CORPORATE FINANCE

EQUITY MARKETS

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Textbook: Arnold, Glen. Corporate Financial Management, Pearson Education. Kindle Edition.

EQUITY MARKETS

- The stock markets available to firms
- Alternative share trading systems
- The regulatory framework
- The financial terms expressed in the broadsheet newspapers (particularly the Financial Times)

IMPORTANCE OF STOCK EXCHANGES

- Today the important contribution of stock exchanges to economic well-being is recognised from Uzbekistan to Uruguay.

- There are now over 140 countries with exchanges and many of these countries have more than one exchange.

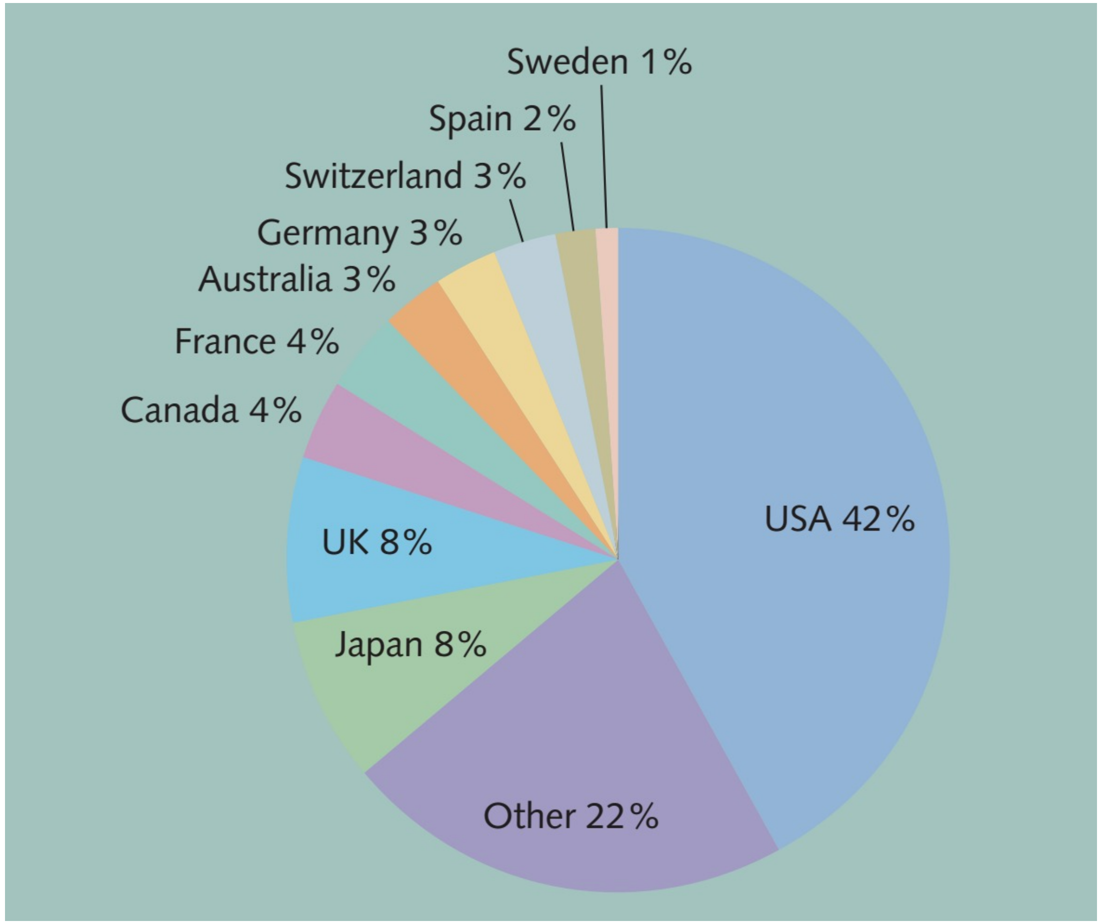
- Many exchanges have been amalgamated with larger ones.
  - the London Stock Exchange (LSE) merged with the Borsa Italiana in 2007.
  - the NYSE merged in 2006 with the Euronext group, itself a merger of the Paris, Amsterdam, Brussels and Lisbon exchanges and in 2008 with the American Stock Exchange.
  - the US market NASDAQ merged in 2007 with OMX, the Scandanavian and Baltic group of exchanges (Stockholm, Helsinki, Copenhagen and Iceland, and Estonia, Latvia, Lithuania and Armenia) and also with the Boston and Philadelphia exchanges, with the result that NASDAQ OMX is the largest US electronic exchange, listing over 2,700 companies in the US and another 778 in Europe.

- In addition to actual mergers, many stock exchanges have holdings in other exchanges or have mutual trading agreements. For instance, the Tokyo Stock Exchange has a 4.9 per cent shareholding in the Singapore exchange.

A COMPARISON OF THE MAJOR MARKETS

- Until quite recently the LSE was the leading stock exchange in the world for trading shares in overseas companies and one of the biggest for the trading of domestic company shares.
- However, the electronic revolution and mergers have dramatically increased the market in foreign equity trading in the US, and NYSE Euronext and NASDAQ OMX now head the field in both foreign and domestic trading.
- Looking only at domestic (home-grown companies') equity, China's domestic trading has shown a huge increase as it opens itself to capitalism.
- Clearly, stock markets are regarded as an important element in the intricate lattice work of a modern and sophisticated society. Not only are they a vital meeting place for investors and a source of investment capital for businesses, they permit a more appropriate allocation of resources within society – that is, an optimum mix of goods and services produced to satisfy people.

RELATIVE SIZES OF GLOBAL STOCK MARKETS BY MARKET CAPITALISATION



MULTILATERAL TRADING FACILITIES (MTFS) (1)

- Traditional stock exchanges had virtual monopoly positions for the trading of shares and other securities in their home countries.
- They had little incentive to cut fees or to improve their trading technology.
- This resulted in the main users, institutional investment funds, banks, brokers and hedge funds, becoming frustrated with the raw deal they were getting.

MULTILATERAL TRADING FACILITIES (MTFS) (2)

- Starting in the US in the early 2000s they determined that the national stock exchanges could do with some competition, so they got together, chipped in a few million for start-up costs and created new trading platforms.
- These were equipped with nimbler technology and required far fewer staff than the traditional exchanges.
- They had narrower differences between the price to buy (bid) and the price to sell (offer) a share, lower execution (transaction) costs, and the time between sending an order and the order being complete was much faster than the traditional exchanges.
- Not only did the institutions now have a cheaper way of trading shares but they could also use the presence of the new trading platforms to force the old exchanges to change their ways.

MULTILATERAL TRADING FACILITIES (MTFS) (3)

- The Americans called these platforms **electronic communications networks** (**ECNs**).
- They are also known as **multilateral trading facilities** (**MTFs**, a term more favoured in Europe) and they have certainly had an effect.
- As recently as 2003 about 80 per cent of the trading volume in the shares listed on the NYSE was handled by the NYSE itself.
- Today less than one-quarter of the trades go through the NYSE; the rest are traded through new trading systems, mostly MTFs including BATS, Direct Edge and ArcaEx.
- NYSE is not alone; NASDAQ has lost a lot of trade to the new venues as well.

MULTILATERAL TRADING FACILITIES (MTFS) (4)

- A major breakthrough in Europe occurred in November 2007, with the introduction of the EU's **Markets in Financial Instruments Directive** (**Mifid**), which has the aim of providing a '*harmonised regulatory regime for investment services across the 30 member states of the European Economic Area.*'
- The main objectives of the Directive are '*to increase competition and consumer protection in investment services*'.
- Following this Directive, brokers acting on behalf of share (and other security) buyers and sellers must now demonstrate that they are achieving the keenest price and using the most efficient, cost-effective trading venues.

MULTILATERAL TRADING FACILITIES (MTFS) (5)

- This encouraged the establishment of cheaper and faster electronic trading platforms to challenge the old ones.
- And, of course, European institutional investors were just as keen as their US counterparts to have alternatives to the national exchanges.
- Traditional stock markets have lost a lot of trade to the new generation of European MTFs (such as BATS Europe, Chi-X and Turquoise).
- These trade the shares from companies quoted on a variety of national exchanges across Europe, and they are far less strictly regulated than stock markets.

MULTILATERAL TRADING FACILITIES (MTFS) (6)

- As recently as 2007 shares in the FTSE100 index were traded largely through the LSE.
- Today MTFs have taken around one-third share of continental European share trading and about half of trading in large UK companies' shares, causing a drop in volume of trading at the LSE and other traditional stock exchanges.
- The proliferation of trading venues means that prices are increasingly being set for shares in a number of different places.
- In 2007, Rolls-Royce's shares were publicly traded in one place; now they are bought and sold on 14 platforms.

GLOBALISATION OF FINANCIAL FLOWS (1)

Over the last 20 years of the twentieth century there was an increasing emphasis on share (equity) finance and stock exchanges. An ‘equity culture’ spread around the world. Given that stock markets have been around for centuries, what happened in those years to spark such a widespread interest?

- The **first explanation** is that a greatly increased number of companies sought a stock market quotation for their shares and there were deliberate attempts by governments to stimulate interest in share ownership. Following the Thatcher and Reagan privatisations, and the push for wider share ownership in 1980s Britain and the USA, hundreds of state-owned or privately held companies worldwide floated their shares on stock exchanges. Governments the world over, regardless of their position on the political spectrum, promoted share markets and other financial markets as enabling tools for economic progress.

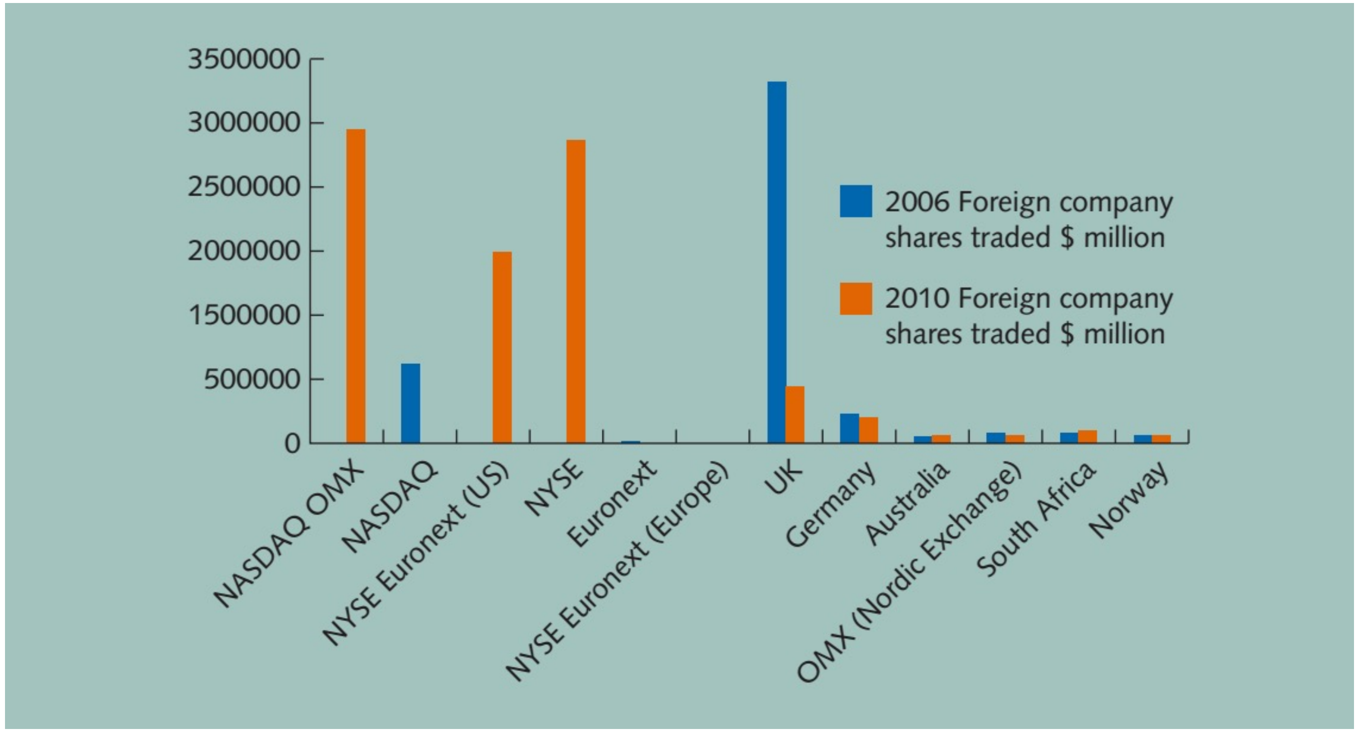
GLOBALISATION OF FINANCIAL FLOWS (2)

- **Secondly**, it became apparent that equities had provided good long-term returns over the first eighty years of the twentieth century – returns significantly ahead of inflation and those on bonds. So, increasingly, those with responsibility for providing pensions decades from now concentrated on buying shares.
- **Thirdly**, the 1980s and 1990s was one of the best periods ever for share returns. The bull market stimulated interest from millions of investors who previously preferred to hold less risky, lower-return securities, such as bonds. Despite the drop-off in interest after the poor returns of the first decade of the twenty-first century, shares and the stock market remain very important for many people across the globe.
  - In the USA, Japan, Australia and Canada for instance, about one-third of households now own shares (either directly or indirectly through mutual funds and pension funds). One-eighth of British households own shares directly. The equity culture has grown so strongly in Germany that over 12 million people hold shares. The Scandinavian countries and the Netherlands are even more 'equitised' than Germany.

GLOBALISATION OF FINANCIAL FLOWS (3)

- **Financial globalisation** means the integration of capital markets throughout the world.
- The extent of the internationalisation of the equity markets is illustrated by the volume of foreign equity trades in the major financial centres.
- A substantial proportion of pension fund and insurance fund money is invested in foreign equities.
- Also, today a corporation is not limited to raising funds in a capital market where it is domiciled.

Value of equity trading in foreign companies on stock exchanges in year



GLOBALISATION OF FINANCIAL FLOWS (4)

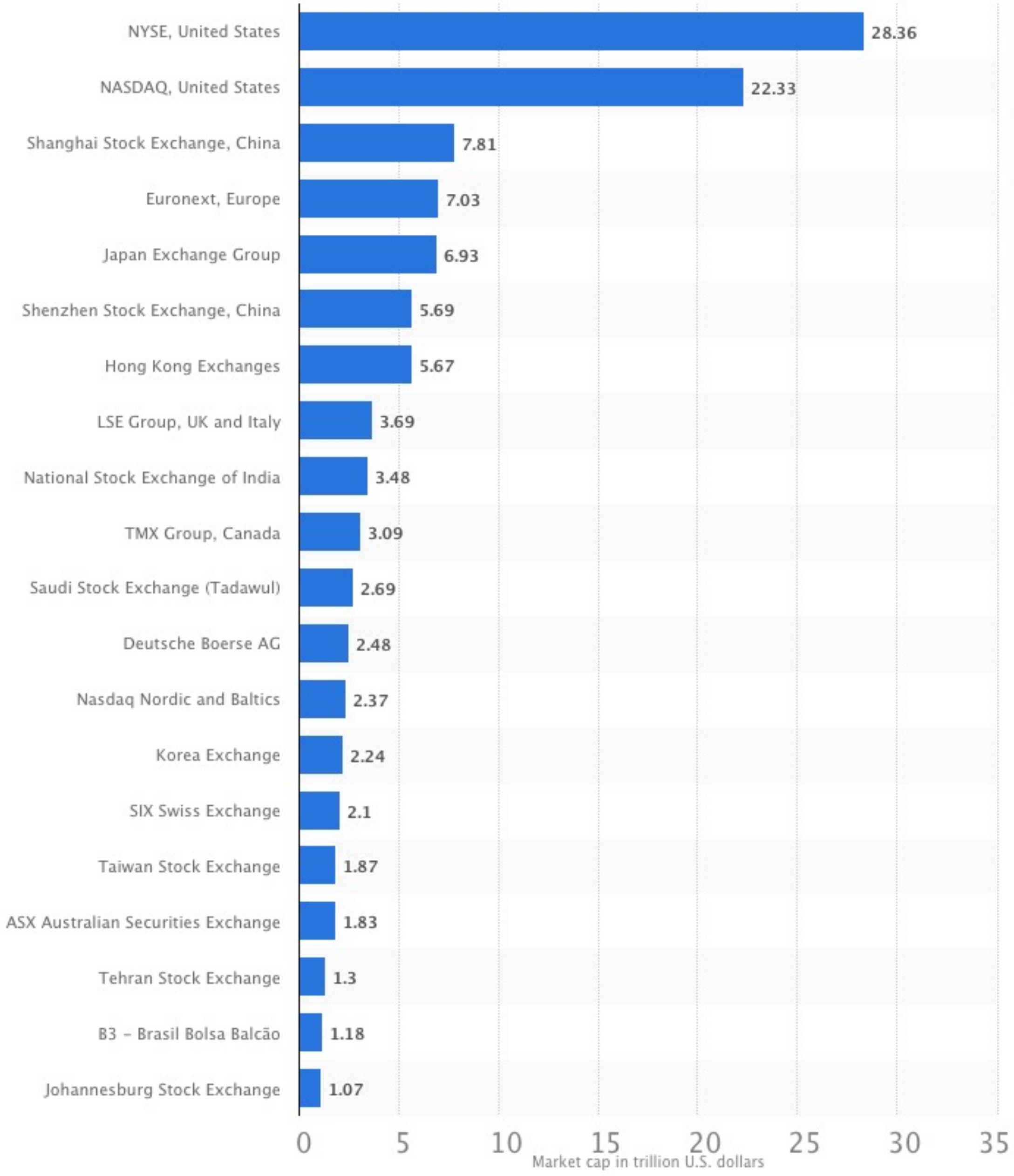
THE WORLD'S TWENTY LARGEST STOCK EXCHANGES AT THE END OF 2010, RANKED ACCORDING TO DOMESTIC MARKET CAPITALISATION OF EQUITIES

End of 2010	Domestic equities market capitalisation[1]	Total share trading in year	Number of listed companies		
	$ million	$ million	Total	Domestic	Foreign
NYSE Euronext (US element only)	13,394,082	17,795,600	2,317	1,799	518
NASDAQ OMX (US element only)	3,889,370	12,659,198	2,778	2,480	298
Tokyo SE Group	3,827,774	3,787,952	2,293	2,281	12
London SE Group	3,613,064	2,741,325	2,966	2,362	604
NYSE Euronext (Europe)	2,930,072	2,018,077	1,135	983	152
Shanghai SE	2,716,470	4,496,194	894	894	NA
Hong Kong Exchanges	2,711,316	1,496,433	1,413	1,396	17
TSX (TMX) Group (Canada)	2,170,433	1,368,954	3,741	3,654	87
Bombay SE	1,631,830	258,696	5,034	5,034	NA
National Stock Exchange India	1,596,625	801,017	1,552	1,551	1
BM&FBOVESPA (Brazil)	1,545,566	868,813	381	373	8
Australian SE	1,454,491	1,062,650	1,999	1,913	86
Deutsche Börse	1,429,719	1,628,496	765	690	75
Shenzhen SE	1,311,370	3,572,529	1,169	1,169	0
SIX Swiss Exchange	1,229,357	788,361	296	246	50
BME Spanish Exchanges	1,171,625	1,360,910	3,345	3,310	35
Korea Exchange	1,091,911	1,607,247	1,798	1,781	17
NASDAQ OMX Nordic Exchange (European element)	1,042,154	750,279	778	752	26
MICEX (Russia)	949,149	408,078	250	249	1
Johannesburg SE	925,007	340,025	397	352	45

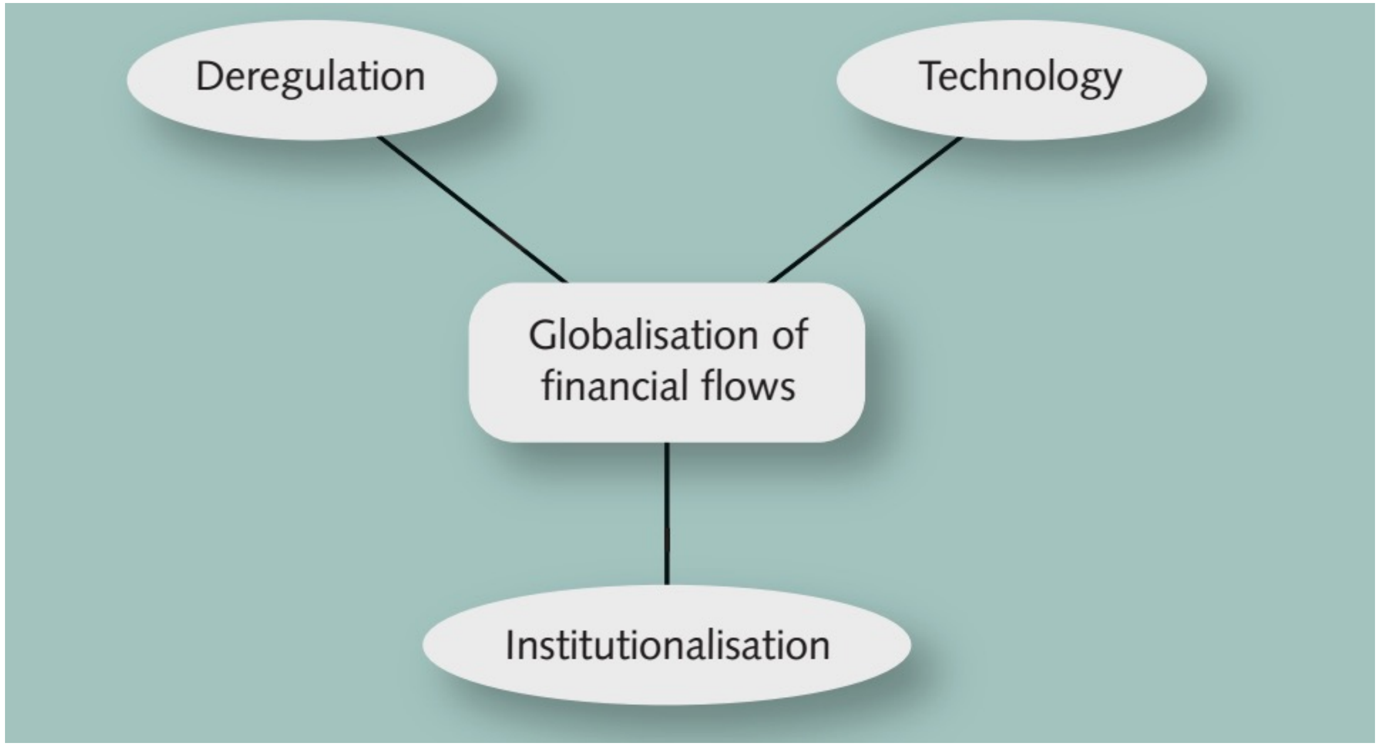
GLOBALISATION OF FINANCIAL FLOWS (5)

LARGEST STOCK EXCHANGE OPERATORS WORLDWIDE AS OF SEPTEMBER 2021, BY MARKET CAPITALIZATION OF LISTED COMPANIES

(in trillion U.S. dollars)



GLOBALISATION OF FINANCIAL FLOWS (6)



GLOBALISATION OF FINANCIAL FLOWS (6)

Deregulation

- The 1980s and 1990s was a period when government deregulation of financial markets was seen as a way of enabling financial and corporate entities to compete in the global marketplace and benefit consumers.
- The limits placed on the purchase and sale of foreign currency (foreign exchange controls) have been eliminated or lowered in most advanced economies. This has encouraged the flow of investment capital.
- Cartel-like arrangements for fixing the minimum commissions paid by investors for buying and selling shares have been eroded, as have the restrictions on ownership of financial firms and brokers by foreigners.

GLOBALISATION OF FINANCIAL FLOWS (7)

Deregulation

- Now, more than ever, domestic securities can be purchased by individuals and institutional funds from another country.
- Commercial banks have found the barriers preventing participation in particular markets being demolished.
- Tax laws have been modified so as not to discourage the flow of funds across borders for investment, and the previously statutorily enforced 'single-activity' financial institutions (in which, for example, banks did banking, building societies did mortgage lending) have ventured into each others' markets, increasing competition and providing a better deal for the consumer.

GLOBALISATION OF FINANCIAL FLOWS (8)

Institutionalisation

- Forty years ago most shares were owned by individuals.
- Today, the markets are dominated by financial institutions (pension funds, insurance companies, hedge funds, the 'mutual funds' such as unit and investment trusts and private equity funds).
- Whereas the individual, as a shareholder, tended to be more parochial and to concentrate on national company shares, the institutions have sufficient knowledge and strength to seek out the rewards from overseas investments.
- They also appreciate the diversification benefits which accrue due to the low level of correlation of returns between some financial markets.

GLOBALISATION OF FINANCIAL FLOWS (9)

Technology

- The rapid transmission of vast quantities of financial information around the globe has transformed the efficiency of financial markets.
- Securities can be monitored, analysed and dealt in on hundreds of share, bond, commodity and derivative exchanges at the touch of a button from almost anywhere in the world.
- The combination of powerful computers and extensive telecommunication networks allows accelerated integration, bringing with it complex trading strategies and enormous daily capital flows.

WHY DO COMPANIES LIST THEIR SHARES ON MORE THAN ONE EXCHANGE? (1)

- There are hundreds of companies which pay for the privilege of having their shares listed for trading on stock exchanges in other countries instead of, or as well as, on their local exchange.
- The most popular secondary listings locations are the USA and the UK.
- There are also substantial numbers of foreign shares listed on most of the northern European exchanges, as well as on those of Canada, Australia, Japan, Mexico, Switzerland and Singapore.
- This dual or triple listing can be a costly business and the regulatory environment can be stringent so there must be some powerful motivating factors driving managers to globalise their investor base.

WHY DO COMPANIES LIST THEIR SHARES ON MORE THAN ONE EXCHANGE? (2)

- **To broaden the shareholder base.** By inviting a larger number of investors to subscribe for shares it may be possible to sell those shares for a higher price and thus raise capital more cheaply (that is, a lower return will be required per £ invested).
- **The domestic stock exchange is too small or the firm’s growth is otherwise constrained.** Some companies are so large relative to their domestic stock markets that they have no choice but to obtain equity finance from abroad. When Ashanti Goldfields, the Ghanaian goldmining company, was privatised it was valued at about $1.7bn, which was more than ten times the capitalisation of the Accra stock market. A listing in London was a great success and the company expanded its activities in other African countries; it also listed in New York, Toronto, Zimbabwe, Ghana and London. Prada chose to list on the Hong Kong market where more money for growth was available.

WHY DO COMPANIES LIST THEIR SHARES ON MORE THAN ONE EXCHANGE? (3)

- **To reward employees.** Many employees of foreign-owned firms are rewarded with shares in the parent company. If these shares are locally listed the share-ownership plans can be better managed and are more appealing to employees.
- **To raise awareness of the company.** For example, Standard Chartered listed on the Bombay Stock Exchange as well as London and Hong Kong to strengthen its brand.

WHY DO COMPANIES LIST THEIR SHARES ON MORE THAN ONE EXCHANGE? (4)

Toyota to list in New York and London

Toyota, Japan's third-largest company by market capitalisation, plans to list its shares in New York and London this month.

The issue is aimed at attracting international investors, meeting the needs of the increasingly global industry and boosting Toyota's image, said Yuji Araki, senior managing director.

The move is the latest in a series of global offers by Japanese companies, which are aimed at increasing the international element of their shareholder base . . .

Mr Araki said the company decided to list in New York and London not only to increase its investor base but also to be able to judge whether Toyota's performance met western standards.

'If they don't, we will have to change ourselves', he said.

Listing in the two cities would also help Toyota sense the changes in foreign stock markets more quickly and from those changes, the economic, social and industrial changes occurring in those markets, Mr Araki said.

Foreigners own a relatively low proportion of Toyota – just 8.8 per cent. But Mr Araki emphasised that the company had no fixed target for foreign shareholders . . .

In addition to New York, Toyota decided to list in London because 'in order to attract international investors it is essential to list in London', he added . . .

However, over the next two to three years, changes would be introduced in Japanese reporting requirements, which would bring them much closer to SEC standards, Mr Araki said.

FT Michiyo Nakamoto and Paul Abrahams, *Financial Times*, 8 September 1999, p. 26.

WHY DO COMPANIES LIST THEIR SHARES ON MORE THAN ONE EXCHANGE? (5)

Prada draws up plans for Hong Kong IPO

By Rachel Sanderson in Milan

Prada, the Italian fashion group, is set to list on the Hong Kong stock exchange as early as May as it seeks to tap voracious Asian demand for luxury goods.

The decision by the group, which is majority owned by designer Miuccia Prada, her family and her chief executive husband Patrizio Bertelli, is a first for the European luxury goods and fashion industry.

It underlines Hong Kong's rising status as a destination for international listings. Analysts say that in a buoyant Hong Kong market, the whole group could be worth as much as €5bn-€6bn ($6.8bn-$8.2bn), whereas a listing in Milan, among the worst-performing markets in the past year, would have less chance of achieving that.

In a move that was closely watched by European luxury goods groups, L'Occitane, a French cosmetics and perfumery company, listed in Hong Kong last May as part of an Asian expansion strategy.

The company raised $704m in an offer that attracted strong demand from institutional investors. Its shares have since surged in value. Bernstein Research expects demand from Asia, outside of Japan, for bags, shoes and watches to drive luxury goods consumption until at least 2015. Prada has abandoned several attempted listings in Milan in the past decade, citing unfavourable market conditions and gaining a reputation in the process for volatility.

FT *Financial Times*, 28 January 2011.

WHY DO COMPANIES LIST THEIR SHARES ON MORE THAN ONE EXCHANGE? (6)

StanChart eyes 'small' listings in China and India

By Sharlene Goff, Retail Banking Correspondent

Standard Chartered, the Asia-focused bank, is targeting stock market listings in Mumbai and Shanghai as it seeks to strengthen its brand in key local markets.

Peter Sands, chief executive, said a listing in India could be launched in the first half of next year, while plans for a listing in China were less advanced.

Speaking to the Financial Times following the bank's trading update, Mr Sands said: 'These two markets are incredibly important to us. We are actively pursuing a listing in India and how we could make it work effectively. Plans for China are at an earlier stage.'

He said the additional listings would be 'relatively small' and were 'not driven by the quantum of capital but what they would do to reinforce the profile and positioning of the bank'.

Mr Sands said he had no plans to relocate from London.

This differs to the strategy of HSBC, which is also primarily focused on Asia and recently decided to move its chief executive to Hong Kong.

Standard Chartered, which derives more than 90 per cent of earnings from Asia, Africa and the Middle East, is on track for record profits this year.

FT *Financial Times*, 30 October 2009.

WHY DO COMPANIES LIST THEIR SHARES ON MORE THAN ONE EXCHANGE? (7)

Indian business opts for Aim

By David Blackwell

Aim is enjoying an Indian summer as companies from the sub-continent opt to join the junior market.

On Tuesday, Caparo Energy will become the third Indian company in a month to float on Aim.

Caparo, which has raised about £50m ($80m), is planning to develop a portfolio of wind farms. Investors include Blackrock and Henderson.

Ravi Kailas, chief executive, said the company had looked at raising the money from private equity groups, but London's institutional investors were aware of the Indian energy sector on Aim and a flotation on the junior market would leave other options open.

FT *Financial Times*, 11 October 2010.

THE IMPORTANCE OF A WELL-RUN STOCK EXCHANGE (1)

A **well-run stock exchange** has a number of characteristics.

- It is one where a 'fair game' takes place; that is, where it is not possible for some investors and fund raisers to benefit at the expense of other participants – all players are on 'a level playing field'.
- It is a market which is well regulated to avoid abuses, negligence and fraud in order to reassure investors who put their savings at risk.
- It is also one on which it is reasonably cheap to carry out transactions.
- In addition, a large number of buyers and sellers are likely to be needed for the efficient price setting of shares and to provide sufficient liquidity, allowing the investor to sell at any time without altering the market price.

THE IMPORTANCE OF A WELL-RUN STOCK EXCHANGE (2)

There are **six main benefits** of a well-run stock exchange.

1. **Firms can find funds and grow**

   - Because investors in financial securities with a stock market quotation are assured that they are, generally, able to sell their shares quickly, cheaply and with a reasonable degree of certainty about the price, they are willing to supply funds to firms at a lower cost than they would if selling was slow, or expensive, or the sale price was subject to much uncertainty.
   - Thus stock markets encourage investment by mobilising savings.
   - As well as stimulating the investment of domestic savings, stock markets can be useful for attracting foreign savings and for aiding the privatisation process.

THE IMPORTANCE OF A WELL-RUN STOCK EXCHANGE (3)

2. **Allocation of capital**
   - One of the key economic problems for a nation is finding a mechanism for deciding what mixture of goods and services to produce.
   - An extreme solution has been tried and shown to be lacking in sophistication – that of a totalitarian directed economy where bureaucratic diktat determines the exact quantity of each line of commodity produced.
   - The alternative method favoured in most nations (for the majority of goods and services) is to let the market decide what will be produced and which firms will produce it.
   - An efficiently functioning stock market is able to assist this process through the flow of investment capital. If the stock market was poorly regulated and operated then the mis-pricing of shares and other financial securities could lead to society's scarce capital resources being put into sectors which are inappropriate given the objective of maximising economic well-being.

THE IMPORTANCE OF A WELL-RUN STOCK EXCHANGE (4)

- If, for instance, <u>the market priced the shares of a badly managed company in a declining industrial sector at a high level</u> then that firm would find it relatively easy to sell shares and raise funds for further investment in its business or to take over other firms.
- This would deprive companies with better prospects and with a greater potential contribution to make to society of essential finance.

THE IMPORTANCE OF A WELL-RUN STOCK EXCHANGE (5)

- To take an extreme example: imagine the year is 1910 and on the stock market are some firms which manufacture horse-drawn carriages.
- There are also one or two young companies which have taken up the risky challenge of producing motor cars.
- Analysts will examine the prospects of the two types of enterprise before deciding which firms will get a warm reception when they ask for more capital in, say, a rights issue. The unfavoured firms will find their share prices falling as investors sell their shares, and will be unable to attract more savers' money.
- One way for the older firm to stay in business would be to shift resources within the firm to the production of those commodities for which consumer demand is on a rising trend.
- More recently there has been a dramatic shift in finance resources as markets supplied hundreds of billions to high-technology industries, such as mobile phone chip technology, e.g. the Cambridge-based company, ARM plc, that designs and licenses 95 per cent of the world's chips for mobiles, or Skype in Internet telephony.

THE IMPORTANCE OF A WELL-RUN STOCK EXCHANGE (6)

3. **For shareholders**
   - Shareholders benefit from the availability of a speedy, cheap secondary market if they want to sell.
   - Not only do shareholders like to know that they can sell shares when they want to, they may simply want to know the value of their holdings even if they have no intention of selling at present.
   - By contrast, an unquoted firm's shareholders often find it very difficult to assess the value of their holding.
   - Founders of firms may be particularly keen to obtain a quotation for their firms. This will enable them to diversify their assets by selling a proportion of their holdings.
   - Also, venture capital firms which fund unquoted firms during their rapid growth phase often press the management to aim for a quotation to permit the venture capitalist to have the option of realising the gains made on the original investment, or simply to boost the value of their holding by making it more liquid.

THE IMPORTANCE OF A WELL-RUN STOCK EXCHANGE (7)

4. **Status and publicity**
    - The public profile of a firm can be enhanced by being quoted on an exchange. Banks and other financial institutions generally have more confidence in a quoted firm and therefore are more likely to provide funds at a lower cost.
    - Their confidence is raised because the company's activities are now subject to detailed scrutiny.
    - The publicity surrounding the process of gaining a quotation may have a positive impact on the image of the firm in the eyes of customers, suppliers and employees and so may lead to a beneficial effect on their day-to-day business.

THE IMPORTANCE OF A WELL-RUN STOCK EXCHANGE (8)

5. **Mergers**
   - Mergers can be facilitated better by a quotation.
   - This is especially true if the payments offered to the target firm's shareholders for their holdings are shares in the acquiring firm. A quoted share has a value defined by the market, whereas shares in unquoted firms are difficult to assess.
   - The stock exchange also assists what is called '**the market in managerial control**'. This is a mechanism in which teams of managers are seen as competing for control of corporate assets. Or, to put it more simply, <u>mergers through the stock market permit the displacement of inefficient management with a more successful team</u>.
   - Thus, according to this line of reasoning, assets will be used more productively and society will be better off. This '**market in managerial control**' is not as effective as is sometimes claimed.

Shenzhen takes over as China's listing hub

By Robert Cookson in Hong Kong

For years, Shanghai has been the undisputed king of China's equity markets, vitalised by a steady stream of initial public offerings from the country's biggest and best state-owned enterprises.

But this year Shanghai has been outgunned by Shenzhen, its less glamorous rival in the south of China, because of an extraordinary boom there in IPOs by The Shenzhen Stock Exchange has seen 246 companies raise a record $33.6bn by listings this year, triple last year's total and much more than the $24.1bn raised in Shanghai.

'This tells us something of epic proportions about China,' says Peter Fuhrman, chairman of China First Capital, a boutique investment bank in Shenzhen.

Most of the companies listing in Shenzhen are small and medium-sized groups owned by private entrepreneurs, as opposed to the state-owned behemoths that typically gravitate to Shanghai.

'Chinese policymakers have seen the central importance to the country's future of allowing private companies greater access to private flows of equity capital,' says Mr Fuhrman.

The China Securities Regulatory Commission, which controls stock market listings in the country, appears to have sharply accelerated approvals of IPOs in Shenzhen this year. Market participants say the CSRC has also become less involved in decisions about size, timing and pricing of share sales.

Shenzhen's IPO boom represents a substantial fresh source of capital for smaller private companies, which have typically been starved of funds by a state-owned banking system that has preferred to lend to other organs of the government.

The bourse is also an increasingly attractive place for private equity groups to make lucrative exits from their investments in China.

Goldman Sachs made a near 200-fold profit on its original $5m investment in Hepalink, when the drugmaker listed in Shenzhen in April.

Shenzhen is still a relatively small part of China's financial system – the Rmb220bn ($33bn) raised by IPOs there this year is dwarfed by the Rmb6,000bn-plus in new loans that Chinese banks have extended during the same period.

THE PRIMARY MARKET (EQUITIES)

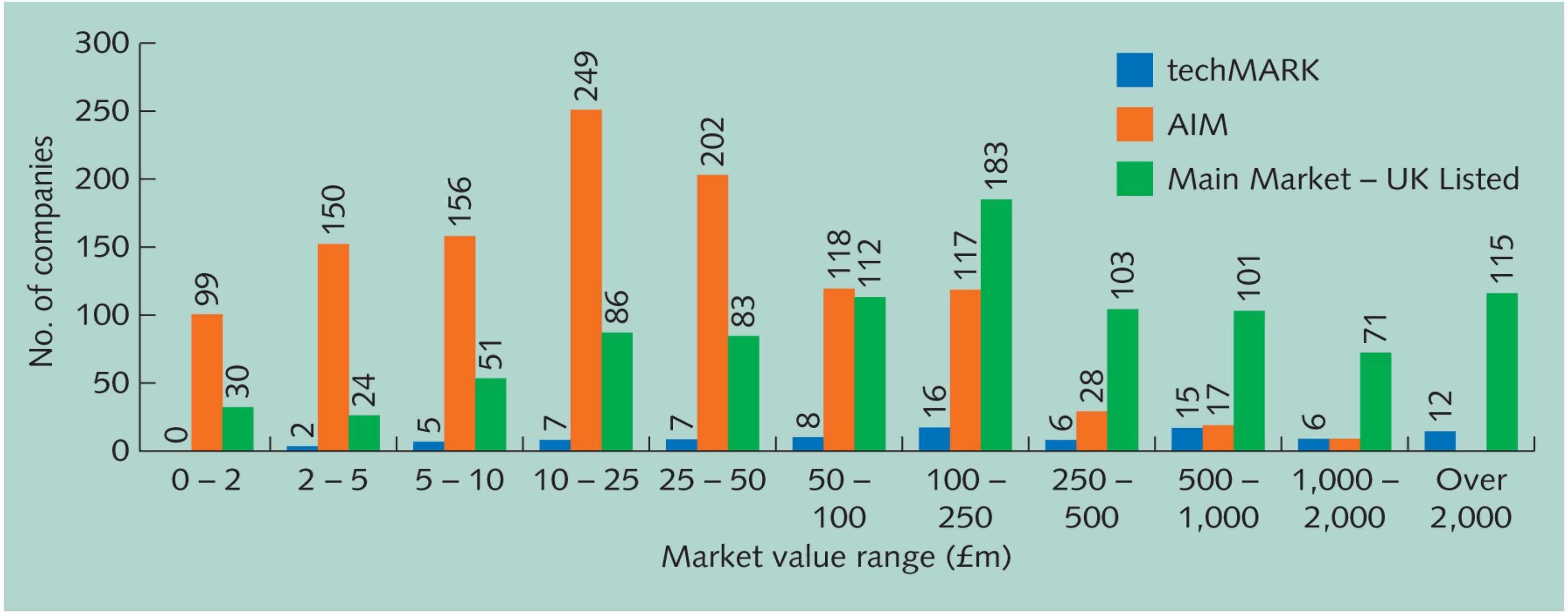
- 2011
  - Over 1,000 UK companies on the Main Market and 80 UK companies on the tech MARK
  - Over 1,100 companies on the Alternative Investment Market

Money raised by UK companies, 1999–2011

*Includes non-UK companies

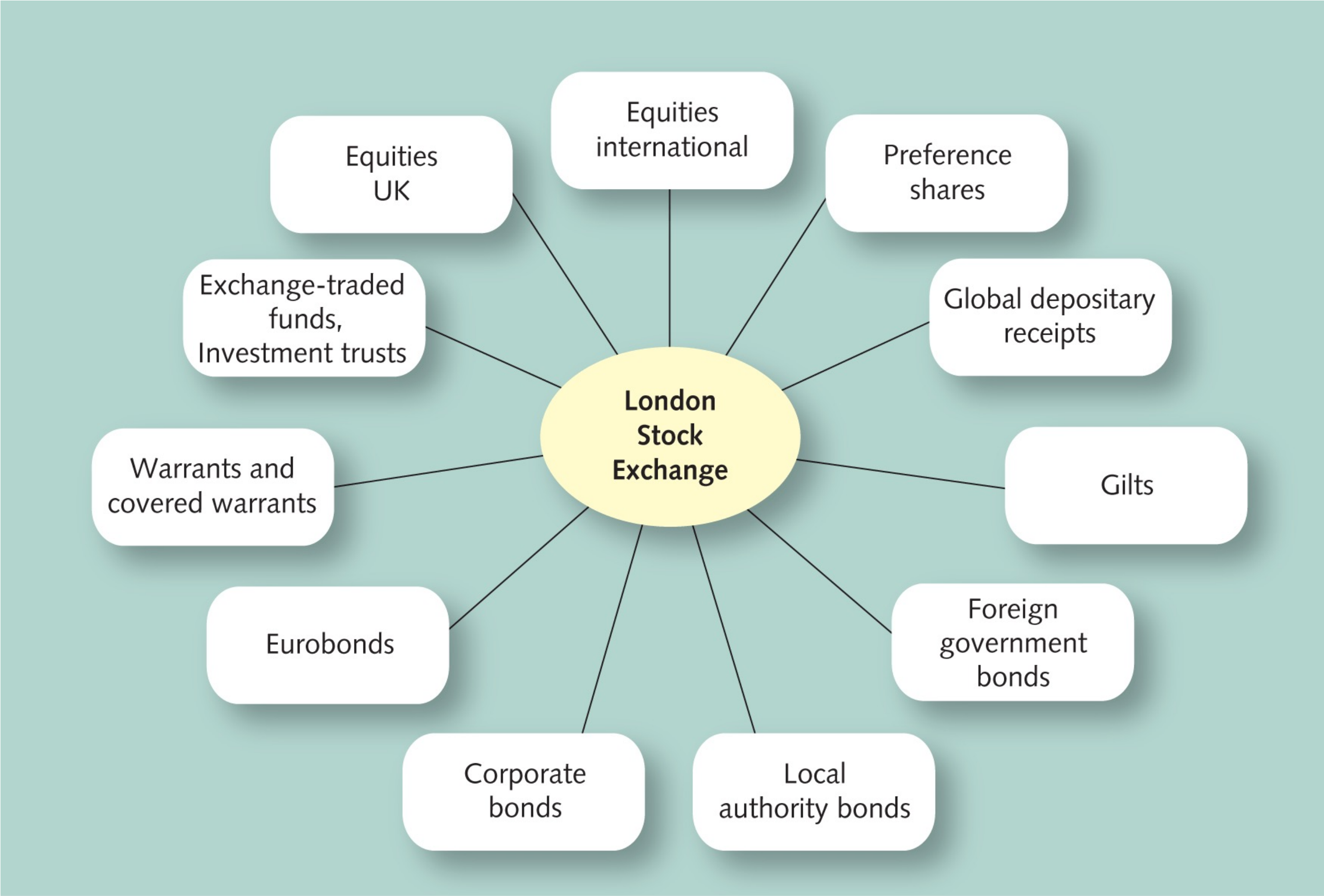
	New companies issuing shares		Other issues of shares and other securities		Eurobonds		AIM	
	No. of Co.'s	Money raised (£m)	No. of issues	Money raised (£m)	No. of issues	Money raised (£m)	No. of new companies joining AIM	Money raised* (£m)
1999	106	5,353	893	9,917	1,022	85,515	102	934
2000	172	11,399	895	13,979	1,012	100,556	277	3,092
2001	113	6,922	866	14,824	935	83,342	177	1,128
2002	59	5,082	763	11,696	815	86,657	160	976
2003	32	2,445	618	4,920	1,096	118,755	162	2,095
2004	58	3,610	690	8,621	1,170	127,508	355	4,656
2005	86	6,078	772	8,099	1,099	148,309	519	8,942
2006	82	9,088	665	14,445	1,500	216,495	462	15,678
2007	73	7,613	477	8,995	2,025	165,924	284	16,184
2008	53	3,110	402	51,666	2,101	432,445	114	4,332
2009	17	458	378	73,907	1,858	254,571	36	5,602
2010	57	6,998	380	12,360	2096	184,465	102	6,958
2011	21	9,240	580	2,462	2,312	196,442	90	4,269

THE SECONDARY MARKET IN EQUITIES



Distribution of UK companies by equity market value at August 2011 for Main Market and TechMARK. The AIM numbers include non-UK companies

THE LONDON STOCK EXCHANGE



THE UK EQUITY MARKETS AVAILABLE TO COMPANIES

- **The Main Market (Official List)**
- **The Alternative Investment Market (AIM)**
    - No requirement for AIM companies to be a minimum size
    - No requirement for a company to have traded for a minimum period of three years
    - No set proportion of shares to be in public hands
    - Nominated adviser ('nomad')
    - Nominated brokers
    - The annual cost of being quoted on AIM runs into tens of thousands of pounds
- **TechMARK**
  - All companies joining techMARK have a market capitalisation of at least £50m and they must sell at least £20m worth of new or existing shares when floating
  - At least 25 per cent of their shares must have a free float
  - Publish quarterly reports
  - AIM admission document

TASKS FOR STOCK EXCHANGES

- Supervision of trading to ensure fairness and efficiency
- The authorisation of market participants such as brokers
- Creation of an environment in which prices are formed efficiently and without distortion (price discovery)
- Organisation of the settlement of transactions
- Regulation of the admission of companies to the exchange and the regulation of companies on the exchange
- Dissemination of information

TYPES OF TRADING : OPEN OUTCRY TRADING

- Traditionally shares were traded between two traders, face to face.
- A few stock exchanges around the world still have a place where buyers and sellers (or at least their representatives) meet to trade.
- For example, the NYSE continues to make some use of a large trading floor, with thousands of face-to-face deals taking place every working day (**open outcry trading**).
- This is the traditional image of a stock market, and if television reporters have a story about what is going on in the world's security markets, they often show an image of traders rushing around, talking quickly amid a flurry of small slips of paper on the NYSE trading floor.
- Most trading now, however, is conducted silently in front of banks of computers, with deals being completed in nano-seconds.

TYPES OF TRADING : QUOTE-DRIVEN TRADING (1)

- **Quote-driven trading** is how most stock exchanges were operated.
- With this type of approach, **market makers** give a price at which they will buy (lower price) or sell (higher price), and they make their profits on the margins between buying and selling.
- Traditionally they operated in '**trading pits**' and used an open outcry system of trading, i.e. shouting and using hand signals to make trades, much like you might see bookmakers at a small horse race meeting.
- They were able to adjust their prices according to what other traders were doing. Although this type of trading does still take place, it has been superseded by **electronic trading**.
- Market makers input their prices ('**bid**' is the price at which they are willing to buy and '**offer**' or '**ask**' is the price at which they are willing to sell) to a computer system and dealing takes place electronically.

TYPES OF TRADING : QUOTE-DRIVEN TRADING (2)

- **Market makers**, also known as **dealers**, fulfil a crucial role in the markets: in those securities in which market makers agree to make a market there will always be (in trading hours) someone available who will quote a price at which they will buy or sell – as a purchaser or seller you may not like the price but at least someone is making a trade possible.
- If you wanted to invest in a small company's shares and there were no market makers, then you might hesitate because the shares would fail to have the important quality of liquidity.
- Investors in companies lacking an active secondary market will demand higher rates of return (lower share prices) to compensate for the inability to quickly find a counterparty willing to trade.

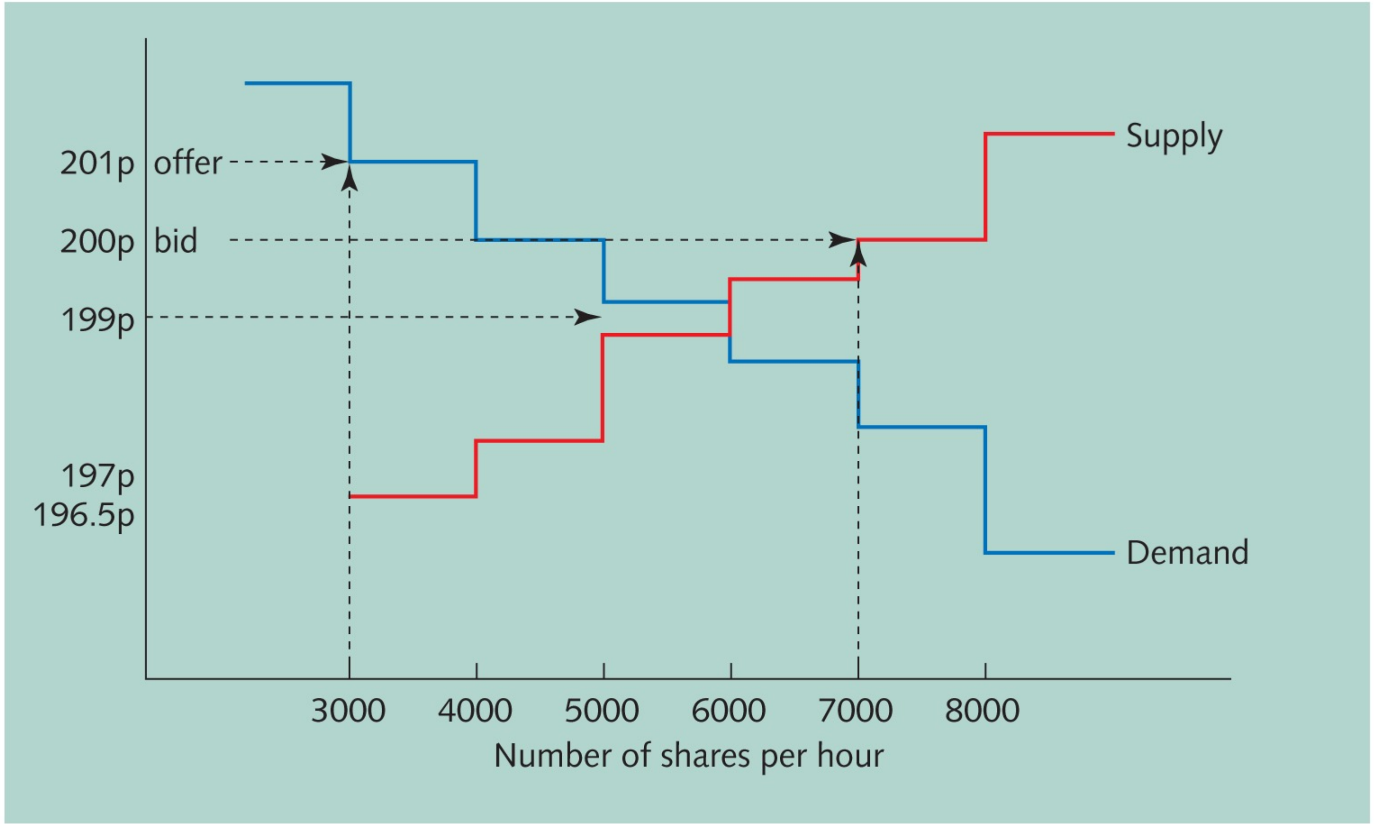
TYPES OF TRADING : QUOTE-DRIVEN TRADING (3)

- The idea is that in a market with competing market makers, if the gap between the bid and offer prices gets too wide then clients will be lured away by better prices being offered by other market makers in that security.
- The difference between the prices is known as the trader's spread or **bid–offer spread.**
- Many of these prices are displayed on electronic systems so that clients can see them displayed on their computer screens throughout the day.
- Other security bid–offer prices are given to you only if you telephone the market maker and ask for a quote.

TYPES OF TRADING : QUOTE-DRIVEN TRADING (4)

- **Market makers take a considerable risk**: they have to hold inventories of shares and other securities to supply those who want to buy.
- Tying up a lot of money in inventories of shares, bonds, etc. can be very expensive, and there is always the possibility of downward movement in price while they hold millions of pounds or euros in inventory.
- The degree of risk varies from one security to another and this helps explain the differences in the size of the bid–offer spread. For some securities it is significantly less than 1 per cent of the value, in others it can be 20 per cent or more.
- The other major factor influencing the spread is the volume of trade that takes place relative to the amount that has to be held in inventory – high volume gives access to a liquid market for the market maker. Thus Marks & Spencer has millions of shares traded every day and so the market maker is not likely to have M&S shares on its hands for long because they are going out of the door as fast as they are coming in – spreads here can be around one-tenth of 1 per cent. Shares of a small engineering company, meanwhile, might trade in lots of only a few hundred at two- or three-day intervals. Thus the market maker has money tied up for days before selling and is fearful of a price fall between trading days.

THE SECONDARY MARKET IN EQUITIES



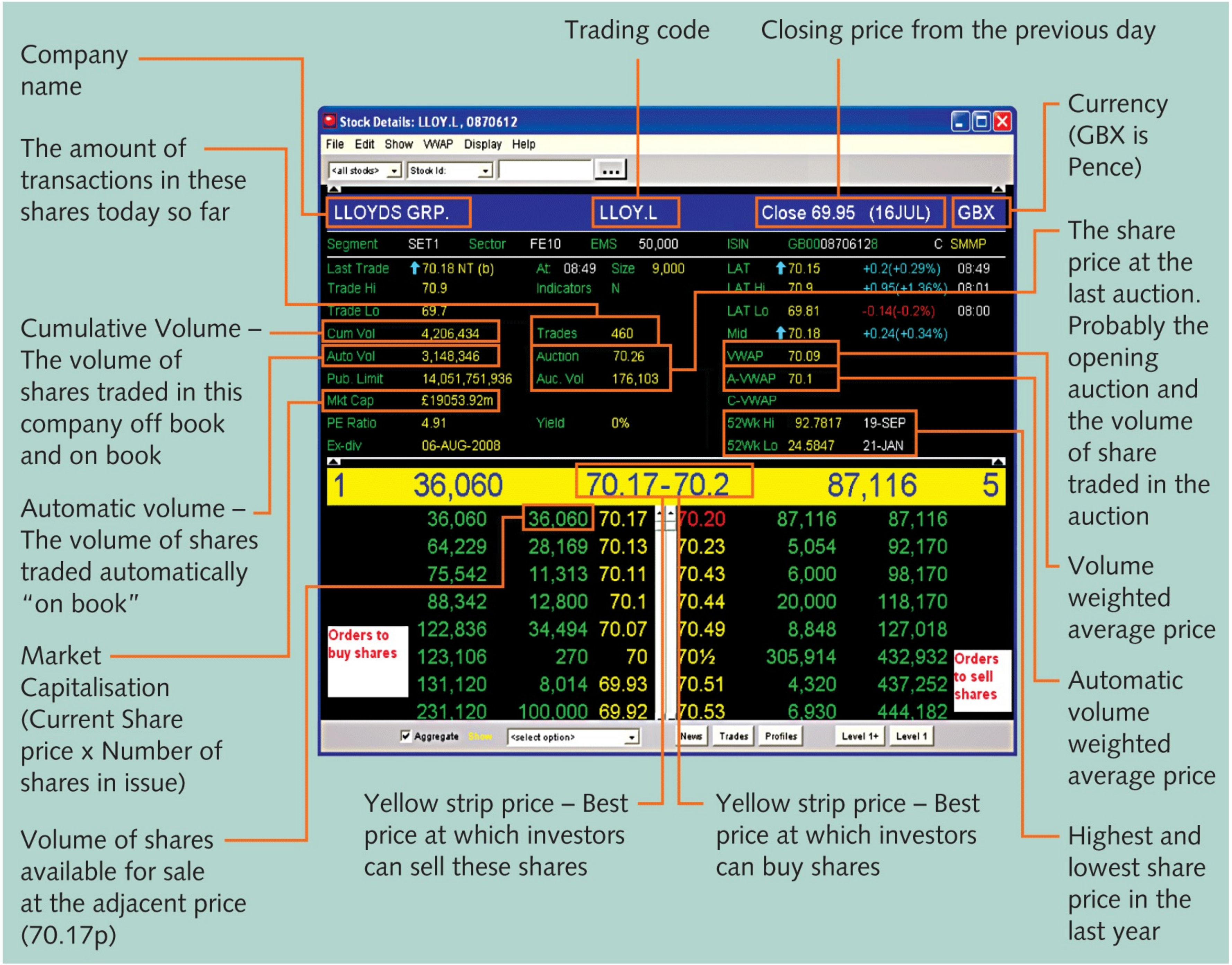
Supply and demand in a quote-driven market

FIVE MARKET MAKERS OFFERING THE FOLLOWING PRICES:

Market maker	Bid price	Offer price
1	198.5p	199.5p
2	197.3p	199.5p
3	197.0p	200.0p
4	198.5p	199.7p
5	198.3p	202.0p

MATCHED-BARGAIN SYSTEMS

- Criticism of trading systems based on market makers quoting bid and offer prices focused on the size of the middleman's (the market maker's) margin led to the development of order-driven trading, where buyers trade with sellers at a single price so that there is no bid–offer spread.
- Most stock exchanges in the world now operate this type of system.
- These markets allow buy and sell orders to be entered on a central computer, and investors are automatically matched (they are sometimes called **matched-bargain systems** or **order book trading**).
- In 1997, the LSE introduced an order-driven service known as **SETS** (**Stock Exchange Electronic Trading System**).



A SETS SCREEN

FOLLOWING A TRADE

- Clear the trade
- Central counterparty risk
- Three-day rolling settlement
- CREST
  - Nominee company rather than in the name of the beneficial owner
  - Dematerialisation
  - Personal membership of CREST

Brussels eyes faster times for settlement

By Jeremy Grant in London and Nikki Tait in Brussels

European regulators are considering ways to cut the time it takes for securities to be processed after trades are done in a bid to reduce risks to the system in the event of defaults and other large financial failures.

Reducing the so-called 'settlement cycle' would be one of the biggest moves taken by regulators in the wake of the 2008 financial crisis since proposed reforms of the over-the-counter derivatives markets, recently finalised by the European Commission.

Settlement is the post-trade process that ensures securities are exchanged for cash, completing a transaction such as the trading of stocks and shares.

Currently settlement in most of Europe takes place three days after the trade is made, in a system known as 'T+3'. Germany uses T+2.

Reducing the cycle by a day would cut by a third the time it takes for a deal to be finalised – and thus reduce the scope for failures such as defaults while transactions work their way through settlement and custody processes. It would also make it easier for the region to handle corporate actions such as rights issues and takeover bids.

The idea of reducing the settlement cycle was identified before the financial crisis as a way of harmonising pan-European post-trade structures to make the region's capital markets more efficient.

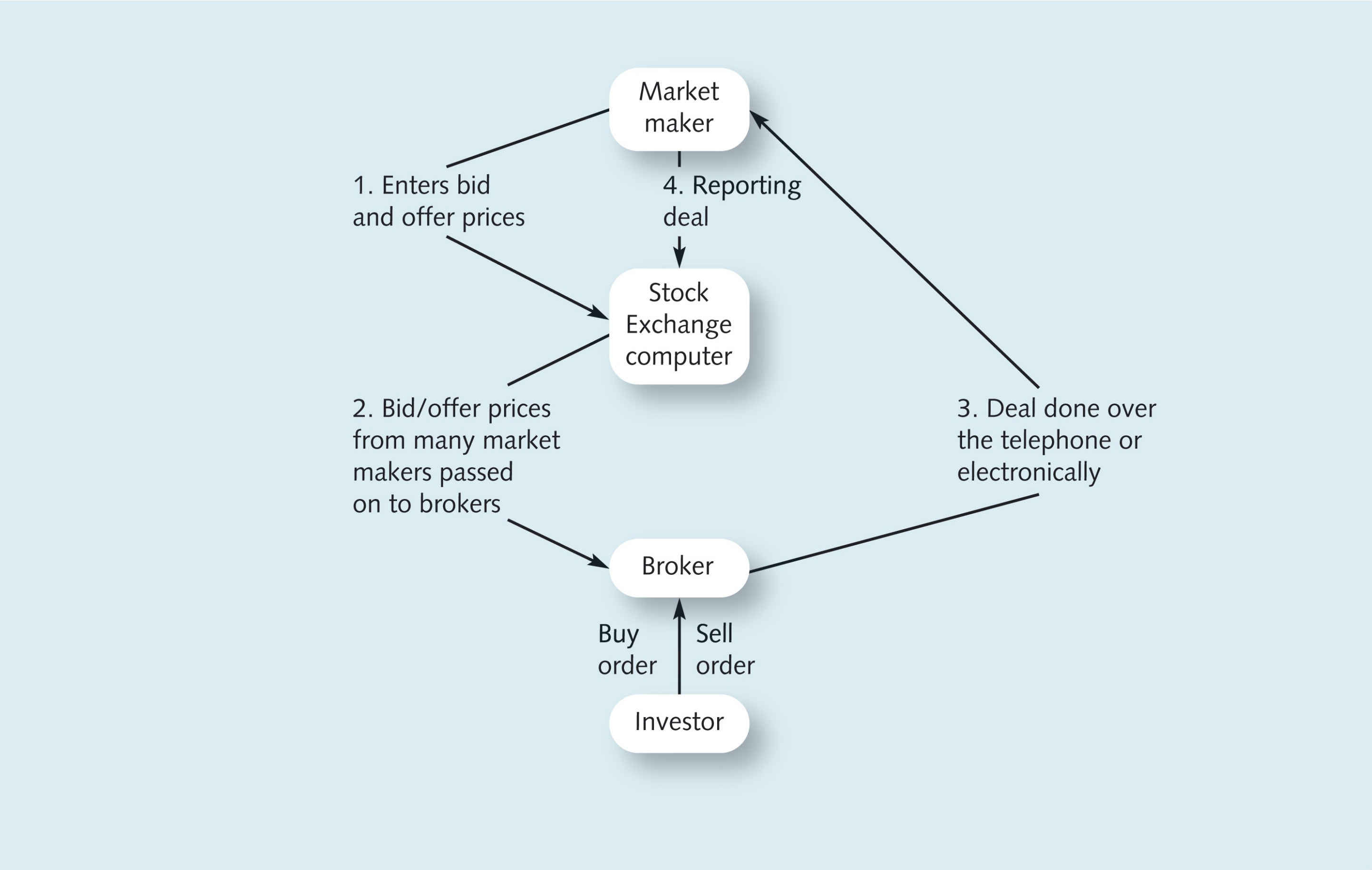
But the issue has received fresh impetus since the collapse of Lehman Brothers, whose default raised alarm over counterparty risk.

FT *Financial Times*, 25 October 2010.

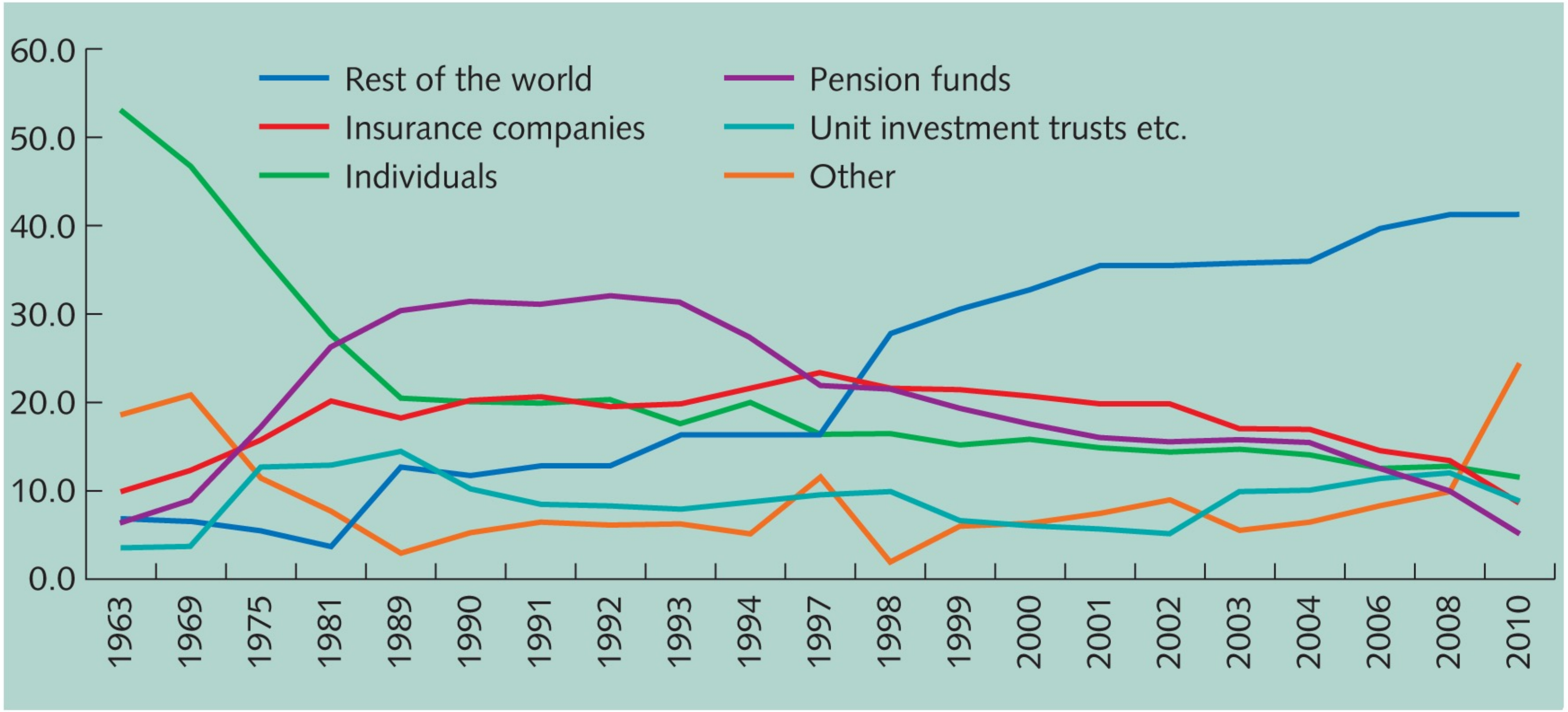
SETSQX

- Stock Exchange Electronic Trading Service – quotes and crosses.
- **Main Market (and a few AIM) shares which are less liquid and not traded on SETS.**
- Combines order book technology (similar to the SETS method of trading) with the best of the LSE's existing quote-driven trading.
- A single market maker's quote can be displayed.
- An investor can connect, usually via brokers, to the electronic system and put onto the system's screen display an order for shares stating a price at which they would like to trade.
- Four auctions per day.

THE SEAQ QUOTE-DRIVEN SYSTEM



SHARE OWNERSHIP IN BRITAIN, DISTRIBUTION BY SECTOR (QUOTED SHARES) (%)

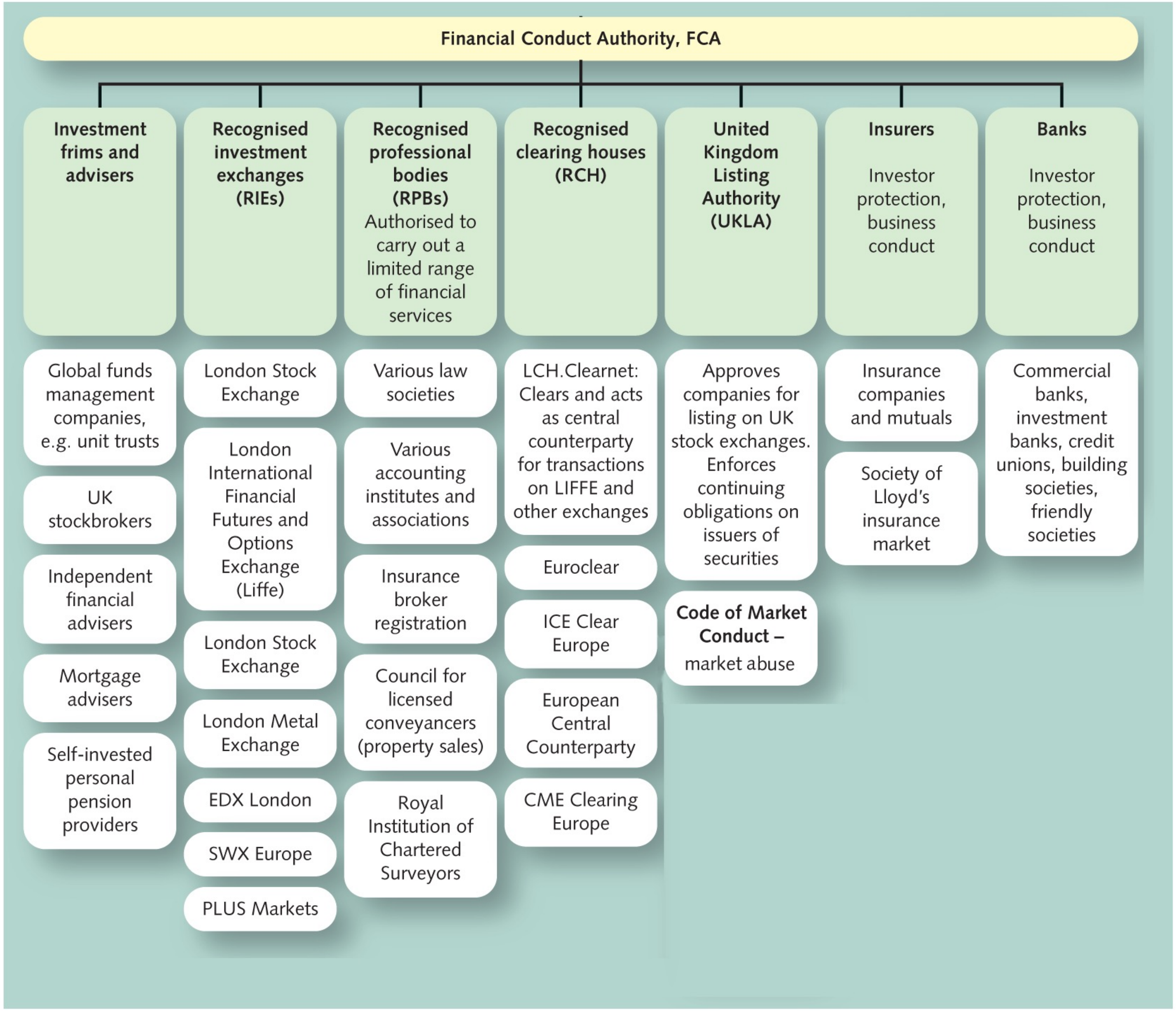


Percentage ownership of UK shares 1963–2010

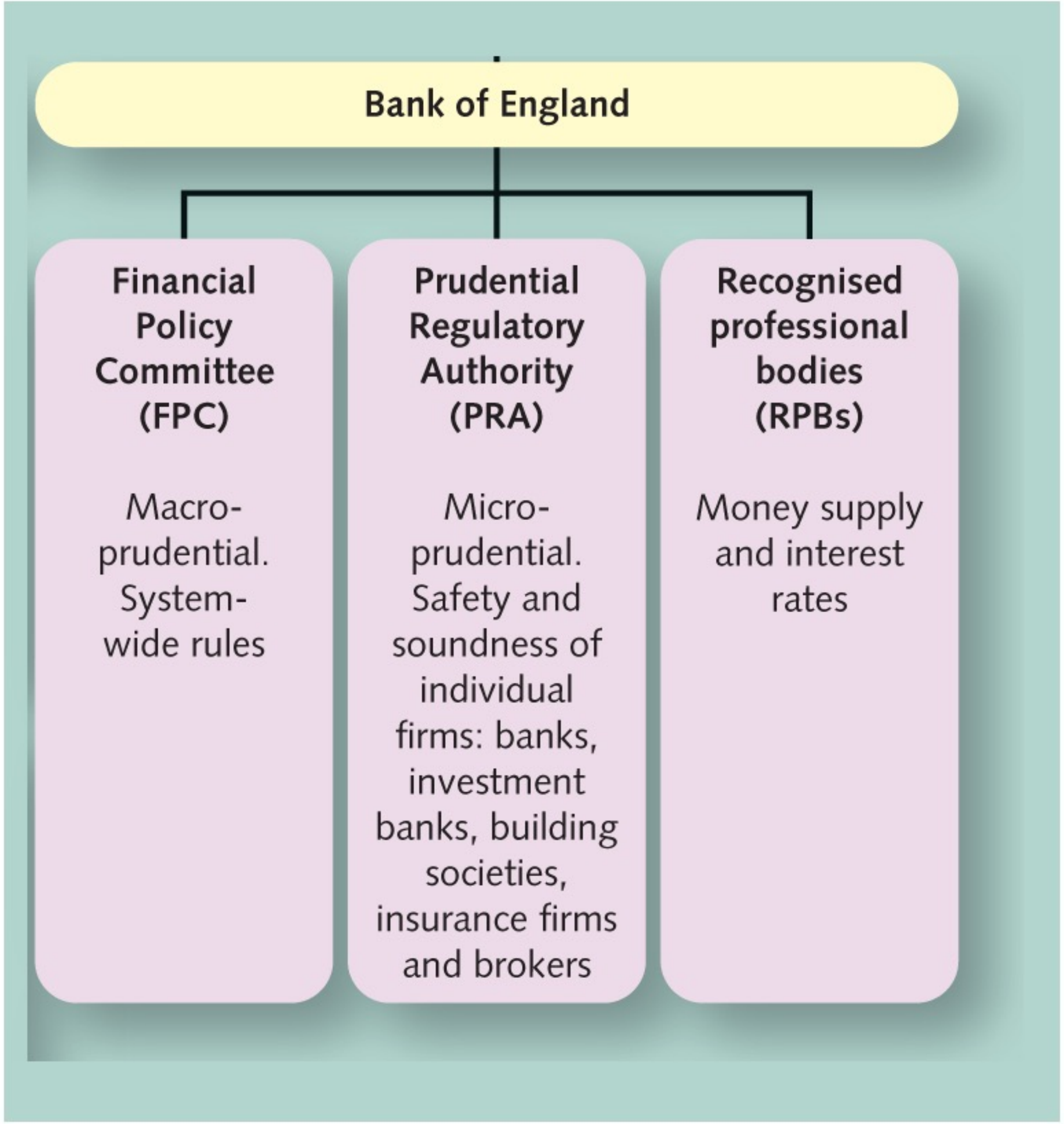
REGULATION

- London's financial markets have a unique blend of law, self-regulation and custom to regulate and supervise their members' activities
- Financial Services and Markets Act 2000
- Financial Services Authority (FSA)/Financial Conduct Authority FCA
- Prudential Regulatory Authority
- Bank of England
- Media
- Legislation prohibiting insider dealing, fraud and negligence
- Companies Acts
- Competition Commission
- Office of Fair Trading
- Panel on Takeovers and Mergers
- European Union regulations
- Accountants
- Companies House

FINANCIAL SERVICE INDUSTRY REGULATION



FINANCIAL SERVICE INDUSTRY REGULATION (CONTINUED)



UNDERSTANDING THE FIGURES IN THE FINANCIAL PAGES

- Indices
  - Mostly market value weighted: the average is derived by weighting each share by the size of the company
- FTSE 100 The ‘Footsie™’
- FTSE All-Share
- FTSE 250
- FTSE 350
- FTSE Smallcap
- FTSE Fledgling
- FTSE AIM All-Share
- FTSE All-small

LONDON SHARE SERVICE EXTRACTS: AEROSPACE AND DEFENCE

WEDNESDAY OCTOBER 5 2011

Notes	Price	Chng	52 Week High	Low	Yld	P/E	Vol '000s
Aerospace & Defence							
AvonRub..†	259	−17.75	340	156	1	13	51
BAE Sys....	254	−6	372.90	241	7.1	7.4	19,439
Chemring.†	519	−9.50	740	470.30	2.4	10.8	557
Cobham...†	168.50	−4.50	247.40	167	3.7	12.4	3,109
Hampson...	9.43	+0.03	41	9.22	–	1.1	1,374
Meggitt....†	322.30	−8.10	400.90	124	3	13.4	16,880
RollsRyc.✠	571	−27	666.61	314.06	2.6	6.3	10,410
Senior......†	137	−5.60	193.60	**128.60**	2.4	10.3	3,114
UltraElc....†	£15.32	+0.11	£19.03	£12.65	2.3	14.4	159
UMECO.....	310.75xd	−6.25	512.50	**305.71**	5.9	22.4	7

MONDAY OCTOBER 3 2011

Notes	Price	Wks% Chng	Div	Div Cov	Mcap £m	Last xd
Aerospace & Defence						
AvonRub..†	258	−2.0	2.50	8.0	87.6	10.8
BAE Sys....	267.30	−2.4	18	1.9	8,889.2	20.4
Chemring.†	528.50	+1.0	12.40-	3.9	1,025.5	13.7
Cobham...†	174.80	−2.6	6.17	2.2	1,912.9	4.5
Hampson...	9.50	−13.6	–	–	26.5	9.10
Meggitt....†	334.90	+5.7	9.55	2.5	2,603.0	10.8
RollsRyc.✠	595	−0.2	14.85	6.2	11,139.7	27.10
Senior......†	144.50	+6.6	3.27	4.1	581.2	4.5
UltraElc....†	£15.05	+0.9	35.70	3.0	1,035.6	17.8
UMECO.....	319.25xd	+0.7	18.25	0.8	153.8	7.9

Price/earnings ratio (PER) – share price divided by the company's earnings (profits after tax) per share in the latest twelve-month period. A much examined and talked about measure

$$\text{PER} = \frac{\text{share price}}{\text{earnings per share}}$$

Market price – this is the mid-price (midway between the best buying and selling prices) quoted at 4.30 pm on the previous day

Change in closing price on day before (Tuesday) compared with previous trading day

The highest and lowest prices during the previous 52 weeks

Dividend yield – the dividend divided by the current share price expressed as a percentage

$$\frac{\textit{dividend per share}}{\textit{current share price}} \times 100$$

Volume of trade in those shares on the day

Market capitalisation is calculated by multiplying the number of shares by their market price

Ex-dividend date is the last date on which the share went ex-dividend (new buyers of the shares will not receive the recently announced dividend after this date) 17th August in this case

Share price change over the previous week

The dividend paid in the company's last full year – it is the cash payment in pence per share (after deduction of 10% tax for UK firms)

Dividend cover – profit after tax divided by the dividend payment, or earnings per share divided by dividend per share

$$\textit{Dividend cover} = \frac{\textit{earnings per share}}{\textit{dividend per share}}$$