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Financial regulation and IPOs: Evidence from the history of the Italian stock market ☆

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A B S T R A C T

This paper studies the impact of regulation on IPO markets using historical data. Regulatory interventions have different effects on the development of public equity markets under different conditions. Studying the whole population of 879 Italian IPOs from the unification of Italy (1861) through the present, we find that tightening regulatory changes improve IPO survival rates. In contrast, easing of regulations tends to harm IPO survival rates, without increasing the number of IPOs.

1. Introduction

The effectiveness of regulatory interventions is controversial and largely depends on how they are implemented. Recent IPO studies find that the level of uncertainty is lower for IPOs issued after regulations are tightened (Ekkayokkaya and Pengniti, 2012). EU Member States have adopted SOX Act-like provisions to reduce the uncertainty surrounding valuations in regulated markets. However, Akyol et al. (2014) show that these provisions have not decreased the average level of IPO underpricing on unregulated markets, particularly London's Alternative Investment Market. From a historical perspective, Chambers and Dimson (2009) highlight that regulations have been less effective than market forces at reducing information asymmetries in UK IPOs.

All of these studies on the effects of changes in IPO regulations focus on underpricing. The rationale is that effective interventions decrease information asymmetries, thereby reducing underpricing. Although underpricing is of interest and offers the possibility of direct tests on the efficacy of regulatory changes soon after their implementation, rules typically need complementary enforcement

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to be effective and should be evaluated as a whole. For this reason, we believe that a long-term perspective can shed some light on the effects of regulation on capital markets. In the present paper, our main focus is on IPO survival.

Although failure is hardly a welcomed corporate event, it is not uncommon in competitive stock markets, and market participants are well aware of this possibility when setting asset prices. Firms go bankrupt with some regularity, more so in bad times. Thus, failure is priced in. However, because the deaths of public corporations may lead to substantial economic and social welfare costs (Bhattacharya et al., in press), the survival of IPO-firms is considered to be a measure of capital market development (e.g., Fama and French, 2004). The underlying argument, as suggested by the law and finance literature, is that better-regulated capital markets develop corrective mechanisms and remedies to address information asymmetries, thereby increasing the survival of firms going public (La Porta et al., 1998).

To date, the relationship between regulation and IPO survival has been the core research question of only two studies. Simon (1989) finds that the US Securities Act of 1933 did not reduce the failure rates of firms listed in the NYSE. Burhop et al. (2014) argue in favor of regulatory changes, showing how a largely unregulated market, such as the IPO market in London in the early 20th century, was unable to grant access to the public capital markets for growth companies. These two studies cover concise periods of time, up to 15 years. Our paper examines the entire population of IPOs in Italy since the country's unification in 1861, for a total of 879 IPOs. The novelty of our research lies in two areas: to the best of our knowledge, this is the first paper studying the survival of IPOs over such a long time horizon, and it is the first survival study of the Italian market and its regulation.

We investigate the effects of changes in regulation both on the number of firms going public each year and on their survival profiles. As regulatory changes are made in response to economic conditions (Peltzman, 1976), we compare the effects of tightening regulatory changes during periods of higher demand for investor protection to changes taking place during periods of demand for capital formation. Controlling for firm-specific and macroeconomic factors, we find a significant increase in IPO survival after tightening regulatory interventions, compared to a decrease in survival when looser regulations are introduced. These results hold in particular for smaller firms. However, the shorter survival profile of firms that go public after restrictive regulatory changes is not accompanied by an increase in the annual number of IPOs, scaled by GDP.

This paper is organized as follows. Section 2 presents the literature review and develops the testable hypotheses. Section 3 describes the evolution of the Italian regulatory framework, summarizing the key regulatory changes that occurred over the history. Section 4 presents the data, sample, and methodology. Section 5 reports the results, Section 6 the robustness checks, and Section 7 concludes the paper.

2. Literature review and testable hypotheses

One of the purposes of financial regulation is to provide more information to investors, as a remedy for information asymmetries between investors, on the one hand, and between issuers and financial intermediaries, on the other. Whenever the social and private values of information differ, indeed, firms trading off the private costs and benefits do not provide socially optimal levels of disclosure (Bushee and Leuz, 2005). By reducing these asymmetries and making information more evenly distributed, regulation can improve the market price-setting mechanisms and the public confidence in their functioning. Nevertheless, the burden of regulation may be regarded as unnecessary, as far as firms have private incentives to provide information voluntarily and markets themselves build in investor protection. In practice, stock prices reflect the known possibilities of firm failure and by pricing ex-ante that expectation. In this way, throughout history, investors are naturally “self-protected” in efficient stock markets.

Despite the fact that some degree of regulation of financial markets is universally required, there are important limits to its effectiveness. First, one-size-fits-all regulation can be costly for smaller firms (Mulherin, 2005). Second, their effectiveness depends on contextual factors. For instance, higher disclosure is useful when recipients can process the disclosed information. This fact is related to the role of financial intermediaries. Bhattacharya et al. (in press) find that the involvement of high-quality intermediaries in the public birth of a firm is associated with lower firm mortality rates. Everything else being equal, the need for regulation is lower when financial intermediaries perform better.

Therefore, regulators face difficulties in identifying the appropriate balance between protecting investors and granting opportunities to raise capital. To this extent, IPO markets offer an interesting setting for calibrating the effectiveness of financial regulation. Early studies by Stigler (1964) and Benston (1973) conclude that the 1933 and 1934 Acts were of no apparent value to investors, whereas Jarrell (1981) shows that by imposing higher registration costs for riskier securities, the SEC induced issuing firms to substitute debt for equity securities at the margin. Furthermore, changes in regulation may take place in response to general macroeconomic or societal changes. The notion of investor protection can serve as political rationale for more regulation, which could be motivated by authorities in response to crises. On the other hand, Jarrell (1984) shows that the emergence of low-cost, off-board alternatives to block trading on the NYSE was one of the main forces responsible for SEC deregulation in 1975. This background motivates our study on the impact of regulatory changes under different conditions. Precisely, we study the impact of regulatory changes when different conditions and interests are in place. According to two competing views (i.e., public interest versus special interest motives for regulation), we elaborate four hypotheses.

First, in periods of corporate scandals or financial crises, regulatory intervention could represent a way to curb and prevent the distrust that grips potential investors and undermines the efficient functioning of capital markets (Seligman, 1983). Coherently, regulatory interventions for the “public interest” are motivated by a need to correct market failures, and they are intended to protect investors and to stabilize the financial system. An example is Government Venture Capital funds (Colombo et al., in press). However, interventions cannot occur without costs, such as those of compliance. For instance, Iliev (2010) finds that the SOX Act raised fees paid