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English Lesson: Uncertain AIM: A Hot Market In London Has Its Risks, Too --- Exchange's Light Regulation Attracts Small Companies But Some Shares Do Badly --- Keeping Eye on the 'Nomads'

By Carrick Mollenkamp and Alistair MacDonald in London and Ann Davis in Houston

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AIM, the London Stock Exchange's market for up-and-coming companies, has exploded in popularity during 2006. More than 200 companies have raised nearly $17 billion this year in initial stock offerings, according to AIM, fueling talk that London is catching up with New York as the world's premier financial center.

But some investors aren't enjoying the boom. So far this year the FTSE AIM Index of all shares on the exchange is slightly down, compared with a 16% rise in the Russell 2000, the U.S. index for small-company stocks. Of the 20 largest companies that have gone public on AIM since the start of this year, half are trading below their offering price, according to data provider Dealogic. Recently AIM companies have delivered a string of profit warnings.

AIM has grown big by offering companies laissez-faire regulation and less paperwork than New York exchanges. Those features make it treacherous for investors, say some pros. "A lot of businesses that have come to market in the last couple of years have been intrinsically dangerous businesses," says Bill Barker, who manages a small-companies fund at Threadneedle Investments, a London unit of Ameriprise Financial Inc. "Unless you manage to do an awful lot of work, you are at great risk buying some of these stocks."

Mr. Barker and others fear that AIM (originally called the Alternative Investment Market) isn't equipped to properly vet the flood of new companies. AIM says that more than half of its 1,600 companies joined the market since the beginning of 2005. This year, AIM has more new entrants than the New York Stock Exchange and Nasdaq combined, according to Dealogic.

The debate over AIM has implications for how the U.S. regulates its markets -- and whether New York should be more like London.

In the U.S., the Securities and Exchange Commission reviews the prospectuses filed by companies seeking to list on the NYSE and Nasdaq. The SEC tries to ensure the documents contain clear language about investment risks. Britain's Financial Services Agency does the same for companies listing on the London Stock Exchange.

AIM companies don't get any such regulatory vetting. That job belongs to private "nominated advisers," or "nomads." Typically, a division of a stock brokerage performs the nomad function and scrutinizes the documents of a company that wants to join AIM. If the nomad approves, a separate part of the same brokerage often pitches the shares of the newly offered company to investors -- a recipe, say critics, for conflicts of interest.

Martin Graham, who oversees AIM at the London Stock Exchange, says AIM is tightening some controls over nomads but he credits the hands-off approach for the "huge success" of the market. "There is no way in a million years we will move to an insane regulatory system like Sarbanes-Oxley," he says, referring to the post-Enron U.S. law that toughened reporting requirements for listed companies. Mr. Graham says brokerages must have a wall between their nomads and their share-marketing units.

AIM is one example of London's growth as a financial center. London's hedge-fund industry rivals that of Greenwich, Conn., the U.S. hedge-fund capital. Many of Wall Street's biggest banks have offices in London that are second in size only to their New York headquarters. Nasdaq Stock Market Inc. is trying to buy the London Stock Exchange, AIM's parent, for $5.3 billion. Yesterday, the LSE formally rejected Nasdaq's latest offer.

Treasury Secretary Henry Paulson recently called for lightening U.S. regulations to ensure New York remains competitive with London. The blue-ribbon Committee on Capital Markets Regulation warned in a report last month that "the United States is losing its leading competitive position." It noted that the U.K. has been "relentless in stressing its regulatory advantage and indicating its commitment to maintaining a 'light-touch' in regulation." The committee suggested loosening a much-criticized section of Sarbanes-Oxley that requires companies to assess their internal controls against financial fraud or mistakes.

On marketing tours, London Stock Exchange officials stress AIM's loose disclosure requirements. Anne Moulier, a marketing executive with the exchange, visited Houston this October and spoke to about 150 people over breakfast at the Houstonian Hotel, Club & Spa. "AIM is the most successful growth market in the world," she told the attendees, many of them oil and gas executives. It's also "by far the least bureaucratic," she said. "A company can put in place governance that is right . . . the best regime for your company."

Joseph P. Lahey, a Houston consultant, helps introduce U.S. companies to AIM. "Doing a transaction here in the U.S. is tough," he says. "It's the cost, number one. Number two, it's the potential of stepping into Sarbanes-Oxley and the additional cost it puts on a young company. It sort of impedes growth."

One of his clients, OPE Inc., is a 12-year-old company that specializes in offshore pipeline technology. Gary Quenan, OPE's president, says AIM is attractive because "they will work with smaller companies," although he recently decided to list on another market that is popular among small energy companies, the Toronto Stock Exchange. On AIM, 90% of the companies have a market value of less than GBP 100 million (about $197 million).

Some executives at small U.S. companies say the U.S. lacks a market like AIM that can attract big institutional investors while offering light regulation friendly to small companies. Nasdaq typically takes larger companies. The U.S. has several forums for small stocks that are popular with fast-trading hedge funds but are often avoided by institutional investors with a long-term focus. AIM benefits from the imprimatur and resources of the London Stock Exchange.

To trade on AIM, companies pay an annual fee of $7,595, plus typical annual fees of roughly $40,000 to $100,000 to their nomad. The annual cost of listing on the New York Stock Exchange ranges from $38,000 to $500,000, while Nasdaq charges between $21,225 and $75,000.

About 90 nomads operate in London. They are typically divisions of small brokerage firms, not the big U.S. and European banks that otherwise dominate finance in the city. The nomad is supposed to analyze a company's management, growth prospects and financial controls, then determine whether it is suitable for AIM.

If the company joins AIM, the nomad stays on. Its function at this stage has no direct analogy in U.S. markets: It is an investor-relations consultant, advising how to handle announcements of news, and also a regulator of sorts, making sure the company is fulfilling its duties to shareholders. A small electronic stock-quote forum in the U.S., the Pink Sheets LLC, is planning to copy parts of the nomad concept next year and give companies the chance to work with a "designated adviser for disclosure," or DAD.

AIM officials argue that nomads take their responsibilities seriously because their own reputation is at stake. The exchange also has a regulatory team of 14 people that vets nomads and monitors unusual share-price movements. It refers any disciplinary matters to an external committee that includes nomads, brokers, accountants and lawyers. The size of the regulatory team has almost doubled since the start of 2005.

AIM is finalizing a new rulebook for nomads that toughens some standards. The book clarifies that it is imperative for a nomad to contact the London exchange if it is concerned about the appropriateness of a company trading on AIM.

Nomads can't bring sanctions against a client company. Their main weapon is a threat to resign. If a company loses its nomad, trading in its shares is suspended until another nomad is found.

A company can also dismiss its nomad without shareholder approval if it dislikes the advice it is getting, a setup that some call problematic. "There is a desperate need on AIM for nomads to get tougher, but there is a considerable reluctance from some nomads to get sacked and lose large fees," says Patrick Evershed, the manager of a fund that invests in small companies at New Star Asset Management, a London-based money manager.

Another challenge facing nomads is keeping up with the huge flow of companies seeking to go public. As AIM booms, "some of the nomads' resources have been stretched," says Andy Crossley, a small-company fund manager at investment house Amvescap PLC and a member of an AIM advisory group. He believes some nomads "may have cut corners."

Smaller nomads lack a presence outside London, making it tough for them to check on AIM's increasingly international roster of companies. Of the 1,600 companies that list on AIM, 283 are based outside the U.K., including 41 in China and 51 in the U.S.

"No nomad can be expected to have the resources to man local offices in each foreign territory," says Andrew Wordsworth, a partner at ***gpw***, a London corporate investigative firm that has worked with London Stock Exchange investors. "Add to that the difference in culture, language, and politics and you can understand why conducting adequate due diligence presents problems for investors."

Several companies brought to market by one of the largest broker-nomads, Evolution Group PLC and its Evolution Securities unit, have delivered unpleasant surprises for investors over the past 18 months.

Last year, shares in an Evolution client, Regal Petroleum PLC, plummeted by 60% after the London-based company said a Greek oil field it was exploring wasn't commercially viable. The announcement came one month after Evolution underwrote the sale of 11.5 million Regal shares priced at GBP 3.90 ($7.68). The announcement helped push Regal's share price down to GBP 1.07. It has since recovered to GBP 1.635.

In May, another Evolution client, Prosperity Minerals Holdings Ltd., a Chinese cement maker and iron-ore trader, went public on AIM, raising $200 million. In September, the company said a typhoon swamped one of its cement plants and a glut of steel was hurting iron-ore prices, causing a downturn in its financial results. Its stock price fell about 18%. Evolution's own share price has suffered and the firm has said investor appetite for new AIM stocks has been limited.

Evolution says the disappointments shouldn't overshadow the slew of successful IPOs it has produced for clients. "We think the quality of what we do is right," says Andrew Umbers, the chief executive of Evolution Securities. He says Evolution is trying harder to verify companies' growth prospects.

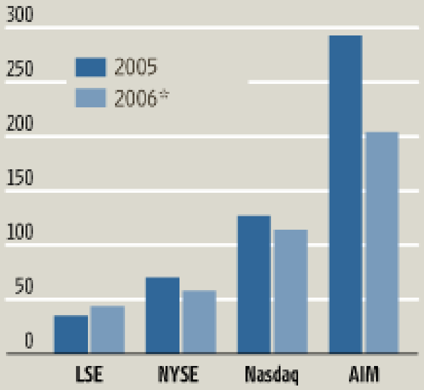
Some AIM companies are looking to move to the LSE's main market so they can continue to appeal to big investors. One is Imperial Energy Corp., a London-based oil and gas firm with assets in Russia. Chairman Peter Levine says institutional shareholders pushed for the change.

"They feel that AIM is a bit tainted at the moment within the oil and gas sector," he says. Oil and gas companies have flocked to AIM to raise money amid high investor interest in the energy industry. But some shares have suffered recently from falling oil prices. The Ernst & Young AIM oil and gas index is down 7% so far this year.

Worried by such perceptions, the LSE may be preparing further steps to restore confidence in the market. One person familiar with the matter says the LSE is investigating infringements of AIM rules by some nomads, including possible cases where they failed to push their clients to disclose significant information to the public. This person says the LSE may take action in the new year, which may include fines, public censures or stripping some nomads of their licenses.

Taking Stock

The AIM market has been a popular place for new companies. Number of initial public offerings, by market:

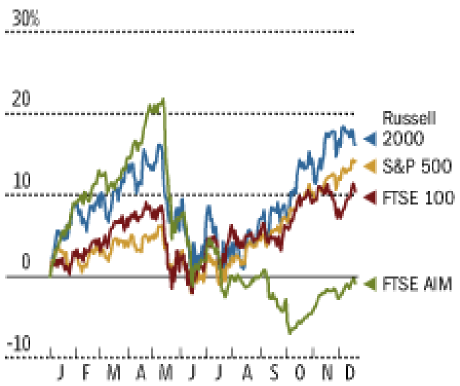


Source: Dealogic

*As of Nov. 30

Performance Review

Shares of AIM companies have fared poorly this year relative to other indices. Year-to-date performance:



Source: Reuters via WSJ Market Data Group