

THE IRISH STOCK EXCHANGE AND REGULATORY CHANGE

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Introduction

The Irish Stock Exchange separated from the International Stock Exchange of the United Kingdom and the Republic of Ireland Ltd in 1995, when the Central Bank of Ireland became the 'Competent Authority' for regulation of the Exchange and its member firms. This paper investigates the implications of separation. The regulatory structure prior to separation is examined within the context of the Irish market. The new regulatory regime and its likely impact on investors and quoted companies is assessed through the medium of interview-based research. It is concluded that, owing to continuing association between the two exchanges, separation will have minimal impact on the then listed Irish companies. Whether large Irish companies of the future seek their primary listing in London as they strive to become world players is very likely to depend on the loyalty of the Irish domestic institutions to such companies.

Regulatory Structure

The International Stock Exchange of the United Kingdom and the Republic of Ireland Ltd was formed in 1973 following the merger of the UK regional exchanges and the Irish Exchange, based in Dublin, with the London Stock Exchange. The link between Dublin and London ended in 1995 when, following implementation of the *Investment Services Directive* (Council of the European Communities 1993), Ireland appointed a 'Competent Authority'¹ – the Central Bank of Ireland² – to regulate the Irish Stock Exchange and its member firms. The objective of this paper is to investigate the likely impact of separation from London on the Irish market, Irish stockbroking firms and, ultimately, the Irish Stock Exchange. In 1994, interviews were conducted with the Irish Exchange, stockbroking firms in Dublin, Irish corporate financiers, and several UK institutional investors. The views of Irish institutional investors were expressed by the Irish Association of Investment Managers (IAIM). In addition, finance directors from two of Ireland's largest quoted companies were asked for their opinion on both the link with London and the impending separation. The purpose of the interviews was, in the first instance, to discuss the structure of the Irish market and the financing of Irish companies. The perception of the business community regarding the links between the Irish and London exchanges was investigated, along with opinions on how the new regulatory structure will serve the needs of the Irish market.

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Prior to 1973, the Irish Stock Exchange, based in Dublin, was one of the regional exchanges of the then London Stock Exchange. In 1973, when all the regional exchanges were absorbed into the London operation, Dublin retained some independence. Whilst remaining an integral part of the International Stock Exchange of the United Kingdom and the Republic of Ireland Ltd, the Irish Exchange retained its ability to list securities and to trade in them. Securities could, therefore, be quoted in either or both London and Dublin. Most Irish companies were dual-listed on both the Irish and the London exchanges. Companies which chose to list in Ireland only, so called 'Dublin-listed' companies usually had no market in their stock. Most Irish stockbrokers advised companies to choose a dual-listing as the additional costs were marginal. The regulatory structure governing the Irish Stock Exchange until 1995 dated back to 1988 when, as a result of the UK's *Financial Services Act 1986*, regulation of UK financial services changed radically (Wedgwood *et al* 1986; Whittaker and Morse 1987). The basic principle underlying the Act was self-regulation. It gave overall responsibility for the financial system to the UK Secretary of State for Trade and Industry who, in turn, delegates many powers to the Securities and Investment Board. One of the main functions of the Securities and Investment Board is to authorise others to carry on investment business, either directly, or through one of four self-regulatory organisations, of which the Securities and Futures Authority is one. The Securities and Futures Authority assumed responsibility for regulating stockbroking firms from the International Exchange, and the Exchange was left with responsibility for regulating market operations. However, the Authority had no statutory backing in Ireland. Irish stockbrokers and the Irish Exchange were regulated by the Securities and Futures Authority, whilst Irish market operations were regulated by the Irish Stock Exchange.

Harmonisation of European capital markets caused this regulatory structure to change. The *Single European Act 1986* sanctioned the development of a single European market in goods and services, including a common regulatory framework for financial services. From 1995 it has been possible for anyone to engage in investment business in any member state of the European Union without having to establish a local branch, as long as they are regulated to do so in any one of the member states ('mutual recognition'). The European Union Investment Services Directive required Ireland to appoint a 'Competent Authority' to directly regulate stockbroking firms. Irish legislation was developed in 1994 which provides for the regulation of both the Irish Stock Exchange and its member firms by the Central Bank of Ireland. The *Stock Exchange Act 1995* provided the legislative framework in which the Irish Exchange operates following separation from the International Exchange. The Bill provides for 'structural regulation', i.e. the determination of which firms/individuals engage in which activities (Kay and Vickers 1988). Under the Bill, a stock exchange must obtain approval from the Central Bank before it can operate in Ireland. Also, firms based in Ireland which wish to become members of an approved stock exchange must obtain authorisation from the Central Bank to operate as stock exchange member firms. Firms authorised in other European

Union member states will, under the relevant terms of the Investment Services Directive, have the right to provide services in Ireland, and authorised Irish firms will have the right to operate in other member states under similar terms.

Regulation of behaviour, also called 'conduct regulation', refers to measures concerned with how firms behave in their chosen activity or activities. The Bill provides that the Central Bank may rely on the Irish Stock Exchange to carry out some day-to-day regulation of the market and stockbrokers' conduct of business. The Bill involves a more publicly transparent system of regulation within the Exchange itself, which becomes more open in enforcing its own disciplinary procedures. Material breaches of Stock Exchange rules, although investigated by the Exchange in the first instance, will be cause for revocation of authorisation. The Central Bank can also appoint, or ask the High Court to appoint, inspectors to investigate breaches of conditions. The reports may be published by the Irish Ministers for Finance and Enterprise and Employment. Transparency is also increased by the requirement that the Exchange appoints a board of directors which is 'broadly based'.

The London-based Takeover Panel, which is acknowledged by the British courts although it has no statutory backing, ceased involvement with the Irish Exchange post-separation. Following the Irish Distilleries takeover by Pernod in 1988, members of the Irish business community, including politicians, felt strongly that it was inappropriate for an English body to make a ruling on the takeover of an Irish company. A working party, set up by the Irish Stock Exchange, which included representatives from the member firms, recommended an Irish panel, the structure of which is based on the London panel. The Irish Stock Exchange's regime of rules is modelled on the UK rules and differs from them only where the different market system in Ireland requires it.³ In addition, the Securities and Futures Authority continues to provide a surveillance support service to the Irish Exchange.

The Irish Stock Exchange

Companies quoted on the Irish Stock Exchange are not a representative sample of companies quoted on the International Exchange. Multinationals play a dominant role in the Irish economy. Foreign investment, concentrated mainly in highly skilled and technologically demanding sectors, for example, pharmaceuticals and instruments, has been encouraged since the 1960s through the use of grants and tax concessions. Indigenous industry tends to succeed, that is, grow large enough to seek a flotation, in activities not exposed to foreign competition, for example, food processing. Small and medium-sized companies have not shown the capacity to grow into large-sized firms. Reasons put forward for this non-occurrence include labour costs in Ireland and the strong position of larger and longer-established foreign competitors. The number of quoted companies in each market is given in Table 1.

Table 1: Number of Quoted Companies on Each Market

<i>At 31 December</i>	1989	1990	1991	1992	1993	1994
<i>Official List</i>	63	59	60	61	62	66
<i>Unlisted Securities Market</i>	26	25	20	18	13	9
<i>Exploration Securities Market</i>	13	13	13	13	13	14
<i>Smaller Companies Market</i>	8	6	6	4	3	3
<i>Total</i>	110	103	99	96	91	92

Note: Prior to 1991, the Exploration Securities Market was called the 'Third Market'

Source: *International Stock Exchange of the United Kingdom and the Republic of Ireland Ltd (1994)*.

The number of new flotations each year is very low. There were no entries to the market in 1992 or 1993. Three companies floated in 1994, two of which entered the official list and one the Exploration Securities Market, the market for companies operating in the oil and gas exploration sector. Several withdrew from the official list finding the requirements of a listing too onerous to meet. Most small and medium-sized companies tend to rely on bank financing. Conversion of the three smallest markets into one market, suitable for small and medium-sized companies, is currently under review by the Irish Stock Exchange. A two-tiered capital market structure is in line with European Union policy relating to harmonisation of capital markets.

Raising finance for large companies has changed over the past 15 years. During the era of exchange controls (1979–89), Irish equities were overvalued on account of high relative returns on domestic securities. Upon termination of exchange controls in 1989, Irish institutions diversified their portfolios with a higher proportion of overseas investments and, whilst earnings rose in the period after 1989, the market prices of Irish equities fell. In 1992 Irish stockbrokers sought investment in the USA and Europe (outside of the British Isles). At present, international investors represent approximately 40% of the investment in the Irish market. The problem of the decline in institutional cash available for investment was exacerbated by the introduction of special favourably-taxed saving accounts in 1993. This significantly increased the attractiveness of deposit accounts compared to equities for the private investor.

Prior to separation, most companies quoted on the Irish Exchange had a dual-listing, that is a primary listing on both the Irish and the London Exchanges. Companies with a Dublin-only listing had low market capitalisations and there was little trading in their shares. In addition, dual-listed Irish stocks were classified as UK 'domestic'

stocks.⁴ A ‘special association agreement’ was reached by the two exchanges in 1994. Companies which had a dual primary listing on both the London and Irish exchanges continued to be dual-listed after separation, and retained their ‘domestic’ classification. However, Irish PLCs of the future would have to choose one of the two markets for their primary listing.

Research Interviews

Interviews were conducted in late 1994 in order to establish the views of the Irish business community on the Irish market, the regulatory structure prior to 1995, and the separation of the Irish Exchange from the International Exchange.

The Irish Market

Stockbrokers interviewed agreed that raising finance for small and medium-sized companies is extremely difficult owing to a ‘finance gap’.⁵ According to Patrick Plunkett (1994) of Riada Stockbrokers Ltd, since fund management margins are smaller in Ireland than in the United Kingdom, Irish domestic institutions are not as supportive of small and medium-sized companies. Share issues which arise with the large Irish companies appear sufficient to satisfy Irish institutional investors. The reintroduction of exchange controls in order to encourage investment in Irish equities would be in conflict with moves towards European harmonisation. However, all interviewees agreed that, in the past, these led to inefficiencies, with some unprofitable companies being supported. The low number of flotations is a matter for concern. The Irish Exchange hopes to obtain tax concessions to aid the development of the secondary market, but recognises that despite harmonisation of European markets, there will not be large numbers of companies listing in Ireland (Abrahamson 1994).

Link with London

Most of the stockbrokers were in agreement about the importance of the link with London to the development of the Irish market over the past 22 years. The London Exchange is a highly respected exchange abroad and most brokers agreed that the link has helped to market Irish stocks in the past. All those interviewed stated that if they had a choice they would not have opted for separation, but emphasised the fact that they had already established themselves abroad and were well placed to go it alone. As one stockbroker commented: “It is important when we are selling Ireland abroad ... but on the day of the split, business will continue as normal”. (Jones 1994) All stockbrokers interviewed were confident that they had already built relationships with foreign investors. In their view, the primary concerns of the investor are the quality of the stock, liquidity and ease of settlement and as investors now had confidence in the administrative organisation, the separation would have minimal effect. However, it was deemed crucial to have reporting standards at least matching those of the London Exchange, owing to

the importance of investors' perceptions of the regulatory environment.

The selling of Irish shares by Irish pension funds during the early 1990s, coupled with the impending separation from London, did worry Irish companies (McGrath 1993). Several of the large companies threatened to remove their domicile to the London Exchange in the event of not being able to raise capital in Ireland. At the start, companies were undoubtedly unhappy about the prospect of separation. This view was reinforced during talks with directors from two of the top five Irish companies, one of whom said that he initially regarded separation as a 'heinous problem'.

The IAIM considered that continuing links with London were important for helping to make Irish stocks look attractive. However, Irish investors hold the opinion that regulation of the Irish stockbroking firms was inadequate prior to separation of the exchanges. In the past few years there were a number of financial scandals which led investors to voice their preference for tailor-made rules to suit the Irish market. For example, the 1993 sale of Greencore PLC shares that resulted in the London Exchange investigation into the conduct of one of the Irish stockbroking firms: "There is always a danger that, with the best will in the world, overseas regulators will be so caught up with domestic affairs that their responsibility for other markets takes second place." (Fitzgerald 1994)

Special Association Agreement

The concession that dual-listed Irish companies at the date of separation retained a dual primary listing post-separation was recognised as crucial by the Irish Stock Exchange in helping to allay disquiet amongst investors and quoted companies. However, the importance of this agreement would, according to the Irish Exchange, diminish over time as it establishes a reputation abroad. The Exchange did not believe that it would be more difficult to market Irish shares in the future since: "One of the key points in achieving the listing agreement has been to satisfy London that the standards will be the same, and international investors will find significant comfort in this." (McHugh 1994)

The continuation of a dual primary listing for Irish PLCs was considered fundamental by stockbrokers. Despite this view, it was considered unlikely by some Irish stockbrokers that Irish companies would choose to have their primary listing in London in the absence of this agreement, or that new public companies would, in the future, opt for a primary listing in London and a secondary listing in Dublin. In their opinion, companies appreciate the loyalty of domestic institutions in a bear market and this would affect their choice of primary listing. Abbey PLC, a UK-based company was cited to highlight this point. All its operations are in the United Kingdom, but it is registered in Ireland and the majority of its investors are Irish. However, a few members of the stockbroking committee did comment on their concern that new Irish PLCs would choose London for their primary listing, given the increasingly diversified portfolios of Irish domestic institutions.

Irish investors would not have been satisfied with a secondary listing in London, according to Anne Fitzgerald of the IAIM. Close links between the two exchanges indicated that separation would have minimal impact on listed companies and would aid the future liquidity of companies' shares. A good institutional following in the United Kingdom was deemed critical by Irish corporate financiers interviewed, and they viewed the primary listing as 'of most benefit' to a company seeking to gain access to London capital markets.

Several Irish stockbrokers interviewed viewed the classification of Irish stocks as 'domestic' to be an advantage, whereas others were of the opinion that classification would make no difference to the marketability of Irish stock. According to Kevin McHugh of the Irish Stock Exchange, there are advantages and disadvantages. Irish stock classified as 'foreign' will be dealt with on a specific page within *Stock Exchange Automated Quotation International*, and aimed at a different set of investors from 'domestic' stocks. This opinion was reinforced during interviews with UK fund managers. Over the past ten years the trend in UK finance houses has been to include Ireland alongside other European countries rather than as part of the UK. In addition, the Irish market has been included in the Morgan Stanley Capital Index since 1 May 1993. Classification of Irish stocks was the subject of some debate at one of the Scottish finance houses in 1993. The view was taken that it is illogical to treat Ireland as part of the UK desk, where stocks are classified according to sector, and Irish stocks were moved to the European desk. The UK investment managers interviewed are of the opinion that Ireland is worth looking at in its own right and that the 'domestic' classification is not important. It may be beneficial for Irish stocks to be dealt with by European fund managers who are used to hedging, particularly where matching of assets and liabilities is not occurring. In effect, separation would make no difference to Irish stocks which were included within a European desk. However, according to a UK investment manager interviewed, if Irish stocks were included within the UK desk, separation would not be viewed in a positive light. The reason given was that 'the notion that they [Irish stocks] were part of the same exchange offered comfort'.

Future Regulatory Structure

The stockbrokers interviewed voiced satisfaction with the choice of the Central Bank as regulator. The primary concern of the IAIM was the extent to which the Central Bank would delegate its functions. The Irish Minister for Finance, responsible for introducing the *Stock Exchange Bill 1994* adopted the Association's recommendation that the Central Bank should carry out an annual audit of the Stock Exchange and its delegated functions. The only substantial criticisms levelled at the Bill are its failure to reform the law on insider dealing, and a failure to institute compensatory mechanisms of a statutory nature (Dail debate on Stock Exchange Bill, 1994, second stage, 13 October 1994). Both of these topics are currently under consideration. Insider dealing falls within the purview of a committee on company law reform, set up in 1994 by the Irish Department of

Enterprise and Employment. Compensation will be dealt with, but probably not before a European Council directive on the matter, and possibly during the implementation of the Investment Services directive to investment intermediaries.

The Future for the Irish Market

According to the majority of stockbrokers interviewed, other exchanges in Europe would be unlikely to replace the historical link. The strong trading link between Ireland and Britain, the common language and time zone, and the similar legal systems were considered important in securing future associations. Irish brokers stressed that there is limited interest on mainland Europe in Irish equities. London and the USA are the preferred options. However, in the opinion of one broker, a European NASDAQ⁶ could become a suitable market in the future for a small company if Irish institutions continue to diversify out of Irish stocks.

There was confidence in the business community that overseas investors, viewed in the past as transitory, were long-term investors who would not be affected by separation. The main concerns of the company directors interviewed were to ensure a high standard of regulation and ease of settlement. Problems with settlement or financial scandals would be detrimental to the reputation of the Irish Exchange. The Irish Exchange is at present investigating the possibility of implementing the proposed London-based system *Crest* in Ireland.

Takeovers

Statutory backing for an Irish Takeover Panel was considered essential by all members of the business community interviewed. In the opinion of Irish stockbrokers, an international company, which would have taken care not to annoy the UK authorities in the event of a takeover of an Irish company, may not show the same concern for the Irish authorities. It was strongly believed that the Irish Exchange is too small to operate a voluntary code. All interviewees were of the opinion that an Irish panel is preferable, but stressed the practical difficulty of obtaining a truly independent panel, given the size of the market.

Conclusion

A major concern for the Irish Stock Exchange is the low numbers of flotations. Restructuring to provide a secondary market for small and medium-sized companies is, consequently, one of its aims. The link with London was viewed by all interviewees as beneficial to the development of the Irish market. Nevertheless, during the interviews, it emerged that Irish investors, despite holding a high regard for the International Exchange, would prefer the Irish market to be regulated by an Irish body. Separation was not viewed optimistically when first announced, but the continuing links between the two exchanges, coupled with the 'Special Association Agreement' reached in 1994,

appeared to satisfy Irish investors, Irish companies and Irish stockbrokers. A few stockbrokers expressed concern regarding Irish PLCs of the future and their choice of market. A factor which will determine where they choose to seek a listing will be the loyalty of Irish domestic institutions to such companies.

Notes

1. The *Investment Services Directive* requires Irish stockbroking firms to be regulated by a national 'Competent Authority'. It does not require the London and Irish exchanges to separate; in theory, two supervisors from different member states could supervise a transnational institution. However, avoidance of ambiguity about supervisory responsibilities was seen as necessary by all parties concerned from the start.
2. The Central Bank of Ireland, established in 1943, has primary responsibility for monetary policy. Other functions include financial market and banking operations, and prudential and supervisory responsibilities in relation to financial institutions.
3. The Irish market is order-driven, based on broker-to-broker dealing or matching of client orders by one broker, i.e. Irish stockbrokers act as agents only. The UK market, on the other hand, is quote-driven or price-driven with market-makers acting as price setters and central wholesalers, and brokers acting as agents between market-makers and clients.
4. The treatment of Irish companies, in terms of market structure, as domestic UK stocks is an historic anomaly, going back to the merger of the exchanges in 1973 when the status of an Official List had no statutory implications. It survived the new statutory structure for Listings in 1984 because it was regarded as reasonable to treat Irish and UK stocks as domestic, for market structure purposes, in the context of a single unified exchange. This could have been challenged by a company from any other European Union state as discriminatory on the basis of nationality (Healy 1993).
5. For a discussion on the ability of the small firm to raise long-term finance in the United Kingdom, see Hutchinson *et al* (1988).
6. National Association of Securities Dealers Automated Quotation (NASDAQ) is a US computer network of dealers.

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