ONE SIZE FITS ALL? INVESTOR PROTECTION REGULATION IN FINANCIAL MARKETS

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Traditional Economics View of Investor Protection Regulation (IPR)

- Firms have incentives to disclose information and act in investors' best interests
- Verification problems overcome by private enforcement of contracts
- IPT at best replicates, and possibly impedes, market arrangements

Alternative 'Law and Finance' View

- IPR reduces threat of minority shareholder expropriation and so encourages market participation
- Financial development and economic growth facilitated by IPR

"*Financial markets do not work well when left to market forces alone*"

[LaPorta, Lopez-de-Silanes and Shleifer, JF 2005]

IPR Dispersion *within* Countries

- **IPR Debate has taken place at the country level**
- **Focuses on relationship between international differences in IPR and major stock market development**
- **But many countries have multiple capital 'markets'**

'One-size-fits-all' IPR?

Intra-country Differences in IPR

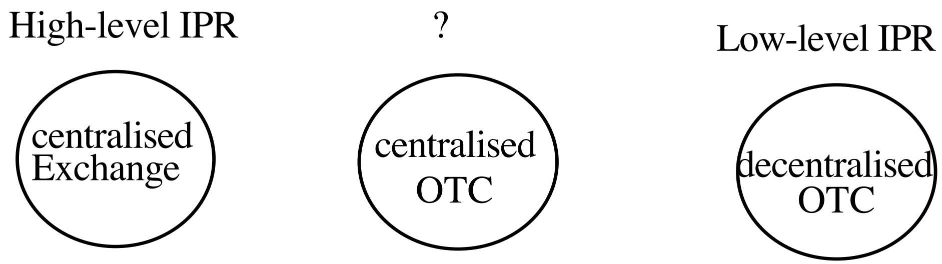
High-level IPR

centralised
Exchange

Low-level IPR

decentralised
OTC

Intra-country Differences in IPR



- Should centralised trading have IPR choice?
- International differences: US/NZ vs UK

Advantages of IPR Choice

- More profitable firms
- Enhances investor welfare
- Encourages competition

Firms

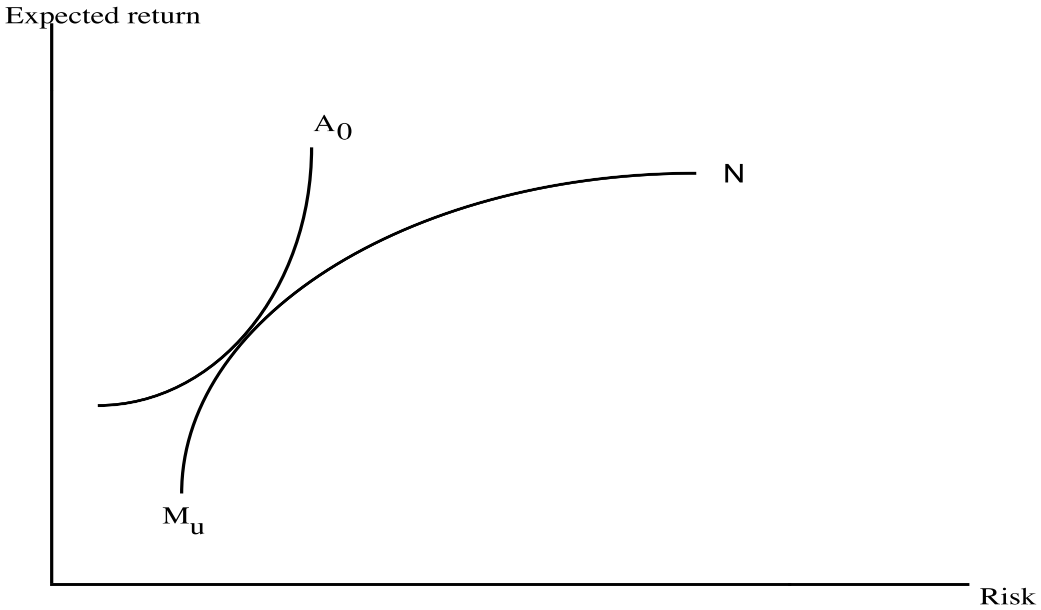
Firms can trade off the costs of high-level IPR against the benefits of a lower cost of capital

Table 1
Costs of capital and IPR

	Trading Platform	
Centralised with high-level IPR (ie, major exchange)	Centralised with low-level IPR (ie, new OTC)	Decentralised (ie, traditional OTC)
IPR costs	Risk premium	Risk premium Liquidity premium

Investors

- Investors can access low-IPR opportunities without being forced to accept an illiquid position



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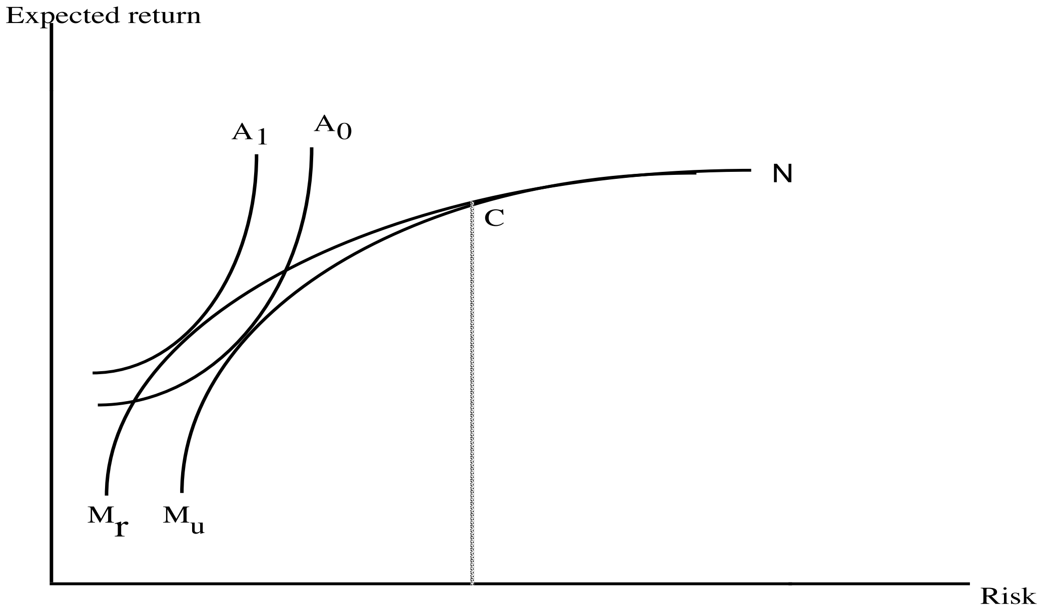

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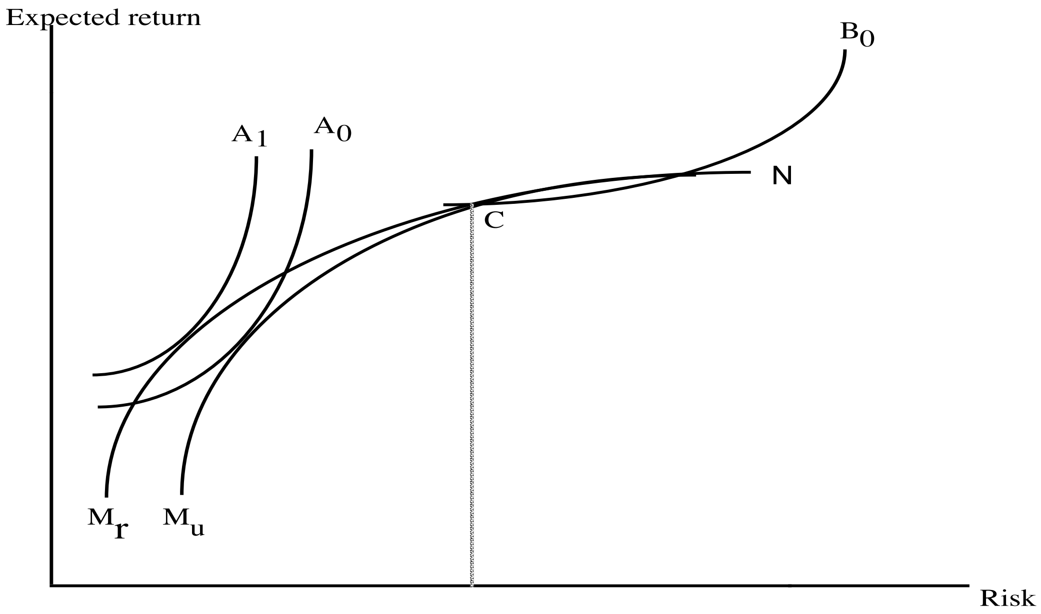

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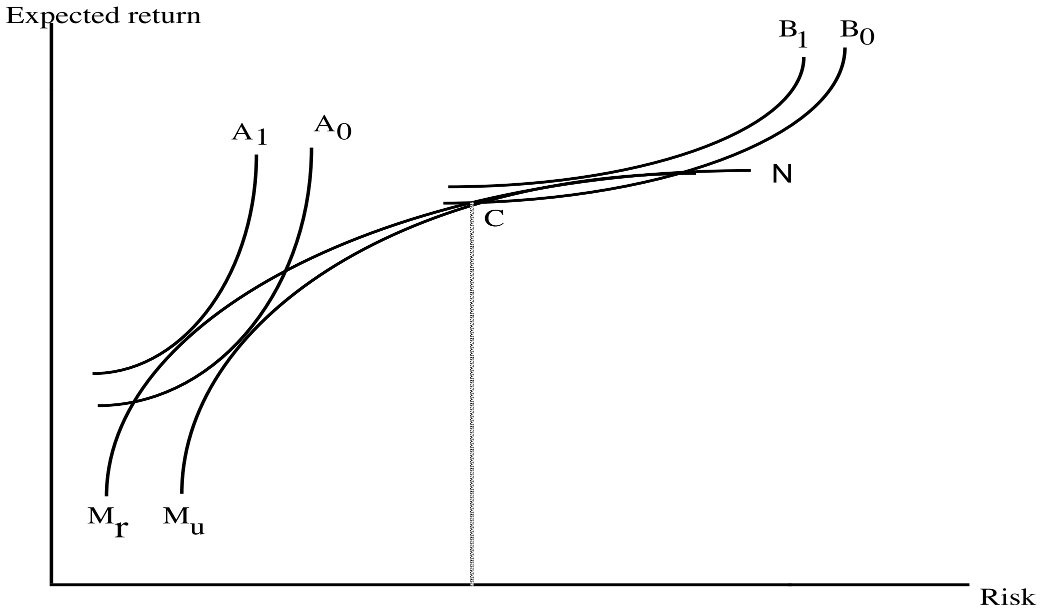


- IPR choice allows some investors to be better off while making none worse off

Competition

- Different platforms compete for listings, keeping costs on major exchanges down

IPR and Financial Market Development: the Evidence

Table 2

Outcome Variable	Mean effect of increasing IPR from the 10th to the 90th percentile
Market Cap/GDP	15 to 39 percentage points
Firms per capita	28% to 74%
Ownership Concentration	-2 to -13 percentage points
Turnover/GDP	24 to 65 percentage points
Cost of equity	-100 to -340 basis points
Integrated countries cost of equity	0 to -100 basis points

Interpretation and Implications I: Endogeneity

- Causality may be reversed
- US and UK experiences

Interpretation and Implications II: Economic Significance

- Open capital markets allow firms to separate own-IPR from country-IPR

- IPR link to cost of capital lower in countries with open capital markets (Table 2)

Interpretation and Implications III: Relevance for Intra-Country IPR

- Tells us only that IPR assists the development of major stock exchanges
- Even if the provision of regulated investments and trading is beneficial, it need not follow that offering *only* regulated opportunities is optimal

Spillovers

- Less regulated platform may impose negative externality costs on more regulated platform

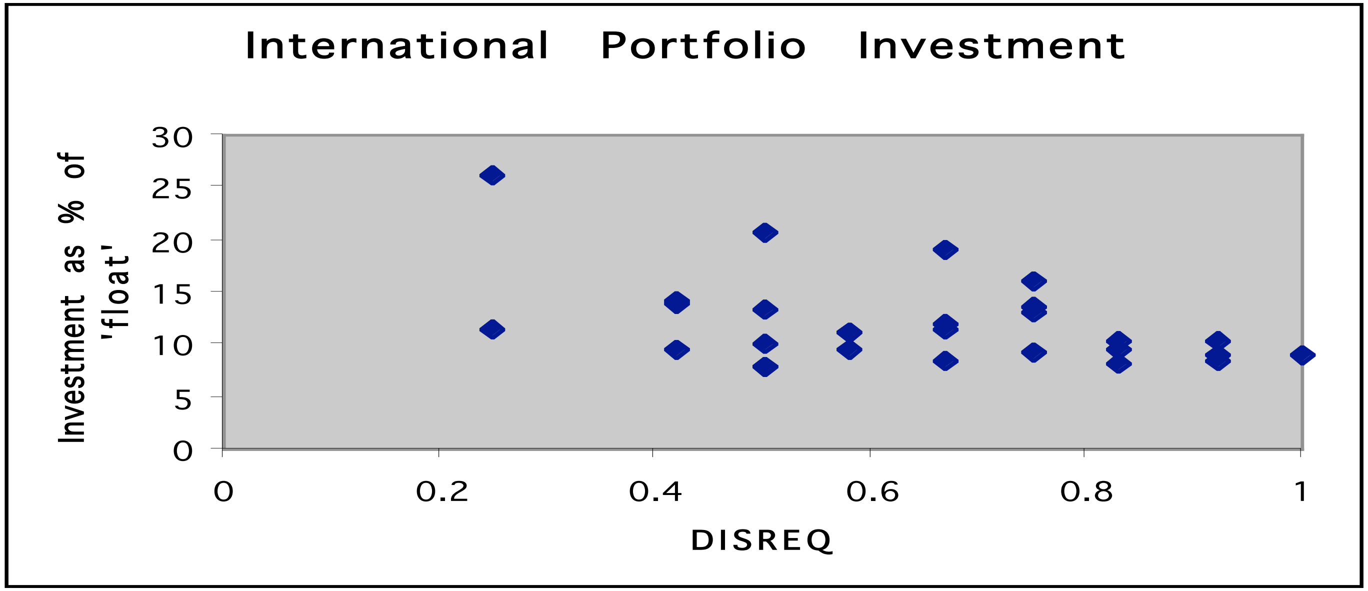
Spillover Effects I: Confusion

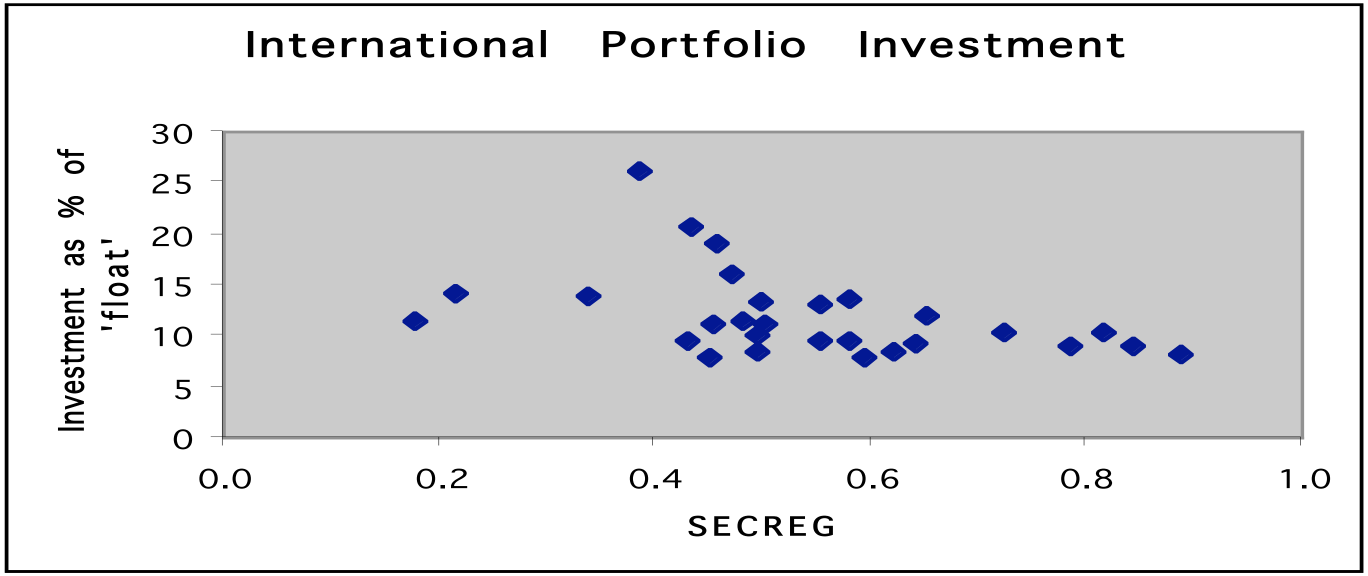
- Simultaneous existence of high- and low-IPR platforms creates confusion and discourages participation in any platform

- But international portfolio investment seems to be independent of IPR

  Moving from 10th to 90th IPR percentile *lowers* US investor holdings of available offshore shares by between four and nine percentage points

- Adjusting for size differences actually makes things worse:


International Portfolio Investment
Investment as % of 'float'
30
25
20
15
10
5
0
0
0.2
0.4
0.6
0.8
1
DISREQ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SECREG

Spillover Effects II: Contagion

- Investors in high-IPR market react negatively to an adverse events on low-IPR market

- Collapse of individual firm doesn't have significant effect on own market

- Actual cross-market disturbances precipitated by macro shocks

- Investors are rational enough to price IPR, but not to ignore irrelevant events

Appropriate Test for Uniform IPR

- Costs of imposing uniform IPR are at least partially irreversible
- Doing so therefore requires

$$B > \lambda C$$

where B is the value of the expected stream of benefits, C represents the associated costs, and $\lambda > 1$ is the 'uncertainty multiple'.

Summary

- Strong IPR almost certainly good for financial and economic development:

  "...leaving financial markets alone is not a good way to encourage them."
  [LaPorta, Lopez-de-Silanes, Shleifer and Vishny NBER, 1999]

- But this doesn't rule out further welfare gains from intra-country variation in IPR

- Costs of uniform IPR are transparent, but proposed abstract benefits of uniform IPR lack empirical support