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

<table>
<thead>
<tr>
<th>Trading Platform</th>
<th>IPR costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Centralised with high-level IPR (ie, major exchange)</td>
<td>Risk premium</td>
</tr>
<tr>
<td>Centralised with low-level IPR (ie, new OTC)</td>
<td>Risk premium</td>
</tr>
<tr>
<td>Decentralised (ie, traditional OTC)</td>
<td>Liquidity premium</td>
</tr>
</tbody>
</table>
Investors

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

• 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

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

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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