing costs in the United States.[44] The LSE sought to accommodate actors on the unregulated by not imposing mandatory application of the UK Combined Code on AIM listed companies .[45] It would be wrong to state however, that the lack of a mandatory Corporate Governance regime means that companies do not have to adhere to any rules at all. Below I will elaborate on how AIM sought to protect its investors without the implementation of mandatory Corporate Governance regulation. First an assessment will be made of the regulatory system of AIM, followed by the Corporate Governance regime applicable to AIM-listed companies. In the end I will elaborate on what type of investors and what type of companies make use of AIM as opposed to actors on the regulated market and why this is of importance for the level of Corporate Governance regulation applicable in the low tier market.

Regulatory system

The regulatory system of AIM is an exchange based system and therefore self-regulated. The result of this is that it is not subject to European Union directives regarding Corporate

[42] H. Christiansen, A. Kolderstova, p. 10

[43] It exceeds the scope of this paper to determine whether or not there are low tier markets that are not a subsidiary of a regulated exchange.

[44] J.M. Mendoza, p. 287

[45] The Combined Code is the Corporate Governance code of the United Kingdom applicable to the regulated market.

Governance as these are mainly aimed at the regulated market.[46] Because of this AIM can remain its low regulatory system. As I have stated before, this does not mean that AIM does not impose regulatory obligations at all on its issuers. Traditionally low tier markets have had a poor reputation because of its history with fraud and low returns.[47] Therefore AIM sought a different approach in order to protect investors: '*the design of the AIM differs from most of these previous experiences in that its goal is not to reduce oversight, but largely to shift it to the private sector by enhancing the role of gatekeepers.*'[48] This allows AIM to maintain its low cost listings, because there is no standard set of rules that companies have to comply with in order to engage in a listing. The regulatory responsibilities are no longer supervised by the exchange venue itself. The responsibilities have transferred to a gatekeeper in the private sector that determines the specific Corporate Governance of the company. The rules can be accommodated to the listing company as opposed to the company having to adapt to stringent regulation. The gatekeeper thus has an essential role in the Corporate Governance system of AIM. The name of this gatekeeper is the Nominated Adviser, or 'Nomad'. The Nomad is a private party with a three-fold function in AIM's regulatory system: the Nomad is to act as a gatekeeper, adviser and regulator of the listing company.[49] AIM has been an exchange regulated market, meaning that it is regulated by its parent organization (the LSE), instead of by a national authority such as the FSA.[50] The LSE has created the regulatory structure of AIM, making it possible to delegate oversight of AIM firms to the Nomads. The Nomads then are given the responsibility to determine the level of Corporate Governance suitable for that specific company.[51] The Nomad is therefore a key actor in the Corporate Governance system of AIM. This raises the question who exactly acts as a Nomad in practice and why do they choose to do so. Nomads are often large firms such as commercial banks, investment banks or audit firms.[52] The reason these large firms choose to be a Nomad is first and foremost because they get paid to do so, but it has been established that the Nomad's role as a broker seems to be the greatest incentive for companies to become a Nomad. To the question what factors influence a company's decision to become a Nomad, a Nomad answered: '*The starting point is that we are generally only happy to become a Nomad if the company is looking to raise*

[46] Of which the MiFID is an exemption as this also regulated Alternative Trading Systems, for this application see the next paragraph.
[47] J. Gerakos, M. Long, M. Maffet, p. 3
[48] J. Gerakos, M. Long, M. Maffet, p. 3
[49] J.M. Mendoza, p. 295
[50] J. Gerakos, M. Long, M. Maffet, p. 4
[51] J. Gerakos, M. Long, M. Maffet, p. 4
[52] Firms that have performed the role of a Nomad in the past include: Merril Lynch, Goldman Sachs, ING, Citigroup, PWC, Deloitte and KPMG.

money. There is absolutely no point in becoming a Nomad to a company which we cannot raise money for. We then look at the company's management, its prospects and the market in which it sits. If we think the company is fundable, we are generally happy to act as its Nomad. Part of a Nomad's role is seen as effectively being bolted on to the company rather inherent in it, so that if the company is deficient in any way we can effectively deal with that by putting on the frills to attracts investors.'[53] The high importance given to the role of a broker as a Nomad puts the Corporate Governance aspect of being a Nomad in a different perspective. You could therefore wonder if the Nomad as a gatekeeper is a sufficient system of Corporate Governance for AIM companies.

The role of gatekeepers in Corporate Governance in regulated exchange venues has been criticized.[54] It has been argued that a the the oversight role is not suited for gatekeepers as they can never be entirely independent. Gatekeepers are hired and paid by the company that they need to supervise. In many cases these are large multinational companies and therefore major clients of the gatekeeper firm. This could put the gatekeeper in an ambiguous position. It has therefore been argued that gatekeepers are not in the position to take on this responsibility.[55] It needs to be noted here that this criticism came in the aftermath of corporate scandals such as Enron in which the accountant had neglected its role as a gatekeeper. The corporate scandals at the beginning of the century thus confirm the doubts about role of the gatekeeper. The role of the Nomad in the AIM regulatory system is not entirely free of criticism either, just as the role of the gatekeeper in the regulated market Corporate Governance system. Most of this criticism however has been rebutted with the argument that Nomads themselves bear the damages in case of misconduct.[56] The idea of making use of a Nomad is based on the assumption that the Nomad cannot afford to become subject to a reputational loss due to misconduct because they have lacked in their role as Nomad.[57] This assumption is confirmed by a company that acted as a Nomad: '*The things that spurs us on in regard to any company is our good name. The fact that we raise money for a client and it then explodes on us can be disastrous as a broker. Having that hanging over our heads is more likely to make us do our job properly because broking is our daily bread rather than anything the SE can throw at us.'*[58] Going by the stance of this Nomad, it would lead to believe that the

[53] C. Mallin, K. Ow-Yong, p. 80
[54] W.W. Bratton, p. 8
[55] W.W. Bratton, p. 7
[56] J.M. Mendoza, p. 295
[57] J.M. Mendoza, p. 296
[58] C. Mallin, K. Ow-Yong, p. 81

reputation of a Nomad is indeed a sufficient safeguard for the protection of a good Corporate Governance regime. However, given the past experiences with gatekeeper failure in Corporate Governance it difficult not to be at least a little skeptical.

Investors and listing companies

Earlier in this paper I noted that the type of investor and the type of company operating on an exchange make a difference in what Corporate Governance system is desirable on an exchange venue. Therefore it is of importance to take a closer look at what type of actors operate on the unregulated market. As has been stated, the low tier listing venues are to facilitate small and mid cap companies that are seeking public equity financing in order to grow. Concomitant to this is that the listing companies are often not fully ‘matured’ companies. This causes a risk for investors. First of all, since most listing companies on AIM are still at the early stages of growth, investors are not likely to see a fast return on their investment. Therefore, an investment in an AIM company hardly ever results in a short-term profit.[59] An investor therefore needs to be the type of investor that is able to bear this investment without the fast return. The second risk with AIM listed companies is that the investment bears a greater risk than an investment in a fully grown company.[60] It is for these two reasons that investors are often institutional investors and professional investment funds.[61] These institutions are often highly experienced and wealthy enough to bear a financial risk. Other than less sophisticated investors, these investment institutions often have the expertise to determine a company’s financial position and growth prospects, making a stringent Corporate Governance regime less of a necessity. It should be noted here that the vast majority of capital of large multinational companies on the regulated market is also held by professional investors, which could lead to argue that the regulated market would not need a stringent Corporate Governance regime either. However, in my opinion, this is not an argument to lower the Corporate Governance standards in the regulated market. With the fragmentation of financial markets the diversity among exchange venues increases providing a greater variety of platforms for investors for trading. The low tier market is a an alternative platform on which some investors conduct business by investing in a different market than the market on a regulated exchange. For some activities this might be the right platform for investors, whereas for other activities they prefer the protection of regulated market with a

[59] J.M. Mendoza, p. 298
[60] J.M. Mendoza, p. 297
[61] J.M. Mendoza, p. 297

more stringent Corporate Governance regime. It is for this reason why I do not believe that, even though both the regulated and unregulated markets are dominated by professional investors, the regulated market should be less stringent as well.

Corporate Governance

The LSE chose to accommodate small and mid cap companies by exempting AIM companies from mandatory application of the UK Combined Code. Therefore AIM is not subject to a mandatory Corporate Governance system. Herein lies its attraction, yet this has also been said to be a disadvantage of AIM, as it would lack investor protection. Also, from the perspective of the bonding theory, one could argue that this lenient Corporate Governance regime would not attract listing companies. The success of AIM proves both assumptions to be wrong. The lack of a stringent Corporate Governance system seems to be AIM's unique selling point and the areas that do call for investor protection are provided for by other means. I will go into further detail on this below.

The means by which AIM seeks protection for its investors are the above mentioned Nomad, and the fact that companies do not refrain from application of Corporate Governance even though it is not mandatory. The AIM company is not entirely free with regards to its governance structures, instead its Corporate Governane regime is determined by the Nomad and tailored for the company's needs.[62] The second reason why Corporate Governance is not entirely absent, even though there is no mandatory system, is because voluntary adoption of Corporate Governance standards. Because of market pressures AIM companies often voluntarily adopt the Corporate Governance provisions of the UK Combined Code.[63] This is due to the composition of the investor base. As seen above the investors in the unregulated market are professional investors that 'would not take an interest in a company lacking the necessary mechanisms to ensure adequate Corporate Governance'.[64] A voluntary system of Corporate Governance has been subject of debate in academic literature regarding the question of what would be a most desirable Corporate Governance regime. From this debate it can be derived that there need to be certain incentives for companies that will result in cost/benefit consideration in favor of adopting Corporate Governance standards.[65] These incentives include but are not limited to preventing investors from devaluating the company

[62] J.M. Mendoza, p. 314
[63] J.M. Mendoza, p. 313
[64] J.M. Mendoza, p. 313
[65] A.Anand, p. 18

and pre-empt a mandatory system of Corporate Governance.[66] Both of which incentives are indeed geared towards a cost/benefit analysis where adopting Corporate Governance principles lead to lower costs and higher benefits.

Besides the essential role of the Nomad and AIM companies voluntarily adopting Corporate Governance standards, AIM also plays an active role in accommodating both investors and listing companies with respect to Corporate Governance. Because AIM companies tended to voluntarily adhere to the Corporate Governance standards of the UK Combined Code, for reasons stated above, the absence of mandatory Corporate Governance started to defeat its purpose of keeping listing costs low. A set of tailored guidelines has therefore been developed. These guidelines called '*Corporate Governance Guidelines for AIM Companies*' were developed by the Quoted Company alliance (QCA).[67] These guidelines have been developed in order to provide a set of principles specifically for small and mid cap firms.[68]

- **Alternative Trading Systems**

Above I briefly mentioned the emergence of ATSs as a result of structural changes in the stock exchange industry. Technological advances have paved the way for the emergence of ATSs. An ATS is 'an entity which, without being regulated as an exchange, operates an automated system that brings together buying and selling interests.'[69]

The academic literature uses different names for these platforms, so it is useful to clarify this and distinguish between the different terms. Alternative Trading Systems (ATSs) is an umbrella term for all trading venues that are not a stock exchange.[70] A different term often used is the term 'Multilateral Trading Facilities' (MTFs), the term used within the European Union after the introduction of the Markets in Financial Instruments Directive (MiFID).[71] ATS is the Anglo-American term and MTFs is more often used within the EU.

'*ATS are facilitated by technological innovations and globalization: the electronic nature of ATS permits easy cross-border operation and access, particularly given advances in*

[66] A.Anand, p. 20
[67] The Quoted Companies Alliance (QCA) describes itself as: 'a not-for-profit trade organisation that works for small and mid-cap quoted companies in the UK and Europe to promote and maintain vibrant, healthy and liquid capital markets'
[68] J.M. Mendoza, p. 314
[69] H. Christiansen, A. Kolderstova, p. 20
[70] See appendix 1
[71] H. Baum, p. 684

communication technology.'[72] With this simplified way to acquire foreign equity and the deregulation in the exchange industry it comes as no surprise that cross listings are declining. The rapid emergence of ATSs can be illustrated by the fact that in Europe 22 percent of equity volume now is executed through ATS venues.[73] In the United States estimates are that as much as up to half of trading of NASDAQ listed stocks are handeled by ATSs.[74] The fact that an ATS is an entity that is not regulated as an exchange makes an ATS an exchange venue operating an unregulated venue. Consequently, the question becomes to what extent the companies that are trading on ATSs are or should be subject to a Corporate Governance regime. The complicating factor in answering this question lies in the nature of ATSs. Whereas traditionally there was a clear distinction between investment firms and stock exchanges, these roles are now becoming less distinctive because both are now providing electronic trading platforms to match companies with investors.[75] The difference in operation between a regulated stock exchange an off-exchange ATSs is that companies listed on an ATS are not subject to a listing process and are not regulated as a traditional exchange. The reason for this is that ATSs make use of technological innovations to match buyers and sellers without functioning as an intermediary. In this sense they differ greatly from the low-tier listings venues as the latter are actual stock exchanges functioning as intermediaries between buyer and seller. The services that both venues provide are therefore similar, yet the regulatory effects are different. Even though ATSs are not a stock exchange in the traditional meaning of the word, ATSs do trade stocks that are listed on a traditional exchange.[76] Whereas the attraction of the low tier market lies in the lower listing costs due to a lenient and tailor made regulatory system, the attraction of ATSs on the other hand lies in the low transaction costs.[77]

An often heard complaint from the regulated market is that ATSs can 'free-ride' on the Corporate Governance obligations of the regulated market, because they trade the same stocks. If it is indeed the case that ATSs free ride on the Corporate Governance system of the venue from which the stocks are derived then one could wonder if ATSs are really as unregulated as they are said to be. Clearly, there is no mandatory set of Corporate Governance rules that

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[72] A. Collins, p. 481
[73] Y.Brandes, I. Domowitz, p. 2
[74] H. Christianssen, A. Kolderstova, p. 20
[75] Consultative Paper: '*Proposed Standards for Alternative Trading Systems*', The Forum of European Secuties Commissions, June 11, 2011. Available at: http://www.esma.europa.eu/system/files/01_035b.pdf
[76] J. Coffee 2002 , p. 1818
[77] H. Christianssen, A. Kolderstova, p. 20

apply to companies listed on an ATSs, but the stocks in which they trade are stocks also traded on a regulated stock exchange. This means that the stocks of these companies have been subject to the Corporate Governance standards of a regulated exchange

This raises the question to what extent Corporate Governance standards are relevant for ATSs. In the literature regarding ATSs the emphasis is on regulating the actual ATSs, such as MiFID in Europe and the ATS regulation in the United States, because of its ever growing importance in the financial market. However, since ATSs merely facilitate trading in already existing stocks, the application of Corporate Governance for companies listed on an ATS seems rather irrelevant. It should be noted that this is in contrast with the low tier markets such as AIM. Even though the low tier markets and ATSs are both considered to be trading platforms operating an unregulated market, the application of Corporate Governanance standards is significantly different.

5. CORPORATE GOVERNANCE IN THE UNREGULATED MARKET

- **The applicability of Corporate Governance in the Unregulated Market**

Regulated exchange venues will always need to comply with the national securities regulation of their home country.[78] Consequently, the companies listed on the exchange venue tow which these securities regulations are applicable are directly subject to the Corporate Governance standards of these regulations. For example, in the United States the SEC is the regulatory body responsible for supervision of SOX. NYSE for example, a regulated exchange, can therefore not opt for a more lenient system than what is applicable to them according to the SEC. At the same token, the companies listed on NYSE can not opt for a more lenient Corporate Governance regime than provided for by SOX. Exchange venues that operate an unregulated market on the other hand are able to create a system more suitable to their target group of issuers. This provides the opportunity for the unregulated market to customize Corporate Governance standards in order to accommodate the needs of individual companies.

In a letter from the Director of Legal & Regulations of Euronext to the Monitoring Commission Corporate Governance in The Netherlands, Mr. G.M. Warringa expresses his point of view regarding this matter. In response to the question whether or not he considers it

[78] H. Christianssen, A. Kolderstova, p. 5

necessary to develop regulation that mandates a tailored, yet mandatory Corporate Governance regime for companies listed on the unregulated market. He answers as follows: '*No, the distinction between the regulated and unregulated market is clear. Investors can make a clear choice whether or not to invest in a specific market. When the choice is made to invest in shares in the unregulated market, they know beforehand that companies are subject to a different set of rules than companies on the regulated market. This is related to the reason why the unregulated market was set up. The goal of these markets is to provide access to public equity for small and mid cap companies without imposing the unnecessary and excessive regulatory burden. Adding an obligation to comply with a (simplified) Corporate Governance code would lead to higher listing costs of the company in question.'*[79] He continues his reasoning by making a comparison to the Belgian Corporate Governance regime in the unregulated market. In Belgium there is a Corporate Governance code for the regulated market as well as Corporate Governance regulation for companies that are not listed on the regulated stock exchange.[80] This includes companies listed on an unregulated market. The difference between these two systems is that the Corporate Governance code for the regulated market is mandatory and that the Corporate Governance code for all other companies are merely a set of guidelines and recommendations. This is comparable to the QCA guidelines previously discussed in this paper. According to Mr. Warringa, such an approach is worth considering for the Netherlands as well, as this would be more coherent with the way Corporate Governance is applied in the unregulated market in other countries.[81] If one regards Mr. Warringa's opinion as representative for the regulated market it could be said that exchange venues on the regulated market have no problem with low-tier markets being subject to low or no Corporate Governance regime. By targeting a different group of investors and issuers unregulated exchange venues are not likely to take away from the profit of the regulated market. This explains why the regulated market is opposed to a more stringent Corporate Governance regime on the unregulated market – it could take away from the listings on the regulated market. It should be taken into account however that Mr. Warringa, as a representative of Euronext has an interest in not burdening its low tier market Alternext with mandatory regulations. This could be different if the regulated exchange would not have

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[79] Letter of Mr. G.M. Warringa, Director of Legal & Regulations Euronext Amsterdam BV in response to remarks made by the Monitoring Commission Corporate Governance in The Netherlands. To be found at http://commissiecorporategovernance.nl/page/downloads/Reactie_Euronext.pdf Question 17, p. 6

[80] This Corporate Governance code is called the 'Code Buysse'

[81] Letter of Mr. G.M. Warringa, Director of Legal & Regulations Euronext Amsterdam BV in response to remarks made by the Monitoring Commission Corporate Governance in The Netherlands. To be found at http://commissiecorporategovernance.nl/page/downloads/Reactie_Euronext.pdf Question 17, p. 7

an unregulated subsidiary as the regulated exchange might lose issuers to a more competitive low tier market. From the point of view of a regulated exchange without an unregulated subsidiary, mandatory Corporate Governance in low tier market could be beneficial.[82] After all, when the listing costs on an unregulated exchange become higher, the unregulated exchange will become less competitive with the regulated exchange.

- **A desirable approach to Corporate Governance in the Unregulated Market**

National governments have the ability to decide whether or not they will create a mandatory Corporate Governance system for the unregulated market.[83] Whether there will ever be a more unified approach towards a multinational Corporate Governance regime, for example at EU-level, remains subject of debate. In the past it has been argued that cross listings would create a 'race to the top' as companies would seek a jurisdiction with the most favorable Corporate Governance regime.[84] Consequently this would lead to an 'ultimate' set of Corporate Governance rules. However, with cross listings declining and demutualization of stock exchanges, we have seen that financial markets become more fragmented. Corporate Governance regulations are no longer exchange based, but instead are being governed by regulatory bodies. In my opinion the fragmentation of financial markets could lead to a fragmentation of Corporate Governance rules instead as exchange venues become more diverse. Corporate governance standards may therefore also become more diverse as they will be tailored towards specific companies.

As far as the low tier market is concerned regulators are reluctant to apply mandatory Corporate Governance regulations. The main reason is because the low tier markets are developed to facilitate the small and mid cap companies. By keeping the Corporate Governance regime in these markets low, these type of companies will remain to have access to public equity as they will be subject to the high agency costs. However, a simplified code, functioning as guidelines, such as the QCA Guidelines in the United Kingdom and the more lenient Corporate Governance code for Alternext in Belgium, could create a more unified Corporate Governance approach among companies listing on the low tier listing venues. This would enhance clarity for investors, yet companies would still be able to keep listing costs

[82] It exceeds the topic of this discussion to investigate the regulated exchanges that do not have an unregulated subsidiary.

[83] Monitoring Commission Corporate Governance Code, Consultation Document 2006 to be found at: http://commissiecorporategovernance.nl/page/downloads/14087_NL_Consuldoc1.pdf, p. 40r

[84] J. Coffee, 2002, p. 1830

low because they could apply the guidelines according to their specified needs. It is not likely that companies are opposed to a set of guidelines as many already apply Corporate Governance standards voluntarily. The advantage of a set of principles is that it is more tailored for the small and mid cap companies operating on low tier listing venues. In order to determine whether or not this Corporate Governance climate is desirable, it is of importance to analyze the type of investor trading on these facilities and what level of protection these investors require. For the same reason it is important to know what type of companies make use of these facilities. This has been established in previous chapters. The type of companies listed on a low tier market are mainly small and mid cap companies with the need to get access to public equity financing. Whereas the investors on the other hand are large and professional, willing to take on the higher risk involved with investments in companies that have yet to grow. Overall, one could therefore say that all of the players on the low tier market - investors, listing companies and the exchange venue itself - benefit from a more lenient and flexible Corporate Governance regime.

With regards to ATSs, a stringent Corporate Governance regime remains redundant as the stocks that are traded on ATSs have already been under scrutiny of the regulated exchange on which the trading companies are listed.

The financial crisis in 2008 has made it apparent that even experienced investors are not invincible. Which could lead to believe that also institutional investors also need a high level of investor protection through more stringent Corporate Governance standards. This would be the case if Corporate Governance failure could be identified as the cause of the 2008 financial crisis. Previous research has shown that this is not the case.[85] I would not argue that professional investor do not need protection, instead I argue that investors have the option to choose from different trading venues and are therefore professional enough to determine the level of protection that the investment requires.

- **Reassessment of cross listing theories**

The most widely used cross listing theory is the bonding theory. It is based on the assumption that the deciding factor for companies to list on a certain exchange is that a stricter Corporate Governance regime provides them with a sense of credibility. The difference with the listings on unregulated market is remarkable. Even though technological developments have made it

[85] B.R. Cheffins, p.

possible for unregulated market to develop themselves, the driving force behind the growth of the unregulated market are simply financial considerations.

With regards to the emergence of ATSs one can say that Corporate Governance considerations were not the deciding factor for companies when they decided to trade their stocks on an ATS. This is because the applicable Corporate Governance standards to a company should not change once they trade their stocks on an ATSs. The lower transactions costs on ATSs are more likely to be of importance for companies. The bonding theory therefore does not seem to apply to the emergence of ATSs.

With regards to the low tier markets it can be concluded that they provide a cheaper alternative to access to public equity because of a less stringent Corporate Governance system. This suggests that the level of the applicable Corporate Governance system is still one of the main factors taken into consideration when choosing a listing venue, yet for entirely different reasons than the bonding theory states. Higher listing costs - concomitant to high Corporate Governance standards - are a reason for a company not to list on a certain exchange whereas a less strict Corporate Governance regime apparently does not refrain companies from listing on an exchange. The question becomes if this is the same for all companies. As we have seen before different types of exchange venues attract different types of actors. All different actors have different Corporate Governance needs. Due to the greater dispersion of ownership and less professional investors on the regulated market it would not be desirable to have a less stringent Corporate Governance system solely to attract more companies. Investor protection is still valued in these markets. It is therefore too easy to entirely dismiss the bonding theory. However, it would be ignorant to ignore the decline in cross listings and de-listings even though Corporate Governance has never been so strict.

Earlier in this paper the explanation for cross listing by means of the bonding theory was given: '*by voluntarily subjecting themselves to higher disclosure standards and a greater threat of enforcement the partially compensate for weak protection of minority investors under their own jurisdiction's laws and thereby achieve a higher market valuation*.'[86] This however dismisses the fact that companies list on an exchange in the first place to acquire public equity. Of course the aim is eventually to create a high market valuation, but the

[86] J. Coffee 2002, p. 1757

bonding theory seems to ignore the simple capitalistic point of view of companies: access to public equity for the lowest possible price. This point of view is supported by opponents of the bonding theory who state that 'Corporate Governance is a second order consideration' in cross listing.[87] Instead of becoming subject to higher Corporate Governance standards the dominant factors in the listing decision making process are indeed access to cheaper finance and enhancing the company's visibility.[88] The latter factor – as one might have noticed – is in line with the signaling theory, whereas the former defeats the bonding theory. With respect to the market segmentation hypothesis it can be established that, as far as the market segmentation hypothesis concerns access to a greater pool of investors, it is applicable to listings on the unregulated market. This is remarkable as it has been said in the academic debate that the market segmentation hypothesis is outdated.[89] Contrary to what the bonding theory suggests the attraction of the unregulated market is the fact that it provides a cheap alternative to get access to public equity.

The bonding theory assumes that by becoming subject to the stricter mandatory rules of – for example the Corporate Governance standards of SOX – a company sends out a sign of credibility. This has been stated as the reason why exchanges with a stringent Corporate Governance system have been so popular with cross listing companies. However in the case of the low tier market, companies send out the opposite signal, namely that they are not subject to high Corporate Governance standards.

Considering these arguments one could argue that the emergence of the low tier market – more specifically the reason of its emergence - is not compatible with the bonding theory. As cross listings are declining while Corporate Governance systems in cross listing countries are becoming more stringent, it is also probably safe to say that the bonding theory needs a serious reassessment. The market segmentation theory seems to be most applicable to the emergence of the low tier markets.

- **Regulatory Competition?**

The question whether or not demutualization leads to a regulatory competition yet remains unanswered. One could reason that when the regulatory responsibilities shift from the stock

[87] A. N. Licht, p. 142
[88] A. N. Licht, p. 142
[89] J. Coffee 2002, p. 1757

exchange to regulatory bodies, the stock exchanges have no power to make their regulatory system more competitive. Instead self-regulated exchanges are being by-passed by readily applicable regulation. A connection between cross listings and regulatory competition in Corporate Governance is still lacking sufficient evidence.[90] It has been argued in the academic debate that demutualization leads to a regulatory competition in Corporate Governance. Now that stock exchanges are geared towards making a profit the exchanges become inherently prone to competition. A more favorable regulatory system will most likely lead to more listing companies. That is however, if the regulatory system is indeed the deciding factor in the decision making process when choosing an exchange venue. As we have seen, however, is that financial considerations are at the forefront of the decision making process when a company engages in a listing. The emergence of the unregulated market could be a threat for the regulated market because they are now also demutualized and thus geared towards making profit. This would be the case if they would be competing for the same type of companies. It has been established however that that is not the case: the new low tier listing venues are not at competition with the regulated market for the same listings.[91] According to the OECD this should therefore not be considered as leading to a regulatory competition where Corporate Governance standards are becoming lower in general. Instead as the OECD states it can be seen as 'an adaptation of governance requirements to suit the size and type of prospective issuers, (…) exchanges may actually have improved the governance and transparency of small and medium size issuers, which might not have listed at all in the absence of such a preferential treatment.'[92] In other words, a lower Corporate Governance system in low tier market leads to an increased specialization of listing venues and not to a convergence of rules that would lead to a 'race to the bottom'.[93]
The emergence of ATSs is not likely to lead to a regulatory compeition, since companies already have to comply with the Corporate Governance standards that are applicable in the regulated market.

When a stock exchange makes the transition to become a public company, its main objective will be to make a profit. Naturally companies make profit by, among other factors, attracting clients. The clients, in the case of a stock exchange are other companies that list on that stock exchange. At the core of making profit is finding a way to attract new customers by being

[90] A. Anand, p. 15
[91] H. Christiansen, A. Kolderstova, p. 11
[92] H. Christianssen, A. Kolderstova, p. 11
[93] J.M. Mendoza, p. 274

more attractive than your competitor. One way for stock exchanges to create a competitive edge is to lower the regulatory burden and therewith the listing and trading costs for listing companies. This competition between stock exchanges has been the subject of an ongoing debate about whether or not this could lead to regulatory competition and if this should be the case whether it leads to a 'race to the bottom' or 'race to the top'. However, the academic debate regarding regulatory competition is often rebutted by the stock exchanges with the argument that companies need the regulatory function of the stock exchange in order to maintain or gain credibility with the investors. In other words, they rely on the bonding theory to ensure regulators that the Corporate Governance standards will naturally maintain their quality.

The fragmentation of financial markets, resulting in a growing role for the unregulated market with the low tier markets on the one hand and ATSs on the other hand, is not likely to lead to a regulatory competition among all different players. The reason for this being that with a wider variety of exchanges to choose from prospective listing companies will make a decision on where to list based on their needs. If markets stick to the Corporate Governance needs of their target group than this is likely to be the right Corporate Governance regime for that exchange venue. The venue with a less stringent regime simply attracts a different target group of prospective issuers. In my opinion this could therefore possibly lead towards an inter-market competition where different markets try to accommodate as many needs as possible, yet probably not towards a regulatory competition.

6. CONCLUSION

At the beginning of this paper I used an article from a financial newspaper in which a columnist called for the stock market to become attractive again for investors. As he stated, the market had become so unattractive because of its high regulatory system that it was almost impossible for small and mid cap companies to get access to public equity. The changing landscape of the stock market industry adapted to this need. In order to serve a broader target group stock exchanges face competition from different types of venues such as low tier listing venues and ATSs. In an ever competitive environment it is necessary to accommodate the needs of different types of companies and investors. Just like any other company needs to assess to the needs of its clients or customers. Demutualization has made it possible for trading venues to offer different services leading to a fragmentation of financial markets. The different Corporate Governance needs of companies urges trading venues to tailor towards these needs. It is remarkable however that the Corporate Governance needs of companies is mainly based on keeping costs low as opposed to wanting to subject themselves to a more stringent system.

As has been established, the unregulated market is not one single market. The unregulated markets that I discussed are the low tier listing venues and ATSs. Even though the low tier markets and ATSs are both considered to be trading platforms operating an unregulated market, the application of Corporate Governanance standards is significantly different.
As far as ATSs are concerned it can be said that Corporate Governance does not need to adapt as ATSs are merely trading platforms on which existing stocks are traded. The stocks traded in are also stocks that are traded on regulated exchanges, meaning that they have already been subject to Corporate Governance standards. With regards to low tier listing venues, based on an analysis of AIM, it is safe to say that Corporate Governance has adapted to the new situation. Corporate Governance in the low tier listing venues has a more individualized approach. This is facilitated by making use of Nomads, which determine a suitable Corporate Governance regime for the company in question. Even though the role of the Nomad as a gatekeeper has been subject of debate, it seems to be accommodate the needs of small and mid cap companies.

Diversification of stock exchange venues will lead to a greater diversity among listed companies, now that small and mid cap companies also have the ability to acquire public equity through the unregulated market. The fact that these companies are subject to a less stringent Corporate Governance regime than their regulated counterpart is not necessarily a negative development, in my opinion. Even though this is contrary to Corporate Governance practice of the past decade, when Corporate Governance standards became stricter and less flexible, I believe that this development could be beneficial to the overall market with enhanced possibilities in trading. This is based on the conviction that enhancing access to public equity should be the main goal of financial markets as opposed to the protection of investors being of greater importance. In my opinion therefore, in a world where financial markets are for profit companies and becoming more diversified, Corporate Governance standards should be tailored towards the needs of the actors on that specific venue.

APPENDIX 1

Box 1. Typology of alternative trading venues

Alternative Trading System (ATS). An ATS can be defined as an "entity which, without being regulated as an exchange, operates an automated system that brings together buying and selling interests – in the system and according to the rules set by the system's operator – in a way that forms, or results in, an irrevocable contract" (Committee of European Securities Regulators). ATS include a variety of platforms, including bulletin boards, crossing systems as well as quote-driven, order-driven or hit-and-take execution systems. Within this article, the term ATS is used as an umbrella description of all off-exchange trading venues, with the exception of systematic internalisors.

Multilateral Trading Facility (MTF). The term MTF became widely used following the introduction of the MiFID Directive. In broad terms, an MTF refers to a system that brings together multiple parties (*e.g.* retail investors or other investment firms) that are interested in buying and selling financial instruments. MTFs can be crossing networks or matching engines, which in accordance with MiFID regulations can be operated by either the operator of a regulated market or an investment firm. A license by a financial market authority is necessary for the operation of all MTFs in Europe. Examples of MTF platforms include Chi-X and Turquoise.

Electronic Communication Network (ECN). The term ECN, coined by the US Securities and Exchange Commission in 1998, refers to order-driven systems where the buy and sell orders of investors meet directly in an order book, either in a call auction or in continuous trading. In order to conduct trades on ECNs, subscribers (institutional investors, broker-dealers, and market-makers) place trades directly with an ECN. Individual investors must have an account with a broker-dealer subscriber in order to place trades on an ECN. Examples of major ECNs include Archipelago and Brut.

Dark Pool (DP). Dark pools are closed crossing networks which isolate orders from the broad trading and provide participants with liquidity not displayed on open order books. As a result, trades executed via dark pools are anonymous (both in terms of price and identity of participants), which is a useful feature for institutional investors who often wish to conduct large trades without revealing themselves to the open market. It is important to differentiate between different types of dark pools. As a matter of a fundamental distinction, some display quotes as part of their business model while others do not. Trade execution can take place either automatically or through a negotiation and may occur either throughout the day or at scheduled intervals. In terms of ownership, dark pools may be independently operated (*e.g.* Instinet), owned by broker-dealers (*e.g.* BNP Paribas) or a consortium of broker dealers (BIDS), or even the exchanges themselves (NASDAQ OMX).

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