



THE LONDON SCHOOL  
OF ECONOMICS AND  
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# From local to global

The rise of AIM as a stock market for growing companies

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## **Purpose of the report**

This document summarises the findings of a study, commissioned by the London Stock Exchange, which examines the recent development of AIM as a stock market for growing companies, and analyses the factors that have contributed to its growth. The research was carried out in May-August 2007.

## **Sources**

This report has drawn on published material, including statistics from the London Stock Exchange and from the World Federation of Exchanges, and reports produced by brokers and consultants, as well as interviews with London Stock Exchange executives and market participants. The interviewees included senior executives from AIM-quoted companies, some of which are profiled in the full report, and representatives from brokers, Nomads and investors.

## **The authors**

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## Principal Findings

1. AIM has established itself as the world's leading stock market for young, growing companies, although competition from other exchanges is increasing. Since the start of the market in 1995 some 2,300 British and 400 foreign companies have come to AIM, raising a total of £49bn; during this period some 1,000 companies have left the market for a variety of reasons (including transfers to the London Stock Exchange's Main Market), leaving the present total of just over 1,600.
2. The competitive strength of AIM lies partly in its location within the City of London financial services cluster, partly in a distinctive regulatory system which is tailored to the needs of smaller companies.
3. The amount of capital raised on AIM has increased sharply in the last few years, rising from £2bn in 2003 to £4.7bn in 2004, £8.9bn in 2005 and £15.7bn in 2006. Much of the increase in the last three years has come from foreign companies. However, AIM continues to provide vital support for the UK's small and medium-sized enterprise sector, including companies based in the regions.
4. The London Stock Exchange has a vital stake, not only in the continuing vitality of AIM, but also in ensuring that it is regulated in a way that preserves the integrity of the market without stifling innovation.
5. The internationalisation of AIM, which has taken place mainly since 2002, and the recent entry of property and equity investment entities, have not undermined the Nominated Adviser (Nomad) system, which is one of the key differentiators between AIM and the London Stock Exchange's Main Market, but it has prompted the Exchange to formalise and tighten some of the regulatory arrangements.
6. Although a large proportion of AIM companies are early-stage businesses and/or operating in high-risk sectors, the failure rate on AIM is low, running at less than 3 per cent in the last four years.
7. With an average monthly trading volume of just over 20m shares, liquidity in the shares of the larger AIM companies is comparable to that of similar-sized companies on the Main Market; the introduction of the new trading system, SETSmm, succeeded in its purpose of increasing liquidity and reducing spreads on the largest stocks. Smaller AIM companies traded on the SEAQ system have an average monthly trading volume of about 6.4m shares.
8. As many venture capital firms now focus on larger and later-stage transactions, AIM has become more important as a source of funding for early-stage high-technology companies.
9. AIM has matured since the collapse of the dot.com boom in 2000-2001, and now attracts a wide range of investors, including some of the world's leading institutions. There is a need to attract more investment from the countries in which non-British AIM companies are based.
10. AIM still acts as a feeder to the Main Market, but this is not its primary role. It is complementary to the Main Market, allowing some companies to achieve their growth objectives without having to move from AIM.
11. AIM has become an important part of the capital-raising options that the City of London offers, as well as enhancing the range of investment opportunities that can be accessed through London. It has also strengthened the City's links with emerging markets. The income generated by AIM in the form of fees and other payments is estimated to be running at around £1bn a year, of which about half comes from non-British companies.

**The London Stock Exchange** has a vital stake, not only in the continuing vitality of **AIM**, but also in ensuring that it is regulated in a way that preserves the integrity of the market without stifling innovation.

# 1

## Introduction

**AIM, having started in 1995 with ten companies, now comprises over 1,600 companies with a total market capitalisation of more than £100bn.**

London's 'junior' stock market, launched in 1995 as the Alternative Investment Market and now usually referred to as AIM, has developed over the last twelve years into a significant player on the world financial scene. Although its largest constituency remains that for which it was originally designed, small and medium-sized British companies seeking equity capital for expansion, it has also attracted, mainly since 2002, a growing number of foreign companies (Figure 1). AIM now comprises over 1,600 companies with a total market capitalisation of more than £100bn, of which about half is accounted for by companies that are either domiciled overseas or have their principal operations outside the UK.

For companies which are looking to raise relatively small amounts of capital, from £10m upwards, principally from well-informed institutional investors, and at the same time to acquire a degree of international visibility, AIM provides a platform which at present is not matched anywhere else in the world. Thanks partly to its distinctive approach to regulation and partly to the fact that it is embedded in the cluster of skills, experience and resources which has been built up in the City over many years, AIM has acquired a scale and a momentum which may be difficult for other exchanges to match.

AIM is an exchange-regulated market, not directly supervised by the Financial Services Authority. The evolution of AIM over the last five years has obliged the London Stock Exchange to adapt and in some respects to tighten a regulatory regime that was designed for a simpler and more homogeneous market. The Exchange has a vital stake, not only in the continuing vitality of AIM, but also in ensuring that it is regulated in a

way that preserves the integrity of the market without stifling innovation.

The success of AIM has prompted imitation, envy and criticism from around the world. Several of the big national exchanges have 'junior' markets aimed at small and medium-sized companies, but flotations on these markets have come largely from domestic companies; AIM is the only one with a substantial international component. However, since 2005 AIM has faced two new European competitors, Alternext in Paris (part of the Euronext group of stock exchanges, which merged with the New York Stock Exchange in 2006) and the Entry Standard segment of the Deutsche Börse in Frankfurt.

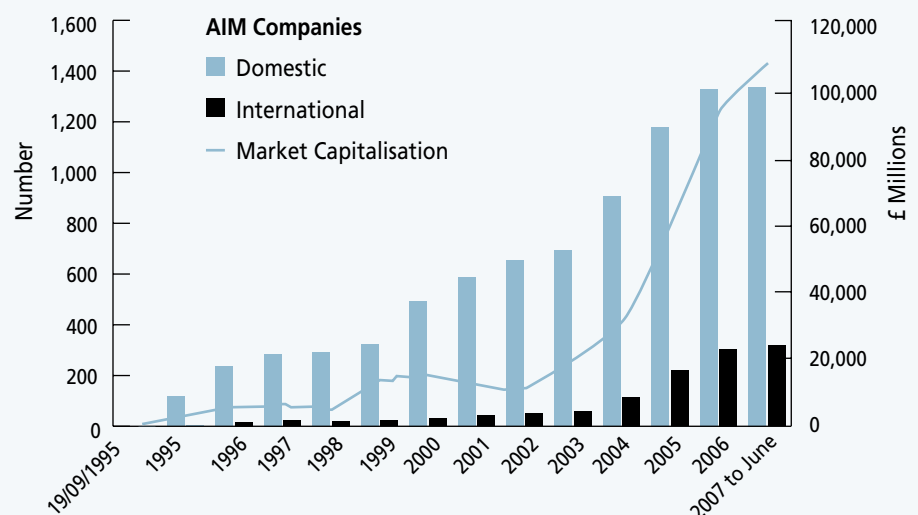
Most of the criticism of AIM has come from the US. Two senior officials from the New York Stock Exchange and the Securities and Exchange Commission have claimed that AIM is too lightly regulated, exposing investors to serious risk. AIM has a regulatory system that is specifically tailored for the needs of small, growing companies, and the rules are in some respects less

onerous than those of exchanges which cater for larger and more established companies. But the evidence presented in this report indicates that the system is working well both for investors and for the companies whose shares are traded on AIM. The failure rate on AIM is low, even though many AIM companies are early-stage businesses and/or operating in high-risk sectors.

For companies which are looking to raise relatively small amounts of capital, from £10m upwards, principally from well-informed institutional investors, and to acquire a degree of international visibility, **AIM** provides a platform which at present is not matched anywhere else in the world.

**Figure 1: The growth of AIM since 1995**

Source: London Stock Exchange: AIM statistics



# 2

## The evolution of AIM

AIM was caught up in the dot-com boom, but it was much less dependent on technology stocks than the new European growth markets which were created during that period, and it survived the crash in much better shape than those other exchanges.

**AIM was created in 1995 to serve British companies which were ambitious to grow and needed access to external capital, but were too small to be listed on the London Stock Exchange's Main Market, and this remains an important part of its role. The internationalisation of AIM has been gathering pace since 2002.**

The creation of AIM followed the decision by the London Stock Exchange to close down the existing 'junior' market, the Unlisted Securities Market, which had flourished in the 1980s but had declined in the early 1990s partly because it was not sufficiently differentiated from the Main Market. This led to a debate in the City about how best the Stock Exchange could improve its services to small and medium-sized British companies. The outcome was the creation of a new market with a regulatory system specifically designed for smaller companies; some of the early entrants to AIM had previously been traded on the over-the-counter market.

AIM was caught up in the dot.com boom of the late 1990s, but it was less dependent on technology stocks than the new European growth markets, such as EASDAQ in Brussels and the Neuer Markt in Frankfurt, which were set up during this period. Partly for this reason, and partly because of the robustness of its regulatory system, AIM survived the stock market crash in 2000-2001 in much better shape than these other exchanges.

From 2002 AIM began to target overseas companies more actively, concentrating first on Commonwealth countries such as Australia and Canada; a growing number of mining and other resource-based companies came to AIM from these countries, often via dual listings with their home exchange. AIM's international reach was subsequently extended

to American and other non-British companies outside the resources sector.

Part of the reason why US companies came to AIM was that it provided a cheaper and less complex means of raising relatively small amounts of capital than US exchanges.

Since 2005, partly because of the influx of foreign companies, the average market capitalisation of AIM constituents has increased. Another factor has been the entry of real estate funds and equity investment entities, some of which focus on investment opportunities in emerging markets such as China and India. However, the inflow of small and medium-sized British companies has continued.



# 3

## The regulatory system

**The growth of AIM and the changes in its composition have posed regulatory challenges, but have not undermined the integrity of the regulatory system, a central feature of which is the delegation of responsibility to Nominated Advisers (Nomads) for assessing the suitability of AIM entrants and monitoring their compliance with AIM rules.**

AIM is not an 'unregulated' market as some critics have alleged. It is an exchange-regulated market run by the London Stock Exchange, which in turn is regulated by the UK Financial Services Authority. As a market, AIM has a separate identity from the Stock Exchange's Main Market, but operationally it is part of the Exchange, and as such it is subject to regulation by the FSA.

Two developments have led to changes in the way AIM is regulated. One emanates from Brussels. Under provisions of EU law due to be implemented in November 2007, AIM's regulatory status will change to being a multi-lateral trading facility operated by the Exchange. The other is the sharp increase, mainly since 2002, in the number of companies traded on AIM and in the character of the market. An important issue for the London Stock Exchange has been to consider how to adapt the regulatory system to this situation, and, in particular, what changes, if any, need to be made in the rules governing Nominated Advisers, or Nomads.

Nomads are unique to AIM, and are the lynchpin of the regulatory system. Their role is quite distinct from that of sponsors to the Main Market, and the regulatory regime which applies to them is far more onerous. All those seeking admission to AIM must appoint a Nomad, and must retain one throughout their presence on the market. Nomads are

responsible to the Exchange for assessing the appropriateness of an applicant to AIM, or an existing AIM company when appointed its Nominated Adviser, and for advising and guiding an AIM company on its responsibilities under these rules. If an AIM company ceases to have a Nomad then trading in its shares will be suspended; if none is appointed within a month then admission of its securities will be cancelled.

Nomads can also act as the issuing broker for an AIM company and as such they have three, potentially conflicting, responsibilities: to the company; to the Exchange; and their own commercial interest in ensuring a good flow of companies onto AIM. There are currently 76 Nomads, although in practice activity is heavily concentrated in the 30 or so Nomads who are appointed to around 80 per cent of AIM companies.

In 2006 the Exchange conducted a thorough review of the Nomad rules. The outcome was the publication in February 2007 of a new set of rules which did not significantly alter the responsibilities of Nomads, but formalised and clarified them in a way that the Exchange believed was appropriate to the changing nature of the market. There is now more detailed guidance as to Nomads' responsibilities both on admission and with respect to the continuing relationship Nomads are expected to have with companies. This helps communicate to new Nomads the nature of their obligations, and the detailed provisions help Nomads explain to companies, especially overseas companies, the nature of both parties' responsibilities under the AIM rules.

As a commercial organisation the Stock Exchange has to balance its obligations to shareholders with its role as a regulator, and this could give rise to actual or perceived conflicts of interest. However, the Exchange has a very strong

incentive to uphold the integrity of the AIM regulatory system and to ensure that the rules are rigorously enforced. The Exchange has three main sets of enforcement powers: to suspend trading or cancel admission; to take disciplinary action against issuing companies; and to take disciplinary action against Nomads. In February 2007 it introduced the power to issue warning notices and doubled the maximum fines than can be levied by the executive panel to £50,000. The external disciplinary panel, which involves market practitioners, can ultimately levy unlimited fines.

As a result of the 2006 review, several changes were introduced to facilitate a more proactive supervisory strategy. Annual returns will be monitored for the purposes of assessing the continued eligibility of the Nomad – for example, the number of relevant transactions completed. In addition, compliance visits will become more structured processes lasting about two weeks; the AIM team will review at least one admission and one continuing relationship with a company, and will interview senior executives and compliance managers. The resourcing of AIM's regulatory functions has been significantly increased.

It is too early to assess how well these new arrangements will work, and how vigorously the new rules will be enforced. The robustness of a regulatory regime lies as much in its implementation as in its rules, and Nomads remain critical to the effectiveness of the AIM regulatory system. The recent changes demonstrate that AIM, the Stock Exchange and the FSA recognise the need to ensure that the regime is adapted in a way that meets the challenges brought about by the expansion of the market.

# 4

## The companies on AIM

Within the foreign contingent the largest group consists of mining, oil and gas, and other resource-based companies which are attracted to AIM partly because of London's long-established reputation as a repository of expertise in these sectors.

**Most of the companies that come to AIM, whether British or non-British, are small businesses that are ambitious to grow. The attraction of AIM is that it enables them to raise relatively small amounts of capital – from £10m upwards – from knowledgeable, predominantly institutional investors which are likely, if the business fulfils its promise, to support further fund-raising rounds.**

AIM companies cover a wide range of sectors, with the two largest, in terms of market capitalisation, being resource-based companies and financial companies (Table 1). Of the 1,639 companies traded on AIM in June 2007, 70 per cent were UK-based, accounting for just under half the market's total capitalisation. The largest non-British component was from other parts of Europe (including Ireland), accounting for 9 per cent of the companies and just under 18 per cent of market capitalisation, followed by the Americas (Figure 2); the latter includes 69 companies from the US and 46 from Canada.

The British contingent on AIM falls into two main categories. The first is made up of companies that are profitable when they come to AIM and generally operate in stable industries; they use AIM to fund their expansion, often by means of acquisition. Some of these companies subsequently transfer to the Main Market, but many of them are able to achieve their growth objectives without moving from AIM.

In the second category are early-stage companies for which AIM provides an alternative to, or complement for, venture capital. They include high-technology businesses which may be some way from profitability when they come to AIM and have few if any products on the market. They attract investors which specialise in this type of business, and, if their product development efforts bear fruit, they use AIM to progress to the next stage of their growth, when they become either free-standing, profit-making companies or candidates for a trade sale.

Within the foreign contingent, the largest group consists of mining, oil and gas, and other resource-based companies which are attracted to AIM partly because of London's long-established reputation as a repository of investment expertise in these industries. For Canadian or Australian companies which may be dual-listed with their home exchanges, AIM provides an additional fund-raising vehicle, and the opportunity to join the Main Market when they reach an appropriate size.

Outside the resources sector, non-British companies that come to AIM are looking partly to raise equity capital, which may be difficult or impossible in their home country, and partly to increase their international visibility. The latter applies particularly to technology companies which are seeking to compete in the world market. There are also some specific

**Table 1: Breakdown of AIM companies by sector (per cent) – first quarter 2007**

Source: AIM Investor Survey 2007, Arbutnot Securities

|                   | By number of companies | By market value |
|-------------------|------------------------|-----------------|
| Financials        | 21                     | 29              |
| Resources         | 17                     | 31              |
| Technology        | 15                     | 7               |
| Business services | 8                      | 6               |
| Media and content | 7                      | 4               |
| Lifestyle         | 4                      | 3               |
| Health            | 7                      | 5               |
| Industrials       | 9                      | 7               |
| Consumer products | 7                      | 5               |
| Construction      | 3                      | 2               |
| Other             | 2                      | 1               |

sectors, such as renewable energy, where AIM has become the stock market of choice for would-be international players.

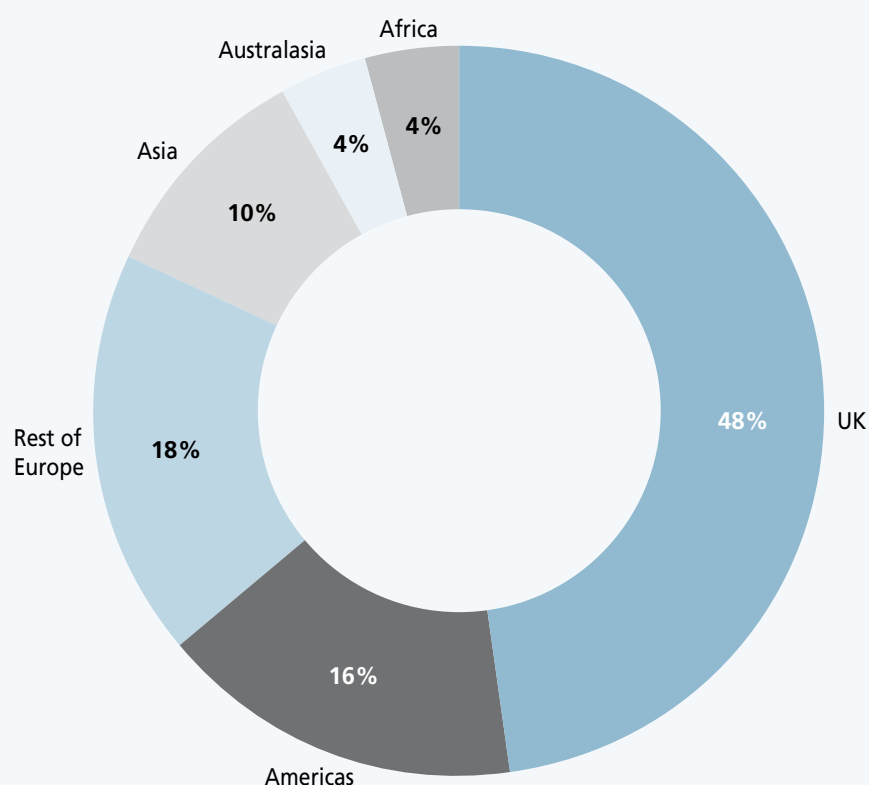
For smaller high-technology companies based in the US and to a lesser extent in Continental Europe, AIM has become more accessible than NASDAQ, where the average market value of new entrants is significantly higher than on AIM. This is also true of companies based in other countries (such as Israel), which might in the past have sought a listing in the US.

The newest element on AIM, which has become prominent since 2005, consists of property funds and equity investment entities which invite investors to back, not individual companies, but management teams with expertise in particular sectors or regions – real estate in India, for example, or manufacturing in Vietnam. The presence of these entities has extended AIM's reach into emerging markets.

The largest companies in all these categories have the option of moving to the Main Market when their market value reaches around £500m (this figure is a guide, not a requirement laid down by the Stock Exchange), and some of them do so; there have been six such transfers so far in 2007. But there has also been a flow in the reverse direction, as smaller companies listed on the Main Market see advantages in moving to a market in which they have greater visibility and which offers greater regulatory flexibility. AIM still acts as a feeder to the Main Market, but this is no longer its primary role. It is complementary to the Main Market, allowing some companies to achieve their growth objectives without having to move from AIM.

**Figure 2: Breakdown of AIM companies by country or region of operation (May 2007)**

Source: London Stock Exchange



There are also some specific sectors, such as renewable energy, where **AIM** has become the stock market of choice for would-be international players.

# 5

## AIM as a source of capital

A big surge in capital-raising on **AIM** has taken place in the last three years; no less than 75 per cent of the total capital raised since 1995 was in the years from 2004 to 2007; the total number of companies admitted to **AIM** was highest in 2005.

**The amount of capital raised on AIM has risen sharply in the last few years, with much of the increase coming from foreign companies, but there is no evidence that this has been to the detriment of British companies seeking admission to AIM.**

A total of 2,365 UK companies and 437 international companies have been admitted to AIM since its inception. Between them they have raised a total of £49bn (Table 2). The total capital raised through IPOs, £28bn, exceeds the total raised through further issues, which stands at £21bn. A big surge in

capital-raising has taken place in the last three years; no less than 75 per cent of the total capital raised since 1995 was in the years 2004 to 2007. The total number of companies admitted to AIM was highest in 2005, while the total capital raised was highest for 2006.

As AIM has become a more international market over the last five years, there has been some anxiety that its traditional constituency – small and medium-sized British companies – might be neglected, or that Nomads and brokers might be diverting their activities to larger and more lucrative non-British IPOs.

**Table 2: Capital raised by year**  
Source: London Stock Exchange

| Year         | Number of Admissions |               |              | Money Raised £ million |               |               |
|--------------|----------------------|---------------|--------------|------------------------|---------------|---------------|
|              | UK                   | International | Total        | New                    | Further       | Total         |
| 1995         | 120                  | 3             | 123          | 70                     | 25            | 95            |
| 1996         | 131                  | 14            | 145          | 514                    | 302           | 816           |
| 1997         | 100                  | 7             | 107          | 344                    | 350           | 694           |
| 1998         | 68                   | 7             | 75           | 268                    | 290           | 558           |
| 1999         | 96                   | 6             | 102          | 334                    | 600           | 934           |
| 2000         | 265                  | 12            | 277          | 1,754                  | 1,320         | 3,074         |
| 2001         | 162                  | 15            | 177          | 593                    | 535           | 1,128         |
| 2002         | 147                  | 13            | 160          | 490                    | 486           | 976           |
| 2003         | 146                  | 16            | 162          | 1,095                  | 1,000         | 2,095         |
| 2004         | 294                  | 61            | 355          | 2,776                  | 1,880         | 4,656         |
| 2005         | 399                  | 120           | 519          | 6,461                  | 2,481         | 8,942         |
| 2006         | 338                  | 124           | 462          | 9,944                  | 5,734         | 15,678        |
| 2007 to June | 99                   | 39            | 138          | 3,515                  | 6,280         | 9,575         |
| <b>Total</b> | <b>2,365</b>         | <b>437</b>    | <b>2,802</b> | <b>28,158</b>          | <b>21,284</b> | <b>49,438</b> |

**Table 3: Breakdown of money raised through IPOs by size 1998-2007**

Source: London Stock Exchange

| Year                | Money Raised (£ m) |                  |                  |               | % of Total |            |            |             |
|---------------------|--------------------|------------------|------------------|---------------|------------|------------|------------|-------------|
|                     | <5M                | 5-50m            | >50m             | Total         | <5M        | 5-50m      | >50m       | Total       |
| <b>1998</b>         | 75.56              | 141.90           | 50.01            | 267           | 28%        | 53%        | 19%        | 100%        |
| <b>1999</b>         | 112.85             | 165.79           | 55.04            | 334           | 34%        | 50%        | 16%        | 100%        |
| <b>2000</b>         | 258.58             | 1,325.60         | 169.90           | 1,754         | 15%        | 76%        | 10%        | 100%        |
| <b>2001</b>         | 172.12             | 420.95           | 0.00             | 593           | 29%        | 71%        | 0%         | 100%        |
| <b>2002</b>         | 123.55             | 185.76           | 180.75           | 490           | 25%        | 38%        | 37%        | 100%        |
| <b>2003</b>         | 82.41              | 379.05           | 633.97           | 1,095         | 8%         | 35%        | 58%        | 100%        |
| <b>2004</b>         | 281.41             | 1,666.55         | 827.94           | 2,776         | 10%        | 60%        | 30%        | 100%        |
| <b>2005</b>         | 350.88             | 2,660.57         | 3,449.79         | 6,461         | 5%         | 41%        | 53%        | 100%        |
| <b>2006</b>         | 283.25             | 2,709.44         | 6,951.13         | 9,944         | 3%         | 27%        | 70%        | 100%        |
| <b>2007 to June</b> | 87.64              | 879.72           | 2,550.49         | 3,518         | 2%         | 25%        | 73%        | 100%        |
| <b>All</b>          | <b>1,828.25</b>    | <b>10,535.33</b> | <b>14,869.02</b> | <b>27,233</b> | <b>7%</b>  | <b>39%</b> | <b>55%</b> | <b>100%</b> |

In 2005 and 2006, when the number of IPOs was exceptionally high, foreign companies raised a total of just over £10bn through IPOs, representing 68 per cent of all the money raised on AIM through IPOs. But the amounts of money raised by British companies also increased during those two years. There is no evidence that the increase in the number of foreign entrants has made it more difficult for British companies to access AIM.

What is also clear, as Table 3 shows, is that the average amount of money raised by AIM companies has risen in recent years. Up to 2002 nearly 30 per cent of new issues were for less than £5m, whereas from 2004 onwards small issues accounted for less than 5 per cent of the new capital raised. The share accounted for by larger flotations,

which was around 20 per cent up to 2002, has risen to more than 70 per cent in recent years. While this may suggest that some small British issuers are being squeezed out, the general view among brokers and investors is that companies should not come to AIM unless they are raising at least £10m. Recent trends cannot be regarded as adverse for UK-based companies.

The average amount of money raised through new issues on AIM has been rising. The share accounted for by larger issues, which was around 20 per cent up to 2002, has risen to more than 70 per cent in recent years.

# 6

## The failure rate on AIM

**Although a large proportion of AIM companies are early-stage businesses and/or operating in high-risk sectors, the failure rate on AIM is low.**

AIM started in 1995 with 10 companies. Since then, a total of 2,698 companies have been admitted to AIM and 1,076 have been delisted, which leaves 1,632 companies on AIM as of February 2007 (Table 4). However, delistings occur for a variety of reasons, only some of which can be classified as failures. The biggest single source of delistings, accounting for nearly half the total, is the reverse takeover, through which a company changes its identity but remains on AIM. Other delistings occur as a result of transfers to the Main Market, acquisitions, or redemptions (investment funds redeeming or closing their funds) – none of which can be described as failures.

Genuine failures can arise from the liquidation of the company; from restructuring because of financial strains; or from a breach of the AIM

rules. In addition, some companies choose to delist without giving a reason. Table 5 shows the number of failures of AIM companies since 2000, including as failures those companies that delisted without explanation. In terms of numbers the failure rate was highest in 2006 at 112, but this was

mainly because of a tightening of rules governing the length of time cash shells could be traded on the exchange; 64 companies not fulfilling the criteria for cash shells were delisted in that year. If those companies are excluded, the average failure rate over the last four years has been less than 3 per cent.

In terms of numbers the failure rate was highest in 2006, but this was mainly because the rules regarding cash shells were tightened in that year. If those companies are excluded, the average failure rate over the last four years has been less than 3 per cent.

**Table 4: Admissions and delistings on AIM by year**

| Year               | Companies – Beginning of the year | New admissions | Delistings   | Companies – End of the year |
|--------------------|-----------------------------------|----------------|--------------|-----------------------------|
| <b>1995</b>        | 10                                | 123            | 12           | 121                         |
| <b>1996</b>        | 121                               | 145            | 14           | 252                         |
| <b>1997</b>        | 252                               | 107            | 51           | 308                         |
| <b>1998</b>        | 308                               | 75             | 71           | 312                         |
| <b>1999</b>        | 312                               | 102            | 67           | 347                         |
| <b>2000</b>        | 347                               | 277            | 100          | 524                         |
| <b>2001</b>        | 524                               | 177            | 72           | 629                         |
| <b>2002</b>        | 629                               | 160            | 85           | 704                         |
| <b>2003</b>        | 704                               | 162            | 112          | 754                         |
| <b>2004</b>        | 754                               | 355            | 88           | 1,021                       |
| <b>2005</b>        | 1,021                             | 519            | 141          | 1,399                       |
| <b>2006</b>        | 1,399                             | 462            | 227          | 1,634                       |
| <b>2007 to Feb</b> | 1,634                             | 34             | 36           | 1,632                       |
| <b>Total</b>       |                                   | <b>2,698</b>   | <b>1,076</b> | <b>1,632</b>                |

**Table 5: Failure rate on AIM (by year)**

| Year               | Average number of companies during the year | Failures | % Failures |
|--------------------|---|----------|------------|
| <b>2000</b>        | 436   | 32       | 7.3%       |
| <b>2001</b>        | 577   | 32       | 5.6%       |
| <b>2002</b>        | 667   | 41       | 6.2%       |
| <b>2003</b>        | 729   | 82       | 11.2%      |
| <b>2004</b>        | 754   | 18       | 2.0%       |
| <b>2005</b>        | 892   | 31       | 2.5%       |
| <b>2006</b>        | 1,517                                       | 112      | 7.4%       |
| <b>2007 to Feb</b> | 1,633                                       | 27       | 1.7%       |

# 7

## Investors in AIM

### AIM now attracts a wide range of investors, including some of the world's leading financial institutions.

When AIM was started in 1995, investment in the new market was stimulated by a range of tax incentives, designed to encourage UK private investors to put money into small, growing businesses. The incentives included exemption from inheritance tax for investors who held shares in qualifying companies for at least two years. There were also two new schemes – the Enterprise Investment Scheme and Venture Capital Trusts – which provided relief of income and capital gains tax for investors in unlisted companies, a category that included AIM companies.

These incentives were put to good use by the investment bankers and brokers which specialised in smaller companies. As the market matured during and after the dot.com boom, and as investment opportunities on AIM widened, mainstream investing institutions became more actively involved in AIM (Table 6). Institutions are now thought to own about half of the shares in all AIM companies, and they account for a larger proportion – probably at least 75 per cent – of the new money raised through Initial Public Offerings and secondary equity issues.

Although the number of IPOs on AIM declined in the first six months of 2007 after the exceptionally large number of flotations in 2005 and 2006, new money continues to flow into the market from institutions and private investors, and there is no evidence that the criticism of AIM from across the Atlantic has significantly affected investor sentiment. Some investors have suggested that too much stress may have been placed on securing IPOs and not enough on nurturing the companies after flotation. There is also some concern about the large number of relatively illiquid

**Table 6: Most active institutions by number of investments in 2006**

| Institution                   | No of investments | Value of investments (£m) |
|-------------------------------|-------------------|---------------------------|
| Fidelity                      | 160               | 1,037                     |
| Artemis Investment Management | 130               | 677                       |
| F & C Asset Management        | 120               | 364                       |
| AXA                           | 118               | 563                       |
| Gartmore                      | 90                | 544                       |
| AMVESCAP                      | 84                | 652                       |
| RAB Capital                   | 78                | 350                       |
| Goldman Sachs                 | 72                | 448                       |
| Bank of New York              | 70                | 257                       |
| Pershing Keen Nominees        | 70                | 83                        |
| Merrill Lynch                 | 67                | 596                       |
| HSBC                          | 65                | 162                       |
| Chase Nominees                | 62                | 243                       |
| UBS                           | 59                | 379                       |
| JPMorgan                      | 59                | 278                       |

stocks at the lower end of the market; various initiatives are under way that should stimulate investor interest in under-performing AIM companies.

The general view among investors is that the expansion of the market, through the admission of more foreign companies and the newer property and equity investment entities, has been good for AIM, broadening the range of investment opportunities that the market provides. AIM now consists to

some extent of several distinct sub-markets, but it has been able to serve these different constituencies without having to alter in any fundamental way the regulatory system that has been in place since the start.



# 8

## Returns to investors

**AIM is often described as a stock picker's market, and its performance cannot easily be measured by an index tracking the performance of all AIM shares since 1995. An analysis of after-market returns on new admissions since 2000 suggests that, on average, investors in these companies have outperformed the wider market.**

Because of the great diversity of AIM stocks, and the changes that take place in the composition of the market from year to year, an index made up of all AIM-quoted shares for the whole period of the market's existence gives an imperfect picture of its performance. The FTSEAIM Index, as Table 7 shows, gave an annualised return of only 1 per cent per annum over the entire period (up to February 2007), which was much lower than the 7 per cent and 6 per cent generated by the FTSE All Share and FTSE100 indices over the same period. However, the performance of the FTSEAIM Index is distorted by the effect of the dot-com boom and bust, producing a very large gain in 1999 and a sharp correction in 2001 and 2002. Since 2003 the FTSEAIM Index has produced positive returns in each year. The newer indices, the

FTSEAIM50 and FTSEAIM100, introduced in 2005, produced annualised returns of 3 per cent and 6 per cent respectively.

Another way of assessing returns to investors is through an analysis of after-market performance of new admissions on AIM. To do this, we used the monthly trading files (available since end 2000) to calculate the monthly returns (based only on capital gains and excluding dividends) from a portfolio consisting of all new admissions on AIM from December 2000 onwards over a period of 36 months. Table 8 shows the cumulative monthly value-weighted returns (over six-monthly intervals) as well as abnormal returns from such a strategy.

The returns generated are 1.38 per cent raw returns or 1 per cent abnormal returns in the first month and from thereon the portfolio generates a consistent positive return (both raw as well as abnormal) over the entire 36 month period. In other words, an investment strategy based on investing in all new entrants as and when they are quoted on AIM on a value-weighted basis since December 2000, generates a raw return of 84 per cent over 36 months and an abnormal return of 60 per cent. The abnormal return is arrived at by subtracting from the raw return of each security for a particular month the overall market return for that month measured using the FTSEAIM index.

**Table 7: Annual index returns**

| Year        | FTSEAIM | FTSEAIM100 | FTSEAIM50 | FTSE ALL SHARE | FTSE100 |
|-------------|---------|------------|-----------|----------------|---------|
| 1997        | -9%     |            |           | 0%             | 0%      |
| 1998        | -20%    |            |           | 13%            | 16%     |
| 1999        | 87%     |            |           | 22%            | 19%     |
| 2000        | -3%     |            |           | -6%            | -9%     |
| 2001        | -46%    |            |           | -14%           | -15%    |
| 2002        | -39%    |            |           | -26%           | -25%    |
| 2003        | 34%     |            |           | 19%            | 16%     |
| 2004        | 19%     |            |           | 12%            | 11%     |
| 2005        | 5%      | 7%         | 14%       | 20%            | 19%     |
| 2006        | 15%     | -8%        | -6%       | 16%            | 13%     |
| 2007 to Feb | 5%      | 6%         | 3%        | 0%             | 0%      |
| Average     | 1%      | 3%         | 6%        | 7%             | 6%      |

**Table 8: Aftermarket performance of new entrants**

| Months after entry | Number of Firms | Cumulative Returns | Cumulative Abnormal Returns |
|--------------------|-----------------|--------------------|-----------------------------|
| 1                  | 1,470           | 1.38%              | 1.00%                       |
| 6                  | 1,410           | 13.54%             | 10.35%                      |
| 12                 | 1,168           | 29.39%             | 22.92%                      |
| 18                 | 902             | 43.52%             | 32.55%                      |
| 24                 | 663             | 56.77%             | 41.34%                      |
| 30                 | 477             | 76.36%             | 54.48%                      |
| 36                 | 333             | 84.09%             | 58.67%                      |



# 9

## Liquidity

**The liquidity of larger AIM stocks is comparable with liquidity on the Main Market, but there is a large number of relatively illiquid stocks at the lower end of the market.**

On liquidity, AIM's performance can be measured by two different indicators:

- **Volume:** This is based on the average monthly trading volume of a stock in a year.
- **Turnover:** This is defined as the total monthly volume divided by the number of shares outstanding.

Both these variables are calculated for each stock for each month and then the median for all stocks across the years for which data is available is presented (Table 9).

Liquidity as measured by the average monthly volume of individual stocks traded has increased between 2001 and 2007 and the average for the period is 1.08 million shares. Liquidity as measured by turnover increased between 2001 and 2006 and has a monthly average of 2.5 per cent; which translates to approximately 30 per cent for the whole year. AIM's turnover of 35 per cent in 2006 compares favourably with that of 'junior' exchanges in other parts of the world, where turnover ranges between 15 per cent and 50 per cent.

Because AIM caters to such a diverse group of companies, three different trading platforms have been introduced.

- SETSmm is the system used for the most liquid stocks on AIM. SETSmm combines an order book with an integrated market-maker liquidity provision. At the end of February, 2007, 131 stocks with a total market capitalisation of £36 billion were trading on SETSmm.
- SEAQ is the trading service for AIM securities that are not liquid enough to trade on SETSmm. The service is

based on two-way continuous quotes, offered by at least two competing market makers. SEAQ has by far the largest number of AIM stocks trading on it. As of February 2007 there were 1,470 AIM stocks on SEAQ with a total market capitalisation of £58 billion.

- SEATS is the trading platform for less liquid securities, which will be replaced by the SETSqx in 2007. SEATS had only 18 stocks having a total market capitalisation of £1 billion trading on it at the end of February, 2007.

In all the months analysed the trading volumes as well as the turnover of stocks traded on SETSmm were way

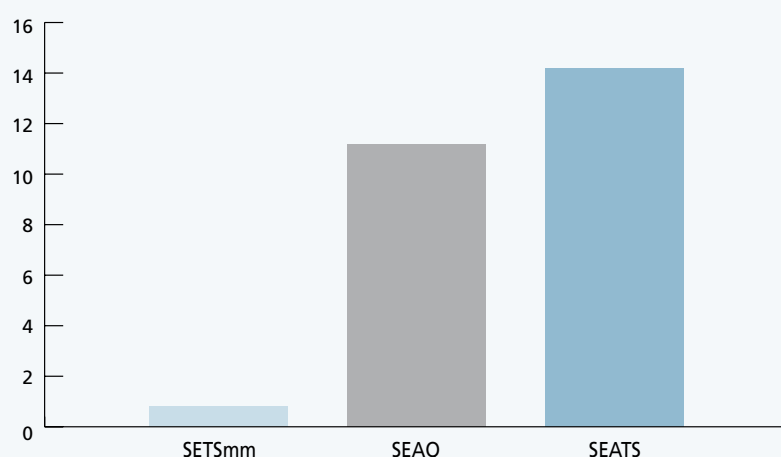
ahead of SEAQ and SEATS. This is to be expected since this category includes the most liquid and largest stocks on AIM. The average monthly trading volume on SETSmm over the period analysed (December 2005 to February 2007) is just over 20 million shares, compared to 6.4 million on SEAQ and 0.22 million on SEATS.

The introduction of SETSmm was designed to increase liquidity and lower spreads on the largest stocks, and it has succeeded in doing that (Figure 3). AIM has the infrastructure necessary to cater to the liquidity needs of a wide variety of stocks.

**Table 9: Monthly average liquidity measures for AIM (medians across stocks for the year)**

| Year           | Number of Companies | Volume (Shares)  | Turnover    |
|----------------|---------------------|------------------|-------------|
| 2001           | 702                 | 709,920          | 2.0%        |
| 2002           | 790                 | 530,067          | 1.5%        |
| 2003           | 873                 | 937,528          | 2.5%        |
| 2004           | 1,106               | 1,179,576        | 3.2%        |
| 2005           | 1,519               | 1,377,674        | 3.0%        |
| 2006           | 1,862               | 1,410,708        | 2.9%        |
| 2007 to Feb    | 1,681               | 1,393,486        | 2.5%        |
| <b>Average</b> | <b>1,219</b>        | <b>1,076,994</b> | <b>2.5%</b> |

**Figure 3: Daily Quoted Spreads for 2006 (by Trading System)**



# 10

## Volatility

### The volatility of AIM stocks compares favourably with other exchanges.

Volatility is typically used to quantify the risk of the market over a particular time period. The most common method of estimating volatility is to calculate the standard deviation of the returns from the market. We used the daily FTSEAIM Index as well as the FTSEAIM50 and FTSEAIM100 to estimate the historic volatility of AIM each year. Table 10 presents the estimates of annual historical volatility based on various indices. FTSEAIM index, which is the

longest series, had an average volatility of 14 per cent per annum, whereas the FTSEAIM50 and FTSEAIM100 indices show a higher volatility of 16 per cent and 18 per cent per annum respectively. The volatility of the FTSEALL Share and FTSE100 indices for the same period were 17 per cent and 18 per cent respectively. Given that a large number of early stage companies are traded on AIM, we would expect higher volatility; however, the table indicates that the volatility on AIM is comparable to that of the main market.

**Table 10: Annual volatility of AIM**

| Year               | FTSEAIM    | FTSEAIM100 | FTSEAIM50  | FTSE ALL SHARE | FTSE100    |
|--------------------|------------|------------|------------|----------------|------------|
| <b>1997</b>        | 6%         |            |            | 12%            | 14%        |
| <b>1998</b>        | 11%        |            |            | 18%            | 21%        |
| <b>1999</b>        | 15%        |            |            | 16%            | 18%        |
| <b>2000</b>        | 28%        |            |            | 17%            | 19%        |
| <b>2001</b>        | 13%        |            |            | 20%            | 22%        |
| <b>2002</b>        | 8%         |            |            | 25%            | 26%        |
| <b>2003</b>        | 7%         |            |            | 18%            | 19%        |
| <b>2004</b>        | 8%         |            |            | 10%            | 10%        |
| <b>2005</b>        | 11%        | 11%        | 12%        | 9%             | 9%         |
| <b>2006</b>        | 13%        | 18%        | 21%        | 13%            | 13%        |
| <b>2007 to Feb</b> | 9%         | 12%        | 11%        | 12%            | 12%        |
| <b>Average</b>     | <b>14%</b> | <b>16%</b> | <b>18%</b> | <b>17%</b>     | <b>18%</b> |

Although most of AIM's institutional investors have their headquarters in London, there is a strong regional dimension among the Nomads and brokers, and many of them have close links to regional venture capital funds.

# 11

## AIM and the UK economy

### Despite the increasing importance of foreign companies, AIM still provides vital support for the UK's small and medium-sized enterprises. In particular, as many venture capital firms now focus on larger and later-stage transactions, AIM has become more important as a source of funding for early-stage high-technology companies.

Since the 1980s successive British governments have sought to improve the ability of small and medium-sized companies to access external sources of capital, especially equity capital. Much of this effort has been directed at business angels and venture capitalists – providers of funds that companies can tap into before they consider a public flotation. But governments have also encouraged the London Stock Exchange to improve its facilities for smaller companies – hence their support for the Unlisted Securities Market in the 1980s and for AIM in the 1990s.

AIM plays an essential role in the provision of finance for growing British companies. Although most of AIM's institutional investors have their headquarters in London, there is a strong regional dimension among the Nomads and brokers, and many of them have close links to regional venture capital funds.

As many of Britain's leading venture capital firms have shifted their attention in recent years from start-ups and early-stage businesses to larger and later-stage deals, including management buy-outs, this has left an equity gap in the £5m-£10m range which AIM has partially filled – hence the lower end of AIM is sometimes described as 'public venture capital'. While there is room for argument about whether some of the very smallest AIM companies are appropriate for the public markets, venture capital firms which specialise in

# 12

## AIM and the City of London

nurturing early stage businesses have no doubt about the value of AIM as a financing option for certain types of business. Equally, the regionally based venture funds regard AIM as essential, not necessarily as a means of making a full exit from their investments, but as a way of bringing in additional investors, mainly institutions, which will support the business in the next phase of its development.

AIM has also become more important as a source of finance for high-technology entrepreneurs. In the case of biotechnology – an industry which has developed more rapidly in the UK than in other European countries – AIM now accommodates some 50 companies, many of which are loss-making and do not yet have products on the market. The failure rate among these companies is inevitably higher than in more predictable sectors, but there have been a number of successes. Venture capital firms and investors which focus on biotechnology attach considerable importance to the role that AIM plays in sustaining this industry.

**AIM has become an important part of the capital-raising options that the City of London offers, as well as enhancing the range of investment opportunities that can be accessed through London.**

The growth of AIM, especially in the period since 2002, has enhanced the position of the London Stock Exchange in what has become an increasingly active competition for leadership among the world's principal stock exchanges. To some extent the gains made by London have been at the expense of New York, and reflect the development in Britain, since the early 2000s, of a regulatory system which is less prescriptive than that of the US. For issuers of securities and for investors London now offers an 'à la carte' menu of options – including AIM – which suit a variety of needs.

AIM has been valuable in linking the London capital market more directly to fast-growing emerging markets such as India, China and Russia. Although London has long been an international financial centre, AIM has proved to be a useful capital-raising vehicle for companies based in countries whose stock markets are under-developed or poorly equipped to serve smaller companies.

AIM has also provided a considerable boost for those London-based investment banks and brokers which specialise in small-capitalisation stocks. As AIM's international scope has increased, these firms have also pushed overseas, often acquiring or forming partnerships with local brokers; thus AIM has contributed to the internationalisation of a part of the financial community that had traditionally been geared to domestic clients. The fee income generated by AIM is estimated to be running at about £1bn per year, of which around half derives from companies based outside the UK; thus AIM makes an important contribution to the City of London's 'invisible exports'.

The City of London has long been an international financial centre, but **AIM** has proved to be a useful capital-raising vehicle for companies based in countries whose stock markets are under-developed or poorly equipped to serve smaller companies.

# 13

## AIM and its competitors

**AIM faces competition from other exchanges which target small, growing companies, but it is currently the only one with a significant international dimension.**

There are at least 12 stock markets around the world which cater for small, growing companies. AIM is the only one with a significant international dimension (Table 11).

Among non-British exchanges, the main competition to AIM over the next few years is likely to come from the two-recently established 'junior' markets in Europe – Alternext in Paris (part of the NYSE Euronext group) and the Entry Standard segment of the Deutsche Börse in Frankfurt. Both these markets have international ambitions, but the momentum which AIM has established, and the network effects from which it benefits as part of the City of London, constitute a powerful competitive advantage.

There is also the possibility, in the longer term, of stronger competition from the US. Most of the American companies that come to AIM are too small to be listed on NASDAQ or the New York Stock Exchange. But there is concern in the US about the lack of public market capital-raising options for smaller companies, and several ideas have been put forward for filling the gap. Any relaxations that may be made in the Sarbanes-Oxley regulatory framework could increase the attractiveness of US markets for foreign issuers.

**Table 11: Number of companies on 'junior' exchanges as of December 2006**

Source: World Federation of Exchanges

| Country          | Exchange           | Domestic | Foreign | Total        |
|------------------|--------------------|----------|---------|--------------|
| <b>London</b>    | AIM                | 1,328    | 306     | <b>1,634</b> |
| <b>Germany</b>   | Entry Standard     | 70       | 6       | <b>76</b>    |
| <b>Euronext</b>  | Alternext          | 73       | 2       | <b>75</b>    |
| <b>Spain</b>     | Nuevo Mercado      | 10       | 1       | <b>11</b>    |
| <b>Italy</b>     | Mercato Expandi    | 26       | 0       | <b>26</b>    |
| <b>Ireland</b>   | Irish Enterprise   | 19       | 4       | <b>23</b>    |
| <b>OMX</b>       | Investor & NM List | 34       | 0       | <b>34</b>    |
| <b>Toronto</b>   | TSX Ventures       | 2,244    | 0       | <b>2,244</b> |
| <b>Hong Kong</b> | Growth Enterprise  | 198      | 0       | <b>198</b>   |
| <b>Korea</b>     | KOSDAQ             | 962      | 0       | <b>962</b>   |
| <b>Singapore</b> | SESDAQ             | 129      | 40      | <b>169</b>   |
| <b>Tokyo</b>     | Mothers            | 185      | 2       | <b>187</b>   |

Some other 'junior' markets have international ambitions, but the momentum which **AIM** has established, and the network effects from which it benefits as part of the City of London, constitute a powerful competitive advantage.

# 14

## The future of AIM

**AIM is an exchange-regulated market, and the London Stock Exchange has been able to maintain an appropriate balance between top-down supervision and allowing market forces to work. The evolution of AIM has been a market-driven process, and the market will continue to develop in response to the changing demands of issuers and investors.**

The core mission of AIM is likely to remain what it has been from the start, to provide a market for small and medium-sized companies which are ambitious to grow and need capital for expansion.

At the time this report was written (September 2007), the London Stock Exchange was in the process of extending its European reach through the acquisition of Borsa Italiana. At the same time NASDAQ, having failed in its earlier attempt to take over the Exchange, was pursuing its bid to merge with the Nordic exchange, OMX. Further mergers or alliances among the world's leading stock exchanges seem likely, and these moves could have a direct or indirect impact on AIM. As things now stand, however, AIM is a valuable asset within the London Stock Exchange, and the Exchange authorities have to consider how best it can be preserved and enhanced.

The two central issues are, first, what sort of market AIM wants to be, and, second, what further change, if any, should be made in its regulatory arrangements.

On the first, the core mission of AIM is likely to remain what it has been from the start, to provide a market for small and medium-sized companies which are ambitious to grow and need capital for

expansion. How 'small' should be defined in this context is a matter for debate, but companies coming to AIM need to be big enough to be of interest to institutional and private investors, to be able to handle the costs and responsibilities that go with being a public company, and to meet the standards of suitability that are implicit – if not precisely spelt out – in the rules for Nomads. Some market participants believe that there

are too many 'microcap' companies on AIM which should probably not be on a public market. While there is no easy way of winnowing out unsuitable companies that are already there, fewer such companies are likely to be admitted in future; there are already indications, partly as a consequence of the new Nomad rules, that Nomads and brokers are discouraging very small companies from coming to AIM.

Against that, the Exchange has to be careful to ensure that the pendulum does not swing too far in the opposite direction and that AIM does not become dominated by larger companies – say, with capitalisations ranging from £100m to £500m. Some of the companies in that size range are potential candidates for the Main Market, and, while they may have good reasons for wanting to stay on AIM, they may be quite similar to their Main Market peers in terms of management, corporate governance and ownership structure. If AIM was to become too skewed in the direction of bigger companies, the distinction between it and the

Main Market could become blurred, as happened with the Unlisted Securities Market in the early 1990s.

On the international side, a big challenge for AIM is how to strengthen its position in Continental Europe in the face of competition from NYSE Euronext and perhaps from the Deutsche Börse. The planned merger with Borsa Italiana will give the London Stock Exchange a direct stake in the eurozone and an opportunity to tap into the Italian business community, which has an ample supply of small and medium-sized companies potentially suitable for an AIM-type market.

Could AIM become too big? While the current number of AIM companies – just under 1,700 – is well below the 3,200 companies listed on NASDAQ, there are dangers that, as the size of the market increases, smaller companies receive too little attention from analysts and have too little visibility among investors. Investors are interested in quality, not

Companies coming to AIM need to be big enough to be of interest to institutional and private investors, to be able to handle the costs and responsibilities that go with being a public company, and to meet the standards of suitability that are implicit in the Nomad rules.

quantity. While the market is to some extent self-correcting – hence the fall in IPOs so far in 2007 after the very large number of new entrants in 2005 and 2006 – the role of Nomads is crucial.

Nomads are central to the AIM regulatory system. There is a heavy responsibility on Nomads for assessing the suitability of AIM companies, and they take on a considerable reputational risk. The 80-odd Nomads currently approved by the Exchange vary in size from ‘bulge bracket’ investment banks like Merrill Lynch and big accounting firms like KPMG to financial boutiques which focus on the smaller AIM companies. If the companies they act for fail, should that be regarded as a failure of the regulatory system, leading to further changes in the AIM rules, or can the market be relied upon to sort things out? Nomads and brokers who bring weak companies to AIM, or whose due diligence turns out to have been deficient, will be shunned by investors on future occasions – this is the market at work.

To what extent should these market pressures be reinforced by specific rules? New rules have been introduced in response to particular events or market developments – for example, the 2005 rules on cash shells, and the 2006 guidelines on mining, oil and gas companies, which required improvements in the quality of the ‘competent person’s report’ on reserves and resources. There is always the risk that any new rules will be taken by outsiders as a sign that the system as a whole is flawed, and this was why a few market participants were not enthusiastic about the new Nomad rules that were introduced in February 2007. In general, however, the reaction to the new rules was positive, on the grounds that, with the increase in the size and complexity of the market, there was a need to clarify and formalise what was expected of

the Nomads. There are indications that, following the publication of the rules, some Nomads are cutting back on the number of companies they act for.

AIM is an exchange-regulated market, and the London Stock Exchange has been able to maintain an appropriate balance between top-down supervision and allowing market forces to work. The evolution of AIM has been a market-driven process, and the market will continue to develop in response to the changing demands of companies and investors. The regulatory arrangements will also need to evolve, as has happened over the last year, but this is likely to take the form of incremental adaptation, rather than any radical reform of a distinctive system which has proved to be effective, and which has contributed to a notable success for the City of London.

The general reaction to the new **AIM** rules that were published in February 2007 was positive, on the grounds that, with the increase in the size and complexity of the market, there was a need to clarify and formalise what was expected of the Nomads.



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