LSE

THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

From local to global

The rise of AIM as a stock market for growing companies

A comprehensive report analysing the growth of AIM

By Sridhar Arcot, Julia Black and Geoffrey Owen

September 2007

London
STOCK EXCHANGE
www.londonstockexchange.com/aim

AIM

Purpose of the report

The purpose of this report, which was commissioned by the London Stock Exchange, is to examine the recent development of AIM as a stock market for growing companies, and to analyse 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, and on 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 report, and representatives from brokers, Nomads and investors; the latter conversations were conducted on an off-the-record basis and are not referenced in the report.

The authors

The authors are on the academic staff of the London School of Economics and Political Science (LSE). Sridhar Arcot is a researcher in LSE's Financial Markets Group. Julia Black is Professor of Law in the Law Department and a research associate in the Centre for Analysis of Risk and Regulation at LSE. Geoffrey Owen is Senior Fellow in the Department of Management.

Contents

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, has 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 three 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.

Executive Summary

1. Introduction

London's 'junior' stock market, launched in 1995 as the Alternative Investment Market and now generally 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, principally since 2002, a growing number of foreign companies in a variety of sectors. The non-British element (taking into account both AIM companies that are domiciled outside the UK and those foreign entities which operate through UK-registered companies) now accounts for about half of AIM's total market capitalisation.

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.

The change in the character of AIM, involving a large number of foreign companies and, more recently, the entry of property funds and equity investment entities, has necessitated some tightening of the regulatory system, but the key feature of the system – the delegation of responsibility to Nominated Advisers (Nomads) for assessing the suitability of AIM entrants – has remained intact.

2. The evolution of AIM

The creation of AIM in 1995 followed a debate in the City about how best the Stock Exchange could improve its services to small and medium-sized British companies. The regulation and governance of AIM were designed in a way that clearly differentiated it from the Main Market and was tailored to the needs of 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. Hence AIM survived the stock market crash in 2000-2001 in much better shape than these other markets.

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, as has the average size of Initial Public Offerings. Another factor has been the entry of property funds and equity investment entities, some of which focus on investment opportunities in emerging markets. However, the inflow of small and medium-sized British companies has continued.

3. Regulation

AIM is an exchange-regulated market run by the London Stock Exchange, which in turn is regulated by the UK Financial Services Authority. 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. There may be further changes in AIM's regulatory regime consequent on developments in EU law, currently under discussion.

AIM's regulatory system relies heavily on Nomads (Nominated Advisers). Nomads are unique to AIM. Their role is quite distinct from that of sponsors to the Main Market and the regulatory regime which applies to them is more onerous. Changes in the composition of AIM and the increase in the size of the market have caused the Exchange to review AIM's regulatory regime. The AIM rules have recently been reorganised into two new rulebooks: Rules for Nomads and Rules for Companies. The new rulebooks formalize and clarify the respective obligations of issuers and Nomads. In addition, the resourcing of AIM's regulatory functions has increased significantly and a new system for monitoring Nomads is being introduced.

4. The companies

Most 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.

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

Some of the small American high-technology companies that come to AIM do so because it is difficult and expensive for them to raise capital on the public markets in the US; the average market value of new entrants on NASDAQ 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 considered a listing on NASDAQ.

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; nine companies have moved to the Main Market so far in 2007. But there has 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. AIM has become a market in its own right, and is no longer simply a feeder to the Main Market.

5. Investors in AIM

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. 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.

The majority though not unanimous view among investors is that the quality of the market has been improved by the inclusion of more foreign companies and the new investment entities. However, there is some concern that in the last two years Nomads and brokers may have put too much emphasis on securing IPOs and not enough on nurturing companies after the flotation. Several initiatives have recently been launched that may lead to greater pressure being brought to bear by investors on under-performing AIM companies.

6. The quality of the market

Although many AIM companies are early-stage business and/or operating in high-risk industries, the failure rate on AIM is low – averaging less than three per cent in the last four years. Failures are treated as companies going into liquidation, or being delisted because of a failure to comply with the AIM rules or delisting without giving any other reason.

Liquidity among AIM stocks varies widely; stocks with the highest capitalisation and the largest free float show liquidity levels that are comparable to the Main Market, but at the lower end of the market there is a large number of illiquid stocks. AIM has sought to improve the liquidity of the market by providing different trading platforms for different types of stock. The volatility of AIM is not significantly different from that of other markets.

The FTSE AIM Index over the whole period from 1997 to 2007 has shown an annualised return of only one per cent per annum, but this figure is distorted by the effects of the dot.com boom and bust, producing a very big rise in the index in 1999 and a sharp correction in 2001 and 2002. The newer AIM indices, the FTSE AIM 100 and the FTSE AIM 50, which were introduced in 2005, have produced annualised returns of three per cent and six per cent respectively. An analysis of the after-market returns on new listings since 2000 – focusing on the 36 months following the IPO – shows that investors, on average, have made healthy gains.

Over the whole period from 1995 to the end of June 2007 AIM companies have raised £28bn through IPOs and £21bn through further equity issues. Some 75 per cent of the total capital raised has been raised in the years from 2004 to 2007.

7. AIM and the UK economy

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 sizeable regional dimension among 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, AIM has 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. Although the failure rate among these companies is inevitably higher than in more predictable sectors, there have been some notable successes among AIM-quoted biotechnology companies. AIM plays a valuable role in sustaining this industry.

8. AIM and the City of London

The growth of AIM, especially in the period since 2002, has widened the capital-raising opportunities that the City of London provides, and has enhanced the position of the London Stock Exchange in what has become an increasingly fierce struggle 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 late 1990s, of a regulatory system which is less prescriptive than that of the US. For issuers of securities and for investors London now offers an 'a la carte' menu of options – including AIM – which suit a variety of needs.

AIM has been valuable in linking the London capital market 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 enterprises.

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 income generated by AIM, taking into account fees arising from IPOs and further equity issues, together with payments made to accountants, lawyers and other advisers, is estimated to be running at about £1bn a year, of which about half comes from non-British companies.

9. AIM and its competitors

AIM was the only 'junior' market left standing in Europe after the stock market collapse of 2000-2001, and it was able to take advantage of the demise of its competitors by attracting more international companies. Since 2005, however, competition has been increasing, in the UK and overseas.

The main competition in the UK comes from what used to be called Ofex, but is now part of the PLUS Markets Group. So far most new issues on PLUS have been in smaller amounts than are commonly raised on AIM, but PLUS is supported by several of the investment banks and brokers that are also active on AIM, and it could become a significant competitor at the lower end of the market.

Outside the UK, there are numerous 'junior' markets – for example, TSX Ventures in Toronto and the Growth Enterprise Market in Hong Kong – which are primarily geared to companies based in their country or region, but also offer internationally-minded companies an alternative to AIM. In the next few years the main competition to AIM is likely to come from the two-recently established 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.

10. The future of AIM

A key question for AIM and for its owner, the London Stock Exchange, is how far it should continue to be a 'broad church', accommodating both very small companies with a market value of less than £10m and larger companies valued at well over £100m. The average market capitalisation of AIM companies has increased in recent years, and this has highlighted the 'long tail' of small and relatively illiquid shares at the lower end. But if AIM were to focus on larger companies, the distinction between it and the Main Market would become blurred.

AIM seems likely to hold to its original mission as a market for growing companies, but to do so in a way which puts greater stress on the quality of new entrants. This implies continuing pressure on Nomads to apply a stringent approach when they assess the suitability of potential AIM companies, and to ensure that that Nomads carry out their responsibilities after flotation as rigorously as possible.

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 regulatory arrangements will also need to evolve, as has happened over the last three years. This is likely to take the form of incremental adaptation, rather than radical reform of a distinctive system which has proved to be effective, and which has underpinned a notable success for the City of London.

1

Introduction

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 a growing number of foreign companies (Table 1.1). AIM now comprises over 1600 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. In June 2007 there were more companies traded on AIM (1,656) than on the London Stock Exchange's Main Market (1590).

The increasing size of AIM and the changes in its composition have had three important consequences.

First, AIM is now an established part of the menu of capital-raising options which the City of London offers to British and non-British companies. 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.

Second, the evolution of AIM from its modest beginnings in 1995 has obliged its owner, 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. As an exchange-regulated market, AIM is not directly supervised by the Financial Services Authority, but falls under the responsibility of the Stock Exchange. 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 reputation of the Exchange, and of the City of London, would be seriously damaged if AIM was to become tainted by scandal or malpractice.

Third, the success of AIM has prompted imitation, envy and criticism from around the world. Several of the big national exchanges, such as Toronto and Tokyo, 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,

Table 1.1 Growth of AIM since 1995

Source: London Stock Exchange: AIM statistics

	Number of companies			Market value (£m)
	UK	International	Total	
19/06/95	10	0	10	82.2
1995	118	3	121	2,382.4
1996	235	17	252	5,298.5
1997	286	22	308	5,655.1
1998	291	21	312	4,437.9
1999	325	22	347	13,468.5
2000	493	31	524	14,935.2
2001	587	42	639	11,607.2
2002	654	50	704	10,252.3
2003	694	60	754	18,358.5
2004	905	116	1,021	31,753.4
2005	1,179	220	1,399	59,618.5
2006	1,330	304	1,634	94,364.0
2007 to June	1,337	319	1,656	107,553.6

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. Both these markets, which were partially modelled on AIM, have international ambitions.

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.[1] AIM has a regulatory system that is specifically tailored for the needs for 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 criticism of AIM comes at a time when the world's leading stock exchanges are jockeying for position in what appears to be a consolidating industry. Apart from the merger between Euronext and the New York Stock Exchange, NASDAQ made an unsuccessful bid for the London Stock Exchange early in 2007; it subsequently announced plans to acquired the Nordic stock exchange, OMX. The London Stock Exchange is merging with the principal Italian exchange, Borsa Italiana.

The report is organised as follows. Section 2 provides the historical background, covering the debate in the City that led to the creation of AIM in the early 1990s, the impact of the dot.com boom in the latter part of the decade, and the subsequent internationalisation of AIM. Section 3 reviews AIM's regulatory arrangements. The remaining sections deal with: why companies come to AIM and what they get out of it (Section 4); investors in AIM (Section 5); the quality of the market (Section 6); AIM and the UK economy (Section 7); AIM's role within the City of London (Section 8); AIM and its competitors (Section 9); and the future of AIM (Section 10).

1 John Thain, chief executive of the New York Stock Exchange, was quoted as saying at the World Economic Forum in January 2007 that AIM lacked stringent corporate governance standards. The London Stock Exchange, he said 'did not have any standards at all (on AIM) and anyone could list' (Financial Times, 27 January 2007). Roel Campos, a member of the Securities and Exchange Commission, was quoted on a Dow Jones newswire in March 2007 as deploring the trend whereby companies simply chose their listing venue based on the lowest level of oversight available. Referring to AIM, he said: 'I'm concerned that 30 per cent of issuers that list on AIM are gone in a year. That feels like a casino to me, and I believe investors will treat it as such'. Mr Campos subsequently said that his remarks had been taken out of context and that he did not regard AIM as a casino. 'What I was referring to', he said, 'was a generalised situation in which if (regulatory) standards are ignored and you have a spiral downward you could get into a situation where an exchange could be nothing more than a casino' (Financial Times, 8 March 2007).

2

The evolution of **AIM**

Origins and early growth

The origins of AIM can be traced back to the long-standing debate, starting with the report of the Macmillan Committee in 1931, about deficiencies in the supply of capital, especially equity capital, to smaller British businesses. This debate continued after the second world war, and the British clearing banks were persuaded by the government to set up a new institution, the Industrial Commercial and Financial Corporation (later re-named Investors In Industry, now 3i), which was designed to fill the so-called equity gap. But while the ICFC and other private-sector initiatives were helpful, small firms found it hard to get access to public markets and thus to a wider pool of investors. The regional stock exchanges, which had handled numerous small company flotations in the inter-war years, declined in importance during the early post-war decades; they were integrated into the London Stock Exchange in 1973.

The financing difficulties facing small firms were partly a reflection of a weak economy and a tax system which did not encourage investment in equities; new issues on the London Stock Exchange fell to very low levels in the 1970s. But there was also seen to be an institutional weakness, especially in comparison with the US, where the NASDAQ exchange, created out of the informal over-the-counter market in 1971, had attracted listings from small, fast-growing companies which found its trading rules more flexible than those of the long-established New York Stock Exchange. The dearth of such companies in the UK, and in Europe as a whole, was highlighted in 1977 by an influential report from the US consultants, Arthur D. Little; a European equivalent to NASDAQ, the consultants said, was badly needed.[2]

The Stock Exchange had been passive in this area – as the regulator of the securities industry it took a cautious line on what sorts of company should be listed – but it came under pressure in the second half of the 1970s to improve its services to small firms. The Exchange was facing competition from an over-the-counter market through which non-members of the Exchange could trade in shares of companies that were too small for the Official List. There was a special Stock Exchange rule (rule 163.2, later rule 535.2) whereby Exchange members could trade in such shares on a matched bargain basis, but it was an unsatisfactory arrangement because the Exchange had little supervision over the securities being traded. 'Either it had to reject these companies, further stimulating the OTC markets made by non-members, or it had to create a market where these securities could be traded which would not jeopardise the reputation of the Stock Exchange'.[3]

In 1980, following recommendations from the Wilson Committee, which had been set up by the Labour government to review the functioning of financial institutions, the Exchange introduced the Unlisted Securities Market (USM). The rules for admission to the USM were less stringent than for the Official List, and the costs of flotation were lower. Only ten per cent of the company's equity had to be offered to the public, compared to 25 per cent for a full listing, and only a three-year trading record was required, against five years on the Official List.

Between 1980 and the end of 1987 just over 600 companies were admitted to the USM, of which 108 were later transferred to the Official List. This was part of a general revival in the new issue market after the depressed conditions of the 1970s, but it also reflected a greater willingness on the part of investors to take the risk of buying shares in unproven businesses. The USM was welcomed by the new Conservative government under Margaret Thatcher. The promotion of enterprise was a central part of the government's economic strategy, and several schemes were introduced to encourage new business formation; these included the Business Start-up Scheme, later renamed the Business Expansion Scheme, which gave tax incentives for investment in start-up businesses. The venture capital industry grew rapidly during the 1980s, and the USM provided an additional exit route for investors who had nurtured a business in its earlier years.

The existence of the USM did not lead to the demise of the over-the-counter market. Unlike USM shares, shares traded on this market were treated by the tax authorities as unquoted and investment in them qualified for tax relief under the Business Expansion Scheme. The growth of the OTC led the Exchange in 1987 to introduce the Third Market, which enjoyed the same tax status as the OTC; Third Market companies did not have to have their prospectuses vetted by the Exchange's quotations department before flotation.[4] However, Stock Exchange member firms continued to make use of Rule 535.2 to trade shares in unquoted companies which were unable or unwilling to join the USM or the Third Market.

---

2 Arthur D. Little, New technology-based firms in the UK and the Federal Republic of Germany: a report for the Anglo-German Foundation, London 1977.

3 Ranald Michie, The London Stock Exchange, a history, Oxford 1999, p572.

4 Roger Buckland and Edward W. Davis, The unlisted securities market, Oxford 1989, p133.

The growth of the USM was halted by the worldwide stock market decline in 1987, and this was followed in the early 1990s by a serious recession in Britain. The number of new issues, on the Official List as well as the USM, fell sharply. In 1991 only £11.6m of new capital was raised on the USM, compared with £308m in 1988. The attractions of the USM were also reduced by new regulations issued by the European Commission. The minimum trading period for companies on the Official List was cut from five years to three, and on the USM from three years to two. Given the greater prestige and visibility of the Official List, most companies that might have contemplated going to the USM preferred to wait another year so that they could qualify for the main market. Another factor was the decision by the Exchange in 1991 (at the request of the venture capital community) to relax its entry requirements on the Official List for biotechnology companies; they were allowed, subject to certain conditions, to come to the market without the normally mandatory trading record.

Having already merged the Third Market into the USM in 1990, the Stock Exchange announced in 1993 that it would close the USM itself, and that USM companies which were qualified to do so should transfer to the Official List. The Exchange was also obliged, under European Union regulations, to close down the Rule 535.2 facility.

The prospective disappearance of capital-raising facilities for smaller companies prompted protests from the investment banks and brokers which specialised in this end of the market. Conservative ministers also expressed their concern, as did the venture capitalists. The response from the Exchange was to introduce a new market within the Exchange – to be known as the Alternative Investment Market (AIM) – which would cater for Rule 535.2 companies and for other small firms which did not qualify for the Official List.

The Exchange did not see AIM as a British equivalent to NASDAQ, and it was not specifically targeted at high-technology companies. Some venture capitalists, led by Ronald Cohen of Apax Partners, favoured the creation of a specialist market which would be organised on a European basis and be independent of the national stock exchanges. In Cohen's view, a market for high-growth entrepreneurial companies needed a distinctive management and marketing focus. The success of NASDAQ, he argued, was due in large measure to the fact that it was managed independently of the New York Stock Exchange and the American Stock Exchange;[5] a similar market in Europe would allow young high-technology companies to raise capital locally, instead of turning to NASDAQ as a growing number of them had been doing.

This proposal was supported by the European Commission, which wanted to promote a more integrated European financial services market and to stimulate the growth of European high-technology businesses. The Investment Services Directive, passed in 1993, made it possible for a stock exchange to be set up in a single country and to operate on a pan-European basis. By 1994 plans for such an exchange, to be called EASDAQ and based in Brussels, had been agreed, although it would not come into operation until 1996, when the Investment Services Directive came into effect.[6]

Faced with these pressures, the Stock Exchange pushed ahead with the Alternative Investment Market, planning to get it into operation well before the start of EASDAQ. The concept of AIM was very different from the USM. Michael Lawrence, who became chief executive of the Stock Exchange in 1994, believed that AIM should be run separately from the Official List, with its own management team and a distinctive regulatory approach. There were sceptics in the City who doubted whether the Stock Exchange was capable of running two separate markets; the conservatism of the Quotations Department, in their view, had contributed to the failure of the USM and the Third Market. But Lawrence was determined that the new market should have its own identity and be regulated in a way that was appropriate for smaller companies; it should also serve a wide range of business sectors.

What form the regulation should take was the subject of much debate in the Stock Exchange, with some arguing that, if it was too 'light touch', there was a danger of scandals which would damage the reputation of the Exchange. The outcome was a set of rules which was less prescriptive than on the Official List – no requirement for a trading record, and no minimum percentage of the equity in public hands – but which contained an important element of self-regulation. Whereas on the Official List new entrants had to have their prospectus vetted by the Listing Authority (which at that time was the Stock Exchange), on AIM the responsibility for assessing the suitability of the company would rest with Nominated Advisers, or Nomads. These were investment bankers or brokers (and some accounting firms) whose role was similar in some respects to that of sponsors on the Official List, with the

[5] Ronald Cohen, chairman of Apax Partners, writing in the Financial Times, 8 March 1994.

[6] Steven Weber and Elliot Posner, Creating a pan-European market: the origins of EASDAQ, Review of International Political Economy, 7, 4 Winter 2000 529-573.

important difference that the decision on suitability was theirs, not that of the Listing Authority. Thus they had a dual responsibility – to the companies they were advising and to the Exchange, for ensuring the integrity of the market.

The initial candidates for admission to AIM were the companies which had been traded by Stock Exchange members under Rule 535.2 (now Rule 4.2); the launch date for AIM was set for June 1995, and the Rule 4.2 facility was kept going until October of that year. But Lawrence and the head of AIM, Theresa Wallis, sought to promote the attractions of the market to companies which had not previously considered any form of public quotation. They conducted road shows around the country to explain how the new market would work, working with the Stock Exchange's regional advisory groups. Lawrence wanted to de-mystify the stock market for business people who had previously shied away from it.

The market opened with ten companies, including a garden centre business, a public house operator called the Old English Pub Company, a mining exploration company and three property companies. The most successful of the ten pioneers was Dawson Holdings, a newspaper and magazine distributor which moved to the Main Market in 1998.

In considering applications from would-be Nomads, the AIM team set high standards, mainly focused on the applicant's record in handling capital market transactions and on the experience of the senior executives. There were 24 Nomads when the market opened (about the same number of applicants had been rejected), and the number increased to about 50 by the end of 1996.

The Stock Exchange was able to persuade the Inland Revenue to treat AIM companies as unquoted for tax purposes, thus qualifying for the tax reliefs that were available under the Business Expansion Scheme. In addition, the Conservative government introduced two new schemes – the Enterprise Investment Scheme and Venture Capital Trusts – which, while not directed specifically at AIM, gave tax relief to individuals who bought shares in unquoted companies, including AIM companies. Shortly after the launch of AIM two investment trusts were set up in 1995 to attract investors into AIM companies, the Beacon Trust from Rutherford Asset Management and the AIM Trust from Isis. These and other fund managers later launched Venture Capital Trusts, some of them concentrating mainly on AIM companies. The favourable tax regime brought private investors into the market, both directly and through collective investment vehicles such as the VCTs.

By the end of 1996 over 200 companies were traded on AIM, and a total of £650m had been raised through new issues. AIM still had an over-the-counter competitor in the form of Ofex which had been set up in 1995 after the Rule 4.2 facility had been withdrawn, but it mainly focused on companies that were too small for AIM.

Shortly after AIM was established, the world stock market scene was transformed by what came to be known as the dot.com boom. One of the triggering events was the NASDAQ flotation of Netscape, the US internet browser company, in 1995; the shares were priced at $28 and rose to $71 as soon as the market opened. There followed a stream of initial public offerings from companies with an internet connection, and prices were driven to levels that bore little or no relation to future profits. Unlike, say, Microsoft, which had floated in 1986, many companies came to the stock market with no track record of making profits, and no coherent business plan. The boom, which lasted until 2000, had a profound effect on AIM and its position in the world securities market.

The dot-com boom

The boom began in the US but quickly spread to Europe, prompting strenuous efforts by the national stock exchanges to climb on the bandwagon and attract high-technology stocks to their markets. The first dedicated high-technology market to get off the ground was EASDAQ, which began trading in November 1996, 18 months after AIM. The first company to be quoted on it was a British developer of anti-virus software, Dr Solomon's Group; it was backed by Ronald Cohen's Apax Partners. However, any hope that EASDAQ would become the preferred outlet for European technology companies was frustrated by the nationalistic reaction of the established stock exchanges.

Although several of these bodies, including the Paris Stock Exchange, had participated in the planning of EASDAQ, they were reluctant to surrender control of what looked likely to be an important growth market. In 1995 the Paris Stock Exchange announced its intention to set up its own second-tier market, the Nouveau Marche; it began trading in March 1996. This was followed by the creation of similar exchanges in several other European countries, including Germany (Neuer Markt), Belgium (EuroNM), Italy (Nuovo Mercato) and Netherlands (Nieuwe Markt). These four exchanges, together with Paris, later joined forces in what was called Euro.NM. This was presented as a decentralised European stock market based on a network of similar national markets. Their argument was that, despite the Investment Services Directive, there was no common supervisory authority in Europe and no common trading rules; hence the best approach to the creation of a European stock market was a loose association of national exchanges, keeping regulation at the national level while promoting sufficient harmonisation to permit cross-border trading. As one commentator remarked later, 'Vested interests from the national financial systems, with the support of their governments, created these new markets to divert the challenge that EASDAQ posed to nationally based, quasi-monopolistic arrangements'.[7]

For the first few years these new markets, including EASDAQ, did well, benefiting from the explosion of interest in internet-related and other high-technology stocks. The most spectacular growth was in Germany's Neuer Markt. The number of IPOs there rose to 168 and 159 in 1999 and 2000; in a country where over the previous fifteen years new issues on local stock markets had rarely exceeded 20 per year, this was an extraordinary change. A big stimulus to wider share ownership in Germany had been the flotation of Deutsche Telekom in 1996 – the first German IPO to be 'promoted through all the channels of the mass media and with all the techniques of modern marketing'. When the Neuer Markt started trading a few months later, 'the good taste of the Telekom IPO was still fresh'. Many of the new issues were viewed as future Microsofts or Netscapes, and prompted frenetic buying by individual investors, although institutional shareholders were sceptical, regarding the Neuer Markt as 'a market for gamblers and freaks'.[8]

By the end of the 1990s the most highly valued companies on AIM were internet based firms, and they helped to push the AIM index, which had started at 1,000 in 1995, to a peak of 2,925 in March 2000. But internet-based and other technology stocks formed a much smaller proportion of the AIM population than was the case in EASDAQ and the Neuer Markt, and, partly for that reason, the growth of AIM in the late 1990s looked lacklustre compared to its European rivals.

The fear that London – both AIM and the Main Market – was losing out in high-technology stocks prompted the Stock Exchange to launch techMARK in 1999. This was largely a branding exercise, aimed at demonstrating that the Main Market did contain a number of strong, high-technology companies. At the same time the Exchange extended the rule that had been brought in for biotechnology in 1991 to other sectors such as computer hardware and software; provided they met certain conditions technology-based firms were allowed to list on the Main Market and to be included in techMARK.

The launch of techMARK reflected concern in London about the competitive position of the Stock Exchange in Europe. As the European financial services market became more integrated, there was likely to be consolidation among European stock exchanges, and it was not clear how this would affect London. Commercially, too, the Exchange was entering a new era at the end of the 1990s. It was about to convert itself from a mutual organisation into a shareholder-owned enterprise and its role as regulator of new issues was being transferred to the Financial Services Authority; it had to make its own way in the world as a profit-making business, without support from the government.

The first response to these new circumstances was an agreement with the Deutsche Börse in 1998 to develop a joint electronic trading platform. In May 2000 this was transformed into a full-scale merger, to create what was called iX (international exchanges). As part of this plan, trading in high-technology stocks would be concentrated in Frankfurt through an enlarged Neuer Markt, while 'blue-chip' companies would be traded in London. At the same time the two exchanges signed a memorandum of understanding with NASDAQ, whereby the American exchange would cooperate in creating a pan-European high-growth market, in competition with EASDAQ and the other new markets.

This proposal aroused opposition from the City of London investment community, not least from the small-capitalisation specialists who deplored the suggestion that trading in high-growth companies would be transferred to Frankfurt. There were also wider reservations, which gained ground in the months following the merger announcement, about the merits of the link with Germany. The Neuer Markt was hit hard by the collapse of the dot.com boom in March 2000, and it was clear by the autumn of that year that many of the companies which had come to the market had done so on the basis of false or misleading prospectuses; there were also allegations of price manipulation and insider trading. The Deutsche Börse was looking an unattractive partner, and the Stock Exchange abandoned the merger plan in September.

The Neuer Markt was not the only casualty of the stock market collapse. Both EASDAQ and the other exchanges grouped in EuroNM were faced by an investor retreat, falling share prices, and a dearth of new issues. The Neuer Markt was shut down in 2002, and it was followed a few months later by the closure of Nouveau Marche in France. It was clear that separate,

[7] Robert Abbanat, Feasibility study: a Pan-European market for technology growth companies, EASDAQ, September 2004.

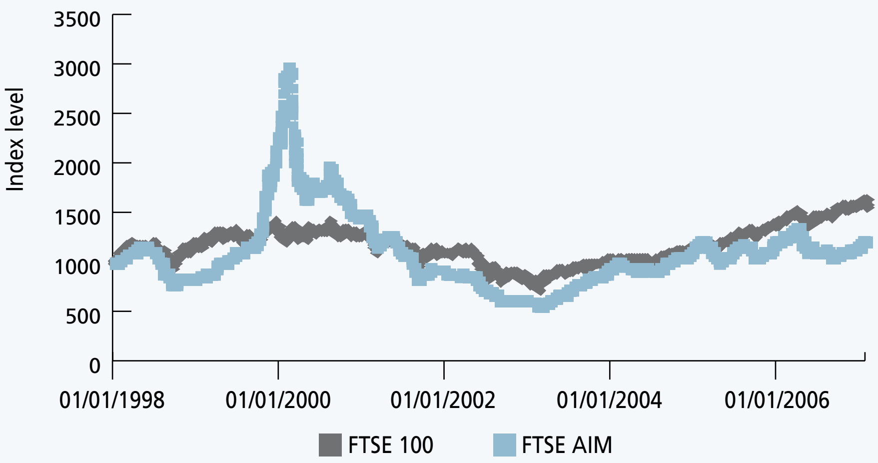
[8] Hans-Peter Burghof and Adrian Hunger, Access to stock markets for small and medium sized growth firms: the temporary success and ultimate failure of Germany's Neuer Markt, October 2003.

national high-technology markets were not viable, although the principle of trans-European collaboration was not abandoned; the French, Belgian, Dutch and Portuguese stock exchanges formed a new grouping called Euronext, through which their main markets would be integrated on a single platform. As for EASDAQ, NASDAQ bought control of this organisation in 2001 and re-named it NASDAQ Europe, but it failed to breathe new life into the market, which was closed in 2003.

Part of the reason for the failure of Europe's new growth markets was fragmentation.[9] None of them were able to attract a sufficient number of listed companies, intermediaries and institutional investors to make the market a self-sustaining concern. Participation from the large investment banks – which have the most influence on where a company is listed – 'was the missing linchpin that prevented any of the exchanges from acquiring critical mass'.[10] Because there were too few listings and too little liquidity in the stocks that were traded, the markets were not attractive to institutional investors. To make matters worse, there was the unfortunate timing of the dot.com boom; the new exchanges were too immature to survive the collapse. 'By contrast NASDAQ had a long incubation period – free of catastrophic trauma – which enabled it to plant its roots. It had its start in 1971 and lingered for years as a mediocre exchange before the likes of MCI, Microsoft and Intel sprung up, making NASDAQ a household name'.[11]

AIM was also a new market when the dot.com boom began, but it had been designed to fill the void left by the end of Rule 535.2 and the closure

Figure 2.1 The rise, fall, and partial recovery of the FTSEAIM Index 1998-2006



of the USM, and it was supported by a group of market participants who had long experience of floating small companies, investing in them and trading in them. It had not gone overboard for high-technology stocks, which never amounted to much more than 20 per cent of the market. The balance was made up of a wide range of sectors operating in more stable industries. Moreover, AIM had a regulatory system which, although it did not prevent the admission of some over-hyped internet stocks, was robust enough to keep out of the market the sort of flimsy, highly speculative businesses that undermined the credibility of the Neuer Markt. Although on paper the German market had stricter admission rules than AIM – two designated sponsors, a free float of 25 per cent and a track record of at least three years – these rules were often waived by the Deutsche Börse in its eagerness to get the market established.

Although the AIM index fell sharply after the stock market collapse (Figure 2.1), AIM can be said to have matured during the period of the dot.com

9 Abbanat, op cit
10 Abbanat op cit
11 Abbanat op cit

boom, not least because of the greater involvement of institutional investors. If they were to get exposure to high-flying internet stocks in the late 1990s, the institutions had to divert at least some of their investment to AIM shares. By 2002 the institutions accounted for some 75 per cent of the new money going into AIM companies; the junior exchange had become an integral part of their investment strategy.

All this was positive for AIM, and its relative strength compared to other European markets raised its profile within the London Stock Exchange. On the other hand, it had been badly affected by the dot.com crash; it needed more listings, more liquidity and more investors. The total number of AIM flotations was 55 in 2002, compared with 94 in 2001, and most of them were very small. (The actual number of companies listed on AIM increased during the year as 36 companies moved from the main market, but these were small capitalisation stocks that were not actively traded). One possibility, suggested by a leading institutional investor in AIM stocks, was to make AIM more of an international market. This was taken up in 2002, with consequences that over the next five years transformed the character of the market.

Internationalisation

The first targets for the Exchange's overseas marketing campaign were Commonwealth countries which had similar legal systems to the UK and a similar approach to equity markets. A number of Australian and Canadian companies were persuaded that a listing on AIM would give them greater international visibility and access to a wider pool of investors; given London's long-standing importance as a source of funds for natural resource development, the Exchange particularly targeted mining and oil and gas exploration companies. The same arguments applied to other countries besides the ones with connections to the UK. One of the biggest flotations on AIM in 2002 was Highland Gold, a Russian gold mining company.

Many of these companies came to AIM in the form of a dual listing, a process that was made easier in 2003 when the Stock Exchange introduced the Designated Markets Initiative, whereby companies that were listed on certain designated exchanges could obtain a secondary listing on AIM through a fast-track process, without having to submit a full prospectus. The list of designated exchanges included Australian, Canadian and South African exchanges, as well as Nasdaq and the New York Stock Exchange, and Deutsche Börse and Euronext in Europe.

The Exchange also promoted the attractions of AIM to investment banks and brokers in these countries. As the flow of companies coming to AIM increased, some of them set up offices in London to become part of the AIM community. One of the most active Canadian brokers was Canaccord Capital (now Canaccord Adams) which acquired a London broker, T. Hoare & Co, in 1999, and became a Nomad in 2001; it has been responsible for many of the Canadian listings on AIM. (Canaccord is itself quoted on AIM, as well as in Toronto).

By the end of 2003 AIM had not only recovered from the stock market crash, but was becoming a significant force both within the London capital market and on the international stage. Its status as an exchange-regulated market not subject to the EU Prospectus Directive, was confirmed in October 2004, allowing the Stock Exchange rather than the Financial Services Authority to continue setting and enforcing the rules.

AIM had become more central to the business of the Stock Exchange than had been the case five years earlier, and its management was integrated more closely with that of the Exchange as a whole. When Simon Brickles (who had taken over from Theresa Wallis as head of AIM in 2001) resigned in 2003 to join Ofex, he was replaced as head of AIM by Martin Graham, who combined the role with his existing post as Director of Markets for the Exchange. There was some anxiety initially in the AIM community about this reassignment of responsibilities, but the Exchange argued that the new management structure would give AIM greater prominence within the organisation. Graham said: 'Our view is that AIM is the lifeblood of the market – it is of massive strategic importance'.[12]

Between 2003 and 2005 mining and oil and gas companies were the most dynamic sector on AIM, replacing the internet stocks which had led the market in the late 1990s. But the London Stock Exchange also targeted other countries and other industries in order to ensure that AIM was not dominated by one temporarily fashionable sector. One potential market was the US. The American business angel and venture capital community was far larger than its British counterpart, and NASDAQ was well established as a market for high-technology companies. However, most of the companies which floated on NASDAQ were larger and more mature than the typical AIM company. There was an opportunity for AIM to attract companies which were too

[12] Financial Times, 7 February 2004.

small to be listed on NASDAQ but still felt that a public quotation would assist their growth. The attractions of the London capital market – the Main Market as well as AIM – were enhanced after the passage of the Sarbanes-Oxley Act in 2002. Companies that were contemplating a listing in the US were faced with additional rules on disclosure and financial controls which were expensive and time-consuming.

By 2007 AIM was a much more broadly based market than it had been five years earlier. The average size of company had increased, with an increasing number valued at more than £50m at the time of flotation. It was also attracting a new class of property and closed end investment entities, some of which were concerned with exploiting investment opportunities in emerging markets such as China, India and Vietnam.

These changes came at a time when a process of consolidation among the world's stock exchanges was getting under way. The London Stock Exchange, having fended off a takeover bid from Deutsche Börse in 2005, found itself a year later on the receiving end of a bid from NASDAQ; this too was rebuffed. In 2006 the New York Stock Exchange unveiled a merger with Euronext. Meanwhile new moves were under way to revive the 'junior' exchanges which had flourished during the dot.com boom. In 2005 Euronext, now NYSE Euronext, opened a new market called Alternext which was tailored to the needs of small and medium-sized companies and had operations in Paris, Amsterdam and Brussels. In Germany the Deutsche Börse introduced a new market segment called the Entry Standard, which it described as 'a flexible and cost-efficient option of listing, imposing fewer bureaucratic burdens on the company than the EU-regulated segments'.

The challenge for the London Stock Exchange was how to maintain and strengthen AIM's position in an increasingly competitive industry. Part of the challenge was to ensure that its regulatory arrangements kept pace with the changes in the character of the market; this is the subject of the next section.

3 Regulation

The rapid growth and internationalization of AIM in the last few years has raised the issue of whether its regulatory regime needs modifying in order to respond to these changes. The regulatory regime is deliberately less prescriptive than that of the Main Market, but one of the chief criticisms of AIM is that it is 'unregulated'. This is a misleading characterisation. AIM does not fall under the technical, legal definition of a 'regulated market', but it is not unregulated. Under the current regulatory regime, AIM is an exchange-regulated market, run by the London Stock Exchange which in turn is recognised and regulated by the UK Financial Services Authority (FSA). As a market, AIM has a separate identity from the Exchange's Main Market, but operationally it is part of the Exchange, and as such is subject to regulation by the FSA which is carried out, in FSA parlance, on a 'close and continuous' basis. AIM is also a regulator: it establishes and monitors a regulatory regime for admission and imposes continuing obligations on issuers and their Nominated Advisers (Nomads).

The regulation to which the Exchange, and thus AIM, is subject has been changing significantly in the last year, and will change again in November 2007. Some of these changes are consequent on changes in EU law, notably the Markets in Financial Instruments Directive (MiFID), one of the central pillars of the raft of EU legislation emerging under the Financial Services Action Plan and which is due to be implemented on 1 November 2007. The Directive introduces changes in the regulation of trading venues which will impact on AIM in a number of ways, detailed below.

AIM's own regulatory regime has also been changing independently of pressures of EU law. In 2006 the Exchange conducted a review of AIM's regulatory regime, focusing in particular on three areas: the implications of the internationalization of AIM and the changing nature of the companies which are admitted to the market; the role of Nomads; and the strength of AIM's day to day regulatory operations. Subsequently, the rules applying to companies and those for Nomads have been clarified and elaborated, and a number of changes are being introduced in the resourcing and performance of AIM's regulatory functions.

This section considers the regulatory regime that applies to AIM and the regulatory regime which it applies to companies admitted to AIM and their Nominated Advisors. Part 1 outlines the broader regulatory regime which applies to AIM and the London Stock Exchange as markets or trading venues, including the changes to be introduced by the implementation of MiFID in November 2007; Part 2 considers AIM as a regulator, focusing in particular on the issue of what type of companies are admitted, and should be admitted, to the market; Part 3 evaluates the role of Nomads in the regulatory regime; Part 4 considers the operational aspects of the regulatory function; and Part 5 considers the role of the FSA and its relationship with the London Stock Exchange and AIM.

1. The Regulation of AIM

1.1 Status under the EU and UK regulatory regimes

Current status

AIM is an exchange-regulated market run by the London Stock Exchange. In order to operate as a market, the Exchange has to be recognised by the FSA and meet certain conditions: the recognition requirements.[13] The requirements consist of both initial and ongoing obligations, the performance of which is monitored by the FSA. They require, among other things, the Exchange to have the necessary financial resources for its operations; to conduct its operations in an orderly manner; to ensure the proper protection for investors and to prevent market abuse or other criminal activities including money laundering on its markets; to provide systems for recording transactions and ensure that systems for clearing and settlement provide for the timely discharge of rights and liabilities arising from transactions on its markets. It is under an obligation to promote and maintain high standards of 'integrity and fair dealing' at all times. In its role as a regulator, the Exchange is required to ensure that there are appropriate systems of consultation for proposed rules; to ensure compliance with its rules and to have effective arrangements for monitoring and enforcing compliance with its rules. It must provide a fair and impartial system of dispute resolution, and any fines ordered to be paid must be applied for the benefit of users of its facilities or for charitable purposes.[14]

The FSA supervises the Exchange on a 'close and continuous' basis, discussed further below. It also has powers (as

13 The Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses (Amendment)) Regulations 2006 (SI 2006/3386) FSA Handbook, REC sourcebook.

14 FSA Handbook, REC 2.

yet unused) to issue directions to the Exchange and ultimately to de-recognise the Exchange for failing to meet its obligations.[15] The FSA has also acquired new powers to review the rules and other provisions of the Exchange and to prevent it from making rules which are excessive, ie which are disproportionate to the end to be achieved or which do not pursue a reasonable regulatory objective. The provisions were introduced officially to preserve the UK's proportionate and risk based approach to financial services regulation, and in practice to guard against the introduction of Sarbanes-Oxley provisions in the Exchange's rules subsequent on any change in its ownership.[16] These provisions will be implemented by the end of 2007.[17]

As a division of the London Stock Exchange, AIM is subject to the recognition requirements that apply to the Exchange. However, the rules relating to trading venues have been altered by the introduction of the Market in Financial Instruments Directive (MiFID), and these will impact on AIM in a number of ways.[18]

Implications of MiFID for AIM

The aim of the new European provisions is, among other things, to facilitate the establishment of trading platforms by removing the ability of member states to require trading to be concentrated on a single market. The concentration provisions had never applied in the UK, and investment firms had begun setting up their own trading platforms, using their FSA authorization to do so. The FSA regulated such platforms through variations of the individual permissions given to investment firms as part of the authorisation process, and guidance in the Market Conduct Sourcebook of the FSA Handbook.[19]

Removal of the concentration provisions facilitates a fragmentation of trading venues, with a number of regulatory implications. In an attempt to stimulate market competition, whilst reducing the scope for regulatory arbitrage, MiFID seeks to harmonise the regulatory requirements that apply to different types of trading venues. Trading venues are now classified into three types: regulated markets; multi-lateral trading facilities (MTFs); and over-the-counter (OTC), which includes systematic internalisers. The London Stock Exchange is a recognised investment exchange, the Main Market is a regulated market, and AIM is a multi-lateral trading facility operated by the London Stock Exchange. PLUS was an Alternative Trading System (ATS) operated by a service company, though it became a recognised investment exchange in July 2007.

The provisions which have been introduced do not establish complete parity between the operation of MTFs and regulated markets either in terms of primary market obligations or functions as trading venues. In general, the requirements imposed on the operators of regulated markets are more detailed, and these are regarded as premium markets.

MiFID introduces broad requirements on those operating MTFs (eg the Exchange) to establish transparent and non-discretionary rules and procedures for fair and orderly trading and to establish objective criteria for the efficient execution of orders. As an operator of an MTF, the Exchange is also required to establish transparent rules regarding the criteria for determining the financial instruments that can be traded on its systems and governing access to its facilities. It has to ensure that there is access to sufficient publicly available information to enable its users to form an investment judgement, taking into account the nature of the users and types of instruments traded.[20]

In addition, the Exchange is placed under an obligation to establish and maintain effective arrangements and procedures for the regular monitoring of compliance by its users, and to monitor transactions in order to identify breaches of those rules, disorderly trading conditions or conduct that may involve market abuse. It is to report significant breaches to the FSA[21] and comply immediately with any instruction from the FSA to suspend or remove a financial instrument from trading.[22]

The main regulatory concern arising from fragmentation of trading is the potential for a parallel fragmentation

15 FSMA ss 296-298.

16 The context and purpose of the Act are set out in House of Commons Research Paper 06/58, Investment Exchanges and Clearing Houses Bill (House of Commons, 23 November 2006), available at www.parliament.uk/commons/lib/research/rp2006/rp06-058.pdf.

17 Investment Exchanges and Clearing Houses Act 2006; the FSA is consulting on the rules: FSA, CP07/10 Notification Obligations under the Investment Exchanges and Clearing Houses Act (June 2007).

18 Markets in Financial Instruments Directive 2004/39/EC (MiFID). MiFID is subject to further detailed elaboration in Directives and Regulations (known as Level 2 measures).

19 FSA Handbook, Market Conduct Sourcebook, Chapter 5.

20 MiFID art 14.

21 MiFID art 26.

22 MiFID art 14(7).

of transparency, with implications for competition, efficiency in price formation, monitoring of compliance with disclosure obligations and market abuse. MTF operators are required to monitor trading on their markets to ensure compliance with their rules, identify disorderly trading conditions and detect market abuse.[23] A key resource which they need in order to perform this monitoring is trade reports. However, there are no detailed provisions on the nature of the post-trade transparency and reporting regime for MTF shares.

There is a significant exception to the lighter regime for trade transparency on MTFs, and that is where the shares traded on the MTF are also traded on a regulated market. Here MTF operators are subject to detailed provisions on pre- and post-trade transparency, which are in line with those that apply to regulated markets.[24]

The exact form of the transparency regime for MTF shares is at present under consideration by HM Treasury and the FSA. It is not yet clear exactly what the impact will be for AIM. The MiFID regime creates the potential for there to be two types of post-trade transparency regimes on a single market, depending on the shares being traded. The FSA is currently consulting on whether or not to extend the MiFID post-trade transparency regime for regulated market shares to MTF shares.

The MiFID requirements largely echo the current recognition requirements imposed on the Exchange by the FSA, and so in most areas meeting the new requirements involves few changes either in substance or in operational practices. However, the new provisions emphasise the need for operators of MTFs to have 'transparent and non-discretionary rules and procedures' to maintain fair and orderly markets. Furthermore, MTF operators are clearly under obligations to prevent market abuse on their markets.[25] The Exchange in effect has the sole responsibility for this with respect to AIM shares traded by non-UK investment firms in other EEA states as these fall outside the current scope of FSA's requirements for transaction reports.[26] Finally, and most significantly, the Exchange will be under a new requirement to manage any conflicts of interest it may have between the interests of its owners and operators and the interests of those who use its facilities or the interests of the markets which it operates.[27]

Taken together, these responsibilities together with the increased size and significance of AIM, may have implications for the position of AIM's regulatory functions within the Exchange's internal governance structure. These are discussed further below.

2. AIM / The Exchange as regulators

In 2000 the Exchange's role as a primary-market regulator of the Main Market was transferred to the Financial Services Authority, which as the UK Listing Authority issues the Listing Rules, vets applications for listing and monitors compliance. However the Exchange is responsible for establishing the primary market responsibilities for those admitted to AIM. The regulatory regime which the Exchange has established for AIM companies differs from that which applies to those listed on the Main Market. In particular, the role played by Nomads is quite different from that played by sponsors to companies seeking listing on the Main Market. Nomads have a dual set of responsibilities: to the company being admitted, and to the Exchange. Nomads are essentially the front line of AIM's regulatory regime. They are meant to shepherd the company not only through the admissions process but thereafter, ensuring that it complies with its regulatory obligations. This is a distinct role from that of sponsors to the Main Market, and Nomads play a critical part in AIM's regulation.

This section considers first the main differences in the regulatory requirements between AIM and the Main Market; the next section considers the role of Nomads in the regulatory regime.

2.1 Admissions to AIM

One of the key questions of regulatory policy for trading venues is whether and how admission to a market should be

23 MiFID art 26 para 1.

24 MiFID art 29, subject to implementing measures in Level 2 relating to different trading systems (Regulation 1287/2006 art 17); MiFID art 30; Implementing Regulation 1287/2006 arts 27-34).

25 MTFs fall outside the Market Abuse directive, which predates MiFID; however MiFID introduces the obligation on MTF operators to prevent and detect market abuse. The UK market abuse regime includes MTFs, but the FSA only receives transaction reports from UK investment firms; only the Exchange receives reports from non-UK investment firms in other EEA states.

26 FSA Handbook, SUP 17.

27 Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) (Amendment) Regulations 2006, SI3386/2006, reg 3 para 7(3).

restricted. Should admission to a market be open to all types of companies, subject to disclosure obligations, or should the market restrict access to companies that meet certain criteria? If so, what should the criteria be? This is an important question, as the admissions criteria have a direct impact on the type of market created.

AIM started out as a niche market for small cap companies, but, as discussed in Section 2, whilst UK small-caps continue to be an important part of the market, the nature of the companies quoted on AIM has changed significantly in the last few years. There are now three types of companies admitted to trading on AIM: British companies, foreign companies, some of which are domiciled overseas, others of which come to AIM via UK registered holding companies (particularly in the oil, gas and mining sectors) and closed end property and investment funds.

The entry of overseas and in particular closed end property and investment companies has changed AIM's character to some extent. The introduction in November 2007 of the Specialist Fund Market specifically for complex and sophisticated investment entities (hedge funds and private equity), a further example of niche market creation, may have the effect of drawing those companies off AIM, leaving it to the more traditional type of trading company and to straightforward investment funds.

The question remains, however, to what extent any trading platform should be criticized for poor performance of the companies it admits to trading. Admission to a market provides access to capital, but it can also have a signalling effect. The question is what signals does admission to a market give, and what should it give. What can a market and its regulator be expected to do? They cannot be expected to remove the performance risks that attach to any investment. Indeed, those operating and regulating the market have to be wary of implicitly bestowing commercial approval on companies that it admits, creating a potential for moral hazard on the part of investors, and the risk of significant reputational damage for the operator and regulator should an admitted company fail to perform as investors expected. But market operators can be expected to remove or at least mitigate risks of abuse of their markets, and to ensure a transparent investment and trading regime. Exchanges have also traditionally played a role in affording certain rights to investors from the management of the companies that are admitted to trading, supplementing those provided in company law – through requirements in their rules for shareholder approval of certain types of transaction, for example, or compliance with codes of corporate governance.

AIM's regulatory regime is clearly less prescriptive than for the Main Market. AIM's new Rules for Companies, issued in February 2007[28] have introduced enhanced disclosure provisions,[29] and the contents of the admission document are to a significant extent derived from EU provisions.[30] There are key differences in the eligibility criteria, however, reflecting and reinforcing the different roles of the two markets.

The criteria for being admitted to AIM are less restrictive: there are no minimum capital requirements and there is no requirement for the company to have been trading for three years prior to admission, although the requirement for three years' of audited accounts for companies that have been trading is the same as for the Main Market. There is no minimum free float requirement, although in practice investors will expect at least ten per cent of the shares to be made available to the public[31] and under the new rules the percentage being offered must be disclosed.

Although AIM companies are not required to have a past trading history, AIM does have 'lock in' provisions for new businesses: where an applicant's main activity is a business which has not been independent and earning revenue for at least two years, it must ensure that all related parties and senior management agree to retain their interests in their securities for one year from the admission to AIM.[32] Moreover the rules on reverse takeovers seek to ensure that an AIM company cannot fundamentally transform its business, board or voting control or (if an investing company) depart substantially from the investment strategy set out in its admission document without

28 The changes were proposed in AIM Notice 24 (October 2006) and introduced in Notice 27 (February 2007) available at www.londonstockexchange.com/en-gb/products/companyservices/ourmarkets/aim_new/For+AIM+Advisers/aimnotices.htm.

29 Companies applying for admission to AIM now have to disclose information on any restrictions on the transfer of shares, the percentage of the free float, and the applicant's expected capitalization on admission to AIM. It now also has to provide information on any legal or regulatory breaches. An AIM traded company is also required to maintain a specific section on its website where it is to publish certain information about the company, which must be kept up to date. Additional provisions apply to investment companies whom must give details of its investment strategy.

30 The Prospectus Directive 2003 applies to public offers, though securities included in an offer with a total consideration of Euros 2.5million calculated over 12 months fall outside the Directive (art 1.2(h)).

31 AIM Investor Survey, Arbuthnot Securities.

32 AIM RC r.7.

shareholder approval and without seeking a new admission to AIM.[33] Admission to AIM, in other words, is not a licence to companies to do what they will. A company cannot be admitted to AIM purporting to do or be one thing and then fundamentally change its nature. AIM seeks to ensure that what investors bought into is in fact what the business does. Any substantial departure from that has to be subject to agreement from investors.

2.2 Continuing obligations: corporate governance and investor protection

On the whole, companies admitted to AIM are subject to the same ongoing obligations for disclosure and transaction reporting that apply to the Main Market, though there are some differences, noted below. Moreover, anyone seeking to invest in an AIM company via an intermediary will be protected by the FSA's Conduct of Business requirements, discussed below.[34]

There are again some key differences, however, notably with respect to the extent to which shareholder approval is required for certain transactions and with respect to their corporate governance obligations.

The managers of AIM companies are required to obtain shareholder approval on fewer occasions than companies listed on the Main Market. In particular, shareholder approval is only required for disposals of over 75 per cent of assets, in contrast to the 25 per cent threshold under the Listing Rules.[35]

Further, there is no requirement for shareholder approval of related party transactions, only a requirement that after consultation with its Nomad, directors consider that the terms of the transaction are fair and reasonable insofar as its shareholders are concerned, and that requirement becomes operative only with respect to transactions which exceed five per cent of any of the class tests, in contrast with the 0.25 per cent threshold under the Listing Rules.[36]

The regulation of corporate governance structure is also less prescriptive than for companies listed on the Main Market. Companies on the Main Market are under a 'comply or explain' obligation with respect to the Combined Code on Corporate Governance: they either have to comply or explain and justify their departure from the Code. AIM companies simply have to have 'appropriate' corporate governance structures. Indeed the provisions on corporate governance are set out in the rules for Nomads rather than rules for AIM companies: Nomads are required to consider, with the directors, the adoption of appropriate corporate governance measures.[37]

The regulatory regime thus relies heavily here, as elsewhere, on there being an implicit shared understanding of 'appropriateness' within the Nomad community. In assessing 'appropriateness', AIM in practice expects Nomads to provide a corporate governance regime which accords with the principles of existing codes, such as that of the Quoted Companies Alliance,[38] if not with their detailed provisions. The justification given by AIM for these differences in corporate governance requirements[39] has a dual basis: the degree of regulation that is appropriate for the type of companies that are admitted to AIM, and the role of Nomads in ensuring the appropriateness of the company's actions. Given the wide variety of companies that trade on AIM, it is not necessarily appropriate to have the full Combined Code requirements imposed upon them. Those companies, it is argued, are young, growth companies with dynamic business operations which should not be impeded by unnecessarily rigid or inappropriate restrictions on their internal operations. Rather than relying on formal requirements to provide protection for investors, the AIM regime relies on Nomads to ensure that the company acts appropriately, coupled, following the recent rule changes, with disclosure to investors. The enhanced disclosure provisions introduced in February 2007 make it easier for existing and potential investors to see these structures.

Whilst these arguments are valid, there is a question as to whether they hold for the larger AIM companies. There are nearly 300 companies on AIM with a market capitalisation of over £100m. Given that they are of comparable size to companies on the Main Market, it could be argued that they should be subject to comparable regulatory regimes for their corporate governance and be required to put in place similar protections for

33 AIM RC r.14 and r.16.

34 FSA Handbook, COB and NEWCOB.

35 AIM RC 15; LR 10.

36 AIM RC 13; LR 11.

37 AIM RN r.18, Sched 3 AR2. The absence of similar provisions from the Rules for Companies underlines the regime's focus on Nomads, rather than companies, as the main target of their regulation.

38 Financial Reporting Council's Combined Code on Corporate Governance and the Quoted Companies Alliance's Corporate Governance Guidance for AIM Companies (available from www.qca.org.uk). Note that proposals are being developed separately on behalf of the private equity for a corporate governance code for private equity funds to enhance the transparency and independence of the corporate governance of companies which they buy, but it is anticipated at present that these will apply only to companies which are equivalent in size to those in the FTSE 250 index: Financial Times 17 July 2007.

39 Including rules on shareholder notification and approvals.

investors. Whilst on their face the rules appear to create the potential for regulatory arbitrage, with companies which might be more suited to the Main Market trading on AIM to take advantage of AIM's less prescriptive regime, it can be countered that both Nomads and institutional investors will ensure that companies ratchet up their corporate governance structures appropriately. Although there is anecdotal evidence that this occurs, there is little systematic empirical evidence as to how and whether this occurs in practice.

2.3 Investment companies and AIM

The question of whether investment companies, a term which includes closed end investment companies, private equity and hedge funds, are the 'right sort' of company to be admitted to AIM has been raised. As discussed in Section 4 below, in 2006 over half of the new money raised on AIM, just over £6bn, was raised by investment companies.

The debate on where and how investment companies should be admitted to trading is striking, for it illustrates the strong sense inside and outside the Exchange of what types of companies are appropriate for AIM. Whilst the rules do not appear particularly restrictive, in practice AIM has quite specific expectations of companies. The informal market requirement of a minimum ten per cent free float was noted above. Although there is no maximum limit on capitalization, companies with a capitalization of over £500m at admission are seen by AIM as more appropriate for the Main Market. In particular, complex share structures are not permitted in practice, and there is a requirement that there should be no restrictions on the transfer of shares. Although the investment companies may be investing in specialist areas (eg property in Vietnam), alternative investment companies such as hedge funds or certain private equity companies have been turned away from AIM in favour of companies which have a 'plain vanilla' share structure and investment strategy. Thus whilst the formal position under the admission rules is quite flexible, in practice there is a strong sense within the Exchange, and indeed the broader AIM community, of which types of companies AIM is appropriate for, and which it is not.

The demand for admission from investment companies has caused the Exchange to review its regulatory regime. Part of the reason why some investment companies have sought admission to AIM has been that they did not wish, or were not able, to comply with the rules for listing on the Main Market. Just what those rules have provided has been an issue of some confusion both within the City and within the FSA. Until 2005, investment companies listing on the Main Market had to comply with additional rules which limited the types of investment strategies they could pursue. The super-equivalent requirements included restrictions on the investment strategies of investment companies. For example it required that they hold no more than 20 per cent of their investments in one company, and were prohibited from exercising control over any company in which they invested.[40] These rules clearly were not suitable for many private equity companies, or active or single strategy hedge funds.

In 2005, as part of a larger review of the UK Listing Rules and the implementation of the Consolidated Admissions and Reporting Directive, the UKLA allowed overseas companies to list under Directive-minimum rules, even if they had not been listed on another market before.[41] Confusingly, these listings were still referred to in the UK Listing Rules as secondary listings, even though there was no primary listing elsewhere. Under the rules, UK companies, however, still had to list under the 'super-equivalent' requirements.[42]

Although overseas investment companies could have avoided these restrictions by using the gateway provided by the amended Chapter 14 rules, this route was not widely used.[43] After consultation with the market, and in particular pressure from the investment trust community, the FSA decided in 2007 that it would remove this gateway and instead provide a unitary regime for all investment companies, irrespective of domicile. The regime will be 'super-equivalent', but the restrictions on investment strategies will go, and will be replaced with requirements to disclose the strategy so that investors can make up their own minds whether it is something they want to invest in. These changes will mean that the Main Market is more open to investment companies than it was before, or at least than it was recognized as being before.

40 FSA Handbook, Listing Rules chapter 15.
41 Under FSA Listing Rules, Chapter 14.
42 Chapter 15 of the Listing Rules.
43 FSA CP06/4.

The creation of the Specialist Fund Market: delineating the markets

In July 2007 the Exchange announced the introduction of the Specialist Fund Market for investment funds, to be launched on 1 November 2007. The introduction of the Market in effect recreates, in regulatory terms, the position under Chapter 14 of the Listing Rules. Its presence should expand the portfolio of London's equity markets.[44]

In creating the SFM the Exchange has expanded its menu of options, and is making the differences between them clear: the Main Market is its flagship international market; the SFM is for highly specialized entities and professional investors only; and AIM is for smaller growing companies and straightforward investment funds seeking to target retail investors.[45] Although the Association of Investment Companies has expressed reservations,[46] the creation of the SFM should help to more clearly position AIM in the minds of investors and issuers alike. The SFM is intended to be a professionals-only market, and the Exchange has stated that only investment entities which target institutional, professional and highly knowledgeable investors will be admitted to trading.[47]

Retail investors are able at present, and will continue to be able, to invest in AIM companies, however, and it is to the protections afforded to retail investors that the next section turns.

2.4 Investing in AIM: retail investors

With the changing nature of AIM companies, the question arises as to whether some AIM companies, particularly investment trusts, are appropriate for retail investors. Retail investors currently invest directly in AIM companies and indirectly via the funds they purchase from institutions. Large fund providers such as Gartmore and Fidelity offer funds for retail investors which specialize in small and medium capitalized stocks, including AIM companies, and pension funds also invest in AIM companies. Indeed, investment in AIM companies by institutional investors has grown considerably since the dot.com boom, and the market has become an integral part of their investment strategy (see further Section 5). About half of the shares in AIM companies are thought to be held by institutional investors. The rest in the hands of owner-managers, family shareholders, employees and other retail investors. Investing in AIM shares can confer considerable tax advantages for individual investors, and for some it is an attractive market.

The main responsibility for investor protection lies with the FSA. AIM ensures that admission documents contain a prescribed statement which draws attention to the risks of investing in AIM companies,[48] but dealing in and advising on investments is regulated by the FSA.[49]

There is no distinction in FSA's conduct of business regime between those seeking to invest in AIM companies and in any other type of equity. Retail investors who purchase AIM shares directly or indirectly from financial advisers are covered by the FSA's conduct of business rules, in particular by the suitability requirement: advisers must ensure that the product which they advise the customer to invest in is suitable for that customer. Those who invest in AIM via investment trusts or collective investment schemes receive an additional layer of regulatory protection, as advisers are under additional obligations, including know your customer requirements and enhanced suitability and disclosure provisions. Retail investors who invest directly in the market via brokers are not covered by the suitability requirement but brokers are under the normal obligations of fair dealing and market conduct imposed by the FSA.

The FSA also has a statutory duty to improve public understanding of financial markets, and has an extensive financial capability programme. It issues generic consumer advice on investing on its website, but does not have specific information on investing in equities. Instead it directs consumers to the London Stock Exchange's Investor Centre. This contains generic information on shares and other equity related instruments, and advice on devising investment strategies. There is also a brief outline of the two markets, and investors are warned that due to its less prescriptive regulation investing in AIM companies is more risky than investing in equities listed on the Main Market.

44 Announced in July 2007, the Specialist Fund Market is intended to provide a venue for highly specialist investment entities with potentially highly complex share structures who wish to target institutional, professional and highly knowledgeable investors. The SFM will be a regulated market, so subject to the full panoplay of EU law, but it will not be a listed market, so the Listing Rules, and their 'super-equivalent' regime, will not apply. The Market will launch on 1 November 2007.

45 Spelt out clearly, for example, in the 'Frequently Asked Questions' on the SFM: www.londonstockexchange.com/en-gb/products/companyservices/ourmarkets/specialistfundmarket/sfmfaqs.htm.

46 Financial Times, 13th July 2007.

47 LSE, The London Stock Exchange's Specialist Fund Market: Guidance for Admission to Trading for New Applicants (London, July 2007).

48 RC Schedule Two.

49 FSA Handbook, Conduct of Business sourcebook, to be replaced on 1 November 2007 with NEWCOB sourcebook, implementing MiFID.

The extent to which retail investors should be protected from themselves is the central issue in retail regulation. Whilst there are key areas of concern in retail regulation, these relate more to the structure of the retail product market, notably but not exclusively the remuneration structure of investment advisers, and there is little evidence at present that retail investors have either 'mis-bought' products which expose them to AIM companies or that these have been missold.

However, given the increasing involvement of retail investors in AIM traded companies through products offered by institutional investors, there may be scope for more to be done by the FSA to improve consumer understanding, of the role and status of AIM, and of the relative risks of investing in the market.

3. Role of Nomads

The central plank of the AIM regulatory regime is the Nomad system. All those seeking admission to AIM must appoint a Nomad (Nominated Advisor), and must retain one throughout their admission to the market. Nomads are responsible to the Exchange for assessing the appropriateness of an applicant to AIM, or an existing AIM company when appointed as its nominated advisor, 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.[50]

The role of the Nomad is unique to AIM. Nomads guarantee the suitability of the company for admission to AIM and have ongoing responsibilities to the Exchange for the company's continued compliance with its rules. They can also act as the issuing broker for an AIM company and as such have three, potentially conflicting, roles: to the company; to the Exchange; and their own commercial interest in ensuring a good flow of companies onto AIM.

The Nomad community has expanded since the launch of AIM in 1995. There are currently 76 Nomads, although activity is heavily concentrated in the 30 or so Nomads who are appointed to around 80 per cent of AIM companies.

One of the key questions is whether the Nomad system has remained sufficiently robust. Following a review of its regulatory regime for Nomads in 2006, AIM introduced new Rules for Nomads in February 2007 in order to emphasise and clarify their obligations.[51]

The changes largely turned the previously tacit and implicit expectations and understandings of AIM and Nomads into explicit and formalized rules and guidance. Whilst the fundamental obligations have not changed, there is now far more detailed guidance as to Nomads' obligations both on admission and with respect to the continuing relationship Nomads are expected to have with firms. This helps communicate to new Nomads the nature of their obligations, and the detailed provisions help Nomads explain to companies, particularly overseas companies, the nature of both parties' responsibilities under the AIM rules.

Given the extent to which AIM relies on market actors to assist with the regulatory regime, it is critical that Nomads have a full understanding and acceptance of their role. In order to try to create and preserve a community of Nomads who are familiar with the market and its obligations, the regulatory regime places considerable emphasis on the need for Nomads to have prior experience before they can become a Nomad, and for them to continue to be involved in the market to retain their Nomad status. To become a Nomad both firms and individuals within the firm must meet specific requirements as to experience and qualifications,[52] and must be independent from the issuer.[53] In particular, the applicant firm has to have practised corporate finance for at least the last two years and / or have acted on at least three relevant transactions during that period (ie transactions requiring a prospectus or offer document on a takeover) and has to employ at least four qualified executives. Qualified executives are full time employees who have acted in a corporate finance advisory role for at least three years[54] and who have acted in the lead on at least three appropriate capital market transactions in the last three years. In order to qualify, the applicant firm or qualified executive must have acted as lead advisor and be prominently and unequivocally named in the public documentation relating to the transaction.

50 AIM RC r.1.

51 AIM Rules for Nominated Advisors (RN).

52 Although technically separate, the term Nomads here will be used to refer both to the firm and to qualified executives within the firm.

53 Independence is defined in RN r.21 and Schedule 1; the burden of proof for demonstrating independence lies on the nomad. Independence includes a bar on being the reporting accountant and/or auditor for the issuer (unless 'appropriate safeguards' are in place); a bar on Nomads, or partners, directors or employees or their associates being directors of the issuer; holding over ten per cent of the shares of the issuer; dealing in the securities of the issuer during certain periods; or holding over three per cent of the shares unless 'appropriate safeguards' are in place; a safe harbour for Chinese walls or equivalent is provided.

54 Acting as legal or accounting advisor does not count for these purposes under the rules.

In addition, proposed qualified executives are required to demonstrate a sound understanding of the UK corporate finance market and AIM in particular.[55]

The overriding principle is whether the firm or its qualified executives 'might endanger the reputation and integrity of AIM'.[56] Applications can be refused on that ground alone. Nomads are also under continuing obligations to perform their functions with due skill, care and diligence and to avoid all conflicts of interest and any semblance of conflicts.[57] In particular, there is a continuing obligation on Nomads to comply with the rules relating to the number of transactions with respect to which they have to act to maintain their Nomad status. The Exchange retains the right to conduct interviews and tests of Nomads to assess their understanding of the rules and of corporate finance. If it finds that the Nomad has fallen below the criteria for recognition at any time in any way it may remove its Nomad status or impose conditions on its ability to act as a Nomad.

These provisions are more onerous than those which apply to sponsors for admissions to the Main Market. The rules are not new: they were contained in almost identical terms in the previous rules. However their re-publication in the new Nomad rule book has heightened their profile, and new provisions have been introduced requiring Nomads to issue annual returns stating who the qualified executives are, and what transactions they have done to ensure that Nomads take their post-IPO responsibilities seriously.

These provisions are strictly applied by AIM, indeed too strictly for some. There is evidence that they are beginning to have the effect of winnowing out Nomads: the number of Nomads this year has dropped from 85 to 76 and is likely to drop further. Despite criticisms from some sectors of the Nomad community, AIM is right to insist on continuing compliance with its eligibility requirements in order to ensure that the Nomad community is fully apprised of its role, and to maintain the depth of understanding as to the regulatory requirements that is necessary for its principles-based regulatory regime to work.

The duties of Nomads have also been more explicitly set out in the new rules. On admission Nomads are required to:

- gain a sound understanding of the applicant and its business
- investigate and consider the suitability of each director and proposed director, and the efficacy of the board as a whole, and where necessary senior managers and substantial shareholders, bearing in mind it will be admitted to a UK public market
- consider with the company the adoption of 'appropriate corporate governance' measures[58]
- oversee the due diligence process and be satisfied that it has been appropriately carried out
- be actively involved in the preparation of the admission document and satisfy itself that it complies with the AIM Rules for Companies and that appropriate verification has been made[59]
- satisfy itself that the company has sufficient systems, procedures and controls to comply with AIM rules and understands its obligations under them.

Significant emphasis is thus placed on the Nomad's ability to judge whether a company is and remains 'appropriate' for AIM. On admission, the Exchange's role is quite distinct from that played by the UKLA with respect to listing on the Main Market. AIM does not approve the admission document; it places the onus on the Nomad to ensure that all is in order, that the rules have been complied with and that the company is 'appropriate' to be admitted to AIM.[60] AIM has only ten days notice of the admission document, and, in practice, the reliance is almost entirely on Nomads to ensure not only that the documents are in order but that the business of the company, its share structure and governance structures are all appropriate for AIM.

The key difference between Nomads and sponsors is in the continuing obligations which Nomads have after admission. Again these have been reemphasized in the publication of the new rules.[61] They are required to:

- maintain regular contact with the AIM company in order to ensure it remains up to date with what is happening in the company and that the company continues to understand its obligations under the AIM rules

55 AIM RN r.4.
56 AIM RN rr.2-3.
57 AIM RN rr.21 and 22.
58 Companies admitted to trading on AIM are not under the 'comply or explain' obligation with respect to the Combined Code, in contrast with those listing on the Main Market.
59 Exceptions are made for quoted applicants, as they do not need to produce an admission document (on the basis they will already have been making disclosures in their home market).
60 AIM RN r.20 Schedule Two.
61 With some effect, perhaps: see 'Aim Market: Nomads quit after Exchange tightens rules on advisers', Daily Telegraph, 22 May 2007.

- advise the company on any changes to its board of directors, assessing the suitability of new directors and the continued efficacy of the board
- undertake prior review of relevant notifications made by the AIM company to ensure compliance with AIM rules
- monitor (or have in place procedures with third parties, usually brokers) for monitoring the trading in securities of an AIM company for which it acts, particularly where there is unpublished price sensitive information in relation to the company.

Nomads are under an obligation to seek the advice of the Exchange where they are uncertain as to the interpretation or application of the rules.[62] Advice will not be given on a hypothetical, no-names basis, however.[63] AIM expects Nomads to be open and honest with it, and in return to provide clear advice. Under a principles-based regulatory regime, consistency of advice is important, and AIM has systems in place to help ensure this.

In practice, the AIM regulation team communicates almost exclusively with Nomads, and very rarely with companies. The position of Nomads as the regulatory front line raises the question of how AIM ensures that they are acting appropriately, and it is to this and the broader question of the operation and independence of AIM's regulatory functions that the next section turns.

4. Operation of the AIM regulatory regime

4.1 The position of AIM within the Exchange's governance structure

AIM is growing in size and significance both for the economy and for the Exchange. The regulatory regime is responding, and the resources being put into regulation are expanding. The regulatory team is deeply embedded within the Exchange's management structure. There is no direct reporting line from the head of AIM Regulation to a Board member. There is an internal AIM management board whose role is to coordinate both the commercial development of AIM, and its regulatory regime. The resilience and integrity of that regulatory regime is seen by the management board as integral to AIM's success. There is also a group of external advisers, the AIM Advisory Group, whose role is to ensure the reputation and integrity of the AIM market.

The increased size and significance of AIM means that the quality of its regulatory regime is relevant not only for the Exchange's own reputation, but is a significant matter of public policy. Thus far the public interest has been addressed through the Exchange meeting its recognition requirements for the FSA. These have not to date included a requirement that its regulatory regime be separated from its commercial functions, nor is one proposed. However, the recent changes in the size and nature of AIM, combined with changes introduced by EU law in the Exchange's regulatory responsibilities and in particular the conflicts of interest requirement, raise the question of whether AIM's regulation can continue to be treated as a relatively small part of the Exchange's operations.

Exchanges have in the past had significant difficulties with actual or perceived conflicts of interest between their commercial and regulatory roles. In response, many have hived off their regulatory functions into separate bodies which are clearly independent, or abandoned them altogether.[64] The New York Stock Exchange, for example, established NYSE Regulation Inc, a non-profit company established in 2006 to regulate its markets, including Euronext. NYSE Regulation Inc is part of the NYSE Group but has a separate board of directors, the majority of whom are not affiliated with any other NYSE Board. NYSE Regulation and the National Association of Securities Dealers (NASD) have recently announced that they will merge to form the world's largest self regulatory body, the Financial Industry Regulatory Authority (FINRA) with over 3000 staff, to regulate their markets under the oversight of the SEC.[65]

There are differences in the scale of the markets and in the regulatory model between AIM and these markets,[66] but the question has to be addressed as to whether there needs to be a greater organizational separation of AIM's regulatory and other roles.

---

62 RN r.19.

63 RN r.19.

64 Again the body will operate independently from the markets. In Canada, on its demutualization the Ontario Securities Commission required the Toronto Stock Exchange (TSX) to establish a separate and independent Regulatory Services division: 23 OSCB 2945 (www.osc.gov.on.ca/MarketRegulation/Marketplaces/Exchanges/ro/TSE/xro-tse_23-OSCB-2495.pdf). In practice a separate company was formed in 2004, Market Regulation Services Inc, to formulate rules ensuring the integrity of trading on those markets who wish to adopt its rules, notably TSX and TSX-V, overseen by the Ontario Securities Commission.

65 It was going to be called the Securities Industry Regulatory Authority, but NASD announced in July 2007 that the name would be changed following representations that the acronym SIRA could cause confusion or offence due to its similarity with the Arabic term used to refer to biographies of Muhammed.

66 Though these differences of scale are not so considerable in comparison to TSX, for example.

There is considerable academic and regulatory debate as to whether or not any exchange can also perform a regulatory role, particularly once demutualized.[67] Whilst some exchanges have divested themselves, or been divested, of their regulatory functions, others have not. Arguments can be made either way: competition between exchanges could lead to a 'race to the bottom' or conversely a 'race to the top' depending on whether a strong regulatory regime plays a role in attracting business. As an IOSCO report concluded, there is no universal solution; rather each situation should be considered on the basis of the quality of the regulatory regime as it operates in practice. It is clearly an issue which has to be kept under view.[68] The Exchange has taken the view that the regulation of AIM is sufficiently operationally autonomous from the rest of the organisation and that there is no need for change.

4.2 Enforcement

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 fine that can be levied by the executive panel to £50,000. The external AIM Disciplinary Committee can impose unlimited fines on companies and Nomads.

The Exchange can exercise supervisory and enforcement powers against both issuers and Nomads. The Exchange may suspend trading in securities:

- Where trading in those securities is not being conducted in an orderly manner
- Where it considers that an AIM company has failed to comply with the rules
- For the protection of investors
- Where the integrity and reputation of the markets has been or may be impaired.[69]

It may cancel admission where a suspension has been in place for six months or where it considers that the AIM company has breached the rules.[70] It may also take disciplinary action with respect to rule breaches by issuing a warning notice, a fine or censure the company, and publish the fact of the fine or censure (though not the warning notice). Companies have the right to appeal.

The Exchange has equivalent enforcement powers with respect to Nomads. It can remove the qualified executive status of an employee of a Nomad for breach of the AIM rules on both companies and nomads, and for failing to act with due skill care and diligence.[71] It can also take disciplinary action against Nomad firms for breach of the rules or if it considers that 'the integrity or reputation has been or may be impaired as a result of its conduct or judgement'. In such circumstances the Exchange can levy a fine, 'name and shame', remove the nomad from the register, and publish the action it has taken and reasons for that action.[72] The Exchange can also prevent the firm from acting as a Nomad whilst disciplinary proceedings are taking place, or if it fails to meet its recognition requirements, is not meeting its obligations or has insufficient staff to do so.[73]

AIM focuses its supervisory attention primarily on Nomads. In practice, AIM has not had a policy of regular, proactive inspections of all Nomads. It has conducted reviews of certain themes or issues. For example, following the increase in mining, oil and gas companies, mainly from overseas, coming to the market in 2004-5, the AIM regulatory team conducted a review of the requirements with respect to these companies leading to the formulation of additional requirements, in particular the need for a competent person's report on the company and its resources. These were published in a guidance note for oil, mining and gas companies in March 2006.[74]

Outside the thematic reviews, investigation of individual Nomads has been largely reactive: to information given by others, to press reports, to

67 See for example IOSCO Technical Committee, Issues Paper on Exchange Demutualization (IOSCO, 2001); P.G. Mahoney, 'The Exchange as Regulator' (1997) 83 Virginia Law Review 1453; R.S. Karmel, 'Turning Seats into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges' (2002) 53 Hastings Law Journal 367; J.C. Coffee, 'Racing Towards the Top? The Impact of Cross-listings and Stock Market Competition on International Corporate Governance' (2002) 102 Columbia Law Review 1757; E. Ferran, Building an EU Securities Market (Cambridge University Press, 2004), chapter 7.

68 IOSCO Technical Committee, Issues Paper on Exchange Demutualisation (IOSCO 2001).

69 RC r.42.

70 RC r.40.

71 Qualified executives can also be removed if they are declared bankrupt, are the subject of disciplinary action by another regulator or becomes mentally incapacitated: RN 27.

72 RN r.29.

73 RN r.30.

74 AIM Guidance Note for Mining, Oil and Gas Companies, March 2006. These set out requirements for a competent person's report to be given on all the material assets and liabilities of the applicant, a formal legal opinion letter to be given on, inter alia, the title or validity and enforceability of any assets, and for the Nomad to conduct a site visit and physical inspection and to have access to specialist sector experts. It also requires resource and drilling updates to be provided to the market, signed off by an appropriately qualified person.

indications arising from communications with Nomads that something might be amiss, or other indicators such as high turnover with a Nomad or low levels of resourcing of the Nomad function within the firm. As a result of the internal review of AIM's regulatory operations, annual returns have been introduced in 2007 for Nomads 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 be conducted to ensure compliance with Nomads' obligations under the rules. A broad risk assessment is undertaken and Nomads prioritized on the basis of their impact (measured by the number of companies they work for), their systems and controls and the quality of their work and behaviour as Nomads. Firms with good systems and controls are not necessarily assumed to be good Nomads: they may act as a Nomad only rarely or not resource the function effectively, and conversely being a good Nomad does not mean there are necessarily appropriate systems and controls in place. Compliance visits are to become far more structured processes lasting about two weeks in which the AIM team will review at least one admission and one continuing relationship with a company, and interview senior executives and compliance managers.

Inspection and compliance activities are being facilitated by the greater specification of Nomad duties in Schedule 3, and by the increased size of the AIM regulatory team. It could still potentially take up to three years to get through the first round of visits to all Nomads, but given the concentration of companies with certain Nomads, 40 per cent of Nomads (calculated on the basis of the number of companies they act for) should be visited within the first twelve months. Many Nomads are also sponsors for companies going to the Main Market. The AIM team works closely with the UKLA in relation to the supervision of advisers, although the two regulators conduct their supervisory functions independently of one another, on separate visits, with relevant information being communicated between them. Specialists are also appointed on a more individual basis, to investigate issues where more specialist knowledge might be necessary, for example with respect to particular types of companies or those who are active in particular sectors (eg mining).[75]

Investigations have so far rarely led to formal enforcement actions being taken against issuers or Nomads. In 2005 there were five private censures of issuers and Nomads and one public censure (of Durlacher Corporation, a Nomad); there was one private censure in 2006. In October 2007 Nabarro Wells became the first Nomad to be fined as well as publicly censured for breaching the rules of the market. The breaches included the failure to undertake the necessary level of due diligence on companies that it was bringing to AIM; the fine for this and other failings was £250,000. As in this case, there are strong arguments for making enforcement decisions public where the conduct of a Nomad or issuer is sufficiently serious or relevant to investors. Publication improves the transparency of the AIM regulatory and enforcement process. It can also have a significant deterrent effect, and provide leverage for Nomads when explaining the obligations of Nomads and issuers to issuing companies.

5. Role of the FSA

5.1 Role of the FSA as regulator of the Exchange and AIM

As a market operated by the Exchange, AIM falls within the scope of regulation by the FSA. There is a separate team within the FSA responsible for monitoring the Exchange, including AIM, and supervision occurs on a 'close and continuous' basis. The FSA uses its risk based supervisory framework, Arrow II, to assess AIM. Arrow II identifies the risks that those being regulated by the FSA pose to the FSA's objectives, and assesses the level of those risks within the business and control functions of the firm.

As a regulator of a regulator, the FSA has to decide to what extent it is going to rely on AIM's reports as to how it is performing its regulatory functions, and to what extent it is going to assess this directly itself. The Exchange is responsible for monitoring and enforcing the AIM rules including the performance of Nomads, but the FSA has a clear interest in understanding the arrangements the Exchange has in place for doing this and in monitoring the effectiveness of the Exchange's oversight of the market, especially with regard to the maintenance of orderly, clear, and proper markets. As part of this the FSA talks to market participants about the way that AIM is performing its regulatory role.

The FSA is aware of the Exchange's concerns as to whether the regulation of AIM was keeping pace with the rapid growth of the market. Whilst

[75] The FSA has been moving away from requiring routine audits of returns for some time, and is proposing to cease it altogether for most types of firms (see FSA, External Assurance of Regulatory Returns, CP 07/15 (July 2007); but it does use external assurers on a bespoke basis quite regularly.

welcoming the recent changes in the rules and regulatory operations, it is keen to see the effectiveness of these changes and has worked with the Exchange to better understand this.

5.2 FSA regulation of AIM companies and dealings on AIM

Companies admitted to AIM are required to comply with the rules of the Exchange. Those undertaking investment business in the UK are also required to be authorised by the FSA and as such are subject to the relevant FSA rules, including those relating to conduct of business. In addition, activities on AIM are covered by the FSA's Code of Market Conduct which sets out the types of market activity that amount to market abuse.

The Exchange monitors trading on AIM in real time with the purpose of ensuring compliance with its own rules and also of identifying potential market abuse. Any potential cases of market abuse are notified to the FSA. In addition, the FSA also receives transaction reports which come in at the end of each business day. The FSA is currently developing a new system, SABRE II, a database of all transactions with a system of alerts to identify suspicious trades. This will further enhance the FSA's ability to identify suspicious transactions which could amount to market abuse.

The fragmentation of trading venues gives rise to a host of regulatory difficulties relating to monitoring of the markets. Both the Exchange and the FSA are currently consulting on a number of proposals relating to post-trade transparency reporting, for example, to improve transparency and the flow of information going to each of them to enable them to perform their market monitoring responsibilities.[76] These fall outside the scope of this report.

Summary

The AIM regulatory regime has undergone considerable change in the last year. The AIM rules have been clarified and obligations of both Nomads and companies have been more explicitly set out. The resourcing of AIM's regulatory functions has increased and a more systematic approach for monitoring all Nomads is being introduced.

It is as yet too early to assess how the new regime for supervising Nomads will operate and whether the AIM regulatory team is sufficiently well resourced to implement the new regime effectively. The robustness of a regulatory regime lies as much in its implementation as in its rules, and the Nomad system remains critical to the effectiveness of the AIM regulatory system. The recent changes demonstrate that AIM, the Exchange and the FSA recognize the need to ensure that its regulatory regime is adapted in a way that meets the challenges brought about by the expansion of the market.

[76] FSA, Trading of MTF Shares: impact of proposed stamp duty changes DP07/3 (July 2007); AIM Notice 18/07 Registered Organisations for AIM Securities (April, 2007).

4

The companies on **AIM**

What sort of companies come to AIM and what do they get out of it? The broad answer is that they are predominantly small and medium-sized companies that want to grow, and they come to AIM in order to raise capital from knowledgeable investors who are likely, if the business fulfils its promise, to support further fund-raising at a later date. New entrants range from early stage businesses which might have an initial market value of £10m or less to more established companies which might be capitalised at £50m or more. The average market capitalisation of AIM companies has risen from £24m in 2003 to £65m in 2007, but there is a continuing inflow of smaller and less mature businesses, mainly from within the UK.

Overview

AIM companies can be classified by sector, by market capitalisation, and by country of operation. As Table 4.1 shows, the resources sector makes up the largest part of AIM on the basis of market capitalisation, and these companies tend to be appreciably larger than, for example, companies in the technology sector, which make up 15 per cent of all AIM companies but only seven per cent of the market capitalisation; the resources sector is also the one with the largest number of foreign companies.

The foreign companies that come to AIM are on average larger than the British constituents. As Table 4.2 shows, there are 141 foreign companies valued at £100m or more, and they account for more than three-quarters of the total market capitalisation of AIM's non-British contingent. (These figures exclude those foreign companies which are traded on AIM through UK-domiciled 'top companies'.) The striking feature of this table is the large number of

Table 4.1 Breakdown of AIM companies by sector (per cent) – first quarter 2007

Source: AIM Investor Survey 2007, Arbuthnot 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

Table 4.2 Breakdown of AIM companies by market capitalisation (May 2007)

Source: London Stock Exchange: AIM statistics

	May 2007			May 2007		
	Numbers			Market Cap. (£ million)		
Current Size	**Domestic**	**Foreign**	**Total**	**Domestic**	**Foreign**	**Total**
>= 100 million	133	141	**274**	29,406	43,914	**73,320**
50 to 100 million	141	92	**233**	10,122	6,689	**16,811**
40 to 50 million	50	27	**77**	2,264	1,234	**3,498**
30 to 40 million	74	37	**111**	2,582	1,259	**3,841**
20 to 30 million	114	47	**161**	2,838	1,171	**4,010**
10 to 20 million	210	60	**270**	2,994	899	**3,893**
5 to 10 million	179	49	**219**	1,261	356	**1,616**
<= 5 million	252	42	**294**	580	97	**677**
Total	***1,144***	***495***	***1,639***	***52,046***	***55,620***	***107,656***

Table 4.3 Breakdown of AIM companies by country or region of operation (June 2007)
Source: London Stock Exchange

Country/region	No of companies	%	Market value (£m)	%
UK	1,144	70.0	52,046	48.3
Rest of Europe	151	9.2	18,896	17.7
Americas	141	8.6	17,165	15.9
Asia	119	7.2	10,941	10.2
Australasia	48	2.9	3,978	3.6
Africa	36	2.1	4,640	4.3
Totals	***1,639***	***100.0***	***107,666***	***100.0***

Table 4.4 Winners of the Aim Company of the Year Award 1996-2006

Moorepay – processor of payrolls for smaller companies (subsequently taken over)
International Greetings – greeting card supplier
Ask Central – pizza chain (subsequently taken over)
Independent Energy – gas and electricity supplier (failed after move to Main Market)
Access Plus – print management company (subsequently taken over)
Inter Link Foods, supplier of cakes to supermarkets (cancelled)
Majestic Wine – chain of wine stores
Mears – support services group
Connaught – facilities management group (moved to Main Market)
Ideal Shopping Direct – distance retailer via TV and internet
Synergy Healthcare – health care equipment and services

British companies valued at £20m or less – representing just over half of all AIM's British companies, but under ten per cent of their total market capitalisation.

A third way of classifying AIM companies is by country of operation – that is, the country where their principal assets are located even if they were admitted to AIM through a UK-registered 'top company'. As Table 4.3 shows, the largest non-British component is from other parts of Europe (including Ireland), followed by the Americas. This includes 69 from the US, 46 from Canada and five from Brazil. From Asia, China is well represented with 49 companies, India with 21, and Israel with 20.

British companies

At the heart of the British contingent on AIM are companies valued in the range of £50m-£500m, operating with a clear business plan in industries which are easily understood by investors. A snapshot of the kind of company that can do well on AIM is provided in Table 4.4, which lists the companies that have won the 'AIM Company of the Year' award in the period from 1995 to 2007.[77]

Among these eleven companies, Connaught, the facilities management group which is profiled on this page, is a good example of a company which used AIM to make the transition from a family-controlled to a more widely held enterprise, and one that was better equipped to expand by acquisition. AIM served the company well, and as it became bigger and of more interest to a wider range of investors, it reached the point where a transfer to the Main Market made sense. While the decision on whether to move from AIM to the Main Market can be finely balanced (as discussed later in this section), Connaught's advisers believed that the transfer would expose the company to a different set of investors, including institutions which are restricted in the amount they can invest in AIM companies. The move to the Main Market did not involve any significant changes in corporate governance, since the company's arrangements were already broadly in line with the Combined Code.

Connaught plc

Connaught was started in 1982 by Bill Tincknell and his son Mark, focusing on the concrete repair business and mainly dealing with older tower blocks that had been built in the 1950s and 1960s. Local authorities and housing associations were the company's principal customers.

In 1996 Mr Tincknell senior retired from the business and his shares were bought by his son and three other senior managers. The buy-out was supported by the venture capital arm of HSBC, which acquired 20 per cent of the equity. Two years later the company was floated on AIM, enabling HSBC to exit (though it retained a small holding in the company through a Venture Capital Trust). Most of the investors which acquired shares at the time of the flotation were institutions specialising in small cap stocks, VCTs and some IHT funds. The proportion of shares held by management after the flotation was around 50 per cent.

In 2002 the company acquired Gasforce, which had originally been British Gas's commercial and industrial servicing arm; it had been sold to employees in 1996. There were 240 employee shareholders, all of whom became shareholders in Connaught through the acquisition. The cost of the purchase was £21.7m (Connaught's market capitalisation at the time was £28m) and it was partly financed by a secondary share issue on AIM.

The subsequent growth of the business brought Connaught to a size where it could consider moving to the Main Market, and it did so in 2006. It did not have to make the switch, but its brokers advised that, if it wanted to continue to grow, it needed to broaden the investor base and attract institutions which were restricted in the amount of money that they could invest in AIM, including tracker funds which invest in the FTSE Small Cap Index but not in AIM.

The move did not require significant changes in corporate governance. The board and management had been strengthened at the time of the AIM flotation, including the appointment of a new finance director. Mark Davies, who had previously held senior executive posts in Courtaulds and Chubb, was brought in as chief operating officer in 2004, and he became chief executive in 2006. When the company floated on AIM there were four executive directors and two non-executives on the board; there are now three executives and three non-executives.

Mark Davies has no doubt that AIM served the company well. 'For eight years, from 1998 to 2006, it provided us with a very supportive environment'. Flotation allowed the VC backers to exit, and gave the company an opportunity to make a large acquisition which would have been difficult to handle if it had stayed private. The acquisition brought in a new group of shareholders, who saw Connaught

[77] The award scheme is sponsored by PricewaterhouseCoopers in association with the London Stock Exchange. According to the prospectus for the scheme, the Company of the Year 'will have demonstrated to its new shareholders that it is a responsible, fully accountable, dynamic business with strong growth prospects and a commitment to AIM. The Company of the Year's growth prospects will be excellent but these prospects will not necessarily have manifested themselves in results announced to date. Above all, the winner will be a serious, well-managed business, having attracted public funding to enhance and develop its growth potential to the full'.

as a company that was ambitious to grow. Today institutional investors, including well-known names such as Scottish Widows, Standard Life and Fidelity, own 80 per cent of the company, with managers, employees and ex employees accounting for 17 per cent, and private investors around three per cent.

Another company which has followed a similar path to Connaught is Mecom Group. Floated on AIM in 2005 and run by former newspaper editor David Montgomery, it has built up a group of newspapers in Continental Europe, including Denmark, Norway, the Netherlands, Poland and Germany; these acquisitions have been partly financed by the issue of Mecom shares. With a market capitalisation of over £1bn, it has been one of the highest-valued stocks on AIM, and is expected to move to the Main Market later in the year.

Connaught and Mecom have been star performers, but many of the other British companies which constitute the heartland of AIM are likely to satisfy their growth ambitions without moving to the Main Market, and have no ambitions to make the switch. An example is Murgitroyd, the patent and trade mark attorney practice which is profiled on this page.

Murgitroyd Group

Murgitroyd Group, a European Patent and Trade Mark Attorney practice headquartered in Glasgow, was floated on AIM in 2001. The business was founded as a sole practitioner and became a partnership in the late-1970s. It was incorporated in 1993, with Ian Murgitroyd and two other founding partners as sole shareholders.

The decision to float on AIM, as Keith Young, chief executive, explains, was to achieve four things. The first was to allow two of the three partners to make a partial exit. The second was to restructure the financial base of the business, replacing bank debt with equity. The third was to obtain access to a larger pool of capital in order to facilitate the growth of the company. There were no plans at the time of flotation for major new investment, and the acquisitions which the company has made have been paid for in cash rather than shares. But the stronger financial base has enabled the company to grow faster than it would otherwise have done; it has been able to finance organic growth and acquisitions in parallel, whereas pre-AIM each move would have been made sequentially. Fourth, having the shares publicly quoted has been helpful for recruiting and retaining key people. As a professional services business Murgitroyd is dependent on a small number of highly qualified employees. The higher profile that comes from being publicly quoted is useful, as is the ability to put in place remuneration arrangements that are linked to the share price. Employees looking to acquire equity in the business can do so in a straightforward way.

The AIM flotation enabled the company to make progress on all four fronts. No major changes had to be made in corporate governance when the company floated – three non executive directors were appointed, with Ian Murgitroyd remaining as Executive Chairman.

Some 45 per cent of the shares are now held by people in the business, or by members of the families of the founding partners. The balance is largely in the hands of institutions, most of whom have held the shares since the flotation. The shares are seen by the institutions as consistent performers, with the business growing organically at around ten per cent a year, paying regular dividends and offering the prospect of predictable growth.

Companies like Connaught and Murgitroyd are profit-making when they come to AIM; the nature of their business can be easily explained to investors. This is not the case with many of AIM's high-technology companies, which come to the market at an earlier stage in their development. The value of AIM for companies of this sort is that it provides an alternative, or least a supplement, to venture capital funding. As British venture capital firms have increasingly focused on larger transactions, including management buy-outs, a gap has opened up in the financing of early-stage businesses. Flotation on AIM is a way of filling the gap, and young companies in high-technology industries have been able to attract investors who are knowledgeable about these sectors and willing to take the risk of investing in what is inevitably a speculative area. The case of Plant Impact, profiled on this page, illustrates this process.

Plant Impact

Plant Impact has its origins in 1993, when PiBioscience was formed to bring to market a range of nutrient products designed by the group's technical director, David Marks. Marks had previously worked with Peter Blezard at the European subsidiary of a US agrochemicals group; Blezard became the chief executive of the new company. Its focus was on developing crop nutrients and natural pesticides that improve the health and productivity of crops, while also being non-toxic and environmentally sound.

At the start the business consisted of two separate companies – one focusing on nutrients and the other on pesticides – with common ownership and management. Early funding came from a group of business angels in the North West, and from the Rising Stars Growth Fund, a specialist venture capital fund set up with the support of the North West Development Agency to invest in early stage technology companies in the region.

The initial investment from Rising Stars was £30,000, and the fund continued to invest in the business as work continued on a promising new pesticide for which patent protection was secured. The business was reorganised in 2005 and the two separate companies were brought together to form Plant Impact. Although still loss-making, it was making good progress and needed more capital An additional £500,000 was raised in June 2005, partly from Rising Stars, partly from private investors; the latter included Martin Robinson, who became non-executive chairman, and Gordon Harman, who became finance director. Robinson was formerly chief executive of Lloyd Street Private Equity and of Henry Cooke Group; he has been involved in AIM from the start of the market and is currently chairman of another AIM company, Braemar Group.

This was followed a few months later by the raising of a further £1m, coming partly from several venture capital firms including YFM and Rising Stars, and a new group of business angels. This was seen as a precursor to an AIM flotation, and the investors subscribed for convertible loan stock which would be converted into shares (at a discount) at the time of flotation.

The AIM flotation took place in October 2006, with Grant Thornton acting as the Nominated Adviser and Fiske as broker. Out of the £4.25m raised, some £3.75m came from new investors, including a number of institutions specialising in small cap stocks as well as private investors. The free float at the start amounted to 48 per cent of the equity though this will increase after the lock-in period expires. Rising Stars has continued as a major investor, with a representative on the board.

Martin Robinson regards what has been achieved so far as a good example of what AIM can do for early-stage companies. Plant Impact has a pipeline of promising products, but needs more capital to exploit them. There is a fair prospect that further funds could be raised on AIM over the next couple of years, and the company could then reach a size where it will attract the attention of the big players in the agrochemical industry. The options could then include licensing the technology to one such company, or the outright sale of the group. If all goes well, AIM will prove to have been an appropriate vehicle for financing a technology-based business during a particular phase of its development, and for generating a good return for investors.

The suitability of such early-stage companies for the public markets is a matter of some debate. That they are loss-making is not in itself an argument against flotation, but some observers believe that an early-stage company in a high technology sector should plan to raise enough money through the Initial Public Offering to take the business through to the point where it is profit-making, or least cash-positive. Going to investors for more money just to keep the business alive is difficult, unless the company can demonstrate a clear pathway to viability. Yet there are many AIM companies which are in this situation, and only a few will make it through to commercial success.

This is part of the larger question of whether there are too many small, under-performing companies on AIM. Although there is no minimum size requirement for new AIM companies, the costs associated with flotation make it uneconomic for companies to raise much less than £10m in their IPO. However, there are nearly 500 companies on AIM with a market capitalisation of less than £10m, and they represent nearly 30 per cent of the British contingent in terms of numbers, although only two per cent of the market's total capitalisation.[78] Of course not every new entrant to AIM can expect to become big, but the presence of so many small, illiquid stocks does not enhance the quality of the market.

Some market participants describe the lower end of AIM as 'public venture capital', and it attracts a different sort of investor from the larger end. But for companies in this category AIM does play an important role. In particular, it has contributed to the growth of high-technology sectors which would otherwise have been constrained by a lack of capital at crucial stage in their growth; the case of the biotechnology industry is discussed in Section 7. Whether some of these companies come to the market too early is an open question, but the main determinant is

[78] It is worth noting that on the Main Market there are 88 companies valued at less than £10m, 81 valued at £10m-£25m and 111 valued at £25m-£50m. These three groups account for 25 per cent of the 1139 companies listed, but less than one per cent of the total Main Market equity value.

whether they can attract support from investors who understand both the industry and the company's business; the presence of such knowledgeable investors is one of AIM's strengths.

Foreign companies

When the push for foreign companies began in 2002, the first targets were mining and other natural resources companies, with the two largest sources being Australia and Canada. Most of them came to AIM through a dual listing with their home exchange, and this was facilitated by the Designated Markets Initiative, introduced by the Stock Exchange in 2003. Of the 31 Canadian companies quoted on AIM in mid-2005, 22 were oil and gas or mining companies. Only three were traded solely on AIM; the others were listed on either the main Toronto Stock Exchange or Toronto's 'junior' exchange, TSX Ventures. One of the attractions of AIM for these companies was that it allowed them to raise modest amounts of money – say £20m to £30m – by means of placements with institutions, and to do so within a flexible regulatory regime. Another attraction was the long-established reputation of London as a repository of expertise in mining and other resource-based stocks; there is a clustering effect here which has worked to AIM's advantage.

Outside the resources sector most of the foreign companies which have come to AIM are those which conduct a large part of their business outside their home country; they are looking to the London market, not just as a means of raising new capital, but as a way of making themselves better known internationally. One example is Protonex, a Massachusetts-based company which makes fuel cell systems for military and commercial applications; it raised $16m on AIM in July 2006. Its chief executive, Scott Pearson, commented later that AIM admission had given the company an awareness and credibility outside the US. 'We are not viewed as just an American company any more'.[79]

One of the reasons why American companies come to AIM is that capital-raising by small companies on the public markets has become more difficult and more expensive in the US. Estimates made by Canaccord Adams (shown in the Appendix to this section) indicate that for a $50m company the costs of an IPO in the US are around $5.2m, compared to $3.9m on AIM, and that the annual running costs for a public company are about $2.3m in the US, compared with slightly more than $900,000 on AIM.

Bigger companies, whether based in the US or outside, will continue to list on NASDAQ or the New York Stock Exchange because of the depth of the US capital market – and, in many cases, the need to raise their profile in what may be the largest market for their products. But there is a gap for smaller companies which AIM has been able to fill. The Citel story, described on this page, illustrates this point.

Citel

Seattle-based Citel is a telecommunications specialist that has its origins in work carried out in Nottingham, England, in the early 1990s on linking the personal computer to the telephone system. The company was founded in 1995, and it went through several rounds of financing from leading British venture capitalists such as MTI and Advent Venture Partners. However, the PC/telephone concept proved difficult to commercialise – not just for Citel but for others who tried to develop that market – and by early 2000 it was clear that a change of direction was needed. At that point Mike Robinson was brought in as chief technology officer; he is now chief executive. He had spent twelve years with Active Voice, which had developed innovative software for voice mail and Internet Protocol (IP) telephony. (Active Voice floated on NASDAQ in 1992 at a valuation of $63m, and was acquired by Cisco in 2001 for $267m.)

In 2001, under Robinson's guidance, Citel switched its attention to the Voice Over Internet Protocol (VOIP) arena, and developed a device that enabled companies to link their existing business telephones to a VoIP-based communications network. The device was originally known as the Handset Gateway, and has now been renamed a Telephone VOIP Adaptor (TVA). A major effort was launched to find partners and customers for the device, focusing primarily on the US. A big step forward for Citel was a co-development and co-marketing deal with 3Com, which was then the leading player in VOIP telephone systems; a few months later another partnership deal was negotiated with Mitel. These developments formed the basis for another round of venture capital finance in the autumn of 2001.

Although the company still did its development work in Nottingham, Citel's centre of gravity was shifting to the US, which was the primary market for the new device. The company headquarters was moved to Seattle in 2003.

[79] Susan Arterian Chang, 'Tech start-ups spurn NASDAQ for London', IEEE Spectrum, December 2006.

Development work continued over the next few years, but the company was still loss-making; it needed a broader product base and it needed one of the big US telecommunications carriers to commit to VOIP using the Citel device. The first problem was dealt with in January, 2005, when Citel acquired MCK Communications, which made a product with similar technology to Citel's TVA. Citel now had about 45 employees split between the Seattle headquarters, the development centre in Nottingham, and MCK's development office in Calgary, Canada.

By the start of 2006 the business was gaining momentum, and in the spring of that year Sprint, one of the big telecommunications carriers, decided to invest on a substantial scale in a VOIP system using the Citel device. This would involve a large increase in the scale of Citel's output, and the company would need more capital.

After considering the possibility of a further private round of finance, the board decided on a public flotation, and Robinson and his team considered a range of options, including the over-the-counter market in the US. NASDAQ was ruled out, mainly because Citel was too small – it needed to raise some $15m – $20m, whereas the minimum size of a NASDAQ issue, given the costs involved, would be at least $50m. AIM was chosen because it was well equipped to serve small, growing companies; it had investors who were comfortable with the high-risk/high-return nature of this type of business; and it had an appropriate level of regulation. The fact that Citel was partly British was also a factor, though not a decisive one.

Citel raised $17m through the IPO at a price of 95p; the NOMAD and broker was Panmure Gordon, and the shares were taken up by a range of UK institutions, including some that specialised in IT companies as well as some generalist investors. After the IPO, Citel suffered a setback as Sprint ran into technical problems with its VOIP launch (not linked to Citel's equipment) and the promised orders did not materialise. However, other carrier partnerships and customer wins have recently been announced.

Robinson has no doubt that coming to AIM was the right decision. He sees AIM playing the same role for small technology-based companies that NASDAQ played some 15-20 years ago. 'NASDAQ has become too big and too crowded', he says, 'and it is very hard for a small company to get any attention, quite apart from the costs involved. One of the attractions of AIM is that you can start small and grow organically into a substantial size – perhaps a $500m business or even more – without having to move to a different exchange.'

The clustering effect which applies in the mining industry may also be influencing some American companies. One of the fastest-growing parts of AIM in the last two years has been the 'clean technology' sector, comprising companies which specialise in renewable energy. One example is Los Angeles based Solar Integrated Technologies, which makes turnkey photovoltaic roofing systems for commercial and industrial applications. It came to AIM in 2004 'because of the desire of our customers to grow our presence in Europe' and to gain access to 'the sophisticated investor base focused in the emerging renewable energy sector'.[80] AIM is increasingly becoming the home for cleantech companies across the globe.[81] Of the 25 companies which make up this sector on AIM, more than half are based in the US.

Several leading US investment banks have acquired Nomad status. For example, Jefferies, a New York-based investment bank and securities firm, became a Nomad last year; it acts as broker for 14 AIM companies and Nomad for ten of them, including four American and two Canadian companies. Jefferies focuses on larger companies, principally those which either have a market capitalisation of £75m or more at the time of flotation or have a clear prospect of reaching that level within a short period. It avoids smaller issues because of concern about the market's ability to support research and liquidity in these stocks.

Another sign of the growing importance of the US to AIM has been the recent move by two of the most active British AIM brokers, Collins Stewart and Panmure Gordon, to increase their presence in the US. The former bought a US investment bank, C E Unterberg Towbin, partly to take advantage of the growing interest among US companies in coming to AIM.[82] The latter acquired Think Equity Partners, a US investment bank specialising in telecommunications, media and technology; again one of the motives was to boost Panmure's ability to bring US technology companies to AIM.[83]

80 London Stock Exchange press release, 12 May 2004.
81 Warming to Cleantech, a report by Library House, June 2006.
82 Financial Times, 22 May 2007.
83 Financial Times, 19 February 2007.

Continental Europe, though nearer than the US, is in some ways more difficult territory for AIM, not least because of the presence of powerful local stock exchanges which have no wish to see their future 'national champions' migrate to the London market. Following the demise of EASDAQ, the London Stock Exchange saw an opportunity to promote AIM as a European growth market, and it received some support in this objective from the European Venture Capital Association. There are now 151 European companies traded on AIM, and they include several technology-based businesses. The first German company to obtain a primary quotation on AIM was SQS Software Quality Systems, which tests software for large industrial companies. It raised £11m on AIM in September, 2005, and a few months later issued further shares on AIM to finance an acquisition.

Outside Western Europe, AIM has attracted companies which might in the past have raised capital in the US. In Israel, for example, there is a dynamic group of high-technology enterprises which have traditionally had close links with the US. There are more than 100 Israeli companies listed on NASDAQ, but London has gained ground in the last few years for the same reasons of cost and regulatory complexity that have influenced US companies; there are now 20 Israeli companies on AIM. One example is Metal-Tech, which makes molybdenum and tungsten-based products. Mr Modi Ashkenazy, chief financial officer, said the company came to AIM because London was seen as the metals capital of the world, and because the company would have had to wait another two years to reach a sufficient size to make it worthwhile floating on NASDAQ.[84] Another case is Leadcom Integrated Solutions, which is profiled on this page.

Leadcom Integrated Solutions Ltd

Leadcom has its origins in three companies, all focused on the Israeli telecommunications market, which were set up in the early 1980s by local entrepreneurs. The most successful of the three was Leadcom, whose main activity was in providing deployment services and solutions to telecommunications network operators and vendors, and, when the three companies were merged in 2003, it was this business which became the heart of the enlarged group; the company was re-named Leadcom Integrated Solutions. The management team, led by Arik Alcalay as chief executive and Eytan Mucznik as chief financial officer, set about re-positioning the business as a supplier of telecommunications services to overseas equipment vendors and network operators, principally in emerging markets.

By the end of 2004, after a good deal of rationalisation had been carried out, the company was gaining momentum and winning valuable overseas contracts. But rapid growth brought financial strains, and the company needed new sources of capital. After evaluating different options, Alcalay and Mucznik reached the conclusion that the best option was to float on the public markets. The Tel Aviv Stock Exchange was virtually closed to IPOs at the time; NASDAQ in the US was open only to service companies with a market capitalisation of at least $100m; and Singapore was not much interested in non-Chinese companies. Thus AIM looked to be the most likely solution, at least as a first step.

The company was successfully floated on AIM in April 2005 at a price of 32p per share, with Corporate Synergy (now Blue Oar) as its NOMAD. (Leadcom subsequently changed its NOMAD to Altium, and more recently to Panmure Gordon, keeping Blue Oar as joint broker). The market was strong at that time and the shares were mostly taken up by UK institutions. However all of the $14m that was raised was needed to repay bank debt. The company was growing fast – new contracts were won in Africa and elsewhere – and it would soon need more capital. In 2006 two important transactions took place. First, the shares held by the founders were placed by Corporate Synergy and Altium at 73p; this raised the free float from 50 per cent to 98 per cent. Second, there was a secondary offering on AIM to raise a further $21m These shares were marketed strongly to UK and American investors, with the result that the proportion of the equity held by UK institutions came down to about 85 per cent.

At the end of 2006 a further capital raising exercise took place – a $30m bond issue sold to Israeli investors. Today Israeli investors hold approximately 40-45 per cent, UK institutions 45 per cent and the rest is held by Americans. The Israeli investors were for the most part private funds which were free to invest in AIM stocks, with conventional Israeli institutions lagging behind.

For companies which like Leadcom are operating predominantly in global markets, London has obvious attractions with its large pool of globally-minded investors. From the company's point of view AIM has

[84] Financial Times, 16 September 2005.

some limitations, not least those arising from the restrictions on Israeli and some other institutions to invest in AIM stocks. If the company continues to perform well, then a move to the London Stock Exchange Main Market might make sense; this would also permit – as an AIM quotation does not – dual listing with the Tel Aviv Stock Exchange.

Real estate and equity investment funds

In 2006 just over half the new money raised on AIM – a total of just over £6bn – was raised by property funds and equity investment vehicles. These IPOs tend to be larger, and they invite investors to back, not a particular company, but a team of managers whose skill lies in identifying and exploiting investment opportunities in a particular sector or region. One example is Dolphin Capital Investors, which concentrates on real estate developments in Greece, Cyprus and Croatia; it raised £203m when it floated on AIM in April 2007 and a further £250m two months later.

The attraction of AIM for the promoters of these businesses is that they are not subject to the rules – for example, on the proportion of the fund that can be invested in one company or one sector – which govern investment trusts and similar investment entities on the Main Market.

These entities have served to extend AIM's reach into emerging markets, especially India, China and Russia. In 2006 Indian-related companies were the second largest source of new listings on AIM after UK-based companies. They included several large property listings, including the $700m IPO of Unitech Corporate Parks. Because of the restrictions on the ability of Indian companies to raise funds in their local exchanges, many of them have chosen to incorporate in favourable tax regimes such as the Isle of Man, and to seek IPOs on AIM. According to a leading Indian banker, Indian companies have been tapping AIM to get access to an international professional investor base that is less volatile than the retail-dominated markets at home.[85]

Movements between AIM and the Main Market

When AIM was launched in 1995, part of its intended role was to act as a feeder to the Main Market. When an AIM company reached an appropriate size and was able to meet the requirements of the Main Market – for example, on the size of the free float – it was expected to make the switch. However, the cut-off point has not been precisely defined, and companies have some discretion in deciding when, and whether, to move from one market to the other. Currently the Stock Exchange has an informal guideline that companies with a market capitalisation of £500m or more should consider making the switch, but this is not mandatory.

When companies move to the Main Market they are subject to more onerous rules, covering not only the free float but also the requirement to seek shareholder approval for mergers and acquisitions above a certain size; they are also subject to the Combined Code on corporate governance. Their shares become officially 'listed', and no longer qualify for the tax advantages enjoyed by AIM investors. On the other hand, they gain access to a wider pool of institutional investors, including tracker funds which invest in the FTSE Small Cap Index but not in AIM. They may also gain a greater degree of visibility with analysts and the financial community as a whole, especially if the peer group to which they belong consists mainly of companies that are listed on the Main Market.

In practice the decision depends, not only on the size of the company, but also on the sector that it is in, on its strategy and on the amounts of money that it is likely to have to raise from shareholders. Over the whole period since AIM was created 111 companies have moved from AIM to the Main Market; their average market capitalisation on transfer was £232m. Over the same period 271 companies have moved from the Main Market to AIM; these were predominantly small companies with an average market capitalisation of £21m. Some of these companies felt they were too small to be noticed on the Main Market; others, especially those which were keen to expand by acquisition, were attracted by AIM's more liberal rules on the size of acquisition that has to be formally approved by shareholders.

What has emerged is not simply a junior/senior relationship, but rather the co-existence of two complementary markets which have different characteristics and suit different types of company. One of the merits of AIM for small companies that want to become big is that it can accommodate substantial expansion – say, from a £10m market capitalisation to £500m or more – without the need to switch to a separate market. Institutions are in any case more interested in the quality of the companies they are considering as possible investments than in which of the two markets they are traded on.

It is true that AIM does include companies that are by definition risky – oil and gas exploration companies, and early stage biotechnology firms – and some companies may feel that, in moving to the Main Market, they are

85 Financial Times 13 July 2007.

demonstrating that they have reached a more mature stage in their development. But this does not imply any pressing desire to get away from AIM. Mark Davies of Connaught remarks that, when the company decided to move to the Main Market, there was no sense that it was trying to escape a tainted market.

Table 1 IPO costs on NASDAQ and AIM

	NASDAQ (in US dollars)	AIM (in US dollars)
Shares issued (numbers)	5m	20m
Amount raised	50m	50m
Registration fee	c.9,000	c.20,000
Filing fee	c.9,000	na
Listing fee	c.100,000	c.7,500
Printing	c.220,000	c.40,000
Legal fees	c.750,000	c.600,000
Accounting fees	c.490,000	c.350,000
Blue sky fees	c.10,000	na
Transfer agent, registrar fees	c.10,000	c.14,000
Retainer	na	c.275,000
Underwriting discount/step-up	c.3,500,000	c.2,500,000
Miscellaneous	c.75,000	c.50,000
Total approximate cost	***c.5,173,000***	***c.3,856,500***

Table 2 Annual costs of being a $200m public company

	NASDAQ (in US dollars)	AIM (in US dollars)
Directors and officers insurance	c.500,000	c.100,000
Directors fees and expenses	c.150,000	c.150,000
Annual audit fees	c.300,000	c.150,000
404 Compliance	c.500,000	na
Legal fees	c.300,000	c.300,000
Internal costs for SEC and Exchange compliance	c.300,000	na
SEC filing expenses and listing fees	c.35,000	c.7,000
Nomad expenses	na	c.90,000
Other (investor relations, mailing etc)	c.250,000	c.125,000
Total approximate cost	***c.2,335,000***	***c.922,000***

Source: Canaccord Adams, 'AIM: a global financing alternative for small-cap companies', Executive Briefing Series 2006.

5

Investors in **AIM**

Who are the investors in AIM companies, and what determines the attractiveness of the market? This section looks first at the tax incentives which have helped to stimulate the interest of private investors in AIM, then at the growing importance of institutional investors.

Tax incentives

When AIM was launched in 1995 it benefited from the tax incentives which had been put in place by the Conservative government to encourage private investors to buy shares in small, growing companies. An important ruling by the Inland Revenue was to treat AIM companies as unlisted for tax purposes. This meant that investments in AIM companies that met certain criteria (principally that they should be trading companies, not financial or property-based) attracted 100 per cent relief from Inheritance Tax as long as the investment was held for at least two years. This tax ruling remains, allowing private client stockbrokers to offer an IHT portfolio service which may be geared wholly or mainly to AIM companies. These IHT portfolios generally invest in the larger and more established AIM companies which pay regular dividends.

In addition, as noted in section 2, the Conservative government introduced two new schemes – the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) – which, though not specifically targeted at AIM, helped to stimulate investment in AIM companies. The EIS was aimed mainly at business angels and other wealthy individuals who were interested in taking a stake in entrepreneurial firms at an early stage of their development. Currently, the main features of the scheme are that individuals who subscribe for new ordinary shares in qualifying companies, up to a maximum of £400,000 in any one year, are entitled to a 20 per cent initial income tax relief on their investment; they are also exempt from capital gains tax on disposal as long as the investment is held for three years. The definition of qualifying companies is framed so as to exclude lower risk activities such as the management of hotels and nursing homes.

The EIS was designed for all unquoted companies, not for AIM in particular, but AIM companies had the attraction of already being on a public market; thus there was greater liquidity in their shares and information about them was more readily available than in the typical unquoted business. Some EIS investors preferred to invest in a spread of companies, and private client stockbrokers developed EIS portfolios, some of them geared wholly or mainly to AIM companies.

Venture Capital Trusts are publicly quoted companies (listed on the London Stock Exchange's Main Market), which, like investment trusts, raise funds from investors to acquire stakes in a range of companies that meet the scheme requirements. The requirements are the same as for the EIS, and exclude low-risk businesses. The most that a VCT can invest in one company is £1m in any twelve month period, and they have to invest 70 per cent of their funds in qualifying companies within three years. Some VCTs invest in companies which are not quoted on AIM or any other public market, while others concentrate mainly on AIM companies. In the early years of the scheme investors in VCTs were entitled to 20 per cent income tax relief on their initial investment and to capital gains tax deferral, as long as the investment was held for five years.

Both the EIS and the VCT arrangements have been modified several times since their introduction, In the case of VCTs for example, the initial income tax relief was raised from 20 per cent to 40 per cent for the tax years 2004-05 and 2005-06, and this produced a spectacular increase in the amounts of money raised – £520m in the first year and £750m in the second. However, the 2006 Budget reduced the initial tax relief to 30 per cent, and the amount raised by VCTs fell sharply in 2006-07, to £270m. Another important change was the ruling that any new money a VCT raised after 6 April 2006, had to be invested in firms with gross assets of no more than £7m; the previous limit had been £15m.

The rules for VCTs were tightened further in the 2007 Budget. For funds raised after 5 April 2007 the annual investment limit per qualifying company was reduced to £2m (that is, the investee company cannot receive more than £2m from funds that were raised through the EIS or from VCTs after 5 April 2007) and qualifying companies had to have no more than 50 full-time employees at the time of investment; previously there had been no restriction on the number of employees. The government was obliged to make these changes in order to comply with the European Commission's guidelines on state aid for risk capital.

As a result of these changes, according to Martin Churchill of Tax Efficient Review, the amounts of new money raised by VCTs in 2007-08 and subsequent years is expected to run at no more than £200m a year. However, thanks to the large amounts of money that had been raised in earlier years when the rules were more liberal, the VCTs still have considerable resources at their disposal, and the 2007 budget changes are not expected to lead to an early reduction in the flow of funds going into AIM companies from VCTs.

For AIM, the tax reliefs available through VCTs have probably been the most important of the various tax incentives introduced by successive governments to stimulate investment in unquoted companies. However, the number of AIM companies that qualify under the VCT rules is small in relation to the market as a whole, and is getting smaller as a result of the new rules. A survey of VCT AIM managers carried out by Tax Efficient Review showed that, out of a total of just under £5bn raised on AIM in the period January-September 2005, only £615m, or about 12 per cent, was VCT qualifying. The bulk of this money has gone into small capitalisation stocks, and these companies have been the principal beneficiaries of the VCT scheme.

Institutional investors

Tax incentives have been helpful for AIM, especially in the early years, and they have been put to good use by investing institutions that specialise in small capitalisation stocks. But, as the market has developed in size and in the range of companies quoted, mainstream investing institutions have become more actively involved. Their interest in the market quickened during the dot.com boom of the late 1990s; some of the 'hottest' stocks available were quoted on AIM, and the institutions needed to buy into them in order to ensure that their overall investment performance kept pace with their peers. Although many of AIM's internet-related companies fell to earth in 2001 and 2002, as did their counterparts on the Main Market, this did not have the effect of turning institutional investors away from AIM. From 2002 onwards, as stock markets recovered, institutional interest in the market increased. Between 2003 and 2007 the proportion of AIM shares held by institutional investors rose from about a third to about 60 per cent.[86]

These institutions include some of the world's largest investment groups; Table 5.I lists the fifteen most active institutional investors in AIM, ranked by the number of investments.

Table 5.1 Most active institution by number of investments in 2006

Source: Growth Company Investor, Institutional Investors in AIM 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

Table 5.2 Value of institutional holdings in principal sectors

Source: Growth Company Investor, Institutional Investors in AIM 2006

Sector	No of Investments	Value (£m)	% of total Investments
Mining	802	6,852	16.0
Oil and gas	441	5,477	12.8
Real estate	301	4,742	11.1
General financial	880	4,852	10.5
Support services	494	2,690	6.3
Equity investment Instruments	222	2,415	5.6
Industrial metals	49	2,284	5.3
Travel & leisure	300	2,222	5.2
Pharmaceuticals & Biotechnology	301	1,826	4.3
Media	415	1,618	3.8
Others	2,144	7,836	19.1
Total	***6,349***	***42,814***	***100.0***

86 Growth Company Investor magazine estimated that in August 2006 institutions controlled 56.7 per cent of AIM shares, compared with 35.2 per cent in 2003.

Not surprisingly, much of the investment by mainstream institutions goes into companies with relatively high market capitalisations. The sectors which contain a large number of such companies include mining, oil and gas, and real estate, and these three sectors accounted for nearly 40 per cent or all institutional investment in AIM in 2006 (Table 5.2). However, there is also considerable institutional interest at the lower end of the market.

To a much greater extent than, say, NASDAQ in the US, AIM is an institution-dominated market. Virtually all IPOs and secondary offerings on AIM take the form of private placings with institutions. Moreover, of the shares in AIM companies that are not owned by institutions, only about half is thought to be owned by genuine retail investors who are actively buying and selling in the market. The rest is in the hands of directors, employees and members of the founding families.

Is this ownership structure a weakness or a strength? One advantage from the AIM company's point of view is that investors who take up the shares at the time of flotation are potentially stable, long term holders and are likely – if the company fulfils its promise – to support further share issues. So far in 2007 60 per cent of all the new money raised on AIM has been in the form of secondary equity offerings, and most of that has been taken up by institutions. On the other hand, AIM needs retail investors to enhance the liquidity of the market. It is estimated that in 2005-06 70 per cent of trading activity on AIM was accounted for by retail investors, although they accounted for only 20 per cent of the value of trades.

More retail investors on AIM would be welcomed by the London Stock Exchange, although any ambitions in that direction are tempered by the fact that AIM is very different in character from the Main Market and best suited for experienced and knowledgeable investors. The literature put out by AIM companies and their advisers has to contain full explanations, not only about the nature of the business, but about all the features of an AIM company – concerning regulatory scrutiny, for example, and corporate governance arrangements – that make it different from a company listed on the Main Market.

On the institutional side, an important priority for the London Stock Exchange over the last few years has been to encourage more non-British institutional investors to take an interest in AIM, especially those based in the countries from which non-British AIM-quoted companies originate. British investors, when considering investing in a non-British company, whether at the time of flotation or later, feel greater confidence if they know that local investors in the country where the company has its main base are also substantial shareholders in the business. The Exchange has been active in promoting the attractions of AIM around the world; the new SETSmm trading system, mainly designed to improve liquidity and reduce spreads, had the additional advantage of being more intelligible to overseas investors who were not familiar with the market-maker system. However, finding new shareholders is largely the responsibility of the investment banks and brokers which handle AIM companies. Part of the reason for the US acquisitions made recently by Collins Stewart and Panmure Gordon, referred to in Section 4, was to strengthen their distribution capacity in the US. Other London firms have made partnerships with overseas brokers in order to bring in more local investors. Further progress in this area is needed, since UK-based investors cannot be expected to satisfy the capital needs of all the world's growing companies.

How do investors view AIM?

Although the number of IPOs on AIM has declined in 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. There has been unease among some investors about IPO over-pricing, and about the amount of money that has gone into investment fund structures targeting a variety of industries such as real estate, film, or distressed debt. As one leading investor put it, 'these vehicles are lucrative for the brokers that introduce them and the teams that manage them, but can be slow to provide returns to investors'.[87] However, the general view is that the broadening of the AIM population has been good for AIM and for the participants in the market. Although AIM does now consist to some extent of several distinct sub-markets, 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.

Some investors have suggested that the AIM management and Nomads may have put too much stress on securing IPOs, to the detriment of existing companies on the market. The managers of Bluehone's

[87] Andrew Crossley, Fund manager, Invesco Perpetual, Foreword to AIM Investor Survey 2007, Arbuthnot Securities 2007.

AIM VCT, one of the largest venture capital trusts, commented in their 2006 report that part of the reason for the disappointing performance of the FTSE AIM All-Share Index over the preceding year 'appears to be that much of the appetite for AIM companies as investments has been satisfied by the provision of new shares as, over the last two years, companies have raised nearly £23bn of new money from investors – more than 1.6 times the money raised in the previous nine years since AIM was launched'. The managers noted that, with more international companies now coming to AIM and growing interest in the market from overseas investors, the high level of fund raising had been relatively easily absorbed. But they went to on to express the hope that 'as existing companies make progress with their business plans this is recognised by investors and results in increasing valuations. However, with so many companies on the market, particularly below £50m market capitalisation, it will take a concerted effort by management teams and their advisers for this progress to be noticed'.[88]

There is also a view that the AIM management could do more to promote the attractions of existing AIM companies, especially to private investors. The main responsibility for stimulating wider interest among private investors in AIM companies lies with brokers, but the AIM management team has also sought to increase the accessibility of the market – for example, by introducing a range of new sector-based AIM indices; the Exchange also runs events known as Capital Market Days to promote less well known AIM companies to potential investors.

Others have criticised Nomads for inadequate attention to their companies after the IPO. According to this view, there are too many under-performing companies on AIM; some of them may need a different strategy or an injection of new management, but are under insufficient pressure to make these changes. Two new funds have recently been established – the Bluehone Value Fund and Collins Stewart's AIM Realisation Fund – which will offer to buy shares from investors in these under-performing companies; the managers of these funds will use their influence as shareholders to bring about the necessary changes. The Bluehone Value Fund will 'agitate for change by shaking up management, forcing through restructuring or mergers and acquisitions'.[89]

These moves are unlikely to affect the very smallest and most illiquid stocks, valued at less than £5m, and the presence of this long tail is seen by some market players as a weakness. The Exchange may have to do more to encourage analysts to look more closely at these under-researched companies. But AIM is a broad church and intends to remain so. While some institutions focus on AIM companies valued at more than £50m – they have little interest in what is sometimes described as the 'public venture capital' segment down below – others like these more speculative stocks, believing that they can make money for their clients by picking out those companies which have a plausible story and a realistic business plan.

AIM is commonly described as a stock-picker's market, and, because so much of it consists of small, growing companies, there is a degree of risk which is greater than on the Main Market. But most investors believe that for AIM to try to eliminate risk through stricter rules over admissions would be a serious error.

[88] The AIM VCT, summary annual report for the year ended 20 November 2006, January 2007

[89] Sunday Times 17 June 2007

6

The quality of the market

The failure rate on AIM

AIM started in 1995 with ten companies. Since then, a total of 2,698 companies have been admitted to AIM and 1076 have been delisted, which leaves 1,632 companies on AIM as of February 2007 (Table 6.1) Delistings occur for a variety of reasons, only some of which can be classified as company 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; restructuring because of financial strains; and breach of the AIM rules. In addition, a company may choose to delist without giving a reason. Table 6.2 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. This was mainly because of a tightening of the rules governing the length of time cash shells could be traded on the exchange; 64 companies not fulfilling the listing 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 three per cent.

Table 6.1: Admissions and delistings on AIM by year

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

Table 6.2: Failure rate on AIM (by year)

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

Liquidity and volatility

To assess the liquidity of the market two different variables are used:

- **Volume:** This is constructed from the monthly trading file as the average monthly trading volume of a stock in a year. We then find out the median across all stocks in a year. We calculate this measure using both the number of shares, as well as the value of those shares.
- **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 6.3 shows that 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. AIM performance is all the more remarkable since it has more than 1,600 companies listed, whereas other 'junior' exchanges, with the exception of Toronto, are very much smaller.

Averages can mask wide variations in the underlying patterns. As Figure 6.1 shows, the highest decile stocks had volumes of 50 million shares a month, whereas the lowest deciles had volumes of less than a million in a month.

Liquidity for all deciles shows a slightly declining trend between 2004 and 2006. However, the decline is small and some variation is to be expected given the fact that the number of companies quoted on AIM more than doubled from 754 at the beginning of 2004 to 1634 by the end of 2006.

As figure 6.2 shows, there is a large difference in monthly turnover between the lowest and highest deciles. Monthly turnover for Decile 5 ranges between one and two per cent (the figures for Decile 1 are less than one per cent and hence were not plotted). On the other hand, the highest group has a turnover ranging between 15 per cent and 29 per cent. This confirms that there is wide variation in liquidity amongst stocks on AIM, and stocks in the highest decile group show monthly liquidity levels of around 25 per cent that are close to levels on other exchanges. Stocks in the highest groups show high liquidity, whereas the lowest groups have low levels of liquidity.

An important influence on liquidity is the size of the free float. Stocks with a high proportion of free float are more likely to be actively traded and to show higher liquidity as compared to those with a lower free float. Since the actual free float numbers of stocks traded are not available, a proxy – investibility weightings – is used for the analysis.

Table 6.3: 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%
Average	***1,219***	***1,076,994***	***2.5%***

Figure 6.1: Average monthly trading volume by deciles

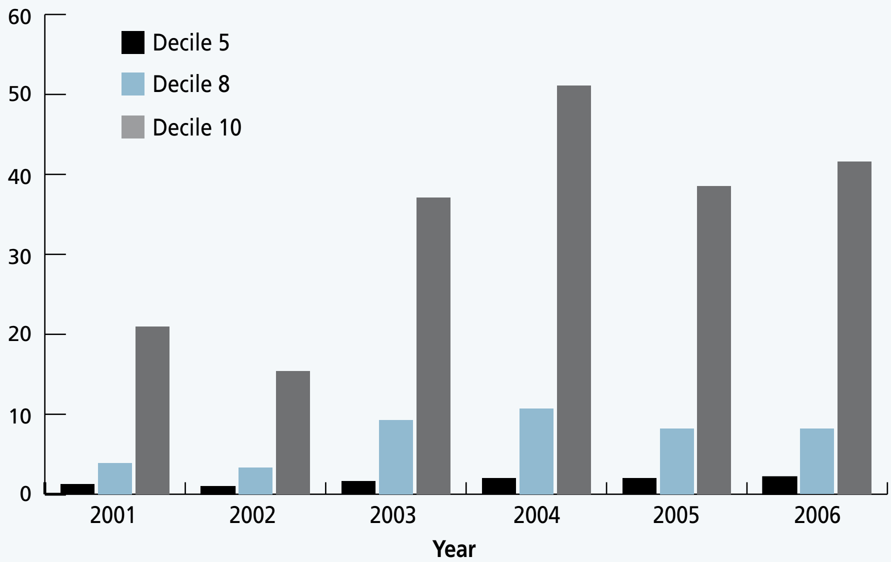
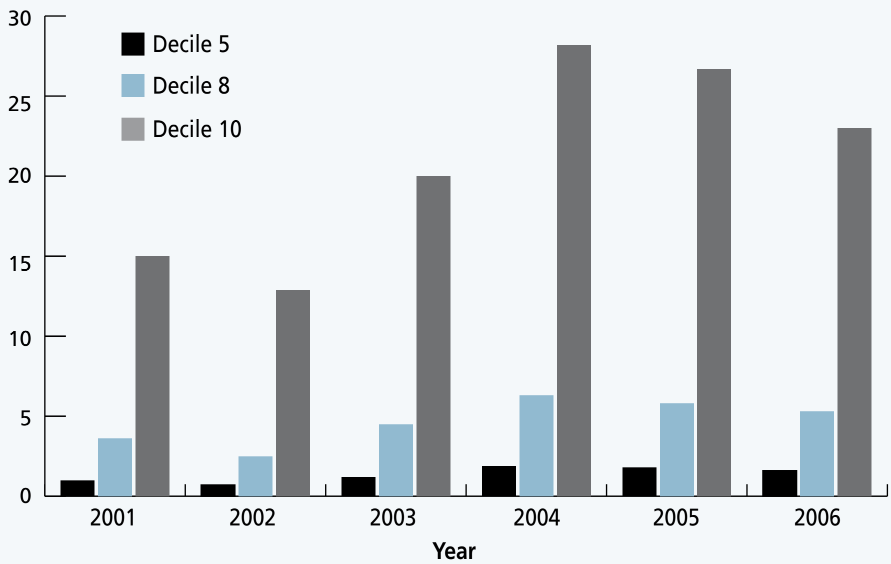


Figure 6.2: Average monthly turnover by deciles



The investibility weightings for stocks are assigned by FTSE and used in calculating their indices. The investibility weightings in turn are based on the free-float of the stocks. FTSE calculates investibility weightings only for stocks which are part of the FTSE All Share Index. There are around 400 stocks quoted on AIM which do not form part of the FTSE All Share Index and hence do not have an investibility weighting.

Figures 6.3 and 6.4 plot the average monthly liquidity of stocks with various investibility weightings. 0 corresponds to a low investibility weighting, 0.5 to a medium, 50 per cent weighting and 1 to a high, 100 per cent weighting. Higher investibility weightings are mainly a result of a higher free float for those stocks.

Figure 6.3: Average monthly trading volume by Investibility weightings

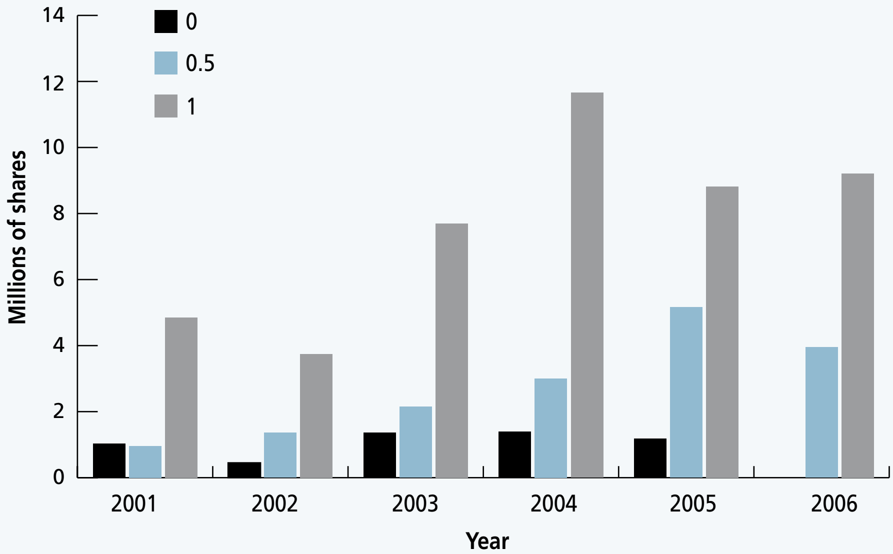
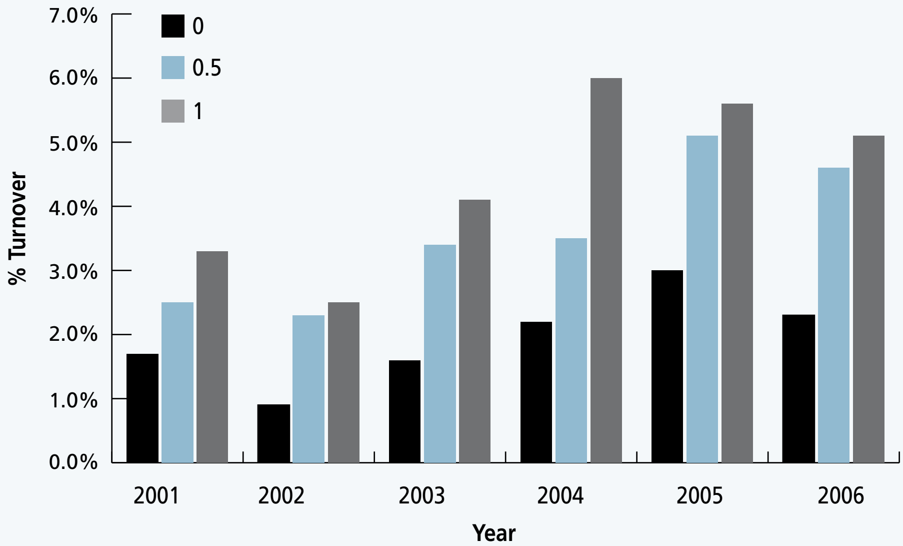


Figure 6.4: Average monthly turnover by Investibility Weightings



As these figures show, there is a clear pattern both in the average monthly trading volume and monthly trading turnovers. Stocks having higher investibility weightings (corresponding to a higher free float) show higher liquidity on both measures as compared to stocks with lower or no investibility weightings.

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

- 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 1470 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.

The monthly liquidity patterns on the various systems are shown in Figure 6.5. Since the SETSmm was introduced in December 2005 the figures below are also presented from that date onwards.

In all the months analysed the trading volumes as well as turnover of stocks traded on SETSmm is 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.

AIM has the infrastructure necessary to cater to the liquidity needs for a wide variety of stocks, and it is clear that the introduction of SETSmm succeeded in its purpose of increasing liquidity and lowering spreads on the largest stocks. Figure 6.7 presents the average quoted daily spreads on different system. SETSmm by far is the best performer with a spread of 0.62 per cent, followed by SEATS and SEAQ with 11 per cent and 14 per cent respectively.

Figure 6.5: Monthly trading volume by trading systems

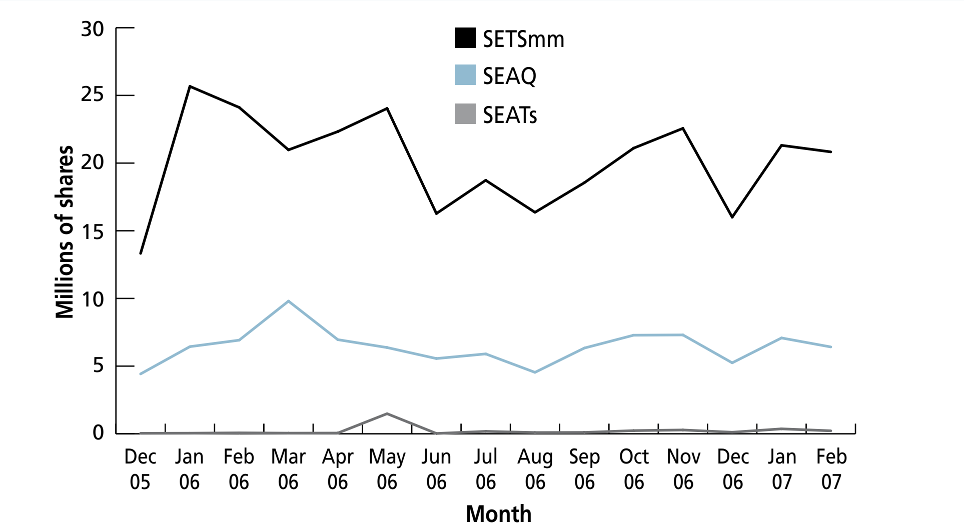


Figure 6.6: Monthly trading volume by trading systems

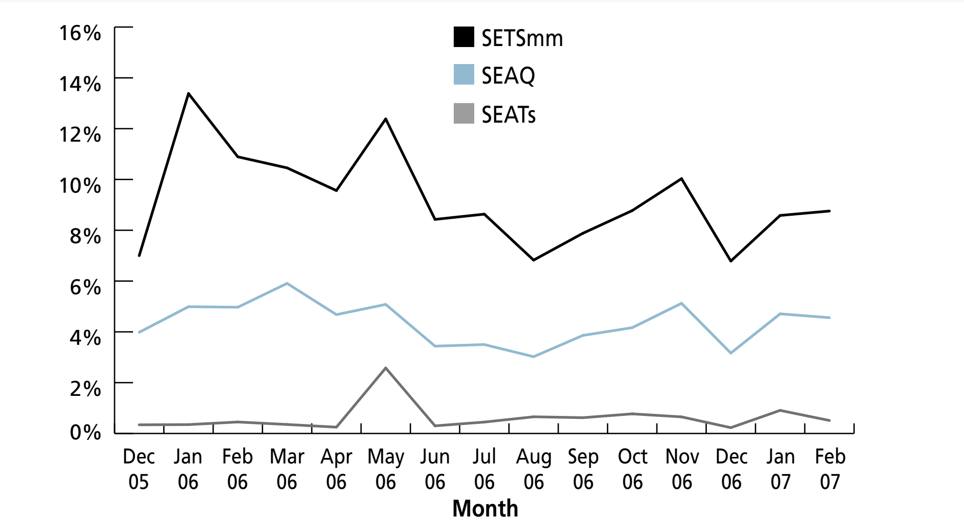
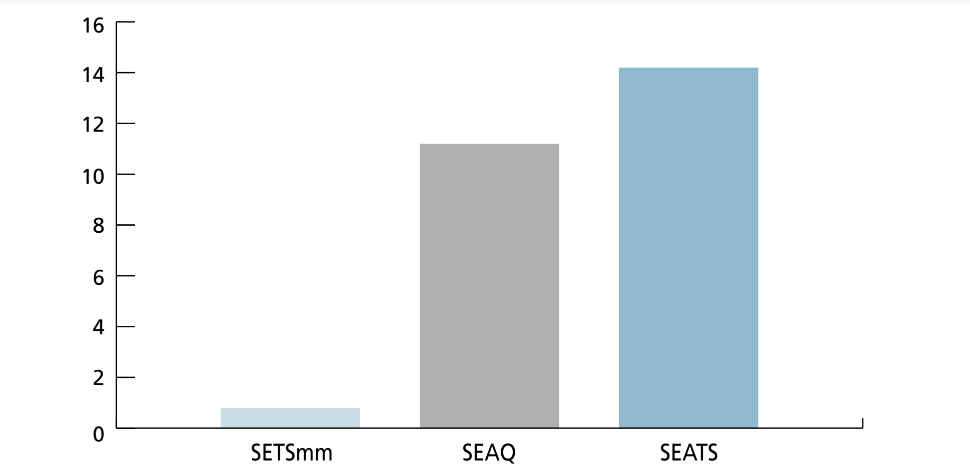


Figure 6.7: Daily Quoted Spreads for 2006 (by Trading System)



Volatility

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 use the daily FTSEAIM Index as well as the FTSEAIM50 and FTSEAIM100 to estimate the historic volatility of AIM each year.

Table 6.4 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 diverse stocks are traded on AIM, one would expect higher volatility; however, the table indicates that the volatility on AIM is stable and comparable to that of the main market.

Capital raised

Another important aspect in evaluating the quality of a market is whether companies are able to raise capital successfully on the exchange. Table 6.5 shows the capital raised by companies through initial public offerings (IPO) and follow-on offerings since 1995.

A total of 2,365 UK and 437 international companies have been admitted to AIM since its inception. Amongst them they have raised a total of £49bn. The total capital raised through IPOs, £28bn, exceeds the total raised through further issues, which stands at £21bn. The total number of companies admitted to AIM was highest in 2005, while the total capital

Table 6.4: Annual volatility of AIM

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

Table 6.5: Capital raised by year

	Number of Admissions			Money Raised £ million		
Year	**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**
Total	***2,365***	***437***	***2,802***	***28,158***	***21,284***	***49,438***

raised was highest for 2006. In fact, 75 per cent of the total capital raised so far was in the years 2004 to 2007.

AIM's has been successful in enabling companies to raise capital. Even though companies have successfully raised capital on AIM in every year since its inception, the amount of capital raised has increased significantly since 2004.

Aftermarket performance of new entrants

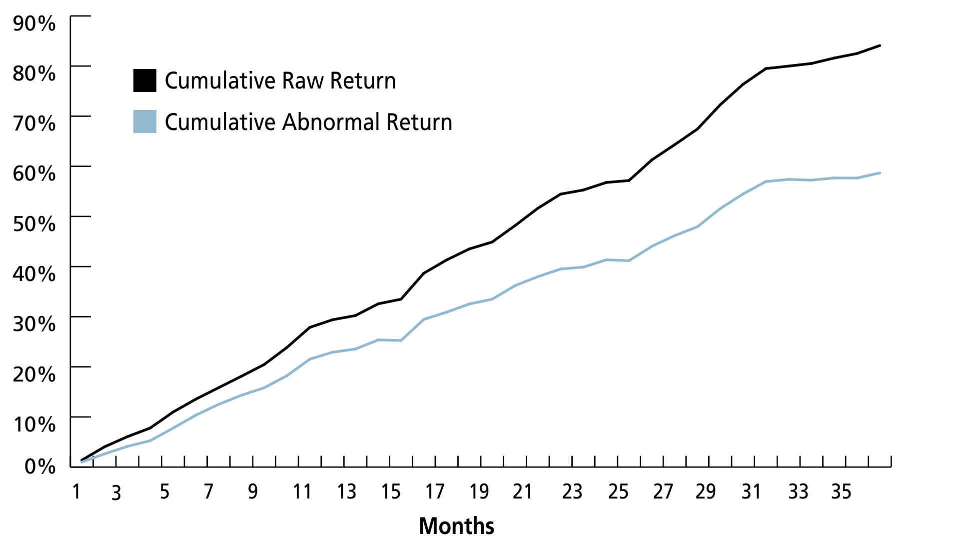
To analyse the after market performance of new entrants on AIM, we use the monthly trading files (available since end 2000) to calculate the monthly returns (based only on capital gains and excluding dividends) from a portfolio consisting of all new entrants on AIM from December 2000 onwards over a period of 36 months. We present in Table 6.6 and Figure 6.8 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 returns or one 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 6.6: 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%

Figure 6.8: Cumulative returns from new entrants



As noted in Section 5, AIM is often described as a stock-picker's market, and indices encompassing all AIM companies have only limited value. We provide in Table 6.7 a comparison of the various AIM Indices with the FTSE All Share Index and the FTSE100 Index.

The longest running index, the FTSEAIM Index, gave an annualised return of one per cent per annum over the entire period (up to February 2007) which was much lower than the seven per cent and six 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 three per cent and six per cent respectively.

Table 6.7: Annual index returns

Source: Daily Return Index from Thomson Datastream for respective indices

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%***

7

AIM and the UK economy

The need to ensure that small and medium-sized firms have adequate access to external sources of finance has long been a matter of concern to British governments. While much of the government activity in this area has been concerned with bank lending, there has also been considerable stress on the need for SMEs to draw on more diverse sources of finance, including stock markets. That was why in the early 1990s the then Conservative government, and the Bank of England, were keen to ensure that the London Stock Exchange set up a successor to the Unlisted Securities Market.

In a series of reports, starting in 1994, the Bank of England monitored the improvements that were made in small business financing. In the final report, published in 2004, the Bank noted the increase in the total value of private equity invested in the UK, but pointed out that the industry had increasingly concentrated on larger, later-stage deals. 'Research has suggested that the low levels of venture capital are largely the result of the high, fixed transaction costs associated with the provision of small amounts of capital, a shortage of available exit options and the historically lower returns gained from early stage investments. Thus, while the private equity market has grown overall this has still left an equity gap'.[90]

The Labour government that has been in office since 1997 has sought to fill the gap in a variety of ways, including the establishment of public sector Regional Venture Capital Funds, which provide risk capital in amounts up to £500,000 to small and medium-sized enterprises; in identifying suitable recipients these funds work closely with private sector venture capital firms. The RVCF normally expects to exit within about five years, at which point the company should be wholly transferred to the private sector, with additional equity coming from the venture capital community. However, this next stage in the company's development has become problematic, because of the lack of interest on the part of many venture capital firms in early-stage businesses. This is the gap which AIM has partially filled – hence the lower end of the AIM market is sometimes described as 'public venture capital'.

Is this an appropriate role for AIM? The few venture capital firms which specialise in nurturing early stage businesses have no doubt about the value of AIM as a financing option for certain types of company. Equally, the regionally-based venture funds, some of which originate from, or have links to, government-funded regional development agencies, regard AIM as essential, not necessarily as a means of making a full exit from their investment, but as a way of bringing in additional investors – mainly institutions – who will support the business in the next phase of its development. As a recent study of funding technology has noted, AIM has become an effective alternative to venture capital for fund raising by companies initially backed by business angels and looking for follow-on capital in the £2m-£10m range. [91]

Of course some of these companies will under-perform, and they may slip back to become 'micro-caps' – valued at less than £5m. As one fund manager who has investments in several of these firms points out, 'they are in a real bind because they can't raise interest from investors and the AIM overheads impact profits, but leaving the market is such an expensive process that that is not an option either'. The best hope for these firms may be to attract the attention of private equity firms – some AIM companies have been taken private in this way – but they may be too small to be of interest.

AIM and the regions

Of the 1,355 UK-domiciled companies traded on AIM in 2007, there is a strong concentration in London and the south east (Figure 7.1). But there is also a substantial regional dimension, as there is among the Nomads. Bell Lawrie, for example, which is based in Edinburgh and is now part of the Brewin Dolphin group, has deep roots in Scotland – it was a founder member of the Scottish Stock Exchange in the mid-19th century – and it has close links both with private clients in the region and with companies that may be candidates for AIM. Among the companies that Bell Lawrie has brought to AIM is Dobbies, the garden centre company; it floated on AIM in 1997 and made a number of subsequent share issues. Dobbies has recently been taken over by Tesco at a price which valued the company at just over £150m.

Scotland is also the home of a large number of technology-based businesses, with a strong biotechnology cluster centred on Dundee. Although one of Dundee's stars, Cyclacel, chose to list its shares on NASDAQ (via a reverse take over in 2005), others have floated on AIM. The Scottish Venture Fund, which makes investments in the £2m-£10m range, is one of three venture funds run by Scottish Enterprise (Scotland's main development agency, funded by the Scottish Executive). The others are the Scottish Co-Investment Fund, investing in the £500,000 to £1m range, and the Scottish Seed Fund (£100,000-£500,000). These Scottish funds have stakes in seven AIM companies, including Stem Cell Sciences, a specialist in stem

90 Finance for small firms, an eleventh report, Bank of England, April 2004.

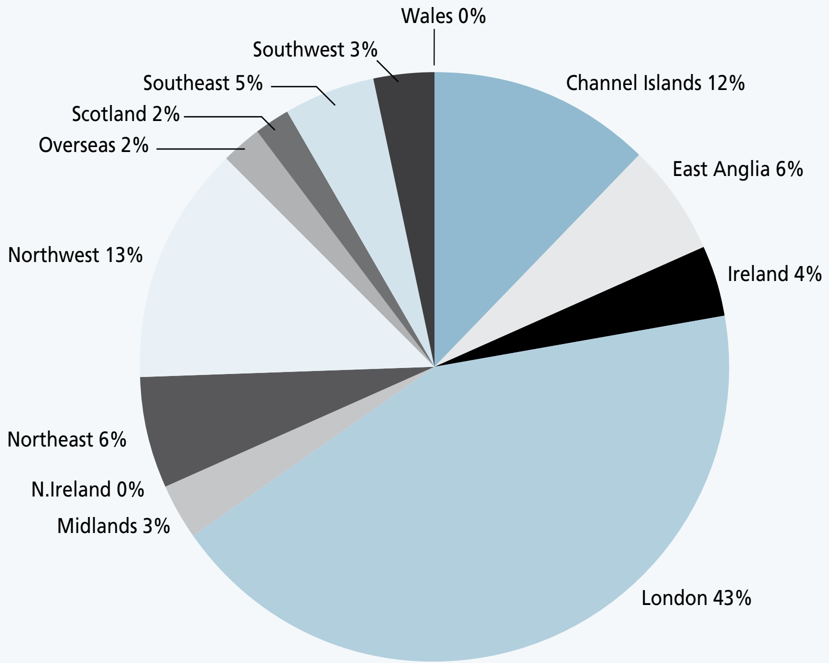
91 David Gill, Tim Minshall, Craig Pickering and Martin Rigby, Funding technology: Britain forty years on, University of Cambridge Institute for Manufacturing, January 2007.

cell technologies, Omega Diagnostics Group, a medical diagnostics company, and Portrait Software, a supplier of customer interaction software.

Another regional venture capital firm with links to the public sector is Leeds-based YFM Group; it was formed 20 years ago as an economic regeneration initiative in Yorkshire but is now owned by its management. YFM has around £300m under management, including private sector funds as well as regional and sub-regional venture capital funds in Yorkshire, London, the South West and the North West. Like the Scottish Venture Fund, YFM often takes small initial stakes in the companies it backs through its regional funds, investing up to £1m, and it has the ability to see them through multiple funding rounds to a flotation. YFM would be unlikely to support an AIM flotation unless the company can achieve a market capitalisation of at least £10m, and on average the companies invested in by its regional funds on AIM are valued at just over £20m; it will often hold on to its stake until an 'exit' event, which may be an acquisition.

As an example of a regionally-based company which has made excellent use of AIM, the Tanfield Group, profiled on this page, could hardly be bettered. But the businesses which make up the Tanfield Group were relatively mature when they came to AIM. To the extent that equity financing problems for small business persist they affect smaller and less mature businesses. A novel attempt to attack this market is the creation of what is described as virtual exchange, called Investbx, by Advantage West Midlands, the regional development agency for the Midlands. Investbx, which was given the go-ahead in 2007,aims to help expanding SMEs raise equity finance up to £2m.

Figure 7.1 Breakdown of UK AIM companies by region



Tanfield Group

Tanfield Group is a regionally based business which started small, used AIM to fund its growth, and now has a market capitalisation of over £500m. The architect of the group is Roy Stanley, an entrepreneur who has specialised in buying companies, turning them round and selling some of them on.

At the end of the 1990s Stanley was running a group of businesses, most of which were privately owed. The one public company was a 3D imaging company called Comeleon, which Stanley had listed on AIM in 2000, mainly in order to get access to the larger amounts of capital that were needed to develop what was becoming an international business – many of its customers were in the US. Although Comeleon prospered at the start, the market for its products changed substantially over the next two years – many of its US customers moved their operations offshore – and the business model was no longer working effectively.

In 2003 Stanley decided to reverse his two private businesses into Comeleon – the enlarged AIM-listed group was re-named Tanfield Group – and to refocus the business on engineering; Comeleon remains part of the group, but it is now a small part of the whole. The attraction of AIM, as Stanley saw it, was that it would give him access to capital as he developed the engineering side of the group over the next few years. The first step came in October 2004, when he bought Smiths Electric Vehicles – a company which Stanley had long regarded as a suitable acquisition; as a manufacturer of 'clean' vehicles in an environmentally-conscious world, it had excellent growth prospects. At the time Smiths was making profits of some £400,000 on sales of £9m, and

[92] Financial Times, June 29, 2007.

Tanfield bought it for £2.4m[92]; it was financed by a share issue that raised some £4m. In June 2006 Stanley made another acquisition of UpRight, a manufactured of powered platforms which fitted well with one of Smith's ancillary operations. A further sum of £10m was raised through AIM.

The company has become a significant contributor to the economy of the north east, with capital investment running in excess of £15 million and a high level of spending on training and development. In June 2007 Tanfield announced the purchase of a US manufacturer of aerial equipment and a placing to raise £115m, of which £50m will be used to fund the acquisition and to pay down debt. The group now employs over 1,100 people, with operations in the US, New Zealand, Japan and the UK.

Stanley believes that AIM provides an excellent platform for a growing business with a sound business plan. 'I've had experience of all sorts of different funding methods – bank loans, venture capital firms, private equity and so on, but AIM has served us extremely well'. Tanfield's investor base now includes leading institutional investors such Fidelity and M & G. The free float is about 85 per cent; Stanley, who had majority control at the time of the merger with Comeleon, now holds just under ten per cent of the shares.

AIM and the biotechnology industry

The development of a strong British biotechnology industry has been a concern for government since the late 1970s. It was at that time that policy-makers became aware of the huge lead which US companies had established in an important new technology. Although part of the reason for US superiority was the scale of Federal support for biomedical research, through the National Institutes of Health, it was also noted that American firms such as Genentech had been able to float their shares on the stock market at an early stage in their development, and this source of funding was largely absent in the UK.

Under pressure from the venture capital community the London Stock Exchange changed its rules in 1991 to allow biotechnology companies to be listed even though they had no record of making profits. The first to take advantage of the change was British Biotechnology, and by the end of 1995 about 25 biotechnology firms were quoted on the Exchange. In the late 1990s the biotechnology sector benefited from the general enthusiasm for high-technology stocks, and several British companies floated in London, both on the Main Market and on AIM, although the most dynamic market for biotechnology firms (for a brief period) was the Neuer Markt in Germany.

The subsequent stock market collapse led to a fallow period for biotechnology flotations in Europe, but by 2003 interest in the sector was reviving, and the London market saw an increasing number of biotechnology flotations. There are now some 56 publicly quoted British biotechnology companies, compared with 19 in Germany and ten in France.[93] Of the 32 biotech IPOs that took place in Europe in 2006, nine were in London, and all but one of them were on AIM.

Many of the 50 or so biotechnology companies now quoted on AIM are still in their early stage of growth, with no profits and no products yet on the market. Reneuron, profiled on the next page, is one such case.

Did these firms come to the public market too early? In the US biotechnology companies generally come to the market at a later stage; they may still be loss-making but they have products well advanced in clinical trials. But this reflects the greater size and maturity of the US biotechnology industry, and of the US venture capital community. Given the way venture capital has evolved in the UK, an AIM flotation is often the only option for British biotechnology companies.

Inevitably some have performed poorly after their flotation, but there have been enough successes to suggest that AIM can play a valuable role for an industry which, despite disappointments, still holds great promise. Companies which come to the market with a credible story and deliver on their promises have been able to raise further capital and achieve impressive growth. One success story is Silence Therapeutics (formerly SR Pharma), a specialist in RNAi technology which was spun out of University College London in 1994. Originally floated on AIM, it moved to the Main Market in 1999, but came back to AIM in 2004. Since then it has raised further funds, some of which were used to acquire a German company, Atugen, working in the same field. Another example is NeuTec, which specialises in the development of genetically recombinant antibodies; it came to AIM in 2002 and was bought by Novartis, the Swiss pharmaceutical company, four years later for £305m.

93 Financial Times, 29 June 2007.

Moreover, there are venture capital firms, of which Abingworth is a notable example, which have specialised in the biotechnology sector for many years and are actively involved in AIM. While it is mainly concerned with UK-based companies, Abingworth recently brought to the market an American company, Entelos, which was too small to list on NASDAQ, and a Swedish specialist in diagnostics, Xcounter, which has done well and currently has a market capitalisation of some £70m. Another Abingworth-backed company, a British drug delivery business called Phoqus, floated in 2005 and recently raised a further £5m.

There are few sure-fire successes in biotechnology, but venture capital firms and investors which specialise in the sector continue to find the biotechnology sector on AIM attractive. Abingworth has raised a new £300m fund, and it will use these resources to support biotechnology ventures from the early stage, when an investment of around £250,000 might be needed to get the business moving, through to an IPO or a trade sale. An IPO on AIM rarely involves a complete exit; Abingworth is ready to participate in further financing rounds before the final exit takes place. As for moving to the Main Market, Abingworth takes the view that there is not much difference, from the investor's point of view, between a £100m company on AIM and a £100m company on the Main Market; the liquidity of the two shares is about the same.

Whether any of the AIM companies will reach the size of the American giants such as Genentech or Amgen is doubtful – they are more likely to sell out to larger groups as NeuTec did – but this has more to do with the nature of the industry than with any deficiencies in AIM, or in the London capital market as a whole. Small though many of the companies are, there is a thriving biotechnology sector in the UK, drawing on the high quality of UK academic science in this field, and AIM helps to support it.

ReNeuron

ReNeuron is an early stage biotechnology company, focusing on stem cell therapy, which was founded in 1997 on the basis of research carried out at the Institute of Psychiatry, Kings College London. It was backed from the start by Merlin, a UK venture capital firm that specialises in biotechnology; Merlin put in £250,000 seed capital at the start, followed by £5m a year later. It was Europe's fist publicly listed stem cell company.

At the time of the company's formation the technology boom was in full swing, and the company had no difficulty securing a flotation on AIM in 2000, raising just over £20m. The company's main focus was on stem cell therapy, but it also had interests in small molecules and proteins as part of an effort to broaden its Central Nervous System franchise.

The flotation came just as the stock market was about to crash and the ReNeuron share price fell sharply, along with other high-technology stocks. Quite apart from the stock market collapse, the company had problems of its own. The stem cell expansion technology on which it had been working was not producing stable cells, and the outlook for the company was uncertain. In these circumstances there was no alternative but to go private again – Merlin took the company out of AIM in 2003.

Over the next two years, under a new chief executive, Michael Hunt (who had previously held senior posts at Biocompatibles International), ReNeuron refocused its business, withdrew from some peripheral operations, and licensed in a new technology which proved to be more successful in the laboratory. Although it was still some way from getting its ReN001 therapy for stroke victims into clinical trials, pre-clinical testing was producing promising results, and the company was able to refloat on AIM in August 2005, raising just under £10m.

As a loss making early stage company with uncertain prospects it may not have been an ideal candidate for public markets, but the company was unable to find further venture capital backers – not because it was too small, but because of the early stage nature of the technology and the regulatory hurdles that would have to be overcome. A flotation on AIM was a way of raising the capital needed to keep the company going, and it was able to attract institutional investors as well as a range of private investors, hedge funds and high net worth individuals who were willing to take a risk on the new technology.

An important milestone was reached in December 2006, when ReNeuron filed its first Investigational New Drug application with the Food and Drug Administration in the US to start clinical trials with ReN001. The share price rose sharply on the announcement although it fell back a month later when the FDA announced that it was putting the application on hold; this was not a rejection of the application, but rather an indication from the FDA that it needed more information about the treatment.

Despite the delay ReNeuron was able to raise a further £5.5m in February of this year through a placing on AIM. The money was *needed to progress the ReN001 stem cell therapy into the clinic as well as accelerating the development of other therapeutic programmes.*

Since the company's return to AIM in 2005 the shareholder base has changed substantially. While Merlin has retained approximately 30 per cent of the equity (and has a representative on the board), a new investor has appeared in the form of the Saad Group, a large conglomerate based in Saudi Arabia, controlled by Mr Maan Abdulwahed al-Sanea. Saad has several other UK investments (including a 3.1 per cent stake in HSBC) and is known to take a long-term strategic view of its holdings; it now holds just under 30 per cent of ReNeuron.

Michael Hunt, the company's chief executive, believes that AIM has served the company well . 'We are a loss-making cash-burn company', he says, 'and it is not easy to interest venture capital or indeed other investors in businesses of this kind – they are more likely to back companies which have already got products in clinical trials'. The entry of new investors, notably Saad, has made a big difference, and much will depend on whether the company can keep the confidence of these new shareholders. Another cash-raising exercise will probably be necessary in the next year, and in the longer term – assuming that clinical trials go well – the company might look to license its technology to a larger biotech or pharmaceutical company; a trade sale would be another possibility.

AIM and its UK constituency

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. 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 issuers has made it more difficult for British companies to access AIM.

What is also clear, as Table 7.1 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 five per cent of the new capital raised. 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. While this may suggest that some small British companies 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, and in that sense recent trends cannot be regarded as adverse for UK-based companies

Table 7.1 Breakdown of money raised through IPOs by size 1998-2007.
Source: London Stock Exchange

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

8

AIM and the city of London

The growth of AIM over the past five years has occurred during a period in which the City of London as a whole, and the London Stock Exchange in particular, has improved their competitive position in what has become an increasingly integrated world financial system. In 2006 London attracted 75 per cent of all the international IPOs that came to Europe – a total of 86 flotations, 66 on AIM and 20 on the Main Market, raising a total of 15bn euros. In the same year the US attracted only 18 international IPOs, raising a total of 6.2bn euros.[94]

This impressive performance followed a period in which the Exchange had gone through a series of upheavals which drastically altered its role and its internal organisation. These included 'Big Bang' in 1986, the shift from floor-based to screen-based trading, the conversion of the Exchange from a mutual ownership structure to an investor-owned enterprise, and the transfer of its responsibility as listing authority to the Financial Services Authority. There were some missteps along the way which upset market participants, notably the initial reluctance to set up a successor to the Unlisted Securities Market and the attempted merger with the Deutsche Börse. But by 2002 the Exchange had emerged from these problems and could concentrate on what was clearly recognised as its primary task: 'to provide its members with a trading forum that combined the minimum regulation required for an orderly and disciplined market and the maximum freedom necessary for innovation and development'.[95] With most of the world's leading investment banks and fund managers now well established in London, it also had an opportunity to increase its share of international company flotations, and of trading in foreign securities.

The Exchange's ability to exploit this opportunity has been enhanced by the changes that have taken place in the UK and US regulatory systems. As a result of the Financial Services and Markets Act of 2000, the UK has a single regulator which is committed to transparency, accountability and a risk-based approach to regulation. Meanwhile the US capital markets have been in the throes of their post-Enron reappraisal. The Sarbanes-Oxley Act of 2002 not only increased the costs and complexity of public flotations, but also served to accentuate the differences between London and New York in the philosophy of regulation. 'The FSA favours an environment where principles of regulation are published and there is a degree of discretion as to how these principles are applied… In the USA the regulatory philosophy is based around more clearly defined rules and is described as more prescriptive'. The Oxera study from which this assessment is taken quoted a senior US investment banker as saying: 'The FSA listens to and understands our concern. In the USA regulators develop rules and expect you to stick to them.'[96]

Within this framework AIM has been able to establish a distinctive role in the a la carte menu of options which London offers to companies which wish to issue securities, to the investment banks which advise them, and to investors. There are three tiers of regulation: the top level which applies to listings on the London Stock Exchange's Main Market and where the requirements are tougher than those laid down in the EU Prospectus and Transparency Directives; a middle tier which applies to secondary listings including Global Depositary Receipts, sold only to professional investors; and a lower tier of which the main constituents are the Professional Securities Market, designed for debt securities, and AIM. A new addition to the menu will be the Specialist Fund Market, which was described above in Section 3.

What is the value of AIM to the City of London? It provides an exit route for private equity firms, especially those focusing on early-stage companies. It allows private investors to take a stake in small, high-growth companies, principally through collective vehicles or through portfolios put together by broking firms. It has contributed to the impressive growth of the 'small-cap' sector of the financial community – the investment banks, brokers and fund managers which specialise in smaller companies.

AIM's success in attracting foreign companies has broadened the appeal of London as a financial centre and reinforced the cluster of experience, resources and management skills which underpins the dynamism of the City. The income which AIM generates – based on fees generated by IPOs and further equity issues, together with payments to lawyers, accountants and other advisers – is estimated to be running currently at about £1bn a year, of which around half comes from companies based outside the UK; thus AIM makes a significant contribution to the City of London's 'invisible exports'.[97]

---

94 IPO Watch Europe: Review of 2006, PriceWaterhouseCoopers.

95 Michie, The London Stock Exchange, p 616.

96 The competitive position of London as a financial centre, Oxera/Corporation of London, November 2005.

97 This figure is an estimate which draws on information contained in 'The cost of capital: an international comparison', a report by Oxera and the London Stock Exchange, June 2006 (this report estimated IPO underwriting fees AIM as 3.5 per cent for domestic companies and 4.9 per cent for foreign companies) , and on the estimates for other costs shown in the Appendix to Section 4 of this report.

9

AIM And Its Competitors

Moreover, while the initial batch of foreign companies that came to AIM were based in developed countries, the AIM population now includes a range of companies from emerging markets, including Russia, India, China and Brazil. There are also investment entities in AIM which focus on countries that are just joining the emerging market category, such as Vietnam. Thus AIM has provided a means whereby capital can be channelled to these countries and investors can benefit from their growth.

For a brief period after the collapse of the dot.com boom AIM was the only 'junior' market left standing in Europe, and it was well placed to take advantage of the demise of its rivals. Since then, competition has been getting stronger, both within the UK – from what used to be known as Ofex, and is now PLUS Markets Group – and in Europe, as leading Continental exchanges seek to re-establish their position at the small- and mid-cap end of the market. There is also the possibility of greater competition from the US, as the established stock exchanges and other market operators look for ways of encouraging smaller companies to float their shares in the US, rather than coming to London.

Competition in the UK

When AIM was created in 1995 a separate over-the-counter market, known as Ofex, was set up by a London stockbroking firm, J P Jenkins, which specialised in small-cap securities. Although there was some overlap between the two markets, Ofex catered mainly for companies that were too small to float on AIM, and some of them later graduated to AIM. In 2004, however, Ofex became part of PLUS Markets Group, which has ambitions, not just to act as a 'feeder' to AIM, but to become a fully fledged stock exchange in its own right. PLUS, which is led by a former head of AIM, Simon Brickles, is backed by several leading City firms, including Winterflood (part of Close Brothers) and KBC Peel Hunt, which act as market-makers on PLUS, while continuing to play a major role on AIM. PLUS itself is a public company which is traded on AIM. In mid-2007 there were about 200 companies quoted on the PLUS primary market; most of the new issues have been in the range of £100,000 to £5m; the larger flotations have attracted the interest of Venture Capital Trusts and other institutional investors.

PLUS also provides an alternative trading platform for small and mid-cap companies that are traded on the Main Market or on AIM. The platform is based on a quote-driven trading system, which for some market-makers is more profitable than the order-driven system, known as SETSmm, introduced by the London Stock Exchange in 2006 for larger AIM shares. (The merits of the two systems have been the subject of dispute between the Exchange and PLUS, with the former strongly denying that the PLUS system offers superior liquidity and lower spreads.[98]) By mid-2007 PLUS was trading over 1000 shares, mostly drawn from companies covered by the FTSE Fledgling and Small Cap indices. About 50 AIM companies are also traded on PLUS.

Looking further ahead, PLUS has aspirations to compete against the Exchange, not just in small capitalisation stocks but across the board. In pursuit of this objective it successfully applied in 2007 to become a Recognised Stock Exchange; this will allow it to trade a wider range of instruments including real estate investment trusts.

In the short term it is not clear whether PLUS will be mainly complementary to AIM or a direct competitor. Some market participants believe that, if the focus of AIM were to shift towards larger companies, it could lose its special character as a market for small, growing companies, and that role could be taken over by PLUS. There is no evidence as yet that this is happening, but the existence of PLUS as a potential alternative is

[98] Letter to the Financial Times from Martin Graham, Director of Markets and Head of AIM, the London Stock Exchange, 9 May 2007

not unwelcome to the investment banks and brokers which specialise in small-capitalisation stocks. They see it as a useful competitive spur for AIM; their support for PLUS could also be an insurance policy against possible changes in the character of AIM, perhaps arising from a change in the ownership of the London Stock Exchange.

Junior stock exchanges outside the UK

There are several stock exchanges around the world which, like AIM, are geared primarily to the needs of small and medium-sized companies, although they vary considerably in size and importance. The only two that are comparable with AIM in the number of companies listed are TSX Ventures in Toronto and KOSDAQ in Korea, and AIM is the only one with a significant number of foreign companies (Table 9.1). AIM also has by far the highest market capitalisation among these exchanges. In December 2006 the market capitalisation of AIM at $177.5bn was only slightly lower than the market capitalisation of all the other eleven exchanges put together. Another difference is that, while AIM caters for a large number of small and medium-sized companies – the average market capitalisation at the end of 2006 was $109m – most of the other exchanges either have a smaller number of larger companies, like Spain and Italy, or more very small companies, like Toronto (Table 9.2).

Competition in Europe

After the collapse of the high-flying European growth markets in 2002 and 2003, the leading Continental bourses re-thought their approach to 'junior' markets. First to start afresh was Paris. In May 2005, the Paris bourse, through the Euronext grouping of which it was a part (and which later merged with the New York Stock Exchange), launched Alternext, aimed not at high technology in particular but at small- and mid-cap companies in general. According to Martine Charbonnier, executive director at Euronext, the aim was for Alternext to become 'the eurozone benchmark for the mid-cap segment'.[99] By June 2007,

Table 9.1: Number of companies on 'junior' exchanges as of December 2006

Source: World Federation of Exchanges

Country	Exchange	December 2006		Average (2002 to 2006)	
		Market Cap. ($ m)	Average Market Cap. ($ m)	Market Cap. ($ m)	Average Market Cap. ($ m
London	AIM	177,464	109	76,984	70
Germany	Entry Standard	-	-	-	-
Euronext	Alternext	4,531	60	2,749	56
Spain	Nuevo Mercado	11,176	1,016	13,883	1,068
Italy	Mercato Expandi	13,621	524	7,990	499
Ireland	Irish Enterprise	3,250	141	1,424	129
OMX	Investor & NM List	1,030	30	1,075	26
Toronto	TSX Ventures	47,161	21	24,128	11
Hong Kong	Growth Enterprise	11,429	58	8,868	46
Korea	KOSDAQ	77,563	81	35,589	39
Singapore	SESDAQ	6,415	38	3,678	24
Tokyo	Mothers	32,543	174	28,392	247
Total		***386,183***	***69***	***204,760***	***41***

Table 9.2: Market capitalisation of 'junior' exchanges

Source: World Federation of Exchanges

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

[99] Euronext press release 11 May 2007.

Table 9.3 Sectoral breakdown of Alternext companies in March 2007 (by market cap)
Source: Euronext press release 11 May 2007

Industrials	26.0%
Technology	15.7%
Consumer services	13.7%
Health care	12.0%
Consumer goods	11.8%
Utilities	8.9%
Financials 7.0% Oil and gas	2.4%
Basic materials	1.2%
Telecoms	1.2%

after two years of operation, Alternext had attracted 100 companies, with a total market capitalisation of over five billion euros. The sector composition of these companies was broadly based, with the technology element amounting to 16 per cent of the total.

All but four of the companies quoted on Alternext in mid-2007 came from the six Euronext countries, but Mrs Charbonnier made clear her intention to compete against AIM for non-European companies, with Eastern Europe, Russia and China being particular targets.[100] The admission rules are similar to those of AIM in that the new entrant has to have a sponsor, comparable to the Nominated Adviser, but more restrictive in two respects; companies floating on Alternext must have an operating history of at least two years, and the free float of shares for a public offering must amount to at least 2.5m euros. Like AIM, Alternext is not subject to the EU Prospectus Directive, and is regulated by Euronext itself.

The Deutsche Börse also re-entered the fray in 2005, introducing a new market segment called Entry Standard for small and mid-cap companies. The rules were more in line with AIM than with Alternext, in that there was no minimum operating record required and no minimum free float of the shares. By July 2007 the number of companies admitted to the Entry Standard segment had reached 100.

In the short term Alternext and Entry Standard, like AIM in its early days, are likely to get most of their business from small, domestically-orientated companies whose shares will be of interest to local investors. They do not have the advantage which has been helpful to AIM, especially at the start – a tax regime which encourages private investors to acquire shares in small, growing companies. The UK also has a more highly developed ‘equity culture’ than either France or Germany, and a stronger tier of banks, brokers and institutional investors that specialise in smaller companies.

In the longer term the combined strength of the New York Stock Exchange and the exchanges grouped in Euronext could represent a credible challenge, not just to AIM, but to the London Stock Exchange as a whole. Some of the recent IPOs on Euronext have been relatively small – a Dutch biotechnology company, for example, raised 50m Euros in June 2007, joining seven other biotechnology firms listed on Euronext – and this market may be attractive to some British companies that wish to raise their profile on the Continent. Sinclair Pharma, which moved from AIM to the Main Market in 2007, also arranged a secondary listing on Euronext.

Although AIM is currently in a strong position, it will not have the field to itself.

Competition from the US

The rise of AIM, and its success in attracting flotations from the US, has aroused some concern in the US. Although one reaction has been to cast doubt on the quality of the AIM market, there has also been increasing discussion about the apparent inability of US public markets to serve the needs of smaller companies. The Schumer-Bloomberg report, published in 2007, noted that since 2001 870 companies had been admitted to AIM, compared with 526 on NASDAQ, and the trend appeared to be accelerating. The report pointed out that less than half the AIM companies would meet the initial market capitalisation requirements on NASDAQ, and the authors did not recommend that US exchanges should relax their listing rules to attract small issues. Nevertheless, they warned that the dearth of small company listings in the US posed ‘a risk that the next Microsoft or eBay could be listed abroad during its infancy, with the United States thus forgoing the associated future benefits’.[101]

There are some facilities in the US which enable small companies to access outside investors. They include the NASDAQ Small Cap market; the Bulletin Board, an electronic quotation system that displays prices and volume information for over-the-counter securities not traded on a national exchange; and the Pink Sheets, through which brokers trading in OTC shares publish bid and ask prices. In 2006 the owners of the Pink Sheets launched a new ‘premier tier’ market, called OTCQX, aimed at filling the gap between the regulated exchanges and the over-the-counter market; the rules were based partly on those of AIM, including the use of ‘designated advisers

[100] Financial Times 8 March 2007.

[101] Charles E Schumer and Michael R Bloomberg, Sustaining New York’s and the US’s global financial services leadership, New York January 2002.

for disclosure'. Another proposal has been put forward by the American Stock Exchange, for a second-tier listing venue called the American Trading Platform for micro-cap companies.[102] But none of these proposals have the attraction – which AIM offers – of allowing small companies to start small and then grow to a substantial size without having to move to another market. As one recent recruit to AIM put it, 'you get the stigma of being looked at as a second-class company yet you must still bear the huge cost in terms of legal and accounting fees to ensure Sarbanes-Oxley compliance'.

Most of the attention of the financial services community in the US is focused on securing some relaxation of the Sarbanes-Oxley rules as they affect all quoted companies, not small companies in particular. Such a relaxation, if it occurred, might have the effect of increasing the attractiveness of a US listing for those non-American companies which wish to tap into the US capital markets and to increase their visibility in the US. But it would not necessarily affect small-capitalisation companies. There is any case a view in the US that companies should not go public too early and that the US system benefits from the exclusion from the main exchanges of untried companies of the sort that come to AIM.

AIM and NASDAQ in their present form are not direct competitors. As the Schumer-Bloomberg report pointed out, to a large extent the two exchanges operate at different places along the IPO spectrum. The companies that come to NASDAQ are generally larger and better established than those that come to AIM. In any case, as a senior US Treasury official recently noted, the vitality of a country's capital markets cannot be measured simply by the number of IPOs.[103] The US is still far ahead of other countries in its ability to fund growing companies before flotation. Moreover, for European high-technology companies for which the US is the most important market for their products, a listing on a US exchange has obvious attractions. To the extent that such listings have become more expensive and difficult, such firms may be more inclined to look for a trade buyer in the US instead of a public quotation.

[102] Letter to the Financial Times from Neal Wolkoff, chairman of the American Stock Exchange, 16 March 2007.

[103] Speech by Robert K Steel, Under-Secretary for domestic finance, May 17, 2007. He said: 'IPOs have become an often-referenced benchmark of capital markets competitiveness, but focusing solely on that measurement is too simple and not forward-looking enough'.

10

The future of **AIM**

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 bid 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 that asset 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 internationalisation, a 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 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 obvious dangers that, as the size of the market grows, the smaller companies may receive little attention from analysts and have little visibility among investors. Investors are interested in quality, not quantity. While the market is to a large extent self-correcting – hence the fall in IPOs in 2007 after a very large number of new entrants in 2005 and 2006 – the role of Nomads is crucial.

As discussed in Section 3 of this report, Nomads are the lynch pin of the AIM regulatory system. There is a heavy responsibility on them 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 perform poorly or fail, should that be regarded as a failure of the regulatory system, prompting 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.

How far 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 withdrawing from the role, or cutting back on the number of companies they act for.

AIM is an exchange-regulated market, and the London Stock Exchange has so far 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 regulatory arrangements will also need to evolve, as has happened over the last three years, but this is likely to take the form of incremental adaptation, rather than 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

This report is printed on recycled stock

Design by: LSE Design Unit (www.lse.ac.uk/designunit)

Photography: Nigel Stead, LSE Photographer and LSE's Office of Development and Alumni Relations

The London School of Economics and Political Science is a School of the University of London. It is a charity and is incorporated in England as a company limited by guarantee under the Companies Act (Reg. No. 70527).

The information in this leaflet can be made available in alternative formats, on request.
Please email: enterprise@lse.ac.uk

This report was produced in association with LSE Enterprise.

For further enquiries please contact:

Simon Flemington,
CEO LSE Enterprise,
8th Floor, Tower One, Houghton Street,
London, WC2A 2AE, United Kingdom

email: enterprise@lse.ac.uk
tel: 020 7955 7128
fax: 020 7955 7980

London STOCK EXCHANGE
www.londonstockexchange.com/aim

AIM