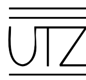
Andreas Beyer, Claudius Schikora

Regulation light – Germany's Entry Standard

Foreword by Alexander Dibelius



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3. Foreword by Alexander Dibelius

We are in the throes of the biggest financial market crisis ever. Therefore, the call for more regulation shouldn't come as a surprise. After all - or so it seems at first sight - it was the lack of statutory rules and oversight that allowed a housing crisis to become a financial market and eventually a global economic crisis. Even before markets started to tumble, the British Prime Minister Gordon Brown claimed that politics can permanently bring the boom and bust cycle to an end. Is this really true?

Doubts are warranted. It is one thing to assume that lacking regulation made this crisis possible or at least contributed negatively to the course of events. Concluding that tougher regulation can avoid crises altogether going forward, however, is delusional and ignores the true nature of the global capital markets. The reason: For this to happen, we would have to contemplate all future scenarios and develop tailored solutions which in turn would require predictable and rigid markets. Yet, by their very nature, markets are dynamic, extremely flexible and at times unpredictable.

Further, to solve the crisis on their own, our policy makers would need universal expertise and skills. Given that lack of expertise and resources this is neither feasible nor desirable because it would inevitably and substantially curtail the freedom of markets and its participants. As a consequence, the realm of policy should be confined to creating a framework and designing market processes that lead to a sustainable economic development. Solutions could include strengthening the supervisory and regulatory rules and taking legislative measures for instance in relation to the role of rating agencies and hedge funds or in relation to transparency and liquidity requirements.

The economy, on the other hand, will have to fill the policy-induced framework with life. It would be negligent to back out and leave it to our governments to learn lessons from this crisis. We need the expertise available in the market, now more than ever- not least in order to avoid mistakes made in prior crises, because it is all too common for people to address only the causes for the crisis at hand. As Bundesbank Chairman Axel Weber rightly pointed out, policy measures do have their limits: „People now build a dam where it would have been needed to prevent today's flooding. But experience shows that the next one will come from a different direction." Thus, we ought to relinquish old and overly rigid beliefs and comprehend markets and governments not as opponents but as partners that complement each other. As market participants, we feel the heartbeat of events and can react flexibly and appropriately. To do so, however, we have to take responsibility - and act where our industry failed earlier, i.e. in defining sweeping business principles that go beyond formal regulation.

We therefore don't need additional rules but better rules that take into account the nature of the capital markets. We must build a dialogue not just between policy makers

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and the market but also between countries. We need to take concerted actions and develop solutions together. Only then will we have a chance to address future crises more swiftly and efficiently.

This books shows on particular area of the financial markets – the regulation of the stock markets with a special focus on Germany`s Entry Standard.

Dr. Alexander Dibelius, Managing Director Goldman Sachs Germany, Austria, Russia und Central- and East Europe

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4. Prolog by Pierre Rafih and Claudius Schikora

The financial world inaugurated the 21st century with a financial crisis that followed the burst of the "New Economy" bubble and kept the stock markets in a lock-down for over three years. This prolonged crisis had been preceded by a five year period of unprecedented and sustained growth that saw stock markets all around the world break record over record level, while whole new market segments emerged on the major European exchanges.

The year 2000 crisis was deemed in hindsight by many to be salutary and overdue. PE Ratios of technology stocks had soared up to ridiculous heights in the wake of fantastic earnings forecasts of fast growing technology companies that were swarming the IPO-markets, craving fresh capital and eager to cash in on early gains. This forced every new IPO-candidate to boast comparable growth rates to attract much needed capital.

This widespread interest for New Economy stocks was spurned not only by professional investors, but for the first time in many European countries to a large degree by retail demand. Countries like Germany or France, that until then had not had a noteworthy popular stock culture, suddenly saw millions of small investors flooding the markets with money that traditionally went into savings accounts or other low-risk investments. While even the most conservative savings banks wanted a share of this lucrative business and were selling IPOs to their retail customers over the counter, newly set up Small Cap technology funds were flooded with money from private and corporate investors and were buying into every new IPO that was hitting the markets that could even remotely be deemed "New Economy".

These developments saw the creation of whole new market segments and indexes catering to these new Small Cap technology stocks. As they were trying to emulate the longstanding success of the American NASDAQ, European Exchanges set up the *Neuer Markt* in Germany, the *Nouveau Marché* in France and *TechMARK* the UK. These segments would reach fame and infamy over the course of only a couple of years.

While all these new market segments saw similar developments over the boom period and ensuing crisis, the development of Deutsche Börse Frankfurt's *Neuer Markt* is emblematic. Not only did it have the strongest growth from its creation to its all time high, its demise was also marked by a series of dramatic delisting, bankruptcies, scandals and legal cases, ending in its closure by Deutsche Börse in June 2003. From December 31st, 1997 to March 10th, 2000 the NEMAX 50 index would soar up from 1,000 points to reach dazzling 9,666 points, only to lose more than 95% of its value within two and a half years to bottom out at 318 points in October 2002.

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Many factors certainly influenced the dramatic rise and fall of the *Neuer Markt* and its European siblings. While it is a futile exercise to assign responsibilities to specific market participants with hindsight, it is indeed helpful to consider the different elements that were instrumental in its spectacular development.

One recurring argument in media and general public at the time was the insufficiency of existing regulations to cope with these developments. Most continental European countries lacked a popular stock culture when the New Economy bubble began to rise in the second half of the 90s and did not have all the necessary instruments and the experience to deal with the situation as it enfolded, critics say.

In as much as investment banks vied with each other for a share of the lucrative New Economy business, so did the European Stock Markets compete to get as big a share of the booming IPO-Market as possible and strove to attract prospective issuers. In order to achieve this, the newly created New Economy market segments like *Neuer Market* or *Nouveau Marché* had less demanding standards, in particular with regards to requirements related to liquidity, issue size and market capitalization. Most other requirements though still matched the criteria of the regulated blue chip markets in those countries.

While it would be overly simplistic to blame the exchanges for adapting regulations to what the market demanded at the time, it is undeniable that certain factors contributing to the dramatic fluctuation of the stock prices lay in the limited liquidity of many of these stocks as much as in their speculative nature.

Although liquidity had hardly been a major issue for other Small Cap markets, it did become a relevant factor for the *Neuer Markt* and its other European equivalents because of the massive capital that was waiting to be invested in New Economy stocks. High levels of demand from national and international investors alike supported four years of sustained strong market growth. Certain small IPOs saw oversubscription rates of up to one hundred times the issue size, with single institutional investors placing orders larger than the total amount of stocks being issued. A lot of this unsatisfied excess demand contributed to the skyrocketing stock prices that were a common sight during this time.

Many institutional investors found themselves holding substantial amounts of the listed stocks of some of these companies, essentially becoming strategic investors in those same companies.

When the tide finally started turning dramatically in 2000, some of the *Neuer Markt's* biggest institutional investors that held substantial position in many of its stocks thought they could halt or at least stall the downward trend of the market by simply buying out stocks whose prices were plummeting, betting on the fact that the crisis would not last overly long, and they could recoup their losses within a year. The

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market capitalization of many of *Neuer Markt*'s stock was indeed so small that this strategy might have worked, had not the confidence of private and institutional investors alike not been broken on a much more fundamental basis.

While this may have indeed slowed the markets' fall to a certain degree, it only prolonged the bleeding when it turned out that the crisis was here to stay. The closing of *Neuer Markt* in 2003 marked the end this inglorious era.

In their evaluation of the factors that contributed to the extent of the crisis, the media and public incriminated regulators, investors, stock analysts, issuers, banks and exchanges alike. As stated earlier, looking for the ones to blame is a fruitless exercise. Certainly the key players all bear a measure of responsibility, but it is the conjunction of many such behavioural patterns and expectations that lead to the boom and crisis the financial world witnessed.

As the main focus of this lies on regulations, let the address this issue. Regulation of the markets falls under the area of responsibility of two players. The first of these two players is the state, its regulatory institutions and its laws, which in Germany include the BaFin[1] and the extensive legal framework encompassed in the German Stock Market and Equity Laws[2]. The second key players in the regulatory game are the stock exchanges, of which Deutsche Börse Frankfurt is Germany's most influential and active representative.

As Deutsche Börse Frankfurt established the *Entry Standard* in October 2005, only 2 years after it had closed the failed Neuer Markt segment in the wake of the latest financial crisis that had hit Germany more strongly than many other countries, questions were bound to arise as to the pertinence of such a decision.

[1] Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority) Federal Supervisory Office for Securities Trading

[2] Aktiengesetz (Stock Corporation Act), Börsengesetz (Stock Exchange Act), Wertpapier-Verkaufs-prospektgesetz (Act on the Prospectus for Securities Offered for Sale), Wertpapierhandelsgesetz (Securities Trading Act), Wertpapierprospektgesetz (Securities Prospectus Act), Wertpapiererwerbs- und Übernahmegesetz (Securities Acquisition and Takeover Act), and Anlegerschutzverbesserungsgesetz (German Investor Protection Improvement Act).

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5. Introduction

On the 25th of October, 2005, a new stock exchange segment was created in Germany: the Entry Standard of the Frankfurt Stock Exchange. The newly-created stock exchange segment is particularly targeted at small companies and offers a quick and easy way to get listed. The segment was based on London's Alternative Investment Market (AIM),[3] which had positioned itself very effectively over previous years as a risk capital exchange in Europe with a low level of regulation and managed to convince a large number of firms to obtain a stock exchange listing.

These two stock markets are linked by the fact that they both rely on a low level of capital market regulation and thus a concomitantly low level of investor protection. They are deemed to be predominantly 'unregulated' and therefore follow a different path to the legislatures of industrial nations, which as a result of balance sheet manipulation and the collapse of companies such as Enron and Worldcom tend to react by tightening capital market regulation.

The USA enacted the Sarbanes-Oxley Act, which has been perceived as a hindrance by firms listed on the stock exchange. The new law was a 'regulation shock' for small firms in particular. The expenditure involved in meeting the numerous requirements imposed and the costs arising in connection with this were no longer proportionate with the benefits of a stock exchange listing.[4] New stock exchange segments that fall outside the scope of official regulation, however, can offer a potential solution that prevents small firms diverting their growth capital away from the stock exchange.

The different levels of intensity in regulation have provoked a discussion in capital market literature referred to as the 'issuer choice debate'[5]. A whole range of scientific extrapolations exist alongside this that are not confined to capital market regulation but instead extend much further.[6] An example of one issue investigated is which countries provide the most favourable conditions for founding a company and offer suitable legal forms for financing growth.[7] Another approach seeks to determine

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[3] Cf. Schlitt/Schäfer 2006, p. 147

[4] Cf. Engel/Hayes/Wang 2004, p. 23

[5] Cf. e.g. the study by Merrit Fox titled "The Issuer Choice Debate" (2001) or his study "Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment" (1999)

[6] Cf. the contributions of Licht 2003, Coffee 2002; Romana 2001 and Tung 2005; see also Mendoza 2007, p. 5, who writes: "An extensive array of literature has been produced […] with regard to the Issuer Choice Debate"; whereas Brummer finds that "the academic community is only beginning to examine issuer choice in capital markets". See Brummer 2008, p. 19

[7] See e.g. Becht/Mayer/Wagner 2006. In their study "Where Do Firms Incorporate? De-regulation and the Cost of Entry" the authors study how deregulation of corporate law affects the decision of entrepreneurs as to where to incorporate and analyses where new companies can be founded at low cost.

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which countries provide a suitable legal framework[8] and which stock exchanges offer the ideal general conditions for going public.[9] The latter two issues are referred to as ‘listing decisions’ in the literature. [10]

The literature also addresses the issue in this context of who the better regulator is at the end of the day: the State or the stock exchange. [11] Since stock exchanges represent different interests than the State, new market segments for issuers have been created; these can be referred to as ‘listing platforms’.[12] The objective of these new segments is to provide an ideal environment for small companies to obtain easy access to the stock exchange, in order to increase the number of companies that allow themselves to be listed on the stock exchange. These new market segments, which exist in various different formats owing to the self-regulation of the stock exchanges, are being analysed in literature with a growing degree of interest.[13] They are referred to as ‘exchange regulated markets’.[14]

These exchange regulated markets are coming under increased scientific scrutiny in view of the heightened degree to which official and Regulated Markets are being regulated. The majority of contributions and analyses in this regard come from the Anglo-Saxon equity cultures in the USA and the UK. These works are orientated less towards the theoretical bases and more towards taking an empirical approach, where under Anglo-Saxon countries and their stock exchanges are analysed comparatively with each other. There is no evaluation of the Entry Standard or even the Frankfurt Stock Exchange (FSE) at all in these studies.[15]

Research into the issuer choice debate is still in its infancy in Germany. Kaserer and Schiereck determined the capital costs of issuers on various stock exchanges in their first ‘listing decision’ analysis[16], and in carrying out an international comparison of stock exchanges including the FSE, arrived at the conclusion that the FSE represented an alternative for companies as a listing location. Richter recently set out an extrapolation that is both empirical and focused on the fundamentals in his publication “Quellen der Unternehmensfinanzierung: AIM, NASDAQ und Entry Standard”, which also examined the Entry Standard.[17]

[8] See e.g. Enriques/Tröger, 2007 who in their contribution “Issuer Choice in Europe” examine securities law aspects of takeover regulation inter alia.

[9] See e.g. Piotroski/Srinivasan 2008, where the authors describe an exchange choice model of their own devising.

[10] Cf. e.g. Sarkissian/Schill 2004 who focus on the “Overseas Listing Decision”, see also Ribstein 2005

[11] Cf. e.g. Brummer 2008, p. 5

[12] Cf. e.g. Wegmann/Kaehlert 2008, p. R250, Scherer 2005, p. 16

[13] Cf. Richter 2008a, Mendoza 2007, Bartl 2005, Engelhardt 2007, Gerbaulet/Heyen 2007, Steinbach/Bramhoff 2006, 2007, 2008 and many others

[14] Cf. Blättchen 2006, p. 42; Blättchen 2007b, p. 42

[15] Cf. e.g. Mendoza 2007 or Bell/Correia da Silva/Preimanis 2006, who all compare various exchanges in Europe and the United States but omit the FSE.

[16] Cf. Kaserer/Schiereck 2006; Kaserer/Schiereck 2007b; Kaserer/Schiereck 2007c

[17] Cf. Richter 2008a

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This work will also dedicate itself to this relatively recent field of research. The objective is to analyse and evaluate the Entry Standard market segment from multiple different perspectives. This extrapolation will focus partly on describing State regulation in Germany compared with exchange regulation and partly on analysing of the success factors for the Entry Standard in comparison with not only the Regulated Market but also with a previous growth market and other European exchange regulated markets. This should finally make it possible to position the Entry Standard as a market segment.

6. Theoretical Considerations on the Economic Necessity of Equity and Stock exchanges

6.1 Equity: Concept and Functions

Companies have a wide range of financing options available to them. Here, it is important to draw a distinction between equity and borrowed capital.

Borrowed capital normally serves the debtor for a certain period and in most cases fixed annual interest rates have to be paid to the creditor. Equity has no maturity, and the return for equity is not fixed because it depends on the performance of the company. Thus, equity serves as a kind of safety belt and consequently is more risky. Therefore a provider of equity (shareholder) is normally entitled to a say in the running of the company (voting right) and should get a higher return than a provider of borrowed capital.[18]

The functions[19] of equity are:

- Starting a business: equity is the single most important source of finance. Without equity an entrepreneur cannot found a company or start a business.
- Financing: equity is, like other types of capital, used to finance the necessary assets of an enterprise.
- Covering risk and loss: any enterprise contains the risk of failure. This risk has to be primarily covered by equity[20]. Losses are covered by equity. Without equity, companies cannot operate, and will cease to exist.
- Showing solidity: having a high percentage of equity (out of total capital), a high level of total equity and/or a high equity-to-assets ratio is a sign of solidity. It indicates credit-worthiness. Equity thus helps to increase the

[18] Cf. Sauer 1993, pp. 16-20

[19] Cf. Sauer 1993, pp. 22-23; Schmeisser 2006, p. 71

[20] This risk has to be primarily covered by equity, which as a matter of general principle is not provided by banks. Banks are not prepared to undergo this specific risk. Saving banks act as trustees for their saving clients and therefore have to minimize risks affecting clients' funds, which are mainly used for lending purposes. Cf. Schumacher 2006, p. 6

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