Bridging the equity gap: a new proposal for virtual local equity markets

by

Tim Mocroft
The Centre for the Study of Financial Innovation is a non-profit think-tank established in March 1993, to look at future developments in the international financial field - particularly from the point of view of practitioners. Its goals include identifying new areas of business, flagging areas of danger and provoking a debate about key financial issues. The Centre has no ideological brief, beyond a belief in open and efficient markets.
Preface

The conventional wisdom is that equity markets will consolidate, both domestically and cross-border. The Deutsche Boerse’s proposed merger with the London Stock Exchange, the Euronext consortium, the NY Stock Exchange’s GEM alliance, Nasdaq’s forays into Canada, Japan and (maybe) Europe … all of them point in the direction of concentration, consolidation and economies of scale.

By and large, that is fine for bigger institutional investors, for whom the dominant issue is liquidity; when they jump in or out of the stock market, there tends to be a big splash, and they want to make sure that liquidity is deep enough that they don’t hit their head on the bottom. But there are a lot of investors who are not big institutions – and this is a fast-growing category as more and more individuals are forced to acknowledge that they are going to have to work their financial assets harder and harder if they are to enjoy the comfortable retirement that they had assumed was their’s by right. For them, the ability to put huge blocks of stock through a market quickly, discreetly, cheaply and at a keen price is not really a relevant issue; what is relevant is whether they understand a stock, whether it reflects an area (geographic or functional) that they know about and whether they can trade it easily at a fair price. How big is this market? Well, no one knows – but pretty much everyone agrees that (based on what has happened in the US) it is growing fast.

So, that’s the demand side.

On the supply side, there are many smaller companies – precisely those fast-growing smaller firms on whom we depend for job generation – who are being squeezed out of conventional markets like the LSE and even AIM. They are looking for a million pounds, or less, and the effective cost of listing on the RIEs is prohibitive. As a result, they depend largely on “family and friends” or on bank debt – and their gearing is, as a result, excessive and dangerous. So, how can one get them on to the equity ladder earlier and at lower cost?

An answer to both these problems is presented in this paper, which has been written – in a purely personal capacity – by Tim Mocroft, who is currently on secondment to the DTI. It is an important paper because it reverses two all too prevalent assumptions:

• that the demands of institutions will necessarily drive stock exchanges into bigger and bigger units; and
• that the real action in the equity area is going to be cross-border.

What Mocroft argues is that there are plenty of investors out there in Middle England who would like nothing more than a punt on a company down the road, which they pass every day on the way to work – or (though he doesn’t develop this) on a company, located anywhere, in a functional area that the investor understands. (A shoe manufacturer, for instance, if the punter owns a shoe shop.)
How do you do it? And, specifically, how do you do it at a cost that isn’t going to price the smaller firms out of the market from Day One? What Mocroft proposes is a de-bundling of the national market - and its reconstitution as a series of “virtual” local markets run by “franchisees”. Some of the stocks listed on these virtual exchanges will be transfers from the main national list – but others will be newcomers, attracted by the much lower cost of a local listing.

And how will listing costs be kept down? Well, partly by simplifying the regulatory burden (in terms of forms to be filled out, and due diligence to be done). And how can that be done without jeopardising investor protection? Mocroft suggests:

• that the new markets should be restricted to high net worth individuals and/or sophisticated investors; and
• that listed companies should not be able to raise new capital until they have served a probationary period on the new market.

No doubt, consumer activists will still feel that investors need belt-and-braces protection. But the arguments Mocroft makes are ones that are doing the rounds in the City today, and they have real resonance. There has to be a way to get equity into smaller companies at a reasonable price – and, if we are to do that, something has got to give in terms of listing requirements and/or regulation. What Mocroft is suggesting is an intelligent and innovative approach that warrants a serious discussion. If you have any views on this, please contact him directly on (0403) 560 082 or e-mail him at tim@mocroft.freeserve.co.uk.

Andrew Hilton
Director, CSFI
Introduction

The ideal financing environment

“Ready access to capital for all business is essential for a vibrant and thriving economy”

Few people would disagree with the comment above, and yet in the UK there are many companies that do not have appropriate access to risk capital. Commentators have described this as the ‘equity gap’. The exact extent of the gap - both in terms of the size of company affected and the amounts of capital involved - is a subject of debate. And it is also true that many high growth companies never encounter this barrier. But, regardless of its size and the type of company affected by it, the equity gap represents a barrier to the future growth of middle market companies. This paper suggests a solution to the problem, and is intended to promote a healthy debate on the issue.

In an ideal world, the diagram below - a finance “escalator” - would represent a model of funding progression for many companies. This is an ideal model because it implies that access to capital is seamless and responds to the needs of companies. In addition, from the point of view of companies, it implies that there is no equity gap. Nevertheless, there are clear benefits to investors in this model. Because a strong link exists between each member in the chain of investors, perceived investment risk for each investor group is reduced by the existence of an exit mechanism. This lowers perceived risk and helps to attract more investors into each category, swelling the pool of capital that is available for companies. The key factor is that the capital market acts as a giant pump sucking cash through the system, and there are no artificial barriers to the size of company that can access the market. Inevitably, however, this model can only work if there is an efficient mechanism for recycling cash between investors and investees as companies grow and develop.

1 “Improving Share Liquidity”, DTI Future & Innovation Unit Report 1999

If these conditions exist, the growth potential of companies can be fully exploited, and capital can be allocated in the most efficient way. Moreover, providers of capital are in a
competitive environment since each category overlaps – ensuring that the cost of capital will be at its lowest. The existence of accessible equity finance also provides funds for development of intangible assets. In the absence of risk capital, this development can only be financed by retained earnings, thus limiting the pace of growth. This is even more significant in a knowledge-driven economy where the development of intangible assets is critical to the success of many businesses.

Unfortunately, the reality is very different.

The Effect of Globalization

The reality

Globalisation has provided an opportunity for a few companies to grow to enormous size. This in turn has encouraged the financial industry to consolidate in order to serve these important clients. Fund managers, too, have followed this trend. Inevitably, the managers of large international funds need two things in this new world:

• large companies to invest in; and
• an exacting listing and regulatory regime to provide assurances about those companies.

By their nature, these listing and regulatory requirements are expensive. But, given the size of the companies involved and the sums of money being raised, the costs can usually be accommodated. Both factors, however, impose a floor on the size of company that can effectively access the main capital markets that serve the UK - namely the official list of the London Stock Exchange and AIM. AIM started life by being a lower cost market for companies to join. But, sadly, its levels of regulation have risen to the point where a listing on AIM costs much the same as joining the official list. Typically, an IPO on either market will cost in the region of £500,000; with such costs, it is uneconomic to raise relatively small sums of capital.
The drive to meet the needs of global companies is, therefore, marginalising the middle market. Unfortunately, from a national perspective, these companies tend to have their operations based in the UK. Moreover, the most innovative companies are often to be found in this category; indeed, their impact on the economy and on employment is fundamental.

The trend towards globalisation is, thus, a major reason why companies do not progress smoothly along the funding escalator. It suggests that investors are no longer able, or available, to serve all companies. This is particularly true of the venture capital community, which is also concentrating its investment in larger companies, because only large companies can take advantage of an IPO on the stock market. A stock market listing is a primary method of investment exit for venture capitalists, not only because it tends to generate a good return but because it allows the venture capitalist to plan an exit at a particular time. Unfortunately, the link between the venture capital community and smaller companies is steadily being eroded.

The drive by capital markets to become increasingly global, primarily serving wholesale investors, has, thus, left a large section of the business community poorly served. It has very few alternatives to asset finance, other than to rely on a limited source of equity capital from a small pool of friends, family and business angels. As a result, among middle-market companies, capital rationing is in operation - with only a few companies qualifying for the limited capital available. If the capital market was operating efficiently, only those companies that could not provide an adequate return to reward an investment would be unable to receive whatever funding they need.

The argument of this paper is, therefore, that the time has come to create a tailored stock market for middle market companies, with very low costs and a large pool of liquidity to facilitate access to the equity they need.

Virtual local equity markets - the perfect solution?

Current circumstances offer an opportunity for the creation of a new complementary market specifically aimed at middle market companies.

This market would not only aim to swell the ranks of quoted companies in the UK, but would also act as a “nursery slope” for companies who wish to move to the main market. Above all, the market would provide access to risk capital for a cost approximately equivalent to the arrangement fees charged by banks. However, it must also be able to achieve this while still providing a transparent and well-regulated market and while protecting investors - thus achieving the seemingly impossible feat of making it economic to raise modest sums of capital (say around £1 million) whilst providing investors with the confidence to develop a pool of capital.

The market would be a national market made up of a network of virtual local equity markets (VLEMs). Using Internet technology, it would harness the best features of both local and national markets. The national infrastructure would give stature and ensure universal standards. The local identity, through repackaging shares listed nationally, would allow a strong affinity to develop between companies, investors and advisors and would bring the market closer to the community it serves.

In addition to utilising cutting-edge technology, this market would have a radically new approach to regulation in order to dramatically reduce the cost of listing, while at the same time continuing to protect investors.
Currently, production of a prospectus is governed by legislation that imposes many subjective disclosure obligations on the directors of a company that are difficult to interpret without a wealth of previous experience. In the face of these obligations, company directors feel the need to appoint advisors; indeed, this is mandatory for listing on the London Stock Exchange. The advisors are then required to vouch for the accuracy of information disclosed by the company — and, more importantly, that all material facts which an investor would need to make a decision are also disclosed. To provide comfort to the advisor that such an undertaking can be given, extensive due diligence is performed; inevitably, this costs a great deal of money.

The cost of raising capital on financial markets would be significantly reduced if companies were required to divulge information in such a way that they could be sure they had met their obligations. In other words, instead of a formal prospectus, companies might be required to complete a form - the content of which could be verified by (say) their auditor (thus removing the need to hire additional advisors). Such a form - requiring disclosure of information of the type included in a prospectus - could be easily completed by a competent board of directors. Because the form would require only factual information, it would also reduce the need for potentially contentious opinions. No opportunity would exist to put a subjective gloss on the information, and it would be easier to determine if the information had been negligently or recklessly produced. The directors could then be held directly accountable, and thus responsible for the contents of the form.

Simplifying the disclosure regime and reducing the costs of producing prospectus information is key to reducing the barriers to access to capital markets. However, investor protection must also be maintained.

It is arguable that simply completing a form is too limiting, and that companies would be under no obligation to disclose all the information necessary for an investor to understand their business. However, because the information would be factual and would address a predetermined list of questions (which would be the same for all companies), investors would be well placed to ask further questions which would depend on the particular nature of the business. While companies would be under no obligation to provide answers, an enlightened company clearly would respond - and a company that refused would not be backed.

In this way, a company could provide the information required by investors and regulators in a more cost-effective way. However, as an additional protection, it is proposed that all companies who list on a VLEM would not be able to raise new capital until after a probationary period of approximately 12 months. During this period the company would be quoted, but shares could only be traded among existing shareholders. This would give potential investors an opportunity to assess the company, its prospects and management over time. Its ability to operate as a quoted undertaking would, thus, be put to the test. Local media would also have an opportunity to examine the company, its markets and prospects during this period to build up a body of information for potential investors. Thus, potential investors would be well served with information of a factual nature from the company and more general background and analysis from other quarters. The cost of providing such information would be modest, and investors could decide how much extra information is necessary to make an informed decision.

The probationary period is important. It means that potential investors are forced to wait before they can invest - while the company is required to perform before it can raise capital. This probationary period has important implications for companies. In particular, they must be able
to anticipate capital requirements in advance and plan accordingly. A listing on a VLEM would, therefore, not be a trivial undertaking, and companies could do themselves considerable damage (without raising any new capital) if they listed before they were competent to do so.

The proposal is based on the assumption that most money lost by investors is the result of businesses that fail either through poor business propositions or poor management. All too often, the critical factor is the investor’s judgement. Prospectus information, however diligently prepared, can only have a limited impact on this judgement. The major influence will be the experience and sophistication of the investor. Investors, therefore, need to be encouraged to be more enquiring. This proposal would reduce the burden on the company to provide mandatory information – but would encourage investors to conduct their own due diligence.

This approach is supported by a recent survey into private share ownership\(^2\). When asked about their preferences for sources of information, active share buyers ranked newspapers and magazines highly (68%), followed by friends/family/colleagues (37%) and then the issuer’s own information (28%). A list of other sources included TV programs (24%), the Internet (23%), Independent Financial Advisors (23%), Teletext (22%) and banks (18%). These responses indicate that, among private investors, third party information on the merits of an investment is more important than the issuer’s own releases.

As a further level of protection, it is proposed that (initially, at least) the market would be restricted to ‘high net worth individuals’ and ‘sophisticated investors’ as defined by the Financial Services and Markets Act. These investors should be in a better position to assess the merits of an investment proposition.

Although it is proposed that the type of investors should be restricted, it is also true that involving a large number of private investors will help the liquidity of the market, and that this cannot be achieved if numbers are artificially restricted. Indeed, one objective of this new market is to provide the public with a wider range of investment opportunities. Any restriction on the type of investor is, therefore, a compromise. On the one hand, it is proposed in order to assure regulators that investor protection is paramount. On the other hand, it is proposed on the assumption that the definition of a sophisticated investor will be wide enough to include a large number of the investing public – including, for instance, investment clubs. It is also anticipated that obtaining sophisticated investor status should be simple and quick, perhaps some form of self-declaration. Thus, while the market would have restrictions on participating investors, it must nonetheless be able to access a large number of investors.

Because there are restrictions on potential investors and on a company’s freedom to raise capital (through the probationary period), some readers may feel that the proposed market will be too restricted. However, the aim of these restrictions is to make it possible to simplify listing requirements (and therefore the costs involved) and yet preserve a high level of investor protection. The creation of a new market that had cheap entry costs at the expense of investor protection would inevitably lead to a scandal.

\(^2\) Private Share Ownership in Britain, MORI Financial Services, September 2000

Liquidity is crucial
How would these markets be structured?

Virtual Local Equity Markets
Interplay between market participants and one typical VLEM

Virtual local equity markets would be created initially by repackaging the shares of local companies that are already listed on a national market. Each VLEM would be administered and promoted within its region by a local commercial consortium formed for the purpose and made up of members of the local business and financial community. The number of VLEMs would be
entirely dependent on local demand, and thus is difficult to predict. However, it is not difficult to see that major cities (e.g. Birmingham, Manchester, Newcastle) - where there is already a concentration of investors, companies and financial expertise - would be the prime locations for VLEMs.

The VLEM itself, at its most basic, is merely an Internet site, with its own brand and style, displaying a listing of local companies. It would also provide background information on the market and access to information filed by those local companies, together with links to local organisations providing services to investors or companies. In essence, it would be a mini version of the national market of which it is a part. However, because it has a local focus it is possible for it to develop products specific to the local environment. For instance, it may be that, in the north east, companies have a particular need for corporate debt - and the market in that area may develop a product to meet that need alongside equity.

In terms of operations, the VLEM would have direct contact with companies and investors, but the national organisation would run the infrastructure for the local market. If a company wished to list on the market, it would first approach its local VLEM. Although the rules of admission would be the same for all VLEMs nation-wide, each VLEM would carry a responsibility for the companies it proposed for membership. Likewise with matters of discipline; the national market would have the job of monitoring company behaviour, but the VLEM would have responsibility for taking matters up with the company.

The national organisation would effectively franchise the right to operate markets, together with providing the necessary services to run them. These services would include information, trading, settlement, membership, listing and regulation – all of which the national organisation may run on its own account or buy in from other providers. Because the services would be organised on a national basis, costs can be kept low.

If a national organisation has an advantage in terms of costs and standards, why is it necessary to create a local dimension? The reason is that, since institutions prefer to invest in larger companies, the market will be primarily supported by private investors who may have a preference for investing in local companies where they have some special knowledge. This knowledge could come from being an employee, a contractor, a supplier or a customer, all of which have a local dimension. Many informal networks aimed at finding finance for middle-market companies already exist in various regions, and the local markets will give a new impetus to this activity.

The proposal has the added benefit that particular regions could develop specific products that may be attractive to local companies and investors.

All of this is based on the assumption that local differences matter. However, because the market would be run via a computerised platform, there is no reason why companies could not be split up by other criteria, such as industry classification. The only issue is what investors want.

VLEM participation

In order to establish if there are enough companies and investors to make this new market viable, research was conducted into both the potential number of companies who might use this market and the number of investors available to support it.
**Are there enough firms to list?**

*Companies:* There are around 35,000 companies in the UK with turnover in excess of £5 million. Of these, only 3,000 are quoted on a recognised exchange (the LSE official list, AIM or OFex). This must reinforce the idea of creating a new market. If only an additional 5% of companies were to list, the VLEM network would have 1,500 new companies.

To understand the needs of these companies, the vast majority of which are not quoted on any capital market, cluster analysis was undertaken. Several sets of variables were tried, many of the combinations producing no significant clusters. However, the variables of profitability, employee growth over three years, year of incorporation and credit score produced the six clusters contained in the graph below. These show a number of interesting characteristics:

The group labelled ‘borrowers’ (clusters #2 and #5) is a prime candidate for this new market. Both clusters have gearing in excess of 160%, and, together, contain 12,374 companies. Although high gearing by itself is not an indication of capital starvation, it does at least indicate that too much of the companies’ finance is based on term borrowing - leaving them exposed to fluctuations in the business cycle. It may also indicate that they have reached the limit of debt capacity, and thus that further finance for expansion can only come from equity or retained earnings. The general profiles of the two clusters are as follows:

- **Cluster #2** (2,940 companies) is, in general, made up of medium-sized and young firms, showing medium employment growth and medium levels of exports. This group contains a higher weighting of AIM companies than other groups. The industry bias in the group is in favour of construction, transport and communications, as well as banking and finance

- **Cluster #5** (9,434 companies) is, in general, made up of small and young firms, with low employment growth and high levels of exports. This group has a high level of unlisted plcs and private companies. Industries which have an overweight representation are agriculture, transport and communications, and public administration
The other group of clusters of similar size is the ‘cash cows’, represented by clusters #4 and #1, which included 13,771 companies in aggregate. They are characterised by low levels of gearing and low growth. This suggests that, in some companies, growth is restricted by lack of investment capital, which cannot be borrowed and thus needs to be raised through equity. These clusters could also represent fertile ground for recruits to the new market. The relative profiles of the two clusters are:

- **Cluster #4** (4,364 companies) is made up of firms that are large, older and with only average profitability and medium exports. The cluster has a strong bias in favour of manufacturing.

- **Cluster #1** (9,407 companies) includes firms that are medium-sized and middle-aged, but which are highly profitable and have high exports. The cluster contains a smaller number of listed companies. Energy and water, plus banking and finance, have a strong representation in this cluster.

These groups represent a sizeable contingent from which recruits could be found for the new market. In addition, there are other organisations that may list, such as university start-up funds. Companies may also use the market to raise corporate debt through bond issues, and other financial products could be developed and traded on this market, such as unit and investment trusts.

**Investors:** Although institutions will be encouraged to invest in the new market, the likelihood is that (because of the orientation of institutions towards larger companies) private investors will support a large proportion of the market capitalisation.

Interest among private individuals in shares has blossomed in recent years, driven by a number of factors set out in *Improving Share Liquidity*. They include:

- relatively poor returns on bank and building society deposits;
- the perception of increasing uncertainty in the employment market;
- the need to supplement the basic state pension; and
- the general rise in the level of disposable income (and thus personal investment capacity).

These conclusions are reinforced by the survey referred to earlier about private shareholders, where it was revealed that the primary reason for investing in shares is the search for a better return.

This urge to invest has been boosted by the introduction of tax-advantaged collective products, such as ISAs. The media has responded by producing analysis about financial products and direct advice on investing in a whole range of financial products. Another indicator of retail investor activity is the dramatic rise in the number of investor clubs; these are being formed at the rate of 300 per month, and now involves 100,000 people with an aggregate portfolio of £149 million.

The new market would be an opportunity for private investors to diversify their investments and to access smaller and start-up companies in which investment would not ordinarily be available to the general body of private investors. Even private investors who have considerable

---

3 *Improving Share Liquidity*, DTI Future & Innovation Unit Report 1999
4 *Private Share Ownership in Britain*, MORI Financial Services, September 2000
wealth may not have the time to be a business angel, but would nonetheless invest in such companies if the opportunity existed.

A 1998 report by Merrill Lynch/Gemini Consulting\(^5\), detailing investible wealth in the UK, supports the idea that private investors could make this market work. It pointed out that the UK is the fifth largest financial services market in the world, and that it has a large pool of wealthy investors. In 1997, 4.3 million people had investable assets in excess of £50k (excluding property and collectibles); in total, these assets amounted to £679 billion. The report goes on to suggest that this number will rise to nearly 4.8 million by 2005, and that aggregate investible wealth will have increased to £1,937 billion.

Merrill’s report analyses the pattern of investment across three distinct groups, reflecting differing levels of wealth. These are:

- the “emerging affluent” (assets of £50k to £100k);
- the “affluent” (assets of £100k to £500k); and
- the “High Net Worth Individuals” (assets over £500k).

It shows that, across these groups, direct equity investment is at its lowest among the emerging affluent, where it represents just 13% of their assets. Affluents have 29% directly invested and HNWI invest 23% directly in shares. Across all three groups, the total wealth invested in shares is £153 billion.

It is reasonable to project that the new market could have a total market capitalisation of around £30 billion, which would be approximately twice the market capitalisation of AIM. This is based on the assumption that 1,500 companies would list on the new market (with an average market capitalisation of £20 million), and that no institutional investors participate. It would require about 10% of the wealth invested directly in shares, based on 2005 assumptions, to be redirected into this new market to support the assumed market capitalisation.

Who will be the intermediaries?

Many cities in the UK already have sophisticated financial services communities that operate informal networks to finance middle-market companies, primarily from business angel and venture capital sources. The new market would provide a new source of capital for clients to tap.

These communities have all the skills to develop the local element of this new market, and would gain from creation of a new market in their region. In addition to the opportunity to be part of any consortium formed to operate the market (and the commercial profit that could flow from that), the publicity it would give to the local financial community would make recruitment and retention of staff easier. The existence of a specialised market also gives the financial community a new product to sell and group of clients to service, and would allow it to build long term relationships with clients that would not end when a company sought to list on a public market. This is often the case now, as London-based advisors replace local firms when companies list on the existing public markets.

---

Liquidity

The issue of poor liquidity dogs small companies – creating the perception that shares in small companies are difficult to trade and that quoted prices are subject to wide spreads between the bid and offer price.

In many cases, this is caused by smaller companies trying to maintain too narrow an institutional shareholder base, coupled with a small free float. Because there are few institutions prepared to invest in small companies, if institutions change investment criteria and want to liquidate their holding, the selling pressure is such that market-makers have to mark down prices sharply to attract buyers. This is a downward spiral that leaves companies with poorly valued shares, unable to raise capital and open to hostile take-over.

The fact that the new market proposed in this paper would be supported by large numbers of private individuals - thus ensuring a broad shareholder base - and the fact that companies would have to release at least 50% of their stock into the market will help considerably. It is also proposed that other measures - such as specifying a minimum number of investors and a cap on the size of stake that can be held - will also add liquidity to the market.

It should also be remembered that, although the market is promoted on a local basis, it is nonetheless a national market, and can therefore draw on a pool of liquidity across the whole market. Thus, there is no reason that investors should be restricted to investing only in their local market. The market could, for instance, alert investors nation-wide about companies that would be particularly attractive to them, on the basis of whatever criteria are relevant.

When considering liquidity, the question arises as to whether market-makers make the situation better or worse. Clearly, if a regime existed where market-makers were required to make a two-way price in a minimum number of shares for the whole market, this would be advantageous. If market-makers are allowed to pick and choose, then only liquid shares will benefit. Since a wealth of trading programmes exist that can provide immediate matched bargains in a market, the best solution may be to give individuals the right to deal direct on the market rather than through intermediaries. This would require the market to operate a system of credit authorisation to verify that a transaction will be honoured, and also a system to deliver ownership of shares. (Both of these exist already.) This approach would effectively eradicate the spread, and would make sure that both buyer and seller got the best price. Making sure that there is absolute transparency about the number of buyers and sellers in the market, the number of shares that are offered and the prices sought would also help liquidity.

Smaller quoted companies currently share an index with some of the world’s largest and most dynamic companies. Consequently, they receive very little publicity in the media. This has a detrimental effect on investor perceptions, and thus on share prices. The companies listed on VLEMs will provide a steady news flow to local media, and thus should receive more coverage.

The benefits of VLEMs

In addition to the direct benefits that have already been identified, a number of spin-off benefits can also be claimed for VLEMs. In particular, they will:
• **Encourage the adoption of employee share ownership plans:** Share options give employees a stake in the prosperity of the business; they are a powerful way to motivate people. But if the company’s shares are not quoted, it is difficult for employees to follow the value of their stake. Companies try to overcome this by running in-house valuation schemes, but these can only be a poor substitute for a quoted price. Normally, companies would not consider obtaining a quote merely to facilitate an ESOP, since the costs would be prohibitive. However, the cost structure of VLEMs would not be a barrier and many companies might seek a listing primarily to facilitate employee share ownership.

• **Recirculate wealth:** The creation of VLEMs would be an excellent way to re-circulate wealth in a particular region. At the moment, much of the personal wealth in a region is invested outside because the opportunity does not exist to invest locally. If only a small proportion of wealth was reinvested, this would have considerable impact on regeneration of the region.

• **Encourage business angels and venture capitalists:** The fact that a market exists - and is accessible to companies raising small sums of capital - means that business angels and venture capitalists have a ready-made exit route for investments in smaller companies. This will reduce the perception of risk and make such investments more attractive.

• **Energise the local job market:** The opportunity offered by a thriving quoted company sector in a local region would enable professional firms to retain staff who are often drawn to London at the moment. The ability to retain and recruit good staff is a boon to any local economy.

• **Provide a currency for acquisitions:** The ability of local companies to access capital markets will give them the resources to make acquisitions. This could be a critical driver in the restructuring of local industry, ensuring more efficient use of capital and the effective regeneration of local economies.

• **Improve lending capacity:** Companies who can access equity will improve their financial gearing and thus reduce the risk for lenders. In a competitive marketplace, this should reduce the cost of loan finance and improve the overall profitability of local companies.

• **Improve credit profiles:** Companies who are reliant on debt finance and who become over-gearied, will have their credit rating downgraded. Re-balancing a company’s finance could improve its rating and its ability to ride out business cycles.

• **Provide “nursery slopes”**: A principal aim of the new market would be to provide a “nursery slope” for companies to become accustomed to the requirements of being a floated company and to prepare them for eventual transition to other markets.

• **Encourage entrepreneurship:** The existence of a low cost local market would be a significant catalyst to entrepreneurs, who would see the possibility of an early listing as a significant milestone.

• **Lower the cost of capital:** Companies will have more alternatives for raising capital - thus allowing competition to drive down the cost of capital. A lower cost of capital will enable companies to make more investments since the internal hurdle rates will be lowered.
What is the potential downside?

There are risks with any capital market, and some of the material ones about the present proposal are discussed below.

**Investor protection**

One of the most difficult areas for any capital market is investor protection. However, a balance needs to be struck between protection and the costs of achieving that protection. If the costs of protection are too high, then good opportunities will be prevented from coming to market. If the number of companies able to list is unduly restricted, then investors will be exposed because their investment options will also be restricted - preventing them from achieving a broad spread of investments.

One criticism which could be made of extensive disclosure by companies prior to listing is that investors are spoon-fed with information, and thus are not encouraged to make their own enquiries. If investors have to work a little harder to research an investment, their knowledge will improve and their desire to invest will be tested.

**Systemic risk and market weakness**

If the investment of the nation’s wealth is too concentrated, then the risk of a substantial loss is increased. The emergence of new markets, with a larger number of investment opportunities, allows greater diversification - and thus a reduction of overall risk.

**Poor capital allocation**

It could be argued that private investors might be driven by sentiment to back local companies because they are local, rather than because they represent a good investment. This could lead to a poor allocation of capital and falling returns. However, this is only a realistic risk if the number of companies quoted is small, and thus investment choice is limited. Provided a reasonable number of companies are listed on each VLEM, competition will ensure that parochial tendencies do not hinder capital allocation or returns.

**International experience and the cost of alternative approaches**

Many countries around the world have successful local exchanges – for example countries like Germany, Scandinavia and the US.

However, no country has the structure that is being proposed here - seeking to exploit the liquidity of a national market with the strong sense of identity that a local market brings. This is an opportunity for the UK to lead the way - and to demonstrate that delivery mechanisms for capital need to be different to suit different users. As in so many things, one size cannot fit all.

The money required to obtain a listing on either the official list of the London Stock Exchange or AIM has increased remorselessly in recent years. A straightforward listing of a simple business
may now cost £750k or more. Unless a company is raising in excess of £10 million, the costs will be out of proportion to the sums raised. Unfortunately, this is a result of the requirement to appoint nominated advisors (and to cover the liability of those advisors). In an international setting and in an institutional market, those costs can be absorbed – but not for smaller, local firms.

What is the role for Corporate UK?

Given that it is most unlikely that the VLEM approach would appeal to existing market operators, we need new players. Indeed, several consortia need to be formed for the operation of this new market. In particular:

- Someone will have to operate the national infrastructure and manage (or buy in) necessary services like settlement, trading, company news, membership, administration and listing rules. This operator would also be responsible for creating awareness of the market at a national level, as well as for liaising with Government regulators and other markets.

- Local consortia would need to be created to operate the local markets on a ‘franchise’ basis. Because the infrastructure is operated centrally and would rely on ICT technology, local franchises would have a fairly light burden. Their primary role would be to promote the market to local users and to ensure that it developed in a way that met the needs of all participants.

This mix between national and local management, each having a clear area of responsibility, is important. It should ensure that the market remains responsive to its users, rather than becoming dominated by one interest group.

In addition to direct participants in the market, many other organisations have a part to play in its ultimate success. In particular, information providers, such as the local media and specialised websites and publications, will be central. In addition, professional advisors will be key to ensuring that companies are properly informed about their obligations and that relevant advice is available. And stockbrokers will be crucial, as will independent financial advisors.

There will also be a role for government. For this market to succeed, government action will be required to remove regulatory barriers and to ensure that no market distortions exist which could discourage potential investees.
Tim Mocroft is currently on secondment to the Future & Innovation Unit of the Department of Trade & Industry. He has extensive experience of issues surrounding SME finance. He is a qualified accountant and has held senior positions in both quoted and unquoted companies in engineering, manufacturing, transport and food. He was Group Finance Director of National Express plc for seven years, covering the period from its initial privatisation to its flotation on the LSE.

If you have any views on the proposals in this paper please contact Tim:

• Tim@mocroft.freeserve.co.uk
• (0403) 560 082
<table>
<thead>
<tr>
<th>CSFI PUBLICATIONS</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. “Financing the Russian safety net”: A proposal for Western funding of social</td>
<td>£40/$65</td>
</tr>
<tr>
<td>security in Russia, coupled with guarantee fund for Western investors. by Peter</td>
<td></td>
</tr>
<tr>
<td>2. “Derivatives for the retail client”: A proposal to permit retail investors</td>
<td>£10/$15</td>
</tr>
<tr>
<td>access to the risk management aspects of financial derivatives, currently available</td>
<td></td>
</tr>
<tr>
<td>only at the wholesale level. by Andrew Dobson. Nov 1993 (Only photostat available)</td>
<td></td>
</tr>
<tr>
<td>3. “Rating environmental risk”: A proposal for a new rating scheme that would</td>
<td>£25/$40</td>
</tr>
<tr>
<td>assess a company’s environmental exposure against its financial ability to</td>
<td></td>
</tr>
<tr>
<td>manage that exposure. by David Lascelles. December 1993</td>
<td></td>
</tr>
<tr>
<td>4. “Electronic share dealing for the private investor”: An examination of new</td>
<td>£25/$40</td>
</tr>
<tr>
<td>ways to broaden retail share ownership, inter alia, by utilising ATM networks,</td>
<td></td>
</tr>
<tr>
<td>PCs, etc. by Paul Laird. January 1994</td>
<td></td>
</tr>
<tr>
<td>5. “The IBM dollar”: A proposal for the wider use of “target” currencies, i.e.</td>
<td>£15/$25</td>
</tr>
<tr>
<td>forms of public or private money that can be used only for specific purposes</td>
<td></td>
</tr>
<tr>
<td>by Edward de Bono. March 1994</td>
<td></td>
</tr>
<tr>
<td>6. “UK financial supervision”: A radical proposal for reform of UK financial</td>
<td>£25/$40</td>
</tr>
<tr>
<td>regulation, (prepared pseudonymously by a senior commercial banker). May 1994</td>
<td></td>
</tr>
<tr>
<td>7. “Banking banana skins”: The first in a periodic series of papers looking at</td>
<td>£25/$40</td>
</tr>
<tr>
<td>where the next financial crisis is likely to spring from. June 1994</td>
<td></td>
</tr>
<tr>
<td>8. “A new approach to capital adequacy for banks”: A proposal for a market-based</td>
<td>£25/$40</td>
</tr>
<tr>
<td>alternative, using the concept of ‘value-at-risk’, to the present mechanistic</td>
<td></td>
</tr>
<tr>
<td>Basle approach to setting bank capital requirements. by Charles Taylor. July 1994</td>
<td></td>
</tr>
<tr>
<td>development finance corporation to promote employment-generating projects in the</td>
<td></td>
</tr>
<tr>
<td>Arab world. by Jacques Roger-Machart. October 1994</td>
<td></td>
</tr>
<tr>
<td>10. “Banking banana skins II”: Four leading UK bankers and a senior corporate</td>
<td>£25/$40</td>
</tr>
<tr>
<td>treasurer discuss lessons for the future from the last banking crisis. November</td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td></td>
</tr>
<tr>
<td>11. “IBM/CSFI essay prize”: The two winning essays for the 1994 IBM/CSFI Prize.</td>
<td>£10/$15</td>
</tr>
<tr>
<td>November 1994</td>
<td></td>
</tr>
<tr>
<td>12. “Liquidity ratings for bonds”: A proposed methodology for measuring the</td>
<td>£25/$40</td>
</tr>
<tr>
<td>liquidity of issues by scoring the most widely accepted components, and</td>
<td></td>
</tr>
<tr>
<td>aggregating them into a liquidity rating. by Ian Mackintosh. January 1995</td>
<td></td>
</tr>
<tr>
<td>13. “Banks as providers of information security services”: Banks have a privileged</td>
<td>£25/$40</td>
</tr>
<tr>
<td>position as transmitters of secure data: they should make a business of it. by</td>
<td></td>
</tr>
<tr>
<td>Nick Collin. February 1995</td>
<td></td>
</tr>
<tr>
<td>14. “An environmental risk rating for Scottish Nuclear”: An experimental rating</td>
<td>£25/$40</td>
</tr>
<tr>
<td>of a nuclear utility. by David Lascelles. March 1995</td>
<td></td>
</tr>
<tr>
<td>15. “EMU Stage III: The issues for banks”: Banks may be underestimating the</td>
<td>£25/$40</td>
</tr>
<tr>
<td>impact of Maastricht’s small print. by Malcolm Levitt. May 1995</td>
<td></td>
</tr>
<tr>
<td>16. “Bringing market-driven regulation to European banking”: A proposal for</td>
<td>£10/$15</td>
</tr>
<tr>
<td>eliminating systemic banking risk by using cross-guarantees. by Bert Ely</td>
<td></td>
</tr>
<tr>
<td>(Only photostat available). July 1995</td>
<td></td>
</tr>
<tr>
<td>17. “The City under threat”: A leading French journalist worries about</td>
<td>£20/$35</td>
</tr>
<tr>
<td>complacency in the City of London. by Patrick de Jacquetot. July 1995</td>
<td></td>
</tr>
<tr>
<td>18. “The UK building societies: Do they have a future?”: A collection of essays</td>
<td>£10/$15</td>
</tr>
<tr>
<td>on the future of UK building societies and mutuality. (Only photostat available).</td>
<td></td>
</tr>
<tr>
<td>September 1995</td>
<td></td>
</tr>
<tr>
<td>19. “Options and currency intervention”: A radical proposal on the use of</td>
<td>£20/$35</td>
</tr>
<tr>
<td>currency option strategies for central banks. by Charles Taylor. October 1995</td>
<td></td>
</tr>
<tr>
<td>20. “Twin peaks”: A regulatory structure for the new century” A proposal to</td>
<td>£25/$40</td>
</tr>
<tr>
<td>reform UK financial regulation by splitting systemic concerns from those</td>
<td></td>
</tr>
<tr>
<td>21. “Banking banana skins III”: The findings of a survey of senior UK figures</td>
<td>£25/$40</td>
</tr>
<tr>
<td>into where the perceived risks in the financial system lie. March 1996</td>
<td></td>
</tr>
<tr>
<td>banker) for the private funding of health, education, unemployment etc. through</td>
<td></td>
</tr>
<tr>
<td>a lifetime fund. by Andrew Dobson. May 1996</td>
<td></td>
</tr>
<tr>
<td>23. “Peak Practice”: How to reform the UK’s regulatory structure. Implementing</td>
<td>£25/$40</td>
</tr>
<tr>
<td>bank intervention – without foreign exchange reserves. by Neil Record. November</td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td></td>
</tr>
<tr>
<td>what might happen if EMU precedes economic convergence. by David Lascelles.</td>
<td></td>
</tr>
<tr>
<td>December 1996</td>
<td></td>
</tr>
<tr>
<td>slip up over the next two to three years. April 1997</td>
<td></td>
</tr>
</tbody>
</table>

28. "Call in the red braces brigade... The case for electricity derivatives": Why the UK needs an electricity derivatives market, and how it can be achieved. by Ronan Palmer and Anthony White. November 1997

29. "The fall of Mulhouse Brand": The City of London’s oldest merchant bank collapses, triggering a global crisis. Can the regulators stave off the disaster? A financial thriller based on a simulation conducted by the CSFI, with Euromoney and PA Consulting Group, to test the international system of banking regulation. by David Shirreff. December 1997

30. "Credit where credit is due: Bringing microfinance into the mainstream": Can lending small amounts of money to poor peasants ever be a mainstream business for institutional investors? by Peter Montagnon. February 1998

31. "Emerald City Bank... Banking in 2010": The future of banking by eminent bankers, economists and technologists. March 1998


35. "Cybercrime: tracing the evidence": A working group paper on how to combat Internet-related crime. by Rosamund McDougall. September 1998

36. "The Internet in ten years time: a CSFI survey": A survey of opinions about where the Internet is going, what the main obstacles are and who the winners/losers are likely to be. November 1998

37. "Le Prix de l’Euro... Competition between London, Paris and Frankfurt": This report sizes up Europe’s leading financial centres at the launch of monetary union. February 1999

38. "Psychology and the City: Applications to trading, dealing and investment analysis": A social psychologist looks at irrationality in the financial services sector. by Denis Hilton. April 1999

39. "Quant & Mammon: Meeting the City’s requirements for post-graduate research and skills in financial engineering": A study for the EPSRC on the supply of and demand for quantitative finance specialists in the UK, and on potential areas of City/academic collaboration. by David Lascelles. April 1999


42. “In and Out: Maximising the benefits/minimising the costs of (temporary or permanent) non-membership of EMU”. A look at how the UK can make the best of its ambivalent euro-status. November 1999


44. “Internet Banking: A fragile flower” Pricking the consensus by asking whether retail banking really is the Internet’s “killer app”. by Andrew Hilton April 2000

45. “Banking Banana Skins 2000” The CSFI’s latest survey of what UK bankers feel are the biggest challenges facing them. June 2000


REGULATION PAPERS
1. “Accepting failure”: A brief paper from the CSFI’s regulatory working group on the need for the new FSA explicitly to accept the likelihood that banks will fail. by David Lascelles. February 1998


4. “Embracing smoke: The Internet and financial services regulation” A new regulatory framework is necessary for the Internet, most important ‘lose the paper’. by Joanna Benjamin and Deborah Sabalot. June 1999

OTHER REPORTS
Internet and Financial Services: a CSFI report. In-depth analysis of the industry’s key sectors. Please order through City & Financial Publishing. Tel: 01483-720707 Fax: 01483 740603; £45/$75
The Centre receives general support from the following institutions:

Abbey National
Andersen Consulting
Barclays Group
Chase Manhattan Bank
Citibank
International Securities Market Association
ISMA Centre, University of Reading
Linklaters & Alliance
Merrill Lynch
PricewaterhouseCoopers
EFG Private Bank Limited
UBS/Warburg Dillon Read

Alliance & Leicester
AMS
AT Kearney
British Telecommunications plc
CGNU plc
Concert
Corporation of London
Deutsche Bank
DTI/OST
EMI Group
factor-e
GISE AG
Halifax plc
HM Treasury
HSBC Holdings plc
Premchand Roychand & Sons
INVESTEC
KPMG Management Consulting
Lloyds TSB
Lloyd’s of London
London Stock Exchange
Midas-Kapiti International
MilleniumAssociates AG
Morgan Stanley/Dean Witter
National Westminster Bank
PA Consulting
Reuters
Rockport Financial
The Rose Partnership
Royal Bank of Scotland
Standard & Poor’s Ratings Group
Standard Chartered Bank
Swiss Re New Markets
Thomas Cook Group

Arthur Andersen & Co.
Bank of England
Brigade Electronics
British Bankers’ Association
British Invisibles
Cable & Wireless Communications
Canadian High Commission
City Consultants
City & Financial
EPSRC
Ernst & Young
Financial Times
Fitch Ratings
FSA
Futures & Options Association
JF Chown & Co.
GCI Financial
Lombard Street Research
National Savings
Prudential plc
Record Treasury Management Limited
Schorers
SERM Rating Agency
The Stuchfield Consultancy
Tradepoint

In addition, the Centre has received special purpose support from, among others, BDO Stoy Hayward, the Building Societies Association, Hammond Suddard Edge, IBM, IMI/Sigeco, Lovells, DFID, *The Banker* and the World Bank Group.