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Firm size and the impact of securities regulation ☆

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ABSTRACT

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Using a newly-assembled dataset of 45,220 firms across 46 countries spanning the years 1996–2007, we find incongruent effects of regulation across firm size. We find that public enforcement facilitates small firm security issuance, while private enforcement benefits large firms more than small firms. However, once small firms access equity markets, private enforcement enhances the amount of equity capital raised in domestic markets. Stronger public enforcement gives rise to larger firms raising capital internationally. Comprehensively, results suggest that public (private) enforcement is more (less) consequential to firm-level access to capital than previously believed. *Journal of Comparative Economics* **xxx** (xx) (2014) xxx–xxx. York University – Schulich School of Business, 4700 Keele Street, Toronto, Ontario M3J 1P3, Canada; Florida State University, 821 Academic Way, 143 RBB, Tallahassee, FL 32306, USA; Redfin Corporation, 2001 S Street, N.W., Washington, DC 20009, USA.

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1. Introduction

Recent research examines the role of enforcement institutions based on macroeconomic measures of access to equity capital utilizing aggregated country-level cross-sectional regressions with up to 50 observations averaged from 1996–2000 (La Porta et al., 2006) and in 2005 (Jackson and Roe, 2009). This paper makes the case for microanalysis of the role of securities laws in promoting access to capital based on one of the most salient differences between small and large publicly listed firms: their financing behavior. We examine a dataset of 45,220 firms across 46 countries spanning from 1996–2007 to be consistent with La Porta et al. (2006) and Jackson and Roe (2009). Both because of differences in equity trading costs (Chang et al., 2006; Hennessy and Whited, 2007) and capital structure preferences (Frank and Goyal,

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2003, 2008; Leary and Roberts, 2010), public and private enforcement of securities laws have disparate effects on a firm's access to capital based on size. We identify this size difference in financing patterns for our data and argue that firm heterogeneity is an important inclusion in determining whether regulation has disparate effects on securities issuers.

We present evidence consistent with the view that aggregate indicators of stock market size do not fully account for the impact of securities laws on access to capital at the microeconomic level, because they fail to successfully account for differences in financing behavior between small and large firms. First, we show that securities laws have a disparate effect on equity access based on firm size. Our results, which survive a battery of robustness tests, indicate that public enforcement allows for enhanced small firm access to capital while being (marginally) negatively associated with large firm access to capital. A separate analysis on international capital raising suggests that large firms react to greater public regulatory requirements by raising capital internationally. This finding supports the contentions of Piotroski and Srinivasan (2008), as well as Stulz (2009), who finds that an increase in the cost of securities laws, which are higher in countries like the U.S., which has strict securities laws, can be prohibitive and can "lead some U.S. firms to go public abroad instead of going public in the United States." It is also consistent with the media's suggestion that American stock exchanges, such as the New York Stock Exchange, became less attractive after the passage of regulation, which increased the costs of adherence to said regulation (see e.g., Doidge et al., 2009). Second, we show that laws regulating private enforcement (i.e., disclosure and liability standards) are not as universally beneficial to equity access as previously asserted. Disclosure benefits large firm access to capital more than small firm access to capital, perhaps because disclosure laws are disproportionately expensive for small firms. This finding is consistent with those of Wintoki (2007), for example, who finds that one of the most recent regulatory enhancements, the Sarbanes–Oxley Act, negatively impacts small firms relative to large firms.[1] Burden of proof is likewise preferentially beneficial to large firms. In fact, our results suggest that this liability standard is actually marginally negatively related to small firm access to capital. Third, we find results consistent with the suggestion that private enforcement of securities laws positively influence the amount of equity capital issued by small firms once they access equity markets. Collectively, our results underscore the significance of legal rules governing *both* public and private enforcement in determining access to capital at the firm level and provide an explanation as to why LLS (2006) found that public enforcement was inconsequential to financial development.

Our work is inspired by research exploring the role of financial laws in increasing a firm's ability to finance its growth through external capital. An early utilization of firm-level panel data in the law and finance literature is found in Demirgüç-Kunt and Maksimovic (1998). In countries with well-developed legal systems and active stock markets, firms grow at higher rates than achievable if these firms had financed growth with internal funds and short-term financing alone. Stock market size was not found to be correlated with access to capital in this study, a finding that highlights the distinction between macro (e.g., capital market size) and micro (e.g., capital market access) indicators of stock market development. Rajan and Zingales (1998) find that "industrial sectors that are relatively more in need of external finance develop disproportionately faster in countries with more developed financial markets." Rajan et al. (2001) show that countries with more efficient judicial systems have larger firms and that those larger firms tend to operate in capital-intensive industries. Laeven and Woodruff (2007) focus on Mexican firms, which share the same national commercial laws; although, they are exposed to legal environments with varying degrees of efficiency and enforcement at the state level. States with better legal enforcement are found to have larger firms. Beck et al. (2005a,2005b) dissect data from the World Business Environment Survey (WBES), in which managers are asked about financing obstacles in meeting collateral requirements, bureaucratic paperwork, and acquiring long-term loans. They conclude that firms in common law countries are better able to garner external finance than those in civil law countries, pointing to the relevance of legal structure to capital access.

This paper provides, for the first time, a firm-level analysis of the relationship between securities regulation and securities issuance. Our analyses build on, and are most similar to, prior work (La Porta et al., 2006, hereafter LLS; and Jackson and Roe, 2009, hereafter JR) examining public versus private enforcement of securities laws that have made use of country-level aggregated data with 49 observations (one observation for 49 countries) and other complementary analyses of securities laws and market outcomes (Cumming and Johan, 2008; Armour et al., 2009a, 2009b; Stulz, 2009; Zingales, 2009; Ball, 2009; Frost et al., 2006; Mahoney, 2009; Cumming et al., 2011). This paper examines 45,220 firms across 46 countries from 1996–2007 (approximately 200,000 firm-years) to explore the possibility that differences in securities laws and enforcement have differential effects on security issuance, depending on firm size. Our data, when aggregated at the country level, are completely consistent with both LLS (2006) and JR (2009). We add to the literature by exploring the disaggregated data to understand the differential impact of securities regulation, depending on firm size in different parts of the world.

The rest of the paper is organized as follows: the next section provides the motivation for firm-level analysis and discusses our economic approach to estimating access to finance. The subsequent section describes the data. Results and robustness are presented in the section after that. Concluding results follow, in the final section.

[1] See also, for example, Klapper et al. (2006), which shows that regulation can impede small firm (i.e., entrepreneurial) entry and their ability to grow, even in industries where this should not be the case.

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