

# **Building a World-Class Stock Exchange**

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# Roadmap

1. Role of Stock Exchanges
2. Components of a Matching Market
  - Attracting Investors
  - Attracting Owners
3. Regional vs Global Attraction
  - Economic Issues
  - Behavioral Biases
4. Attracting Family Firms
5. Parting Thoughts

# 1.1. Foundations of Exchanges

- Matching Investors with Entrepreneurs
- Location to conduct exchanges
- Describe common rules of trade
- Matching Difficult
  - Information Differences
  - Power Differences
  - Settlement Problems

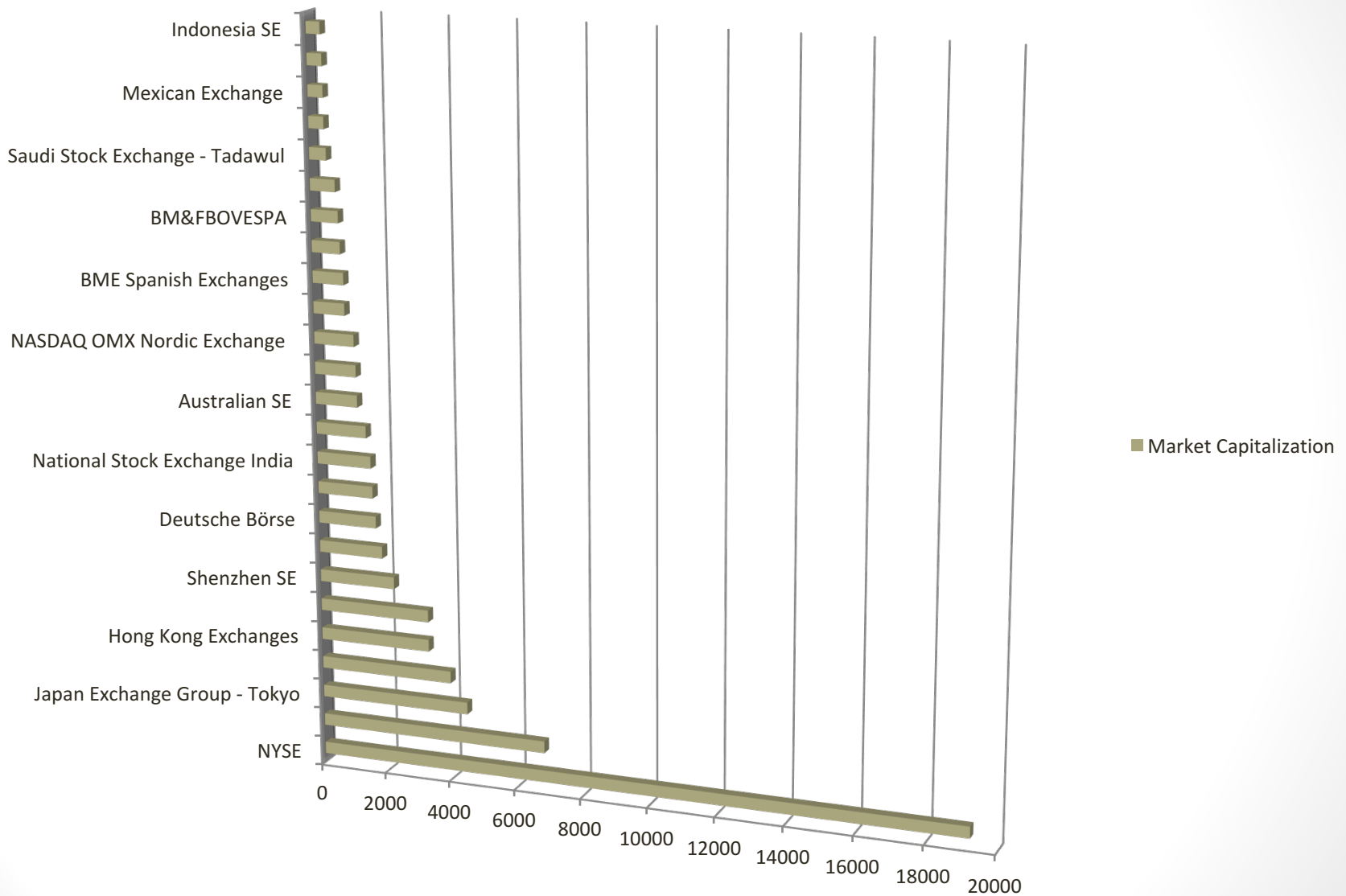
# 1.2. Importance of Exchanges

- Capital Investment for Risky Endeavors
- Fund R&D Investments
- Foster Venture Capital: Endgame
- Facilitate Economic Growth
- Comparison to Alternatives
  - Syndicated Loans: Property and Equipment
  - Government Funds: Solid Investments
- Liquid/Diversified Portfolio for Investors

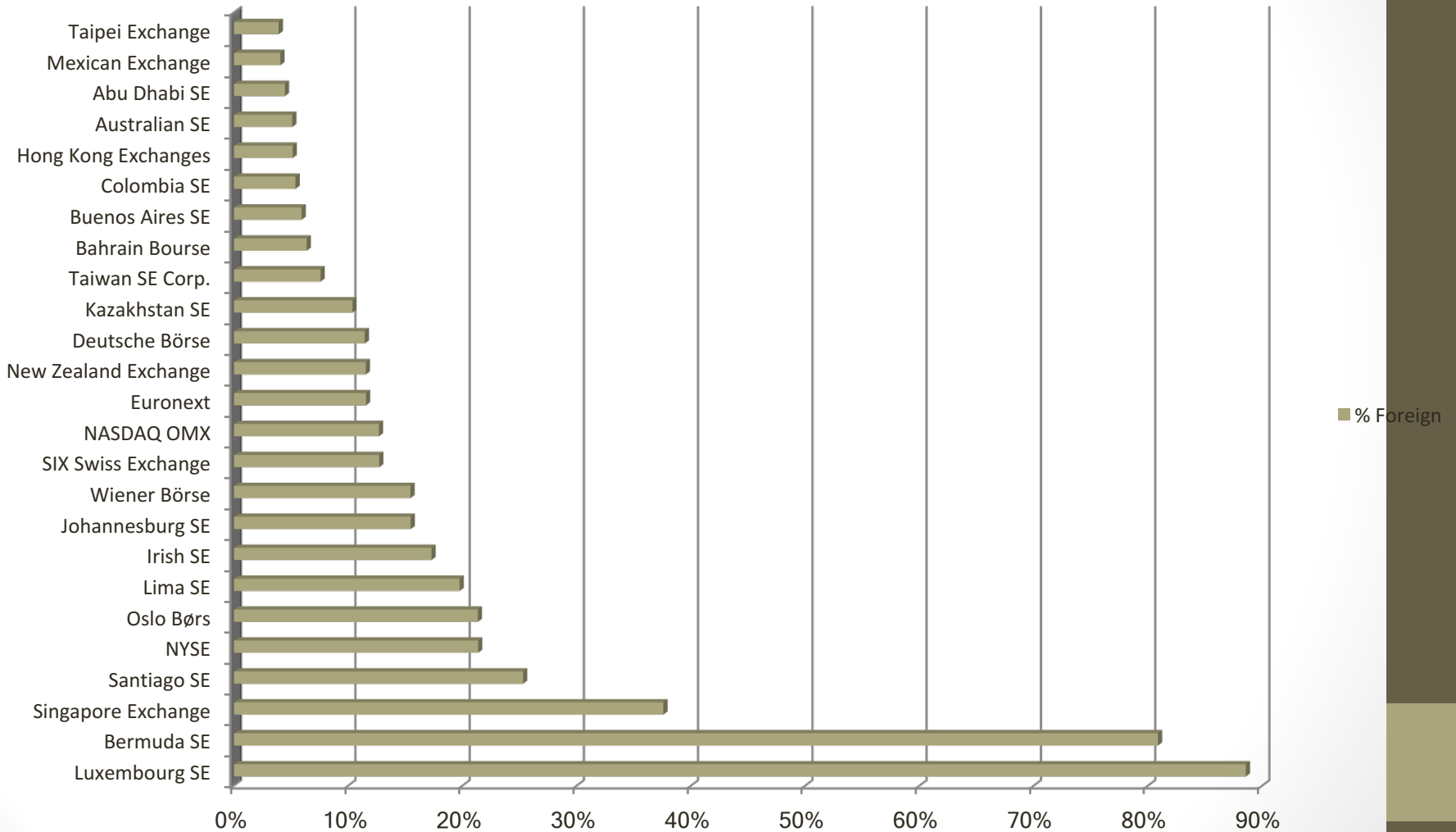
# 1.3. Measuring Exchange Success

- Capitalization as a Measure of Success
- % Foreign Firms as a Measure of Success
- IPOs as a Measure of Success
- Capitalization as a Percentage of GDP

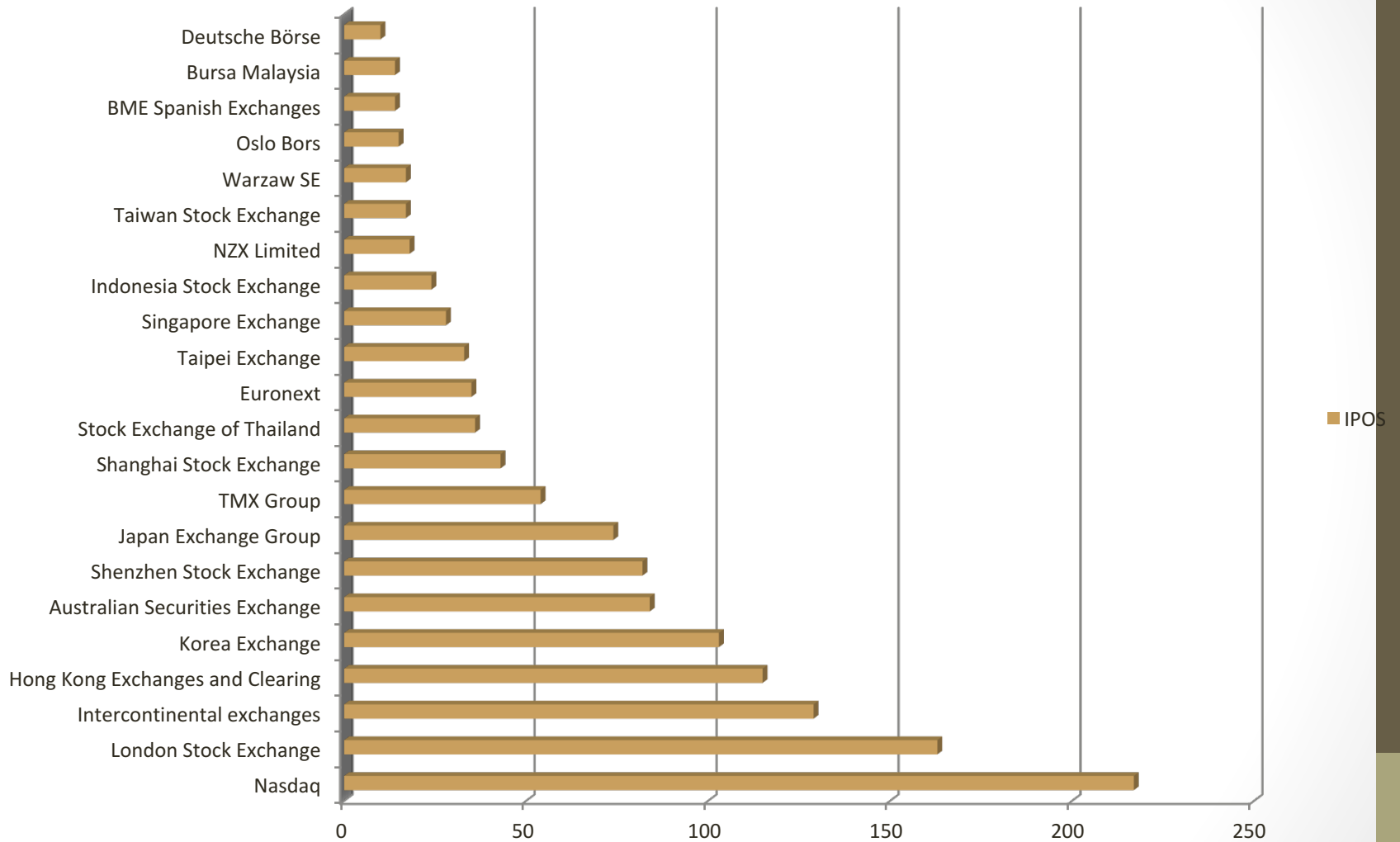
# Market Capitalization



# % Foreign Companies Listed on Exchange

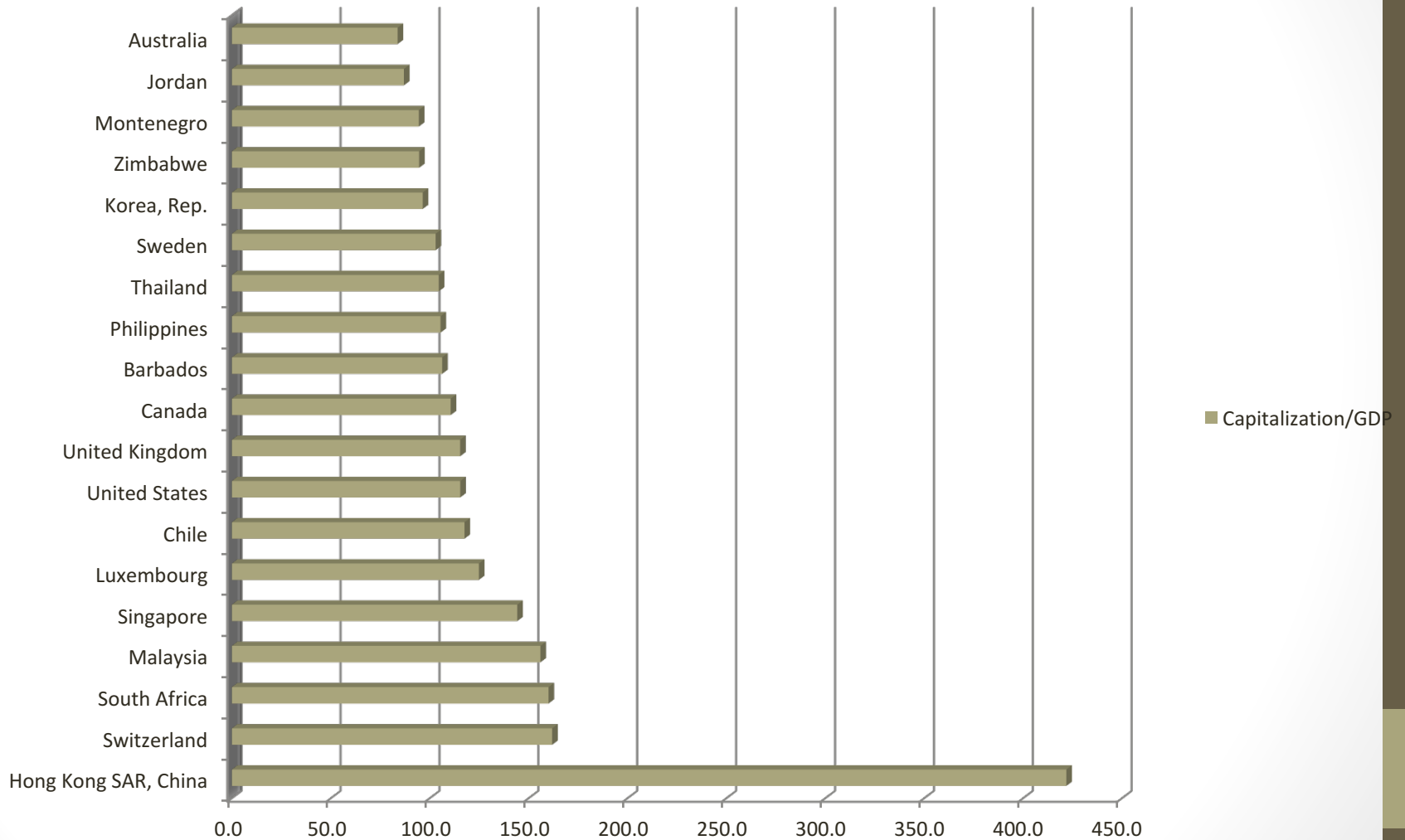


# 1,413 IPOs in 2014

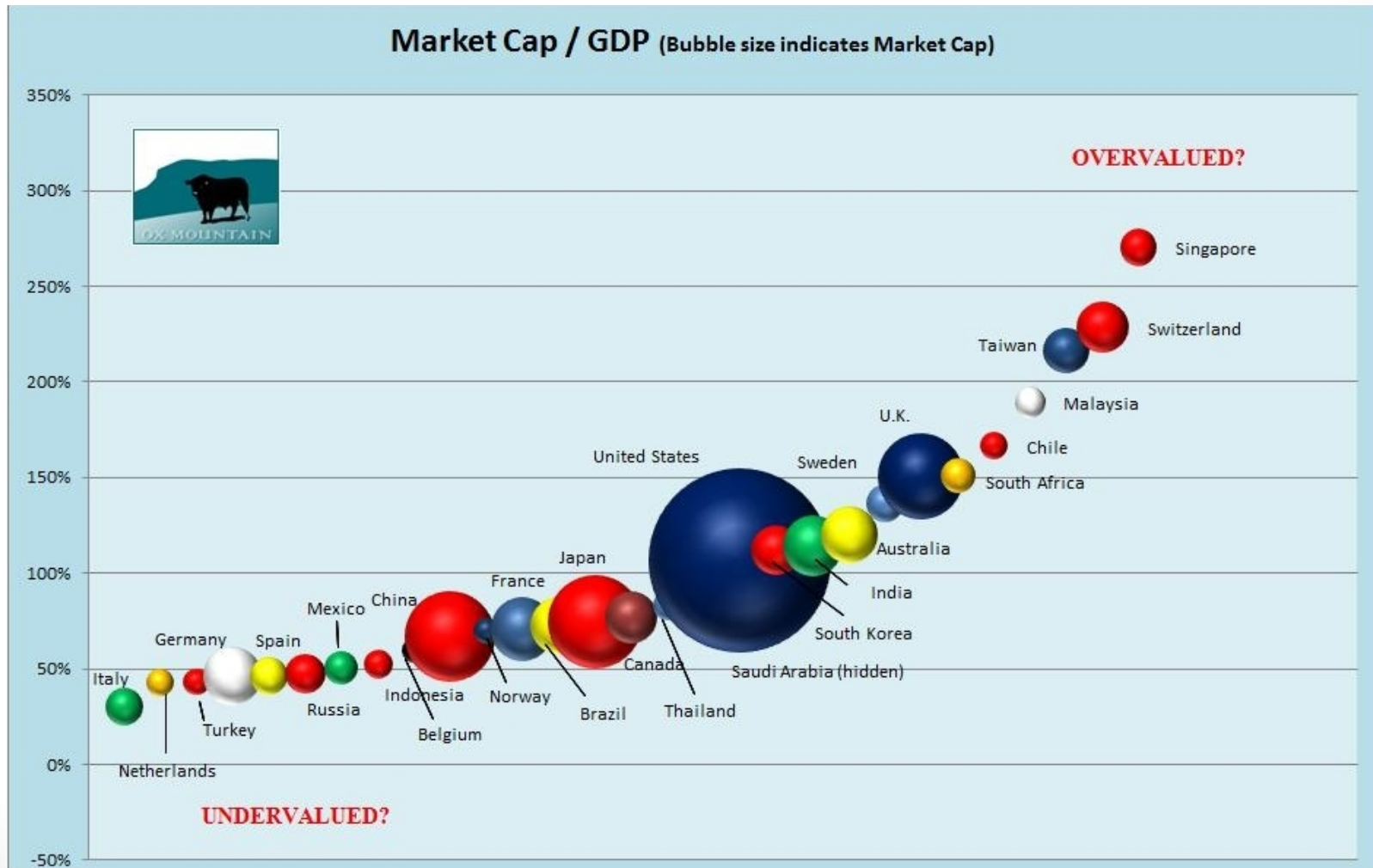




# Capitalization/GDP



# Market Cap/GDP: Buffet Approach



# 1.4 Tale of Two Exchanges

- AMEX (now bought by NYSE)
  - Started as Curb Exchange ~ 1849
  - 1908 Codified Trades, 1921 Physical Location
  - Focus on Young, High Growth Firms
  - Easier Financial Requirements than NYSE
- NASDAQ
  - 1971 – Electronic Quotes – Phone Orders
  - Allowed for lower spreads
  - In 1980s – often called OTC
- Financial & Ownership Requirements

## 2. Components of a Market

- Attract Both Sides: Stable Equilibrium
- University: Student and Faculty Match
  - Lots of countries with a Uni that attracts top students but not in top 200 Uni's
  - Need great faculty and great students
  - Rise of Chicago, NYU, UTAustin, NUS, NTU, HKUST
- Amazon & Alibaba
  - Attract Sellers
  - Attract Buyers

# 2.1. Attracting Investors

- Legal Protection/Property Rights
- Disclosure Rules
- Governance Mechanisms
  - Board of Directors
  - Compensation Contracts
- Institutions
  - Analysts; Rating Agencies; Auditors
  - Trust in Regulator
- Yet – some of these restrict entrepreneurs

## 2.2. Two Types of Monitoring

- Limit Expropriation & Shirking
  - Tunneling
  - Firm as Piggy Bank
  - Limited Effort: Lets Play Golf
- Limit Creativity and Risk Taking
  - High punishment for failure
  - Exclude if short term performance weak
  - Dual Role: Advising vs Monitoring
  - Entrepreneur seeks to limit information flow

## 2.2. Attracting IPOs

- Family Firms
  - Prevalent Around the World: Bulk of Listed Companies
  - East vs West: Exit Strategy
  - Control in Developing & Developed Countries
- VC Led Firms: Market one exit strategy
- Controlling Shareholders
  - Worry about expropriation of their Work Product
  - Syndicated Loans less risk of Control Loss
  - Differences in Physical Asset and Knowledge Firms
  - Making Attractive to Family Firms
    - Often willing to forego growth to ensure control
    - Ideal: Raise capital, pursue growth opportunities, control

# 3. Regional vs Global Attraction

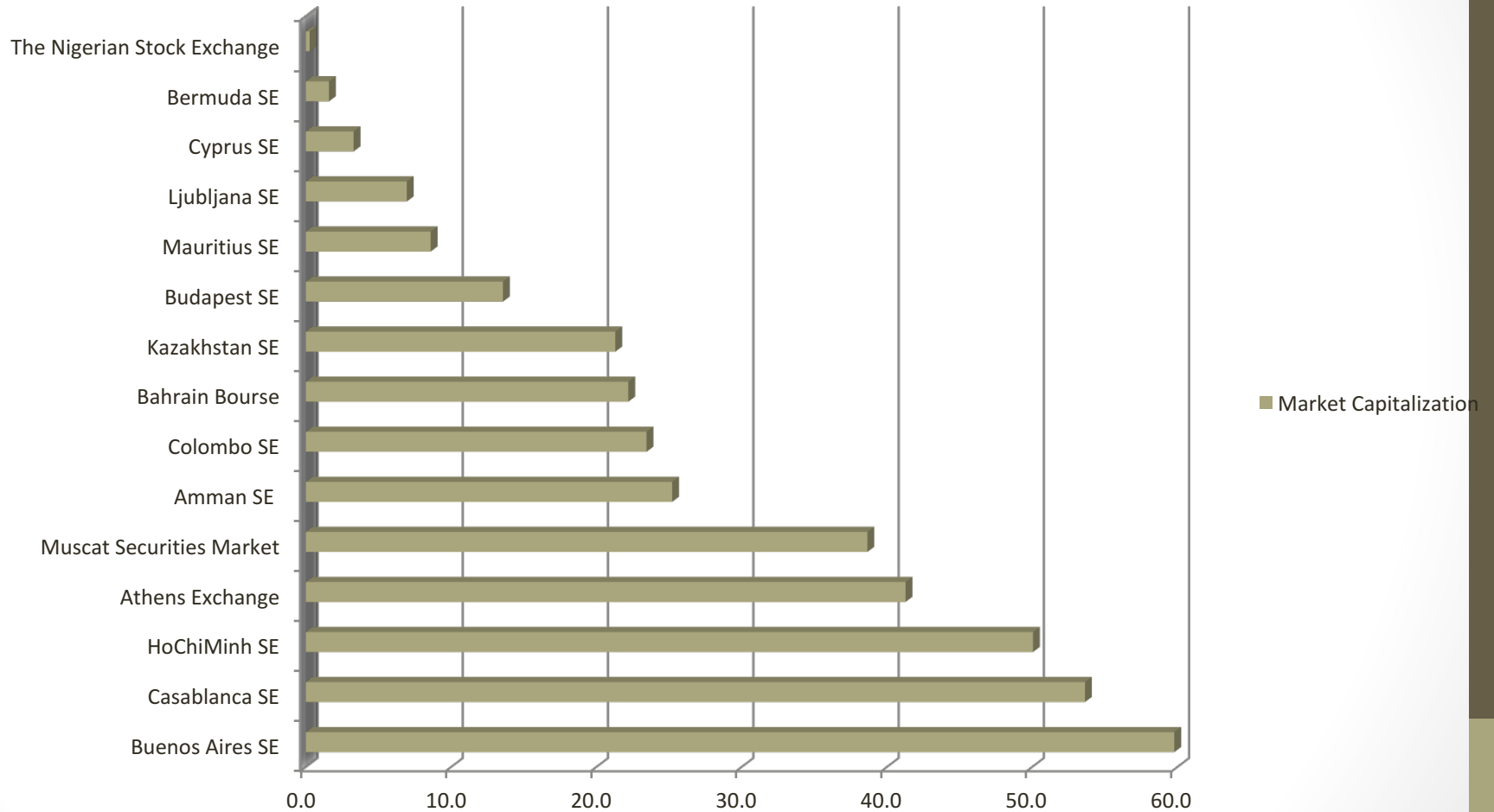
- Investors
  - Limit Expropriation by Controlling Shareholders
  - Information Asymmetries in Foreign Markets
  - Overcoming Investor Home Bias
  - Status Quo Bias
- Family Owners
  - Limit Expropriation by Outside Shareholders
  - Maintain control of family legacy
  - Overcoming Family Home Bias
  - Status Quo Bias



# 3.1 Regional Exchanges

- Thrive in host of countries
- Partial Solutions
  - Information Asymmetry
  - Home Bias
- Markets exist: Just stay local
  - Poor property rights
  - Poor governance
- Family Owners Seek to Stay in Firm
  - Source of Social Standing/Identity
  - US/UK are anomalies – used taxes to dismantle family firms
  - Yet, need capital with control
  - Result: Lots of companies with 15% to 30% floated shares

# 10 Smallest Stock Exchanges



## 3.2. Global Exchanges

- Necessary Conditions
  - Attract Investors: Rule of Law & Monitoring
  - Attract Family Owners: Limit Loss of Control
- Strong Geographic Support
  - Extended Area Underserved
  - High Trust in Regulators
- Overcoming Frictions
  - Information Asymmetry
  - Regulating Foreign Firms
  - Home Bias
  - Status Quo Bias

# 4. Attracting Family Firms

- Family Firms Prominent in S.E. Asia
- Nearby Economies > 500 Million
  - Indonesia - 234 Million People
  - Bangladesh - 164 Million People
  - Philippines - 94 Million People
  - Myanmar - 50 Million People
- Middle Class & Growth of New Firms
- Role of Entrepreneurship: Knowledge

# 4.1 Family: Not Lose Control

- Dual Class Shares & Fairness
  - Dual Class Airplanes; Mortgages; Credit Cards
  - Role of Pricing ~ 6.5% premium
  - The Evidence: 2,000 Largest US Firms

	Dual Class	Single Class
Family Firm	140	812
Non-Family Firm	3	1045

- Incorrect Comparison: 143 vs 1857
- Correct Comparison: 140 vs 812
- Supervotes; Golden Shares; & Poisson Pills
- Family Board Seats

# 4.2 Investors: Not Expropriated

- Anglo-American Diffuse Shareholder Solutions
  - Board Independence: Effectiveness in Lg Shareholder?
  - Compensation Contracts?
- Potential Considerations For Family Firms
  - Board Observation Rights
  - Executive/Owner Personal Certification
  - Information Intermediary Roles: Analysts & Auditors
  - Mandatory Disclosure Requirements
    - Hard Information
    - Soft Information
- **Trade-off Greater Control Rights for Greater Information**

# 5. 1. Parting Thoughts: Foundations

- Stock Exchange - Critical for Knowledge Entrepreneurship
  - Innovation Depends on Equity Financing
  - VC Led growth relies on Exchange Exits
- Building Global Market
  - Attract Investors
    - Protection Necessary Condition
    - Not a Sufficient Condition
  - Attract Family Controlled Firms
    - Limit Ability to Lose Firm
    - Separate Monitoring and Loss of Control

## 5.2. Parting Thoughts: Trade-Offs

- Matching
  - Not About Who You Want Partner To Be
  - Rather How Make Both Sides Want the Deal
- Mechanisms to Limit Expropriation by Controlling Shareholders
  - Diffuse Shareholder Mechanisms Limited Use
  - Need to Explore/Develop New Mechanisms
    - Family Firms
    - Foreign Firms
  - Greater Mandatory Disclosure Is Key Attribute
    - Recognizing Role of Soft Information
    - Non-Disclosure Problems & Disclosure Precision Issues
    - Recognizing Both Economic Incentives and Behavioral Biases