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The value of firms' voluntary commitment to improve transparency: The case of special segments on Euronext

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ABSTRACT

This paper examines whether a firm's commitment to increase transparency affects firm value and liquidity by studying firms' voluntary decision to be listed in “special segments” created by Euronext. The empirical analysis finds positive valuation effects for firms that opted into the special segments and documents positive effects on the liquidity of these firms. In contrast, when similar market regulations are imposed on all listed firms, and the segments become unavailable, I find marketwide negative valuation effects. The findings suggest that stock exchanges can provide an effective channel that improves firms' liquidity and value; however, when a regulation with similar requirements is imposed on all firms in the market, the effect is less likely to be recognized, at least in the short term.

1. Introduction

By using special segments created by Euronext, this paper examines whether a firm's voluntary commitment to increase transparency affects its stock market liquidity and value. At the beginning of 2002, Euronext launched two special segments, NextPrime and NextEconomy, to improve listed firms' transparency, thereby offering investors a broader menu of options in terms of firms' disclosure policies. To be included in either of the segments, firms had to satisfy requirements related to corporate governance, liquidity, and reporting quality, in addition to abiding by the standard listing requirements of Euronext. Joining the segments was voluntary; therefore, when a firm decided to join a segment, it committed to self-regulation to enhance its quality.

When the two segments were subsequently discontinued, firms had to follow disclosure requirements similar to all firms listed on Euronext. The discontinuation occurred following the European Union's Transparency Directive (EU TPD) (see Christensen et al., 2011, for detailed information), which mandated enhanced transparency and disclosure for all publicly traded firms in the European equity market. Consequently, this prevented firms from voluntarily distinguishing themselves by committing to high-quality standards. This event demonstrates how market responses to voluntary self-regulation and the effects of self-commitment by firms differ from similar mandatory requirements imposed as marketwide directives. I assess how the discontinuation of rules differently affects firms that adopted self-regulation and those that did not.

Unlike existing studies that focus on listing choices of firms (Bris et al., 2012; Doidge et al., 2004; Hail and Leuz, 2009; Lel and Miller, 2008), I examine the effect of firms' efforts to increase transparency, given that firms already had to satisfy the listing requirement mandated by Euronext. The timing of segment creation followed the merger of Europe's regional exchanges. By creating the two special segments, Euronext provided a cost-effective way for self-regulating firms to distinguish themselves from

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non-self-regulating firms. Creating the segments was also to Euronext's benefit because it allowed the exchange to attract firms and maintain its competitiveness by providing alternative mechanisms that provided firms an opportunity to appeal to a broader group of market participants. Another advantage of joining the segments was that firms enjoyed enhanced visibility via the introduction of two indices comprising the securities in each segment, which offered them the potential to attracting more investors.[1] Existing studies provide evidence for the positive effect of being included in the index (Chen et al., 2004; Harris and Gurel, 1986; Shleifer, 1986).

Using this institutional setting, I investigate whether there are differential effects between firms that join the segments to improve transparency and those that do not put any additional effort into signaling their quality to the market. I assess whether there were positive effects on firm value when the exchange launched the two segments. The launching of a voluntary channel through which firms can commit to improving their quality is expected to be positive news for the market. Additionally, it is likely that a firm's announcement that it is joining such a voluntary program is value-increasing news. Overall, my analysis shows that the decision to join the segments has a positive valuation effect for the firms that have committed to self-regulation. My results reveal a negative valuation effect when firms are removed from the exchange because they do not meet the requirements to stay in the segments.

I also conduct a difference-in-difference test to assess the effect of a firm's voluntary self-regulation on liquidity. Comparing firm liquidity around the time the new segments were launched, I find that the liquidity, as measured by the yearly average of bid-ask spread and the proportion of zero-return days, improves more for firms that opted into the segments versus those that did not. One concern about this methodology is that the decision to be included in either the NextPrime or NextEconomy market segments is a firm's endogenous decision. Therefore, the result may be driven by differences in firm characteristics that already exist. To mitigate the endogeneity problem, I use a propensity score matching method to form samples with similar observable characteristics. The relative differences in liquidity improvement between the two groups of the firms are valid after propensity score matching.

Furthermore, I assess the valuation effect of firms while they were in the segments using the implied cost of capital and Tobin's Q. Although there is a reduction in sample size, I find a lower cost of capital for firms that opted in and stayed in the segments compared to those that did not. Similarly, I find higher Tobin's Q for segment firms than for nonsegment firms. This result implies that the positive effect of committing to improve firm quality continued after a firm has realized the initial benefits of liquidity improvement.

Last, using the segment discontinuation event, I examine the valuation effect when self-selecting opportunities became a mandatory requirement. I find negative valuation effects both for firms that were in the segments and for those that were not. One possible reason for the negative returns is that the discontinuation removed the tools that distinguished firms that commit to improve transparency and corporate governance from those that do not. When segments existed, it was easier for investors to recognize which firms put effort into improving transparency and accounting quality by checking which were included in the segments. Additionally, the segment indices increased the visibility of segment firms, helping investors distinguish between the two types of firms. With the segment discontinuation, this tool became unavailable to investors, making it difficult to differentiate between firms that had committed to improving firm transparency and reporting quality versus those that had not. The negative valuation effect for nonsegment firms implies that these firms did not opt in presumably because the marginal costs of joining the segments exceeded the marginal benefits. Although there were potential benefits to firm value and liquidity, joining the segments was not the optimal choice for these firms.

Additional difference-in-difference tests reveal that firms that did not opt in to the segments experience worsening liquidity relative to those that did opt in. Although the regression using the matched sample lowers the magnitude, the negative effect for nonsegment firms remains valid. This implies that the effect of mandatory regulatory changes observed around the segment discontinuation was not as effective as it originally was intended to be. Considering that the financial crisis hit right after the segment discontinuation, the result also implies that low-quality firms that did not invest in improving transparency previously were affected by market conditions more severely.

My empirical findings reveal the benefits of voluntary commitment to improve firm transparency, via exchange regulations that require increased firm disclosure and corporate governance, are also observed in well-developed capital markets. Existing studies focus on firms in less developed capital markets in which investor protection is weaker and the expected benefit of increased transparency is substantial (De Carvalho and Pennacchi, 2012; Dewenter et al., 2010). In contrast, the empirical results I provide are more directly applicable to exchanges in well-developed, more integrated financial markets, and potentially provide policy implications for effects of imposing regulations to improve transparency.

My study provides new insight into which types of regulations are more likely to produce the desired results. I take advantage of the segments Euronext offered, which has a starting point and a period when a policy once voluntary became mandatory. My findings suggest that stock exchanges can provide an effective channel that improves firms' liquidity and value; however, when a regulation with similar requirements is imposed on all firms in the market, the effect is less likely to be recognized, at least in the short term. Additionally, my results suggest that the intended outcome of marketwide regulation is not necessarily realized. This finding is consistent with Bushee and Leuz (2005), who document that once the Securities and Exchange Commission (SEC) applied stricter disclosure requirements to all over-the-counter (OTC) firms, there was a substantial negative effect in firm value and liquidity for the firms that did not voluntarily comply with SEC rules previously.

[1] According to *Euronext Annual Report 2002* (2002, p. 40): "The segment indices are capitalization indices, in which the weighting of each constituent is based on its total capitalization, subject to a 10% ceiling. Companies included in the Euronext100 index are excluded so that the indices reflect movements specific to the segments as precisely as possible."