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DISCUSSION PAPERS

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Prototypes of Securities Regulation For Africa: Key Issues

Philip A. Wellons

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For information contact:
CAER II Project Office
Harvard Institute for International Development
14 Story Street
Cambridge, MA 02138 USA
Tel: (617) 495-9776; Fax: (617) 495-0527
Email: caer@hiid.harvard.edu

PROTOTYPES OF SECURITIES REGULATION FOR AFRICA:

KEY ISSUES

Submitted to the U.S. Agency for International Development

by

Philip A. Wellons
Program on International Financial Systems
Harvard Law School

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TABLE OF CONTENTS

CHAPTER 1. INTRODUCTION AND OVERVIEW

INTRODUCTION

USAID gives substantial assistance to countries in Africa, and worldwide, to develop their securities markets. A significant part of this assistance concerns laws and regulations that govern the issuance of securities and their trading, particularly on stock exchanges. A perennial problem for this assistance is to identify the kind of laws that are most effective for securities markets in Africa. USAID and other donors continue to encounter this very basic question in many African countries. The laws of other countries, with more developed markets, serve as models—positive or negative—for emerging markets.

This study identifies the major elements of law governing securities markets and the players in the markets, including stock exchanges. "Law" includes all types of substantive rules: legislation, regulations, decrees, and other promulgations or decisions by the executive, legislative, or judicial branch of a government. It includes the process of making, implementing, and enforcing the substantive rules. A "securities regime" is the law and institutions that govern securities markets and players. The study examines the basic options revealed in the models of more developed countries that are available to regulators of emerging markets.

The audience for this study is, first, the USAID missions in the region, which can apply the findings in their policy dialogue with host governments. The primary audience consists, then, mainly of people who are not trained in law and may not be trained in finance. A broader audience for the findings is decision-makers elsewhere in the developing world, and their technical assistance providers, who could benefit from rationalization of the laws and regulations governing securities markets.

Country Models

Securities law generally protects investors and the integrity of the markets in order to maintain confidence, instill a sense of fairness, and minimize systemic risk. For the recipient designing or improving its laws, and the aid donors helping it, a useful approach is to identify the basic regulatory choices open to the recipient and then evaluate the costs and benefits of each, based on experience in a variety of countries.

The tendency has been to think in terms of transplanting, and possibly adapting, a single country's entire securities regime. One reason is that in practice bilateral donors help the recipient countries adopt the regulatory system of the donor country. French assistance brings a French securities regime, including regulations based on those in France. German assistance in Eastern Europe and the Former Soviet Union carries the German system of laws. American aid brings the U.S. system, recognized as the most advanced and globally applicable. The specialists providing the skills are often lawyers or law firms from the donor country. They may come with the best of intentions, but their deepest skills usually lie in their knowledge of the rules of their

home country and their economic interest lies in replicating their own regulatory system. Self-interest also plays a role. Once their replicated regime is in place they are better positioned than law firms from any other country to advise at least foreign investors in the intricacies of the new national law. This has been described as "an unhealthy competition between major international law firms pushing one system over another."[1] It can occur because the major donor countries still use very different approaches to regulating securities markets. While these differences are well known, the literature devoted to careful comparison of basic systems to regulate securities markets is remarkably thin.

Conventional wisdom sets the approach of the U.S. at one end of the regulatory spectrum. The U.S. uses a comprehensive set of formal rules embodied in laws and regulations. According to one commentator:

> The [U.S.] system working through ... seven ... statutes results in the regulation of the distribution of securities, a mandatory corporate disclosure system for publicly traded companies, the regulation of securities professionals, the regulation of investment companies, the regulation of trading markets, the regulation of takeovers, acquisitions and shareholder solicitation, and the regulation of insider trading.[2]

The U.S. relies on the informed investor to police the market and so requires an issuer to disclose fully all risks the investor may face. The independent U.S. Securities and Exchange Commission (SEC) actively implements the rules but does not itself judge risk. Other countries' regulatory systems differ in substance and process from the U.S. in significant ways. The same commentator, for example, described the traditional Japanese and Swiss regimes as much more "informal" and "consultative."[3] Their substantive laws have been narrower and less detailed. Their processes for making, implementing, and enforcing these rules have been less formal than those in the U.S have. In a similar way, the German approach has been to rely on financial intermediaries, notably its universal banks, to police the markets on behalf of the investor. It has, therefore, set less rigorous standards of disclosure and, in the past, been less concerned about insider trading.

The conventional debate about the choice between regulatory systems is often phrased in terms of the relative importance of the capital market in a country's financial system. Regulatory consequences are extrapolated from the answer. Will the country have a system dominated by deposit-taking institutions? If so, a German or Japanese model might seem most apt. Or will the country seek a vibrant capital market? In this case, the U.S. approach is appropriate. This conventional approach is too simplistic for African countries today. It is no more obvious that, just because a developing country wants an active stock market, it should adopt the U.S. regime

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1 See Norton, J. J., and H. Sarie-Eldon, "Securities Law Models in Emerging Economies," in Norton, J. and Andenas, M., eds., Emerging Financial Markets and the Role of International Financial Organizations, Kluwer Law International, London, 1996, at 335. Cited as Norton and Andenas (1996).

2 J. Cheek III, "Approaches to Market Regulation" in F. Oditah, The Future for the Global Securities Market: Legal and Regulatory Aspects (Oxford: Clarendon Press) 1996. Cited as Oditah (1996) and Cheek (1996).

3 Cheek (1996), at 249 and 250.

than it is that if it wants to rely on commercial banks to mobilize and allocate savings it should adopt the discredited Japanese regime.

Some argue that the debate about the relative merits of U.S. and other systems is moot because the different models are converging. Substantive law in the leading financial centers is increasingly similar. The UK moved closer to the U.S. in 1986 with the adoption of the Financial Services Act, and closer still in 1998 when it centralized regulatory authority in one agency. Japan's Big Bang appears to be a financial revolution that applies much of the U.S. substantive law to Japanese securities markets. Germany strengthened its insider trading laws in the early 1990s, largely in response to rules set by the European Union but also to improve Frankfurt's competitive position in regional and international financial markets. Cheek (1996) notes that Swiss legislation in 1995 moves "toward principles embodied in the U.S. regulatory system," emphasizing disclosure, transparency, trading, and takeovers.[4] The regulatory processes seem to be converging as well. Japan seemed to move in the early 1990s toward an independent commission, then tried again in 1998. But these processes still diverge. The Swiss were unwilling to set up a strong centralized independent agency as securities regulator. The Japanese and UK changes remain to be fleshed out and tested. One cannot say that the regimes have converged. Even if they were in developed countries, it is not clear that the prevailing regimes for developed markets are more appropriate for many emerging markets than the prior regimes, which were for simpler markets.

That significant differences persist among major national regimes to regulate securities markets should not be surprising. The tendency of slow-changing institutions to impede fundamental change in policy is well established in experience and the academic literature.[5] Its counterpart in law, the slow adjustment of legal institutions and procedures that hinder important changes in substantive law, has been documented for developing and developed countries in Asia over a 35 years period beginning in 1960.[6]

Even if the regulatory regimes for developed securities markets did converge, it is not obvious that emerging markets need or can use similar regimes. Their markets differ from those in the most developed countries along almost every dimension: number of companies and securities, complexity and variety of instruments, skills and numbers of brokers, dealers, and other financial intermediaries, and volume of domestic savings. Their supporting regulatory infrastructure is usually much weaker in the number and competence of lawyers, regulators, legal institutions like courts, and accountants. These broad generalizations are appropriate, particularly for Africa, but also for many other developing and transition economies, despite evidence supplied for years by the International Finance Corporation (IFC) to demonstrate the

4 Cheek (1996), at 249.

5 See D. North (1990), Institutions, Institutional Change, and Economic Performance, Cambridge, New York, Cambridge University Press.

6 K. Pistor and P. Wellons, The Role of Law and Legal Institutions in Asian Economic Development, 1960-1995, Hong Kong, Oxford University Press, forthcoming 1998.

great diversity among both developed and emerging markets and the overlap between the two groups.[7]

Specialists in securities regulation who have advised governments in transition and developing countries, routinely note that any foreign model should be tailored to the conditions of the recipient country. For example, "in a particular developing country, attempts to copy the 'ready-made' law of industrialized countries cannot work. Adaptation to these models, and awareness of social, economic, and legal differences should be taken into account."[8] Or, "There are no universal models in securities regulation, although there are, of course, more or less agreed model approaches and a few model provisions, for very specific issues."[9]

The inappropriateness of relying for a model on the securities regime of any single developed country prompts this paper. The analysis must shift from general models to prototypes of narrower types of regulation.

An Alternative Approach: Comparative Options for Key Functional Decisions

Thoughtful observers acknowledge that each of these model regimes must be adjusted to circumstances in the recipient country that differ radically from those in the donor.[10] Many African countries need to know both the basic choices, and other factors to consider when deciding where on the spectrum they should be. Often the recipient and the donor do not recognize their practical options. This study seeks to help them systematically identify the best available options without reinventing the wheel each time.[11] This study draws on the experience of USAID projects and those of other donors, as well as reports by technical advisers to many transition and developing countries to help answer these questions

A finer analysis of the real choices facing countries is more functional, identifying a small number of options, both substantive and procedural. Common examples include whether to regulate insider trading, whether (and how) to restrict trading to formal markets, and whether the regulator should be an independent commission, the finance ministry, central bank, or a self-regulating agency. A basic choice concerns the balance between merit review and disclosure. What, if any, circumstances justify merit review of potential issuers by a regulatory body? Many emerging markets, including some in the crisis countries of Asia, used merit review, which is fraught with the danger of rent-seeking by regulators. Even securities regulators in the U.S., with the archetypal disclosure regime, acknowledge occasions when they consider the merits of an issuer.

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7 See International Finance Corporation, Emerging Market Factbook, various editions.

8 Norton and Sarie-Eldin, at 341.

9 B. Rider, "Blindman's Bluff—A Model for Securities Regulation?" in Norton, J., and Andenas, M., eds., Emerging Financial Markets and the Role of International Financial Organizations, Kluwer Law International, London, 1996, at 351, cited respectively as Norton and Andenas (1996) and Rider (1996).

10 See Rider (1996), at 357

11 See Rider (1996).

Among the major elements in the regulation of securities and stock markets, we chose to examine the following seven carefully and comparatively. They are among the most important matters that need to be resolved:

- *merit/disclosure*: one prototype is for the government (or industry group) to decide who has the right to issue to the public, while the other is that the right to issue to the public is broadly available and the investors determine risk based on full disclosure of all pertinent information.
- *type of regulatory authority*: several prototypes exist for using a government agency versus self-regulatory agencies; ministry of finance versus central bank versus independent commission; multiple agencies versus one agency; and neutral regulator that just enforce rules versus active regulator to develop infrastructure (e.g., clearance, settlement, central registry).
- *governance of the exchange*: here the prototypes are the exchange as a public market vs. the exchange as a firm.
- e*nforcement*: the prototypes are reliance on criminal action (by the government), civil action (by the government or private parties), or administrative sanctions.
- *capital requirements for securities operations: the* prototypes are no special rules, simple flat rates, capital standards fixed by regulators, and capital set by the firms' own internal models but subject to oversight by the regulator.
- *public and private offers when securities are issued: the* prototypes are similar or different disclosure rules for offers to retail investors and sophisticated investors.
- *treatment of insider trading* level playing field versus laissez-faire.

Although choices between such policies as merit review and disclosure are framed as opposites, many are really more like extremes on a spectrum along which regulators may move. The position regulators choose may depend on the state of their market's development. For countries with simple securities markets, the choices may seem rudimentary*: the* difficult question is what they can do with very limited resources and skills. For those with existing markets, the issue is often how they make the transition from one approach to another (e.g., from merit review to disclosure).

The main tension is between policies that centralize and protect, on the one hand, and those that let market forces govern, on the other. While the tendency today is toward the latter, few countries embrace market forces in an unqualified manner. Particularly in Africa, many of the institutions that would temper market abuse are missing; weak accounting standards and unreliable courts are two examples. In these circumstances, many authorities acknowledge the need for regulation, but certain types of regulation may be inadequate to the task. So a key question is when a particular option is appropriate. This report is designed to help answer this question.

CHAPTER 2. MERIT vs. DISCLOSURE REGULATION

A. INTRODUCTION: THE BASIC ISSUE

A major question confronting all securities regimes is whether the government should screen potential security issues or issuers and prevent some from reaching investors, because they are, in some way, too risky or inappropriate. This is called merit regulation, because the regulator makes judgments about the merits of the offering. Often the regulator exercises discretion in making the judgments. Merit regulation is usually seen as the opposite of disclosure regulation. There, when a new issue comes to market, the regulator simply tries to make sure that the issuer discloses all risks to potential buyers and lets the investors decide whether to take on those risks. Of course, an important part of the calculation for the investor is whether the price of the security reflects its risk.

Merit and disclosure are presented as opposing prototypes of two very different approaches to securities regulation. In fact, they co-exist in differing degrees in most securities regimes, and the core question is where to strike the balance. Merit regimes and disclosure regimes also have their own prototypes. This chapter presents basic prototypes for both regimes and discusses prototypes for striking the balance between the two, that is, for mixing disclosure and merit regulation.

B. DISCLOSURE: THE COMMON GROUND IN THEORY

1. The General Need

The need for disclosure is widely accepted among securities regulators, at least in principle. All securities laws require issuers to disclose some information, simply varying about the nature of what should be disclosed, and when. No regime relies solely on merit regulation whereby the government alone decides which securities may be issued and that a permitted issuer need not disclose anything about the security.

An overview of the standards for disclosure is straightforward. As stated by the International Organization of Securities Commissions (IOSCO) in a set of basic principles, "There should be full, accurate and timely disclosure of financial results and other information which is material to investors' decisions."[12] Just what this means depends on the circumstances and is subject to great debate and analysis. One U.S. commentator listed the following items that an issuer should disclose:

12 IOSCO (1998). Consultation Draft: Objectives and Principles of Securities Regulation, Article 10, at 25.

(1) material historical information relating to such elements as assets, earnings nature of operations, and managerial self-dealing,

(2) the purposes for which the proceeds derived from the offering will be used,

(3) reasonably accurate financial statements prepared in compliance with recognized accounting practices and auditing standards, and

(4) forward-looking developments, events, and contingencies that are reasonably likely to occur and to have a material financial effect on the enterprise.[13]

The rationale for full, accurate, and timely disclosure is that it allows investors to make informed decisions about risk, which they and not the government must bear, and promotes the efficient allocation of resources within the financial system and economy.

While most regulators accept the importance of disclosure, at least in principle, not all scholars do. A body of thought grew that was critical of the reliance of regulators, particularly but not only in the U.S., on regulations to promote disclosure. The basic argument was that the market itself could force issuers to disclose needed information. Issuing companies' managers will be induced to disclose material information voluntarily because they, like shareholders, can be given incentives for maximizing shareholder value. The incentives would be designed so that the market must be convinced by the managers that it is receiving all relevant information about the company. This is called self-induced or voluntary disclosure. According to economic theorists of agency costs and signaling, managers who fail to convince the market are the major losers, (Coffee 1984).

A critique of the theory of voluntary disclosure has several strands (Coffee 1984). First, securities research is underprovided because information is in many ways a public good. Because professional securities analysts cannot keep their information from all users that have not paid for it, the analysts are undercompensated and their firms are reluctant to invest adequately in research. Coffee repeats a SEC finding that security analysts only report thoroughly on 10% of the companies reporting pursuant to the 1934 Act. So mandatory disclosure helps to reduce the costs to the system as a whole by forcing issuers to shoulder the cost of providing more and better information than would otherwise be available. Second, the absence of mandatory disclosure would lead to greater inefficiency as investors duplicate one another's work gathering information about companies, leading to excess social costs. Third, self-induced disclosure is flawed by the lack of congruence between the interests of shareholders and managers. Compensation schemes that can eliminate all prospects for opportunism by managers are too difficult to implement successfully. Circumstances like the opportunity for leveraged buy-outs by management create reasons for managers to withhold disclosure of information that would reveal to shareholders the correct (higher) valuation of their shares and increase the cost of the buy-out to managers. Because proof of intent is often very difficult, fraud

13 Steinberg, M.I. (Winter, 1996). "Emerging Capital Markets: Proposals and Recommendations for Implementation." 30:4 The International Lawyer 715, 728, citing Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, Report on State Merit Regulation of Securities Offerings, 41 Bus. Law. 785 (1986).

rules cannot readily protect shareholders against all managers who withhold material data. Takeover costs can be too high to discipline many managements.

Today, in practice, regulators in developing and transition markets, pay more attention to the question of whether to temper disclosure with merit regulation, than they do to the question of whether to abandon all formal regulation in favor of discipline by a market, and that is because it is by definition emerging, and lacks the institutions to provide that discipline.

2. The Major Issues for Disclosure Regulation

Any disclosure regime must address several questions: What must be disclosed? How specific must the disclosure be? How is the information disclosed? Who frames and enforces the disclosure rules? Behind these questions is the need to balance the shareholder's need for transparency against the issuer's cost of supplying the information. Assembling the data, publishing it, distributing it, and keeping it up to date is expensive. Many countries elect to reduce the cost to the company and accept that the investor will be less protected.

A comprehensive study in 1993 by the International Organization of Securities Commissioners (the "IOSCO study") compared the rules in 14 countries and the EC. The countries were Australia, Belgium, Canada, France, Germany, Hong Kong, Italy, Japan, Luxembourg, the Netherlands, Spain, Switzerland, the UK, and the U.S. Much of the material for the prototypes described in the following sections is drawn from this study. The study reported the laws as they appear on the books, not as they are enforced. It is, however, a fair assumption that, most if not all, of these countries enforced the laws as they are written.

The study asked whether the disclosures were made in the issuer's offering documents, listing particulars (i.e., the data the issuer had to disclose to list the security on an exchange), or annual reports, or in some other venue, such as newspapers or other official publications by the issuer. It also asked if the disclosures were required by binding law or regulation or, instead, by custom or practice in the country. Where these differences are significant, they are mentioned below

3. Common Disclosure Rules that Most Countries Have

When it is the common practice among all or most of the 14 countries for the issuer to disclose certain information, one has a fair description of best accepted international practice. The IOSCO study reports types of disclosure about which, the countries almost all agreed or generally agreed. These appear in the following paragraphs.

The IOSCO study reports that all countries require disclosure of material changes in a company's financial position or by reason of other developments. The study found little difference about the use of the concept of ***materiality***, because all 14 agreed that "an issuer should disclose all information necessary to enable an investor to make an informed investment decision" [at 8]. In their view, the 14 countries agree about the substance of what information is material and only differ about whether law or custom require the disclosure.

The 14 countries also showed a ***high degree of commonality*** about disclosure of:

a. the data required to describe the issuer's business, including revenue by existing product/service line, new lines, employees, patents and copyrights, contracts under renegotiation, and (but less frequently among almost all the countries), seasonality of business, sources and availability of raw materials, and material contracts) (the US and Canada are most complete, Switzerland and Hong Kong least);

b. the distinction between foreign and domestic revenues (in annual reports), as well as exports by geographic region (the Australia, Canada, and the U.S. rules are most complete);

c. the location and character of property held by the issuer (all countries);

d. legal proceedings that are material (all except Switzerland);

e. the performance of the company's stock, including dividends, warrants and options, number of holders, significant holdings of a security, price history, trading locations, changes, and dividend restrictions) (the countries vary as to which of the factors in this long list they disclose, with no pattern emerging);

f. prospects or analysis of financial condition and operating results, including historical information about capital expenditure, unusual factors affecting income, the effect of price and volume changes on income (except as to liquidity, the impact of inflation, and profit forecasts) (while most countries require these items or provide them by custom, the U.S. requires all but one by law);

g. financial information for two or more years and profit forecasts, including information for consolidated controlled entities (except that the wide variation in accounting and auditing practices across the countries vitiates the effect of requiring apparently similar types of financial information; for example, rules about how current financial information must range from 30 days to 18 months);

h. executive compensation to officers as a group (but almost no country required disclosure of compensation to individual officers);

i. certain aspects about the issue itself:

1. factors that make the offering high risk or speculative (all countries);

2. how the issuer will use the proceeds of the issue (issuers in all countries disclose this, but by custom, except in Australia and Switzerland, which require it by regulation);

3. the names of significant people in the issuing company who are selling their holdings of the security, including senior managers or others with material relationships to the company (all countries but Australia and Switzerland);

4. the distribution plan and information about the underwriters, including their compensation, obligations, and relations with the issuing company, as well as the period of the offering and what happens if subscriptions are reduced (most countries except Hong Kong and Switzerland have most of these rules);

Note that although the countries show a "high degree of commonality" in their disclosure rules for these matters, often one or two countries do not require disclosure of much or even any information about a particular item.

Despite a slightly lower degree of congruence, the 14 countries had ***generally similar rules*** about disclosure concerning:

a. the general development of the issuer's business, including acquisition or disposition of material assets, principal assets and main external investments, form and year of organization, any bankruptcy or insolvency, even of significant subsidiaries (here the European countries and Japan are much more complete than Australia, Canada, or the U.S.);

b. matters that are being submitted to holders of the security to vote on (but these usually appear in official publications or news announcements rather than annual reports, listing particulars, or offering documents (Switzerland requires the least disclosure);

c. exchange rates, including risk exposure, funds received by currency (here Hong Kong, Switzerland, and the UK require more types of data, the U.S. requires less);

d. restrictions on foreigners' rights to hold the security (only Switzerland and Canada have no rules);

e. tax laws (but not double taxation agreements) (Japan and the U.S. are more complete than the other countries);

f. disagreements with auditors or change of auditors (only Hong Kong and Switzerland require no disclosure here);

g. ownership of substantial shares of the security (that is, countries other than Switzerland required disclosure, but their definitions of when a block of shares had to be disclosed ranged from 2% to 25% of the outstanding security, which as a rather large range, may prompt one to ask if the countries' rules really are generally similar);

h. transactions with related parties (again, almost all countries required disclosure, but the threshold varied considerably) (only Switzerland required no disclosure); and

i. industry-specific information about oil and gas operations.

On the spectrum, Canada and the U.S. emerge as requiring the most disclosure, while Switzerland emerges as fundamentally different from many of the other countries, being much more oriented toward letting issuers decide what the market demands from them and how to respond to it. The IOSCO study does not report if some countries apply these generally similar rules much more consistently and thoroughly than others.

4. Major Differences in Disclosure Rules

Generally, different accounting rules can lead to major differences in disclosure even if regulations appear to call for the same information across many countries. Among myriad possible examples is the practice in Japan, until recently, of allowing companies to engage in window dressing at the end of a reporting period. For the last day of a fiscal year, a company could shift its bad debts, for example, to an offshore subsidiary that was not consolidated with it (or even to a bank), in exchange for a "good" loan from that subsidiary or bank. For the end-of-fiscal-year report, the company would not have to show the bad loans because they were off the books then. The next day, on the first day of the next fiscal year, the company and its subsidiary

(or the bank) would reverse the transaction and the bad loans would be back on the books of the reporting company. Such devious behavior, countenanced by the regulators, allowed the companies to disclose inaccurate information to shareholders. In 1999, these practices came under severe attack.

Other major differences in disclosure rules of the 14 countries in the IOSCO study were in the specificity of the required disclosures and in the need for continuing disclosure. The following sections describe these differences.

a. Specificity.

The 14 countries ***differ significantly*** in terms of their approach to disclosure of the following matters:

1) the issuer's ***business by industry segments***. While all 14 countries require issuers to disclose annual revenues by industry segment, they do not agree about whether or how much to disclose about assets or operating profit or loss attributable to each segment (only Australia, Canada, and the U.S. required issuers to discuss the industry segment performance if it did not indicate future results, and only Canada and the U.S. require disclosure of all five items including revenues, operating profit, assets, amortization, and capital expenditures).

2) the issuer's ***geographic distribution*** of assets or operating profit or loss (Canada, the UK, and the U.S. required this, others did not);

3) the impact of ***exchange controls*** on the issuer, including the way controls affect remittances and capital exports (Canada, Japan, and the U.S. require more information, while the rest require almost none);

4) detailed information about ***directors and officers***, including details about their service, details of business experience, other directorships they hold, new significant employees, family relationships, involvement in legal proceedings, executive compensation (though all countries require the directors and officers be named) (only the U.S. requires most items as a matter of law, while several others provide it by custom; Switzerland requires or customarily provides the least information and none about executive compensation);

5) certain aspects of ***the issue*** itself:

a. incorporation by reference (Japan and the U.S. permit this in more circumstances than the other countries);

b. ratio of earnings to fixed charges (only Canada, Spain and the U.S. require this disclosure);

c. dilution, including net book value before and after distribution, amount of increased book value attributable to cash to be received in the offering, and the amount of the immediate dilution (only Canada and the U.S. require all these items to be disclosed and most countries require none);

d. interests of experts and counsel in the issue (Australia, Canada, Hong Kong, Japan, the UK, and the U.S. require this disclosure and the other countries do not);

e. prior performance of the company's organizers, sponsors, or directors and managers in similar ventures (only Australia and the U.S. require this).

6) additional ***industry specific information*** for banking and real estate companies varies substantially across the 14 countries.

b. Continuing Disclosure.

There are several different approaches to requiring continuing disclosure while the security remains in public hands. These are discussed in the following paragraphs.

Disclosure only at issue or listing. In the past, many emerging markets simply required disclosure when the security was made available to the public, but not further disclosure after that time. None of the 14 countries in the IOSCO study was in this category, however. When this approach is used, the public is best protected by requirements that the prospectus be delivered to each prospective investor before the purchase. Reliance on listing particulars is another version of the same rule.

Disclosure during trading. When continuing disclosure is required, the basic choices are between requiring it at periodic intervals (in which case the question becomes how frequently), or when a material change occurs, or both. The U.S. requires both: a firm must make quarterly and annual reports, as well as report within five to fifteen days of a material development. Many other countries, and particularly developing countries, require reports only once a year. Hong Kong is an example (see Daniels, 1996). Some countries go beyond. The Korean Stock Exchange was concerned about the way rumors circulated despite its requirement that listed companies report the occurrence of any specified event (such as having its checks dishonored or part or all of its business suspended). So the KSE began to collect rumors about listed companies and publish them on a rumor chart (Yim 1993). The prototype requiring only an annual report protects shareholders much less than the prototype combining quarterly and supplementary reports.

Simplifying disclosure: Shelf registration. A country that requires substantial and continuing disclosure may reduce the significant costs by simplifying the frequency of the reports. The U.S. did so by permitting what is called shelf registration. Certain types of issuers could register a large amount of securities in a single registration and then issue the securities over a later period of time. Shelf registration in the U.S. grew slowly as the SEC experimented with it. Carefully limited at first, it was gradually permitted to more issuers and in more circumstances. A country that chooses to allow shelf registration may want to imitate this cautious approach.

By the mid-1990s, an issuer could use shelf registration for a primary offering if the issuer reasonably expected that it would offer and sell the securities within two years of the registration. The issuer had to have been filing periodic reports for 12 or more months and have outstanding voting equity securities worth $75 million or more (called a public float), held by other than its own affiliates. The issuer could indicate how it expected to offer the securities, but it did not have to do so. For example, many types of securities could be registered this way: options, warrants, convertibles, depositary receipts, and mortgage-backed securities. Rules provided for the sale of the securities over a period at the fluctuating market price rather than a fixed price, but

the voting stock being sold could be no more than 10% of the public float sixty days before the filing. Special disclosure rules were needed. The issuer had to amend any prospectus used more than nine months from the shelf registration, if the data in the prospectus were from time to time over sixteen months before the registration. The issuer had to amend the prospectus after any "fundamental change" of data in the registration, which was considered to be a major and substantial change, such as a large acquisition. The issuer had to amend the prospectus if the distribution plan changed materially (Jacob 1996). Shelf registration not only reduced costs, but also gave the firm much more control over the timing of the issue.

Simplifing disclosure: Company registration. A step toward further simplification was the idea of registering the company rather than just the individual securities that it issued. By registering, a company would make all its offerings public, even those that would otherwise qualify as private placement or offshore issues. The company would pay a fee every time it issued securities, rather than at the time of registration. It would disclose information about the transaction at the time of issue. The idea was to start only with large issuers, as a test, and set eligibility requirements higher than those do for shelf registration (e.g., a minimum 24-month history of periodic reports). Its liability to shareholders would increase, compared to shelf registration, because private placements would be included. Company registration allowed the issuer even greater flexibility than shelf registration. The registered company could issue any kind of security automatically. Its at-the-market offers would not be limited. There would be no prior review by the SEC (Jacob 1996).

c. Liability and enforcement.

While the chapter about enforcement examines matters that cut across many topics in this report, some topics specially concern disclosure.

The risk of a serious liability problem for any issuer arises from its voluntary disclosure of information that looks forward into the future. The danger is that the anticipated and reported event does not actually occur. To what extent should the issuer be liable? The U.S. addressed this problem in the Private Securities Litigation Reform Act, in 1996. This reform act gave established issuers a safe harbor from private suits under the Securities Act of 1933, or the Securities Exchange Act of 1934 (but not from actions by the U.S. regulator, the SEC). The reform act excluded from its protection issuers of cheap stock or convicted felons and excluded statements in the issuer's financial statement, in an investment company's registration statements, in tender offers, initial public offerings, and a few other situations. The protected forward statements could concern projected income, profit and loss, capital costs, dividends, plans for the future, expected economic performance, and reports of an outside reviewer hired by the issuer. In these forward statements, the issuer did not need to hedge them with much cautionary language (Thomson and Chrisman, 1996).

For regulators in developing countries, enforcement of disclosure rules easily conflicts with the regulatory agency's mandate to develop the securities markets. Korean regulators discovered that, because they had encouraged many companies to go public, they could not enforce the rules when the companies encountered problems later. Enforcement would raise the listed company's costs at a time when they were in trouble. So the regulatory agency rarely enforced the law (Yim 1993).

Regulators enforce regulatory standards. We found no special disclosure policies that were enforced only by regulators of securities markets, though some might argue that criminal action alone is appropriate when, for any number of reasons, the judiciary is not equipped to resolve civil suits.

Narrow civil action by actual purchasers/sellers at the time. Some countries allow a company's shareholders to sue the company when it fails to abide by disclosure rules, but they do not allow class action lawsuits. This approach makes it difficult for shareholders to enforce disclosure laws by civil suits. Korea limits private litigants' damages to "damages suffered only due to a price formed as a result" of the illegal action (Yim 1993, at 70). As a result, the individual shareholder that takes the company to court, because of inadequate disclosure, cannot hope to receive enough to pay the costs of litigation. The shareholder would have an impossible time demonstrating sufficient damage to its shares' value caused by the improper disclosure.

Broad civil action by purchasers/sellers after the fact. As discussed in the chapter on enforcement, shareholder suits often become financially viable only when class actions are permitted. Some countries do allow class action.

5. Conclusion

In practice, countries temper the disclosure rules that they adopt with some elements of merit regulation. The following section reviews the logic of merit regulation, its forms, and its prototypes.

C. MERIT REGULATION

1. The Rationale for Merit Regulation

Merit regulation seems at first glance, to run counter to capital market theory and the apparent best practice in regulation, so why would a country resort to merit regulation? The reasons are four-fold, and are discussed in the following paragraphs: to protect at least the unsophisticated investor, to prevent egregious abuses that are disclosed, to substitute for, or augment disclosure regulation that by itself would be crippled by weak implementation and enforcement, and to maintain government control over the capital markets.

Most domestic investors in a country may be so unsophisticated that the regulator fears they will unwittingly take on risks far beyond their capacity and then, when the risk becomes reality and they face substantial loss, turn to the government to bail them out in political circumstances that force the government to intervene. That is, when several basic tenets of disclosure regulation cannot be met. An emerging market often lacks the accounting standards and business practices required for full, accurate, and timely disclosure. The investors are not competent, perhaps from lack of training or experience with securities markets, to make informed decisions about risk even in basic instruments like shares in a company. Many may not have lived through the down cycle of a market, so have not learned that an investor cannot rely on the continued rise of a market that has steadily risen for many years. Investors may lack experience with slightly more complicated instruments, like convertible bonds. In these circumstances, they do not

expect to bear all the risk of their investment; indeed, they expect the government to intervene in some way if the value of their investment starts to fall substantially. This is not a problem merely of novice investors in developing countries. In the late 1980s, many Japanese retail investors expected—correctly—that the government would intervene if the bull market crashed. One might accurately say that these expectations need to change, but the reality for government officials is often the political power of these investors. In the crunch, the government cannot say no to them.

Issuers may so egregiously abuse their position, that the offering is "unfair, unjust, or inequitable" even if they reveal enough of their activities to comply with the disclosure rules. For example, insiders may have bought their shares at very low cost or may hold "inequitable" options or warrants. The underwriter's spread may be much too large. Investors sometimes ignore these activities if they expect a large return. The notion is that disclosure alone does not protect investors against "rip-offs" (Steinberg 1996, at 728).

When a country lacks the institutions needed for disclosure to protect investors effectively, the government may decide to use merit regulation as a substitute for disclosure. These are the institutions that permit reliable financial reporting, implementation of the rules, and enforcement of rights and obligations created by law. There is not much point disclosing financial data that are likely to be inaccurate because of weaknesses in the accounting profession or its standards. A securities regulator needs the human, technical, and financial resources to make sure that prospectuses and other reports filed with it comply with the law. A securities regulator's staff must act expeditiously, because offerings are usually designed for prevailing market conditions and markets can change fast. Absent this capacity, filing with the regulator becomes an empty formality. Disclosure rules normally rely on the securities regulators and investors to enforce them in the courts. When a country lacks courts in sufficient numbers or with adequate resources, including judges who understand the markets and rules, lacks a tradition of litigation to enforce rights, and lacks sufficient lawyers with adequate skills, then a system relying on disclosure will not protect investors. These institutional weaknesses in developing countries are probably the best argument for some form of merit regulation.

Countering the arguments that governments should intervene to protect investors because of market imperfections, is the reality that merit regulation usually gives regulators enough discretion to make them quite powerful in the markets. A regulator that acts as a gatekeeper to the securities market, assessing the quality of each potential issuer and granting or withholding permission to make an offer, holds a pivotal position to exact rents from the players. The very realistic fear that this opens the door to abuse argues against merit regulation.

So, emerging markets face a classic between-a-rock-and-a-hard-place dilemma. Many lack the institutions and investors needed for disclosure regulation to work well, but an attempt to resolve the problem through the bureaucratic intervention of merit regulation defeats the very market forces that capital markets are supposed to harness. Because all countries mix disclosure and merit, one question is whether some optimal middle ground exists. The kind of merit regulation employed, and the length of time it is used, may resolve this double bind for emerging markets. But experience seems to undercut this hope.

2. Prototypes of merit regulation

Merit regulation takes different forms, distinguished by the extent of the regulator's discretion and the frequency of its use. At one extreme is complete discretion regularly exercised, at the other, very limited discretion occasionally used. In between are merit regulation tempered by published guidelines that attempt to be objective and merit regulation applied subjectively, with few or no standards to limit the regulator's authority. In all cases, the issuer is also subject to disclosure rules whose stringency varies inversely with the extent of merit regulation.

The regulator exercising merit powers may be the governmental agency that regulates securities markets, such as the securities commission or a bureau in the finance ministry, or it may be a self-regulating organization, usually the stock exchange. The power is exercised at the time the issuer registers to issue securities to the public or applies to list them for trading on the exchange.

a. Merit regulation in which, the regulator makes all the important decisions almost all the time. At one extreme, general vague disclosure rules couple with substantial authority in the regulator to decide the merits of every potential issue. This authority may be based in legislation or may derive from the regulator's ability to impose its will on market players. Disclosure rules are minimal. Some Latin American countries fitted this category up to the 1960s, when they switched to a much greater reliance on disclosure.

b. Merit regulation in which, the regulator very rarely uses its power. At the other extreme is the system that relies almost exclusively on disclosure, but gives the regulator discretion under extreme conditions to slow the speed with which the issue can reach the market, and thereby kill the issue. The U.S. is an example of the latter. Disclosure is the major and dominant tool. But. if the SEC staff concludes that an offer is very dangerous, it can simply not waive, as it usually does, the requirement that the issuer wait 20 days from the time of filing to the time of issue. In the 20 days, the pricing of the issue will probably cease to reflect market conditions and the issue will fail. This power is rarely used, but exists even in the U.S.

c. Merit regulation subject to objective criteria. In this prototype, published rules set minimum quantitative standards designed to weed out risky issuers. Issues that cannot pass these threshold tests simply do not reach the market. This approach requires detailed disclosure, but makes the regulator the gatekeeper. The regulator applies the quantitative standards set by statute or regulation, such as minimum targets for profitability or a history of paying dividends over the previous five years. Although jurisdictions applying this approach generally acknowledge their use of a merit system, formal recognition is not necessary. Generally, to the extent that the regulator has, or can successfully assert authority to slow or halt consideration of any application, a merit system is at work even if the law as written seems to rely on disclosure and seems to limit the regulator's discretion with the objective criteria.

"Objective" is a slippery concept that is often difficult to apply. It is generally used to mean measurable or quantifiable tests that the regulator can make. An applicant to issue or list shares offers data that demonstrate it either passes or falls short of the numeric threshhold. Either it did earn profits over the past three years, as required by the regulatory measure, or it did not. The regulator simply applies the quantitative tests. It does not exercise discretion about whether the

company passes or fails them; the numbers tell the story. But, several problems arise. Either the tests are too simple to protect all parties, issuers as well as shareholders, or the tests leave too much discretion with the regulator. The problems are three-fold. Regulators may lack the ability to make sensitive judgments because of limited training or resources. Regulators may apply criteria, such as resource allocation guidelines favoring one group in the country over another or one type of industry over another. These criteria are designed to accomplish a national political or economic goal, but not to protect investors, which is the stated goal of merit regulation. Nothing suggests that regulators of securities markets have special competence in resource allocation. Finally, regulators may use their power to collect bribes from prospective issuers or listers and quantitative tests can be inadequate to the complexities of a firm's business. Many states in the U.S. use some form of merit regulation to protect their shareholders. A study of one aspect of merit regulation in one state, Oregon, reveals the problems of trying to define and apply objective criteria as a discipline to regulators who otherwise would have considerable discretion (Hurwitz 1996). Oregon requires its Director of the Department of Consumer and Business Services to find that the security being registered is "fair, just and equitable" to investors. Like regulators in other merit states, the Director must adhere to standards set by the North American Securities Administrators Association Inc. (NASAA). In his review, Hurwitz examined the effect of relying on NASA standards when evaluating registration of securities that included those provided to a company's promoters. "Fair, just and equitable" would seem to require that promoters selling their stock not take advantage of gullible investors by selling them securities the promoters bought at a vastly underpriced cost. So NASAA standards require that the promoters have paid 85% of the market value of the securities, determined at the time the securities are offered to the Oregon public. This is a simple rule that is simple to apply. But for that very reason it fails to take into account sweat equity, which is one of the most common ways promoters earn their shares in the company. Hurwitz sees this deficiency as evidence that attempts to provide objective guidelines to merit regulators can fail, because they must oversimplify to remove the regulators' discretion. Reliance on guidelines of this sort would appear risky.

It may be possible, despite these potential weaknesses, to design a more effective merit regime with a range of sensible quantitative hurdles, but countries put escape clauses into the laws that allow regulators considerable discretion. Even the more complex quantitative measures leave room for regulatory discretion. Taiwan moved toward such a regime in the early 1990s, according to Wang (1996). After having been directly involved in decisions about offering documents and listing for many years, the regulatory commission placed the decisions solely in the hands of the stock exchange as a self-regulatory organization. The regulators required the exchange to publish the criteria that it would apply when deciding whether to list a security. It published quantitative criteria and also more qualitative criteria that it tried to present as objective. The process of review was also designed to reduce the SRO's discretion.

The quantitative tests in Taiwan included ratios for operating profit and profit before tax. These would seem to be objective, but turned out to be manipulable by the applicant. In Taiwan, issuing companies were usually part of a financial or industrial group of companies. The problem of applying the quantitative tests was that a group could manipulate the accounts of its member companies, so that the issuing company reported profits and the other companies hid the group's losses.

In applying qualitative criteria, Taiwan's regulators used a negative approach. Through the stock exchange's listing requirements, they would slow or prevent a security from reaching the public if the issuing company was involved in certain kinds of activities. The published regulations carefully defined each factor by describing the "events that constitute satisfaction of each" (Wang 1996 at 82). These were negative factors: their appearance would prevent the security from receiving permission to be issued or listed. According to Wang, the 18 negative factors included certain kinds of litigation, labor disputes, pollution, irregular transactions, and breaches of trust. In the absence of these factors, the securities could reach the public. In this sense, the presumption was in favor of issuance or listing by the applicant.

The review process itself, was ostensibly designed to limit the discretion of Taiwan's regulators. It relied on outside experts, including financial scholars, to impose some objectivity on the regulator and the exchange. But the process fell afoul of serious criticism: the scholars lacked market experience, secrecy hid the decision, and the panel lacked time or information for an informed review. The procedural checks and balances did not work.

The ultimate problem with Taiwan's form of merit review was that it left regulators considerable discretion. A catchall of "other events" justified most denials of listing requests and raised questions about the extent to which the stock exchange was really limited in its discretion. Market participants doubted the objectivity of the regulators in practice.

The exercise of these discretionary powers, however, was not uniformly damaging to the market in Taiwan. It sometimes helped to solve problems in the market. Taiwan's regulators were able to use their significant power to cool an overheated market in the early 1990s. They tightened the listing requirements (lengthening the preparation period from 1 to 2 years, for example) and slowed the supply of securities. While this might be expected to raise the price of listed shares it signaled official displeasure with soaring P/E ratios and investors, anticipating an imminent decline, backed away from the market (Wang 1996). Experience of this sort reinforces support for merit regulation.

d. Merit regulation that gives the regulator substantial discretion. A last prototype of merit regulation makes no pretense of imposing objective external criteria on the regulator. The regulator applies subjective tests to decide whether a security should be issued or listed. This discretion may be cloaked in the appearance of a shift toward disclosure because the disclosure standards are set high. The experience of Malaysia and Japan illustrate this.

The removal of guidelines for regulators, usually billed as a step toward a stronger disclosure regime, gave Malaysia's regulators greater discretion. This happened in the early 1990s when the enabling act of the Securities Commission (SC) was changed to eliminate criteria about the company's viability and its management's capabilities, previously required when the SC reviewed applications. By giving the SC the power to "reject, approve, or condition approval on such terms and conditions it deems fit," the amendment expanded the regulator's discretion (Wang 1996 at 70). The commission continued to use quantitative standards, such as minimum paid-in capital or financial performance.

The SC also used administrative guidance, in letters and private meetings with the underwriters, to spell out policies that were not published. These policies went far beyond the normal support given to investors by merit regulators. The SC discouraged issues by firms in

sunset industries like textiles, or gave special treatment to privatizing firms or those in sunrise industries, such as high technology. This is resource allocation by the regulator. With no legislative or regulatory guidance or even definition of terms, the SC weighed the dynamics of a potential issuer's business, competition, and industry, its management, its risk exposure, and its likely impact on economic growth and the government's goals. Underlying the regulator's discretionary power is its enforcement power. Two tools proved most effective in Malaysia, according to Wang. One tool was very high fines, reaching as much as US $400,000, that were imposed on underwriters and their individual employees. The other tool was to impose a moratorium on the underwriter's ability to submit applications for listing. Criminal penalties were not effective because political connections could help the violator escape this kind of punishment.

This use of merit regulation imposes several costs on capital market development. It opens the capital markets to arbitrary decisions by the regulator. In Malaysia, a merit review could routinely take up to six months, leading to delays and costs on issuers. Basic allocational decisions are not made by the market, nor do investors learn to evaluate risk fully. It may be that the merit review permitted regulators to allow less than full disclosure.

Malaysia, like Taiwan, required disclosure of information despite the merit reviews. While they required delivery of the prospectus to investors (and the printing of prospectuses in newspapers), along with continuous disclosure afterwards, their disclosure laws fell short of international standards. Taiwan had no definition of "material." Financial information about segment performance, earnings, or contingent liabilities was absent from disclosure statements. Accounting standards continued to be weak. The regulators did not verify data. A company's statements simply tracked the law. Rather than provide information in formats readily understandable by the individual investors the regulators were seeking to protect by merit rules. This suggests that it is difficult to use merit regulation as a transitional device, which is in place while market-based institutions and practices grow, and later, removable. The institutions and practices to not grow sufficiently.

Bureaucratic inertia is the other major reason to doubt the temporary usefulness of merit regulation. Even as this sort of merit regulation fails and many forces push the regulators toward greater reliance on disclosure, the process is very slow and the regulators are reluctant to relinquish their power. One of the most publicized examples of the mix of merit and disclosure that gave regulators important, though diminishing, discretion is Japan post-World War II to the mid-1990s. Securities regulators applied eligibility criteria to various types of securities. One type is the issuance of yen-denominated bonds by foreigners, called Samurai bonds. Shimada (1991) described the evolution of the rules over most of the period:[14]

> When the first Samurai bond was issued in December 1970, the Samurai bond market was limited to supernational banking institutions [like the World Bank. In March 1979 MOF allowed the first private issuer.]... In July 1984, issuing criteria were further relaxed. As a result, AAA-rated issuers were permitted to issue an unlimited number of Samurai bonds.

14 Y. Shimada, "A Comparison of Securities Regulation in Japan and the United States," 29 Columbia Journal of Transnational Law. 319, 354-357 (1991). Since then, Japan relaxed many of these rules, eliminating minimum rating requirements and streamlining filing procedures and times.

> Again in December 1984, the eligibility criteria were ... eased to permit AA- and AAA-rated corporations with net assets (defined to equal shareholders' equity) greater than ¥900 million and a shareholders' equity-to-total assets ratio of over forty percent to issue these bonds. After November 1985, all corporations and certain international institutions ... that were rated AAA or AA, were rated A or were non-rated, were permitted to issue Samurai ... bonds with maturities up to fifteen, twelve and seven years respectively. . . .
>
> [In the early 1990s,] the MOF generally will not approve an offering of Samurai ... bonds unless the issuer has met certain eligibility criteria. Separate criteria exist for corporate and sovereign issuers. Corporate issuers with net assets totaling less than ¥600 billion must either have an A rating or better from one of the rating companies or satisfy other financial criteria. Corporate issuers with net assets totaling more than ¥600 billion need not meet any financial criteria nor have obtained any minimum rating. Corporate issuers ... which have not obtained an A rating or better must satisfy certain criteria. Corporate issues with net assets totaling between ¥100 billion and ¥300 billion must have a shareholders' equity-to-total assets ratio of more than 45% and met three out of the following four requirements:
>
> (a) a long-term debt-to-total capitalization ratio of less than 30%;
>
> (b) an operating profit-to-total assets ratio of more than 8.5%;
>
> (c) an interest coverage of more than 3.5 times; and
>
> (d) a long-term debt-to-case flow ratio of less than 250%.
>
> [Slightly less strict tests were applied to issuers with larger net assets.] Ineligible corporate issuers are permitted to issue Samurai ... bonds if guaranteed by an eligible parent company. Sovereign issuers engaged in a public offering that have previously issued bonds need not meet any rating or financial criteria, while those that have not previously issued any bonds must have an A rating or better in order to be eligible.

According to Shimada, the process for enforcing these rules relied on the leading Japanese securities companies. The discussions between MOF and the securities companies occurred before any formal filing or notification was made to the MOF.

> The four largest securities companies in Japan dominate the Samurai bond market, and typically, each submits to the MOF a list ranking, in order or preference, those clients who wish to issue Samurai bonds. If any particular offering is opposed by the MOF, the securities companies eliminate it from the list. Each fiscal quarter, these securities companies engage in discussions amongst themselves to arrive at a joint master list compiled on the basis of the various eligibility criteria. If the securities companies cannot reach agreement, the MOF intervenes to arbitrate. This interplay between the MOF and the underwriter(s) eliminates the issuer as an active participant in the approval process and delegates its role to an observer awaiting the outcome of stricter domestic negotiations. . . .

Japanese regulators had asserted similar authority over Japanese issuers for many years, relaxing their grip a bit faster than they did for foreign issuers. Even so, the U.S. Treasury reported in 1994[15] that:

> Through the use of administrative guidelines, MOF sets minimum rating requirements and other financial criteria (such as minimum net worth) for corporate bond issuers. These restrictions narrow the pool of eligible issuers ..... Minimum rating and net worth requirements have been relaxed in recent years, but restrictions remain. These regulations prevent smaller firms from participating in the capital markets and have the effect of preserving their business for Japanese banks.

Note that the authority for regulating foreign issuers in Japan came not only from the Securities Act but also the Foreign Exchange Control Law of 1948. According to Shimada, the MOF justified this limitation on the ground that increased yen holdings outside of Japan would lessen control over monetary policy and render the Japanese economy more susceptible to adverse economic events and conditions in other countries. "[T]oo rapid establishment of a free Euroyen market may have adverse effects on Japanese fiscal and monetary policies, exchange rates, and Japan's domestic financial systems. . . ."

D. CHOICES FOR EMERGING MARKETS

The mix of merit and disclosure varies across countries and continents. In the present, markets in Asia probably rely more on merit than do countries in Europe and Latin America. In the past, countries in Europe and Latin America relied more on merit than they do today. Most countries in Latin America ended their formal merit systems by the 1960s, for example. The U.S. federal laws are the epitome of disclosure regulation and every country at least gives disclosure lip service. But in the United States, state regulators continue to apply some merit regulation and regulators in other countries have ways to impose merit standards even when the formal securities law relies on disclosure.

Given the diversity in the mix of merit and disclosure, what are the lessons for emerging markets? The trend and popular opinion worldwide is toward greater reliance on disclosure. The financial crisis in Asia is pushing countries there in this direction. Even before the crisis, Malaysia and Taiwan shifted to greater disclosure, while retaining some merit powers.[16] Japan's approach, described above, is under attack now in Japan. If the system failed for Japan today, does that make it inappropriate for emerging markets today? Some observers answer with an unqualified yes.

A more qualified answer is that Japan's merit system failed because its economy and financial system became too complex for the regulators to manage as they had in the past, when the stock market played a relatively unimportant role financing the country's economy. Arguably, the circumstances in many emerging markets are much less complex than in Japan

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15 See U.S. Treasury, National Treatment Study (1994).

16 See N. Wong, "Easing Down the Merit-Disclosure Continuum: A Case Study of Malaysia and Taiwan." 28:1 Law & Policy in International Business, Fall, 1996.

since about 1980. Carefully designed merit rules might help resolve the double bind on regulators in emerging markets. But, for merit regulation, Japan probably had about the best regulators available to a country because in the past the finance ministry could recruit the technocratic elite from the universities and offer them superior status. One might have to give regulators in emerging markets bright line rules and leave them with little or no discretion.

In the abstract, one might be able to design merit rules, but could they be temporary? As the market becomes more complex, it would be essential to drop a merit system in order to avoid the Japan phenomenon. Institutional inertia is well documented, however. The danger of designing any form of merit system for an emerging market, even today, is that once the regulatory institutions are in place, they become very hard to change when circumstances no longer justify their existence.

Even if the regulator can relinquish the position of power accorded to it by a strong merit regime, the institutions needed to police a more market-oriented disclosure regime may not have developed, precisely because of the merit regime. In Taiwan and Malaysia, the accountants, underwriters, and lawyers did not learn how to carry out key roles because the regulators in both countries performed the roles instead. According to Wang (1996 at 70-71), the great limitations came from

> the takeover of the due diligence, timing, and pricing roles by the Malaysian [Securities Commission] and Taiwan's SEC and [Taiwan Stock Exchange]. The regulatory agencies scrutinize the financial information and operations of potential issuers at length. As a consequence, securities firms do not perform their own review for disclosure and pricing purposes (although Malaysian underwriters are very careful in making profit forecasts due to potential penalties for deviation from actual profits. The lengthy regulatory evaluation process also devalues an underwriter's recommendation regarding the time of the issue. . . . [T]he Malaysian SC determined IPO prices in accordance with a predetermined price-earnings (P/E) schedule that dated from 1993 and thus resulted in below-market prices for the new listing of shares. . . . The industry's characterization of Malaysian underwriters as "postmen" —who simply ensure that the companies satisfy the regulations in a checklist fashion, compile company-provided information along with the auditor's reports, and send the package to the regulators for review—is equally applicable to Taiwan underwriters.

The same rationale discouraged investors from careful risk analysis. If this is a consequence of either type of merit regulation, with objective criteria or subjective, then it appears that merit regulation defeats itself. It is justified as a temporary tool to use while the needed market institutions take root. Instead, it appears to prevent them from taking root and growing.

Several proposals by Taylor (1997), writing about transition countries, would shift responsibility to the market. One proposal is to allow exchanges to impose qualitative listing standards without setting quantitative standards, because the latter would not be reliable given accounting practice. Related to this is the proposal for an Issuer SRO. It "would restrict membership to those firms willing to comply with stringent disclosure requirements aimed at qualitative issues. Membership in the SRO would provide an instant signal to the market of the quality of the firm." Taylor envisions enforcement of high standards of quality by the SRO

members themselves, rather than the government. She recognizes the danger of self-serving behavior by the members, but believes that their greater self-interest is in accurate reporting.[17]

17 Taylor (1997), at 99-106.

CHAPTER 3. TYPE OF REGULATORY AGENCY

Selecting the kind of regulator is another basic choice for an emerging market. Countries provide such a wide set of possibilities and divergent trends that the lessons are far from simple or obvious. In various countries, the securities regulator is in the central bank, the finance ministry, the department or ministry of commerce or industry, an independent agency called a securities commission, the company registry, or located in a trade association that is usually private, like a stock exchange, in which case it is called a self-regulatory organization (SRO). To complicate matters further, securities regulatory functions are often scattered across several of these agencies.

The core problems are: where in the government to place the regulator, the degree of centralization or fragmentation of tasks affecting securities markets, the extent to which the government itself leads or delegates regulatory functions to SROs, the sources of funding for the regulator, whether the regulator should merely regulate or also promote securities markets, and what sort of regulator to have for a federal system. Several of these are related.

A. LOCATING THE REGULATOR IN THE GOVERNMENT.

Developed and developing countries usually assign the task of regulating securities markets to one of several different agencies in the government: central bank, finance ministry, or an independent commission. To the extent one can discern a trend, at least formally, it seems to be toward commissions.

Prototype 1. The Central bank

The logic of assigning securities regulation to the central bank is that it is responsible for the core of the financial system, deposit-taking banks. The central bank often supervises their safety and soundness as well as managing the money supply, and it is responsible for operations in the government securities, so it has some experience with securities markets. Among government agencies in emerging markets, its staff is likely to have the best training and experience in financial regulation and can usually be paid more than the civil service wage. Various developed and developing countries give their central banks the task of regulating securities markets. In the late 1980s, the OECD reported that, among its 24 members, bank regulators assumed regulatory responsibility in Austria, Belgium, Denmark, Finland, Germany, Luxembourg, Norway, Portugal, Sweden, and Switzerland.[18] Developing countries also use their central bank. Malaysia, for example, relied on the Bank Negara Malaysia to supervise securities markets for years. Brazil shifted power from the central bank in 1974. The central banks often acted by default, because their country lacked another institution to regulate securities markets. Of fifteen emerging

18 OECD (1988), at 24.

markets examined for this report, however, only one—Ghana—has continued to rely on the central bank to regulate securities markets.

The central bank's major concern, the commercial banking system, may make it an inappropriate regulator for securities markets. It may not even be able to regulate non-banks, which are entities that do not take deposits. In Switzerland before 1995, the central bank regulated banks' securities activities and non-banks were subject to no regulation other than regular commercial law.[19] This changed in Switzerland with the new law, though the central bank continued to play a key role. More to the point, commercial and investment banking are very different financial activities and require very different types of regulation. Commercial banks are principals that lend. They are concerned with the ability of their borrowers to repay over what may be a long period of time, generating a revenue stream that will allow the banks to service their obligations to their depositors. The banks' regulators need to be sure that the banks can meet these obligations even in bad times (preventing panics that lead to bank runs), so the regulators are more interested in preserving the commercial bank as a going concern than closing it down. Investment banks traditionally make their money advising or acting as agents rather than principals. Much more transactional than relationship based, they do not generate the same systemic risks as commercial banks. Regulators of investment banks therefore try to ensure that an insolvent investment bank can pay its senior liabilities, including obligations to customers, and then be closed without disturbing the market.

Of course, as markets integrate these simple dividing lines erode. Commercial banks seek fee-income and investment banks take large positions, though still probably much more in the United States than in most emerging markets. The effect, however, is that the central bank may lack the skills, experience, and even mind-set to regulate securities markets. The central bank may be too risk-averse, for example, suppressing large swings in the stock markets and stifling the innovation that securities markets need to thrive.

Prototype 2. The finance ministry

The finance ministry would seem to be the logical location in the government for the securities regulator. Until 1997, Japan thought so. In Ireland, another example, the finance ministry "supervises the stock exchange and stock brokers," according to the OECD.[20] The ministry should be able to coordinate policy toward, and supervision of, each of the country's financial markets, such as banking, securities markets, or insurance, and other financial activities like taxation. As financial markets integrate, the finance ministry would be well positioned to prevent dangerous gaps in rules or conflicts in the policies behind them. Yet this rosy picture of what could be often fades in practice.

First, the securities regulator must know the markets, but low civil service salaries may prevent the finance ministry from attracting skilled people with securities experience. Securities companies operate in markets where a staffer can generate huge profits on capital gains in a short

19 OECD (1988), at 31.

20 OECD (1988), at 25.

period of time and the companies reward the winners with big bonuses to keep them. The opportunity costs may be very high for a talented person who works for the finance ministry regulating the market rather than playing in it as an investment banker, particularly in a developing country with a weak civil service that is poorly paid. This is less a problem when the finance ministry regulates commercial banks, because the banks' good employees may at best slightly increase the modest profits the bank earns on spreads and will not win huge bonuses.

Second, national politics may cripple the finance ministry's efforts to regulate securities markets much more than it would undermine an independent central bank or agency, both of which are usually—but not always more insulated from political pressure. Russia has been a case in point.

Third, the finance ministry's job of raising funds for the government through taxes and bonds raises the possibility of serious conflicts of interest with prudential regulation of the securities market. Governments sometimes try to impose a tax or force investors to accept government securities in ways that would hurt the development of the securities market. In economies with large state-owned sectors, the government itself as a major shareholder of parastatal companies might undermine efforts to develop market-oriented corporate governance. Securities regulators in the finance ministry would lack the independence to counter these moves. A solution, arguably employed in Japan, is to separate the various finance ministry bureaus—banking, securities, insurance, tax—so that the conflict of interests do not arise below a political level. The bureaus in Japan's finance ministry, however, waged constant turf wars with one another. This hamstrung the major purpose of placing all these regulatory functions in the ministry, which was to coordinate them.

Prototype 3. The office of the prime minister

To underline the separation of the securities regulators from other established financial regulators (the finance ministry or central bank), some countries place the securities agency in the prime minister's office. Japan did so in 1998 when a backlash of political anger about the country's financial system transferred the securities regulators from the finance ministry to the prime minister's office. Vietnam's regulatory agency reports to the prime minister rather than the central bank or finance ministry, giving it a cabinet office status.

This location in the prime minister's office has a clear advantage and several drawbacks, particularly from the perspective of emerging markets. The advantage is that it gives securities markets the attention they need to change fundamentally what is usually a bank-oriented financial system that has been used for years to allocate credit and control the prices of financial services. The finance ministry, central bank, and state owned banks often represent the old system. For the securities regulator, which is expected to help develop financial markets that are a counterweight to the existing bank-based system, to report to either the ministry or the central bank condemns the securities regulator to second-class status. Putting the prime minister in charge signals an intention to change the financial system.

The problem is that the prime minister may not have a long-term interest in the development of the capital markets, while the considerable overlap between the banking and capital markets makes it important for those responsible for the banks and securities firms to be able to work

together. This cooperation is not assured even when they are part of the same ministry, as the Japanese experience before 1998 shows.

Prototype 4. An independent agency

The independent agency is supposed to solve these problems and many emerging markets are choosing to set up what they call securities commissions rather than lodge regulatory responsibility elsewhere. Most of fifteen countries examined for this report used a commission or a board. Certainly market players think commissions are the wave of the future. The head of Hong Kong's securities regulator said that "It has been the universal trend of market regulation to vest clear and objectively stated powers of market regulation on an operationally independent but publicly accountable market regulator."[21]

The idea of a securities commission, with members selected by the executive, revenues from fees that exceed costs, and a budget approved directly by the legislature, is that it is formally independent of the government. It can pay better than civil service salaries to attract staff with more training and experience. It specializes in securities, so it can act as spokesman for the industry threatened by other policy interests of the government. This gives its staff the ability to learn the industry, allowing them to regulate and monitor it more effectively. In developed markets, the worry is that close ties to the industry leads to regulatory capture as the regulators and the securities firms build a cozy relationship. This is certainly a concern in emerging markets, but the more serious concern is that independence is an illusion.

False independence probably characterizes many securities regulatory agencies in emerging markets. A "securities commission" may just be another unit in the executive branch. Some, like the commission in Vietnam, report to the prime minister. This gives them a cabinet office status and some independence from the central bank and finance ministry. But if the finance ministry is responsible for the commission's budget and personnel decisions, the independence is qualified. As discussed below, financial independence is not an option when the market is so small that fees paid to the commission are negligible. Or the commission may appear independent of the government, perhaps even privately owned, but if a large part of its board consists of senior government financial officers, such as the finance minister and central bank governor, then the commission cannot really be said to be independent. This prompted the Thailand commission to ask that government officials be dropped from its board in an effort to privatize it.

In developing countries the most serious concern is probably whether the commission is more independent of political currents in the government than the finance ministry. Surely in emerging markets this depends on the type of government. A strongman as president is unlikely to respect a commission's formal independence. Indonesia under Suharto is just one example. Indeed, this must be one of the major drawbacks about using an independent agency to regulate securities markets in many developing countries. Funding is a related problem. In the United States, the SEC charges fees for its services and regularly reports a surplus. But the enormous securities markets in the U.S. can pay those fees without serious threat to efficiency. If the emerging

21 Andrew Sheng, quoted in International Securities Regulation Report, v. 11, no. 22, (October 22, 1998), at 6.

market is a mere fledgling, filing and other fees are unlikely to pay the full cost of the commission. As the commission turns to the government for financial support, its independence erodes. So in many developing countries, the commission's "independence" is likely to free it of certain operating constraints like salary limits, which is useful, but not from executive or legislative politics.

B. CENTRALIZATION OR FRAGMENTATION.

Threaded through the discussion of where in the government to lodge supervisory authority for securities markets is the complicated matter of the acceptable level to fragment that authority. Part of the problem concerns the regulation of different financial markets. According to the OECD,

> [W]here supervision is carried out on the basis of functional criteria, and different markets are supervised by different bodies[,] [s]upervisory systems may not adequately reflect the degree of integration that exists among markets or the full variety of operations performed by a single institution. This problem is characteristic of countries with more than one supervisory authority and is less significant in countries with universal banking systems where the bank supervisory authorities have substantial responsibility for securities market supervision.[22]

The problem may always be with us. Generally, commercial banking is regulated by regulating the banks as institutions, not their instruments. The same may be said about regulators of institutional investors, like pension funds and insurance companies. The primary regulator for the banks, or the pension funds, or the insurance companies, is not the securities regulator, but the securities regulator is interested in them when they operate in the capital markets. So the regulator of banks (or pensions, or insurance) and the regulator of securities markets must share some functions. A different form of regulation governs securities markets. They are regulated as markets, with rules governing the players, of course, but also the instruments and their issuance and trading. These very different approaches to financial regulation probably cannot be reconciled. So they will constantly collide. The trends integrating commercial banking and securities markets bring the two regulatory systems into regular contact.

1. Fragmentation

The dispersion across many government agencies of the tasks regulating securities players, instruments, and markets can have serious consequences for effective regulation. This fragmentation was seen as a major problem in markets as old and large as Brazil's and India's. India remedied it by centralizing. Brazil continues to try to manage it. Fragmentation can be functional, public/private, or national/provincial.

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22 Organization for Economic Cooperation and Development, "Arrangements for the Regulation and Supervision of Securities Markets in OECD Countries," Financial Market Trends, No. 41, OECD, Paris, (November 1988), at 32.

a. Functional fragmentation

The OECD identified an obvious problem, that different authorities might regulate different sectors of the capital market, such as equities, bonds, and derivatives. It noted that after the October 1987 market break, people in the U.S. realized that "several sub-sectors ... were regulated as if each were independent, … when in … fact, the market is best seen as a single entity."[23] The OECD added that "under certain circumstances, action taken by one regulatory authority may counteract those of other authorities."[24] It gave as one example an equity instrument traded in the same country on two markets, one of which stops trading when conditions are disorderly while the other permits trading. A second example is the turbulent market in which one regulator raises margins to reduce speculation while another regulator lowers margins to reduce forced liquidations. So fragmented regulators can work at cross-purposes.

Fragmentation can take other forms. The bank regulator/central bank may regulate banks' securities activities while securities regulators supervise brokers, as in France, Italy, the Netherlands, and Spain.[25] Investor protection could be in the ministry responsible for companies (e.g., the commerce ministry), because the company law sets disclosure rules for public companies. Control of the companies registry may also give a ministry of commerce a role. Supervision and enforcement may be separate, so that the securities regulator must rely on the government's prosecutorial office.

In many securities markets, fragmentation can be even more severe than the OECD described. South Africa, for example, scattered aspects of regulatory authority across many government agencies. A registrar of stock exchanges licenses the exchanges and brokers. The registrar of companies regulates prospectuses. Different regulators supervise banks as intermediaries, and pension funds and units trusts as institutional investors. South Africa's regulatory system gradually evolved this way and was partially corrected in 1995, but no single agency oversees the securities markets. The U.S. is hardly centralized. Cheek lists the other government agencies with which the SEC shares regulatory responsibility: "the Federal Reserve Board, the Department of Treasury, the Department of Labor, the Commodities Future Trading Commission, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities Investor Protection Corporation, and the Pension Benefit Guaranty Corporation."[26]

b. Fragmentation between governmental and self-regulatory bodies

A system that relies on many different self-regulatory agencies may encounter severe problems due to fragmentation. The UK gave fragmentation a legislative imprimatur in 1986, with the Big Bang. Having relied on the stock exchange as the main regulator until then, the UK

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23 OECD (1988), at 32.

24 OECD (1988), at 32.

25 OECD (1988), at 27.

26 Cheek (1996), at 246.

created "the Securities and Investments Board which authorizes the self-regulatory organizations that make and enforce rules with respect to their members' activities in the financial services industry." Thus the UK "relies ... heavily on ... a fragmented system of self-regulatory organizations that make and enforce rules with respect to their members activities."[27] The question of how SROs are used is discussed below.

c. National/Provincial fragmentation

Countries with federal systems of government encounter another type of fragmentation, namely the division of authority between the federal and provincial governments or, in the absence of a federal regulator, the geographical division of authority between provinces that elect to regulate securities markets. Among developed countries, the U.S. and Germany are in the first group, while Canada and Australia are in the second. In the U.S., despite a strong securities commission at the federal level, many states have their own securities regulators. Some of these state regulators apply a merit system as an overlay to the SEC's disclosure approach, for example. In Germany, despite the role of the central bank, state (lander) governments supervise stock exchanges. In Australia and Canada, the provinces, rather than the federal governments, regulate the securities markets. In Canada, each province's writ runs only to its border, creating barriers to the integration of a national securities market. Some, if not all, of these arrangements arise from separation of powers principles set out in the constitution of the country, so there may be a basic limit to the opportunity a government has to centralize securities regulation.[28] Canadian exchanges and regulators try to solve their problems though cooperative networks, harmonization, and specialization.

Fragmentation can take other forms, which need not be examined in detail here. The bank regulator/central bank may regulate banks' securities activities while securities regulators supervise brokers, as in France, Italy, the Netherlands, and Spain.[29] Investor protection could be in the ministry responsible for companies (e.g., the commerce ministry), because the company law sets disclosure rules for public companies. Control of the companies registry may also give a ministry of commerce a role. Supervision and enforcement may be separate, so that the securities regulator must rely on the government's prosecutorial office

2. Coordinating a fragmented regulatory structure

As a matter of policy, some fragmentation may be useful as, indeed, the international association of securities commissions, IOSCO, accepts. In its principles for the regulator, IOSCO says, "there need not be a specific regulator," noting that "in many jurisdictions"

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27 Cheek (1996), at 247.

28 See P. Wellons, Integration of Stock Exchanges in Regions in Europe, Asia, Canada, and the U.S., Consulting Assistance on Economic Reform II Discussion Paper No. 14, (Cambridge: Harvard Institute for International Development, April 1998) and OECD (1988), at 25.

29 OECD (1988), at 27.

securities regulation is "the shared responsibility of two or more government or quasi-government agencies."[30]

Several institutions or processes can overcome, at least partially, the problems coordinating a fragmented system. A lead regulator can be designated for every firm that operates in several markets, each of which is regulated by a different government agency. The UK did this, but the Barings debacle cast doubt on the capability of the lead regulator to lead. The Bank of England was Barings' lead regulator, but it failed to comprehend the extent and effect of Barings' bank's huge loans to finance Barings' securities positions in Japan and Singapore.[31] This may have occurred, because the central bankers were not as conversant with Barings' activities in securities markets than banking markets. Some governments create coordinating committees staffed by members of each agency. France, for example, set up the Capital Markets Liaison Committee, chaired by the Treasury with members from the central bank, stock exchange, stock exchange commission, futures board, and the federation of financial institutions.[32] Canadian exchanges and regulators try to solve their problems though cooperative networks, harmonization, and specialization.

South Africa rejected both the powers of the U.S. SEC, which it found excessive and pure self-regulation that lacked adequate government sanctions. It chose to decentralize and limit regulatory authority. The company registrar and a takeover panel had limited power over all companies, listed or not. The stock exchange, as SRO, had responsibility for all surveillance of listed companies, and was supervised by a financial services board that also supervised many institutional investors without coordinating that supervision.

3. Centralization

Centralization is supposed to solve this dispersion of authority. At the extreme, all regulatory functions concerning securities markets would be located in a single regulatory body, but in practice some functions remain elsewhere. Centralization would, at least in the abstract, bring operational efficiency to securities regulation. By putting most if not all tasks in a single agency, the government provides a one-stop service that should reduce the regulators' costs as well as the cost of companies trying to comply with the securities rules. Centralization would allow the government to present a unified policy to increasingly integrated financial markets.

While centralization would accomplish some of these goals, several factors raise doubts about its usefulness. Many market players fear the effects of excessive regulation and believe that multiple regulators compete with one another in ways that reduce burdensome rules. Some of the functions may not belong under one roof. For example, giving the regulator the job of promoting the growth of the stock market may create conflicting goals (see below). The banking and securities businesses, and their regulation, differ a lot. The experience of centralized

30 IOSCO Principles, at 10, footnote 5.

31 See H. Scott and P. Wellons, International Financial Transactions, 5th edition, Foundation Press, New York (1998), at 958 et seq.

32 OECD (1988), at 33.

regulators, such as Japan, has not been good. But we lack systematic analysis of the conditions under which centralized and fragmented regulation fare well or poorly.

4. Trends in centralization

The trends give no clear message about centralization and fragmentation, even among developed countries. The centralized Japanese system appears to be fragmenting as part of Japan's Big Bang. In 1998, Japan's legislature spun off the securities regulator from the finance ministry, which kept only general policy authority, at least on paper. On the other hand, the U.K in 1998 changed its very fragmented regulatory system to one that would be much more centralized. The new Financial Services Authority was to absorb regulatory tasks of nine agencies, including the existing Securities and Futures Authority, which regulated dealers and advisers for securities and derivatives, the financial supervisory work of the Bank of England (the central bank), and the Investment Management Regulatory Organization, which regulated companies that managed investment funds. The goal was that "A single regulator will remove the scope for duplication, gaps, and inconsistency that affects the current system."[33] The process to achieve this, however, would be long and difficult. Almost a year later, the UK was still working on the implementing legislation. It proved difficult to fuse the bank regulators transferred from the Bank of England and the securities market regulators transferred from the other agencies. They brought their old systems and thinking to the FSA, undermining integration.

In developing and transition countries, the trend is also not obvious. U.S. efforts to centralize, or at least rationalize regulatory authority, founder repeatedly on vested interests in government and the private sector. Countries in Central and Eastern Europe and the former Soviet Union that follow the advice of German donors set up a modest agency to regulate stock exchanges. Those that follow U.S. advisors create independent commissions. Indeed, many new regulatory systems did choose some form of securities commission, which could aid centralization if the commission took responsibility for developing the markets. In Asian emerging markets, Malaysia, Thailand, and Indonesia have centralized, creating commissions.

C. GOVERNMENT AS LEADER OR DELEGATOR

Should the government itself take the lead in making and enforcing the rules, or should it delegate some or all of the job to a private entity like a stock exchange? Few governments see this as an exclusive choice between leading or delegating, because almost all have a government regulator with important authority and stock exchanges that make rules for, license, and discipline members, which is self-regulation. Specifically, the self-regulating organization (SRO) could "be responsible for monitoring trading practices, licensing intermediaries and for setting standards for admission of securities to trading and quotation in the secondary market."[34] Many different kinds of entities may be SROs. Stock exchanges qualify, as do industry

33 G. Graham, "Regulator 'to Set Example to the World," Financial Times, July 31, 1998, at 11.

34 OECD (1988), at 25.

associations, like a brokers' and dealers' association. So, the answer to the initial question is a matter of relative balance between leading and delegating, not an either/or choice. Even countries with universal banking —Germany, Finland, Switzerland— the central bank or bank supervisor regulating securities markets delegates some important regulatory tasks.

Governments delegate to SROs for several reasons. The stock exchange knows the markets and players much better than government regulators; it is in constant transactional contact with brokers, issuers, and investors and is itself, both a market and a player. As a private or quasi-private entity, the stock exchange can be more flexible and act faster than a government regulator, making the SRO a cost-effective vehicle for regulation.[35] Much more than a government agency, the stock exchange needs the securities markets to work effectively if it is to prosper, so it has a deeper stake in sustaining good markets. And, because it is not limited by many of the procedural constraints that bind government activity, the stock exchange can go further in its regulation, setting finer standards for ethical behavior in addition to the bright-line rules the government can set.

The source of a stock exchange's special capabilities—its place in the financial markets—also sets the SRO's basic limitations. Its scope is narrow. A stock exchange excludes, by definition, off-exchange activities by issuers, underwriters, brokers, dealers, and investors, so over-the-counter markets are out of its reach. The exchange has an incentive to create barriers to the development of these markets, because they compete with it. The SRO's powers are mainly contractual, allowing it to license and discipline members, but not more. Legislation can grant the exchange greater enforcement authority, but it is unlikely to give any criminal power. In the UK, this constraint limited the London Stock Exchange's ability to deal with fraud and led to the 1986 legislation creating a governmental overseer where previously there had been none.[36] An exchange ordinarily relies on fees paid by the members it is supposed to regulate. This places a natural limit on the exchange's resources, because competition with other exchanges and OTC markets constrain attempts by the exchange to raise its fees.[37] Most fundamentally, dependence on members to finance their exchange's supervision of them creates a potential conflict of interest for the SRO.[38] And, because the SRO as a non-government agency may be subject to less strict procedural and confidentiality standards, it may find it easier than the government agency to resolve a conflict of interest improperly.

It is important to clarify the responsibilities of government regulator and SRO. A long-standing turf battle between the regulator and the stock exchange created such mistrust between

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35 Taylor.

36 Rider (1996), at 367.

37 Steinberg (1996), at 722.

38 Some scholars are very skeptical of regulatory oversight of the SROs. George Benston concluded that, in the U.S. at least, (1) stock exchanges did not "ill-serve" the public before the era of government regulation; (2) NYSE anti-competitive rules did not diminish much after government regulated it; (3) competition among exchanges and other trading systems benefits investors; (4) government intervention raised costs to investors and the economy; and (5) only efforts to reduce fraud justify government regulation of the exchanges (Benston 1997).

the two that it became "a barrier to improving the local capital markets," in the view of the stock exchange.[39]

IOSCO listed the tasks an SRO should perform. IOSCO urged that the SRO be required by legislation or regulations to:[40]

- have the capacity to carry out the purposes of governing laws, regulations and SRO rules, and to enforce compliance by its members and associated persons with those laws, regulations, and rules;
- treat all members of the SRO and applicants for membership in a fair and consistent manner;
- develop rules that are designed to set standards of behavior for its members and to promote investor protection;
- submit to the regulator its rules for review and/or approval as the regulator deems appropriate, and ensure that the rules of the SRO are consistent with the public policy directives established by the regulator;
- its own rules and impose appropriate sanctions for non-compliance;
- assure a fair representation of members in selection of its directors and administration of its affairs;
- avoid rules that may create uncompetitive situations; and
- avoid using the oversight role to allow any market participant unfairly to gain advantage in the market.

IOSCO recommended that SROs be subject to the same "professional standards of behavior on matters such as confidentiality and procedural fairness as would be expected of the regulator."[41] IOSCO proposed to solve the conflict of interest problem by requiring that the government regulator be able to identify potential conflicts and be able to act quickly to "take over the responsibility for an inquiry from an SRO."[42] Chapter 4 discusses the enforcement issues that arise with SROs.

Countries strike a balance between leading and delegating in different ways. A bird's-eye view suggests that simple markets can leave most power in the SRO and that as the markets become increasingly complex the SRO's power and autonomy diminish, not simply displaced, but subject to the more extensive and thorough authority of a government regulator. Both static and dynamic views suggest this. A cross-section of countries shows this array. Namibia, with a simple market, has no securities regulator and left all powers in its SRO. South Africa, with a

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39 "Exchange Apprehensive Over Letting SEC Obtain Too Much Independence," International Securities Regulation Report, April 19, 2000 12, no. 4, (Jan. 14, 1999), at 2.

40 IOSCO (1998), at 15.

41 IOSCO (1998), at 16.

42 IOSCO (1998), at 15.

much more complex market, rejected pure self-regulation that lacked adequate government sanctions, but gave its exchange significant surveillance powers and limited the role of its several decentralized government agencies. In the U.S., with the biggest markets in the world, the SROs (the stock exchanges and National Association of Securities Dealers) have considerable power within their authority, which is consistent with the tasks that IOSCO recommended, and the SEC is a powerful government regulator. A dynamic view of the UK shows the same. As described elsewhere, the UK relied almost entirely on SROs before 1985, at which time it rationalized the SROs and added government agencies to supervise them. In 1998, the government centralized financial regulation in the Financial Services Agency, further reducing the role of SROs. To tap the expertise of the private sector, in late 1998 the FSA set up a practitioner board and a group to advise on rules. Members came from all over the financial sector. The job of the board was to review and comment on FSA policies (e.g., their cost effectiveness). The advisory group is to evaluate the impact of proposed rule changes on the financial sector.[43] This appears to be a substitute for the role played by individual SROs in the past. It also coordinates across the financial markets.

Perhaps it does not matter much if the government regulator leads or delegates to an SRO. Norton and Sarie-Eldrin raise the possibility that the argument between the two approaches is "contrived. In reality, there probably does not exist in the more industrialized countries any pure examples of either model." They suggest that the difference between the UK's former overseer-plus-SROs approach and the US commission-plus-SROs is not very great.[44] But the 1998 initiative by the UK government suggests it does not agree with Norton and Sarie-Eldrin.

D. SOURCES OF FUNDING FOR THE REGULATOR

The funding issue is of enormous practical importance for many developing countries. When the regulator is not placed in a government department, and therefore not financed and disciplined by the government's current budget, important issues arise about its funding, whether it is an independent commission or an SRO. Steinberg identifies six market-based sources of funds:[45]

1) Registration fees for issuers;
2) Periodic registration fees for brokers and dealers;
3) Periodic "franchise tax" on corporations and other businesses;
4) Listing fee for companies listed on the exchange;
5) Use fee on brokers and dealers when they use the exchange; and
6) Penalties imposed on those who violate the rules

43 "Practitioner Board and Rule Advisory Group Start Operations," International Securities Regulation Report (Dec. 17, 1998), at 8.

44 Norton and Sarie-Eldrin (1996), at 344.

45 Steinberg (1996), at 722.

These fees cannot be so great that they discourage issuance and trading of stock. They also must be applied even-handedly. The commission or exchange cannot use them to favor one group over another by, for example, penalizing only those in its disfavor and ignoring similar infractions by those it prefers.

When the securities markets are too new or thin to meet all the regulatory costs the question is, who pays them? This issue is discussed above. The danger is that the commission loses its independence from the executive or that the SRO, usually the stock exchange, loses its private sector perspective, if either relies on the government to pay a significant part of their costs. The regulator needs a revenue source that does not compromise its position.

When the market is viable enough to generate fees that could sustain all regulatory costs, a question is whether it is good policy for the regulator be entirely self-supporting. Steinberg raises a point. "Tying personnel salaries and perquisites to the revenues generated is fraught with risk. For example, if the levying of money fines against alleged violators directly redounds to the financial benefit of the enforcers, nonmeritorious cases may be pursued and excessive fines may be assessed," leading the market to catastrophe.[46] The implication is that the regulator should not have full control over its budget. This conclusion can be reconciled with the conclusion of the preceding paragraph, but it is not a simple synthesis.

E. REGULATE ONLY OR ALSO PROMOTE.

In developing and transition countries, it is common to expect the securities regulators to encourage to the growth of the market. One would assume that is a key role for them. Indeed, countries like Malaysia specifically identify market promotion as a task of the securities regulator. In the 1980s, Thailand and Jordan went farther, "combining the functions of the securities commission and the stock exchanges into one organization. The legislative approach, however, is that the developmental role—as opposed to the 'protective' or regulatory role—is explicitly recognized.[47] The question is whether this combination is bad for the regulator.

Rider asserts that "to place in one agency responsibility for promoting the markets and at the same time regulating and policing them, is considered by many commentators to be a recipe for, if not disaster, at least schizophrenia."[48] He contrasts one section of the law in Malaysia that makes the Commission "responsible for encouraging development of the securities and future markets in Malaysia" with another section requiring the Commission to "suppress illegal, dishonorable and improper practices." The notion seems to be that the neutrality needed for a regulator to do a good job is not appropriate to promotion. In some circumstances a promoter would look the other way when shady practices occur, while a policeman could not. In Indonesia in the late 1980s the new head of the regulatory agency, faced with a shortage of traded companies, sought out and encouraged many companies to issue shares to the public and list

46 Steinberg (1996), at 722-3.

47 Quiazon (1990), at 106, citing Van Agtmael, Emerging Securities Markets, Investment Banking Opportunities in the Developing World (1984).

48 Rider (1996), at 366.

them for trading on the exchange. The fear then was that the regulator, having asked companies to go public, could not enforce the rules that were designed to protect investors. On the other hand, a regulator entrusted with both tasks could try to introduce a merit system to promote investor confidence in the market.

CHAPTER 4. ENFORCEMENT

Securities laws must be enforced. Putting enforcement techniques in place requires three major decisions. First, is the question of how extensive to make the government's enforcement powers. Second, and somewhat independent of one's answer to the first issue, is the type of sanctions that should be used to enforce the law. This decides the relative balance between civil, criminal, and administrative sanctions. Third is the issue of how much enforcement should be carried out by the government itself and how much by self-regulatory organizations (SROs), such a stock exchange. This chapter discusses prototypes adopted by countries for each of these decisions.

Possibly more than in any of the other topics discussed in this report, the choice of enforcement prototype is profoundly affected by the structure of the country's legal system. Of course, other important elements of a securities law do not operate in a vacuum. Issuers will select the corporate form with the legal power to create shares that can be sold to the public. On the other hand, a securities law can allow issuers to create special instruments that were not previously found in the law. New financial intermediaries, such as securities companies that act as brokers, dealers, and underwriters, can be created in the securities law. Novel enforcement techniques and penalties are harder to slip in to a country's legal system through a securities law, however. In part, this is because the securities law is just one of many laws enforced by the legal institutions in the country. For example, countries prosecute crimes, according to established procedures using a specific set of agencies and people with long accepted bundles of skills. When securities laws impose criminal penalties for violations of certain rules, the enforcement of those rules and the imposition of penalties for violation have to conform to the country's existing criminal procedures. It is very difficult for designers of the securities law to win for their sector special enforcement arrangements that are not consistent with enforcement techniques generally used in the legal system. A reliance on shareholders to enforce the law, for example, may be very inappropriate for the many emerging markets that lack the institutions to support private litigation. This reality will, or should, be felt throughout the securities law. A drafter should think hard before proposing to set standards of behavior that the legal system will not or can not enforce on those who violate those standards.

A. EXTENT OF THE GOVERNMENT'S ENFORCEMENT POWERS.

This section presents three prototypes for the range of enforcement powers a that government can adopt, then examines the advantages and disadvantages of each for emerging markets.

1. The range of powers

A government's powers of enforcement can range across a spectrum from minimal to extensive. Three useful prototypes for the powers that the government entity responsible for regulating securities markets may take are: first, it has negligible enforcement powers; second, it can inspect but do no more on its own; or third, it can investigate and impose sanctions itself in addition to inspecting for violations.

a. Negligible enforcement powers.

Some countries, more in the period before the mid-1980s than after, gave the government very little enforcement power. In this group was the UK, until its 1986 Big Bang changed the rules, and regimes based on the UK system. This prototype relies on enforcement by means that are not based on the statutes embodying the securities law. Rules are enforced by the market. This is very similar to, but not the same as, enforcement by self-regulating organizations like the stock exchange. These SROs may derive their enforcement power from the securities law, which can give the SROs wide-ranging enforcement techniques. See the discussion of self-regulation later in this chapter.

The negligible regulatory powers prototype has a historical basis and a very different theoretical basis. The historical basis for this prototype is that it is the enforcement component of an approach that has been described as non-legal regulation (Ho 1997, from which much of this discussion is derived). The notion is that market players—particularly the banks and securities firms that are the key intermediaries in financial markets—can police compliance with their own rules. For this to work, if one can judge from the UK's experience, the market players must understand that their reputation is vital to doing business, which means that everyone in a relatively homogeneous financial community knows each other, and that leading firms, who must clearly abide by the rules, exercise enough market power to enforce the standards against fringe firms. In these circumstances, the regulator needs few enforcement powers.

The theoretical basis for giving governments negligible regulatory powers is the notion that efficient markets exert a more effective discipline over players than state regulators. Emerging markets lack the institutional infrastructure that this argument assumes for markets to work effectively, so this section discusses the prototype in terms of the historical model.

Into the recent past, governments in countries as far-flung as Zimbabwe and Hong Kong had negligible regulatory powers. Both are interesting because they show the UK system at work in an emerging market. In Zimbabwe, the only notable government agency, from the perspective of those in the market, was the company registrar, who had several jobs administering the law and, therefore, related enforcement powers. Its staff ensured that companies filing a prospectus pursuant to the Company Law did supply the prospectus required by the law. The company registrar's staff made sure the company filed the regular audit reports. In both cases, the staff's enforcement power was simply to reject a filing for non-compliance when the report failed to include the data required by the statute. It did not evaluate the contents of the report or pursue companies that made false statements in their filings, even though the law established civil liability (as opposed to criminal liability) for misstatements. This is a clerical process.

Hong Kong relied on the UK securities regime (and indeed on all UK law) until 1997. During this period,"the regulatory framework" had "three distinctive features. First, the core of corporate and securities 'regulations' has no legal force and therefore carries no legal sanctions. Second, private enforcement of [these]... regulations that do have legal force is so beset with difficulties as to be nonexistent. Third, there is an abundance of criminal offences on the statute books, but with fairly low penalties and too few prosecutions" (Ho at 606).

Several arguments support this prototype of negligible enforcement powers for governments in emerging markets. First is that the market players are best situated to enforce standards of

conduct. By virtue of their constant involvement in the market they will know sooner than government regulators when the rules are flouted. In this view, many of the newer emerging markets are small enough for all players to know one another and concentrated enough for market leaders to be able to discipline marginal players who stray. Second, the cost of enforcement is lower in this prototype than others that require a greater government role. This is important because small emerging markets cannot sustain the cost of a large regulatory infrastructure. The licensing, registration, and listing fees are simply too small and the government finds itself subsidizing the regulatory system (unlike in the U.S., where the SEC reports an annual surplus of revenues over costs). Third, is the belief that it is dangerous to the market development to concentrate much power in the hands of the government of a country that until recently controlled so much economic behavior and that is still inclined to intervene to allocate resources given an excuse. These points appear elsewhere in this report in discussion about a simple and limited regulatory presence, but they are important to decisions about enforcement. The fourth reason to favor negligible enforcement powers is that they allow the market to develop best practices in a flexible regime rather than impose minimum standards to which market players will flock.

Arguing against this prototype is the fact that the assumptions often prove to be wrong. First, many developing and transition countries lack financial firms that are market leaders with enough power to enforce the standards. Indeed, many countries lack a substantial private financial sector, because state-owned banks often play such a dominant role. Second, the business community, and even the financial community, is often not homogeneous. Sometimes, as in Hong Kong, families dominate and pursue their interests over the interests of others (Gaylord and Armitage, 1993). In some countries, foreign intermediaries may play a major role. They are commonly not able to lead in this prototype because they play by other rules, as the UK recognized. Sometimes the community mixes two or more groups from different regions or ethnic groups that are very segregated socially and politically. Instead of a community sharing common standards, they are at odds in many ways. If the financial community is dominated by one group in such circumstances, the broader population that must issue and invest for securities markets to succeed will not trust that group to make and enforce standards in the interest of groups other than the dominant group. They will turn to law. Third, leaders often protect their own. Fourth, reputation may not turn out to be vital to doing business. In Hong Kong, most of the small number of corporate leaders who were disciplined during the 1980s and early 1990s were able to continue to do business profitably in related lines (Ho 1997). So this prototype requires a certain market structure that is absent from many emerging markets.

Even if the required market structure is present, however, the prototype has limited application. Sanctions, such as deprivation of business opportunities, imposed on a company because of the wrongdoing of its controlling shareholders will hurt minority shareholders as well. This often stymies market leaders trying to impose the sanctions. Victims cannot be compensated by market discipline even though the wrongdoer is punished. Others in the market may deprive an insider trader by no longer allowing it to do business with them. Shareholders who suffered as a result of inside trading, however, would not be paid for their loss. Complex markets are less amenable to enforcement by the market leaders, because information is harder for a small number of leaders to get and, when they impose economic sanctions, the wrongdoer

can move elsewhere. So a country needs laws that can penalize bad behavior with sanctions that focus precisely on the wrongdoer.

The notion is that as the market develops, the enforcement powers of government will inevitably be called into play. This is what happened elsewhere. The trend has been away from this prototype for securities regulators around the world. The countries examined here, the UK, Zimbabwe, Hong Kong—have moved to greater powers as their markets became increasingly complex.

b. Inspection only

The second enforcement prototype gives government agencies simply the power to inspect and make a public inquiry that examines for compliance with a statute setting standards for market activities. They may be the only governmental agencies vested with any power to enforce laws governing securities issuance and trading (as opposed to general criminal and civil laws).

This prototype tended to be used in common law jurisdictions adopting early British law, such as the companies law. The companies registrar could inspect the books of a company for compliance with the statutory rules about a reporting company's financial accounts, for example. The statute could require annual publication of the balance sheet. The registrar might find a report insufficient and inspect the books of the filing company. A finding that the company failed to comply with the rules would be made public. Or simple rules to promote fair-trading might allow the government to appoint a commission to inspect parties accused of insider trading or market manipulation. The commission's activities or final report would be public, but the government itself would not be expected to act further. If the inspection identified activity that might violate the country's criminal laws (e.g., criminal laws against fraud), the criminal prosecutor would have to decide whether to investigate. The power permitted by this prototype at most allows a public airing of the matter, not the ability to assess penalties or force behavior. The use of this prototype is closely linked to reliance on SROs or nonlegal enforcement.

The idea is that exposing a possible malfeasor to the bright light of publicity is a penalty in itself. The prospect that its failure to comply with the rules will become known by others in the financial industry, the business world, and the wider society will deter noncompliance. The drawbacks, in practice, are that government agencies of this sort rarely exercise their inspection powers because they lack resources and, given the regime, the inclination to inspect. Even when they do inspect, publicity does not create serious problems for those being inspected (see Ho 1997). Deterrence fails.

c. Investigation and sanction.

The third enforcement prototype gives the government the power to investigate for failure to comply with the rules governing securities markets and, when it finds non-compliance, to impose penalties on those whose duty it was to comply. The investigative powers go far beyond inspection, but the range varies. Near one end of the spectrum is the view that the government regulator should have the full panoply of powers to investigate and apply sanctions. This is the position of IOSCO. It concluded that "the complex character of securities transactions and the sophistication of fraudulent schemes require strong and rigorous enforcement of securities laws." IOSCO did not decide that the securities regulator needed to be able to prosecute crimes on its

own, however. This would be difficult in many countries. The powers IOSCO recommended[49] were:

- regulatory and investigative powers to obtain data, information, documents, statements and records from persons involved in the relevant conduct or who may have information relevant to the inquiry;
- power to seek orders and/or to take other action to ensure compliance with these regulatory, administrative and investigation powers;
- power to impose administrative sanctions and/or to seek orders from courts or tribunals;
- power to initiate or to refer matters for criminal prosecution;
- power to order the suspension of trading in securities or to take other appropriate action [such as trading restrictions like position limits, reporting requirements, trading only to liquidate positions, or special margins];
- enforcement action can be taken, the power to enter into enforceable settlements and to accept binding undertakings.

This list captures the range of powers government agencies should have but also makes recommendations about the government institutions in which the powers should rest, such as the securities regulator, the criminal prosecutor, and the courts. These issues are discussed in more detail below.

2. A comparison of the prototypes for emerging markets

For emerging markets, the key question appears to be whether the regulator should have strong enforcement capacity. It is not surprising that IOSCO, an association of securities commissions, would urge that its members be powerful. But, in emerging markets, fledgling stock exchanges are in countries that often have weak legal systems, regulators with limited skills and resources, low pay scales for government employees so the most capable are hard to attract, authoritarian governments, and a history of government intervention in many markets, as sketched above in the discussion of the type of regulator. A case can be made for limiting a regulator's enforcement power in these circumstances.

For a start-up market, the appeal of the first prototype, that the regulator has negligible powers to enforce, is its low cost and the way it keeps a potentially interventionist government at arms length. Several arguments support this prototype of negligible enforcement powers for governments in emerging markets. One is that the market players are best situated to enforce standards of conduct. By virtue of their constant involvement in the market they will know sooner than government regulators when the rules are flouted. In this view, many of the newer emerging markets are small enough for all players to know one another and concentrated enough for market leaders to be able to discipline marginal players who stray. Second, the cost of enforcement is lower in this prototype than others that require a greater government role. This is important because small emerging markets cannot sustain the cost of a large regulatory

49 IOSCO 8.3 (1998), at 18.

infrastructure. The licensing, registration, and listing fees are simply too small and the government finds itself subsidizing the regulatory system (unlike in the U.S., where the SEC reports an annual surplus of revenues over costs). Third, is the belief that it is dangerous to the market development to concentrate much power in the hands of the government of a country that until recently controlled so much economic behavior and that is still inclined, given an excuse, to intervene to allocate resources. These points appear elsewhere in this report in discussion about a simple and limited regulatory presence, but they are important to decisions about enforcement. The fourth reason to favor negligible enforcement powers is that they allow the market to develop best practices in a flexible regime rather than impose minimum standards to which market players will flock.

Arguing against this prototype is the fact that the assumptions often prove to be wrong. First, many developing and transition countries lack financial firms that are market leaders with enough power to enforce the standards. Indeed, many countries lack a substantial private financial sector, because state-owned banks often play such a dominant role. Second, the business community, and even the financial community, is often not homogeneous. Sometimes, as in Hong Kong, families dominate and pursue their interests over the interests of others (Gaylord and Armitage, 1993). In some countries, foreign intermediaries may play a major role. They are commonly not able to lead in this prototype because they play by other rules, as the UK recognized. Sometimes the community mixes two or more groups from different regions or ethnic groups that are very segregated socially and politically. Instead of a community sharing common standards, they are at odds in many ways. If the financial community is dominated by one group in such circumstances, the broader population that must issue and invest for securities markets to succeed will not trust that group to make and enforce standards in the interest of groups other than the dominant group. They will turn to law. Third, leaders often protect their own. Fourth, reputation may not turn out to be vital to doing business. In Hong Kong, most of the small number of corporate leaders who were disciplined during the 1980s and early 1990s were able to continue to do business profitably in related lines (Ho 1997). So this prototype requires a certain market structure that is absent from many emerging markets.

Even if the required market structure is present, however, the prototype has limited application. Sanctions, such as deprivation of business opportunities, imposed on a company, because of the wrongdoing of its controlling shareholders, will hurt minority shareholders as well. This often stymies market leaders trying to impose the sanctions. Victims cannot be compensated by market discipline even though the wrongdoer is punished. Others in the market may deprive an insider trader by no longer allowing it to do business with them. Shareholders who suffered as a result of inside trading, however, would not be paid for their loss. Complex markets are less amenable to enforcement by the market leaders, because information is harder for a small number of leaders to get and, when they impose economic sanctions, the wrongdoer can move elsewhere. So a country needs laws that can penalize bad behavior with sanctions that focus precisely on the wrongdoer.

The assumption is that as the market develops, the enforcement powers of government will have to be called into play. This is what happened elsewhere. The trend has been away from this prototype for securities regulators around the world. The countries using this prototype examined above—UK, Zimbabwe, Hong Kong—have moved to greater powers, as their markets became increasingly complex.

The idea behind the second prototype—inspection powers only—is that exposing a possible malfeasor to the bright light of publicity is a penalty in itself. The prospect that its failure to comply with the rules will become known by others in the financial industry, the business world, and the wider society will deter noncompliance. The drawbacks, in practice, are that government agencies of this sort rarely exercise their inspection powers because they lack resources and, given the regime, the inclination to inspect. Even when they do inspect, publicity does not create serious problems for those being inspected (see Ho 1997). Deterrence fails.

The appeal of the third prototype—a full range of powers—is that it gives the government the ability to enforce the detailed and complex set of securities laws that more and more nations have adopted. In most emerging markets, no one other than the government can do the enforcement job. There is little reason to write rules that cannot be enforced; indeed, it may be counterproductive to do so. The decision about enforcement powers is thus directly related to decisions about the breadth and depth of the substantive securities laws. This links enforcement to strategic decisions about the kind of securities market that the country wants, or that is wanted by aid suppliers for the country, which may be quite different. So the kind of securities market dictates the kind of enforcement power the government exercises.

B. BALANCE BETWEEN CIVIL, CRIMINAL, AND ADMINISTRATIVE ENFORCEMENT.

The second major question concerns the way in which the government should enforce the rules. Four traditional legal mechanisms are available. A government may use the criminal justice system by bringing criminal actions against a person accused of violating the law. The government, normally through the agency regulating securities, may use the civil justice system by bringing civil actions against a possible violator. Third, the government may decide to allow, or even rely on, private parties to enforce much of the securities law by themselves suing in the civil courts when they are affected by a failure to comply with the rules. Finally, the securities regulator may itself have the power to decide whether someone has failed to comply with the securities law and, if so, to apply penalties.

The choice of mechanism certainly reflects the powers given to the government and its ability to act within the framework of the country's legal system. A government that can investigate and apply sanctions may be given the power to use criminal sanctions. In this sense the choice of prototype analyzed in the previous part of this chapter determines the way in which the government enforces the law.

Beyond this, governments have some latitude to strike the balance between civil (mainly private parties), criminal, and administrative enforcement. While the balance among these is key, a country may decide to rely primarily on one or the other mechanism for specific types of violations, or as a general matter. The U.S. SEC is forthright about its inability to police every securities market all by itself. So the U.S. gives private parties the right to unearth certain types of violations of the securities law and recover damages for the violations. Other countries may choose instead to rely almost entirely on the securities regulator to enforce the law, either on its own by administrative action or by using civil courts. Still others rely primarily on criminal courts to enforce the rules. The following sections explain these three prototypes and discuss their strengths and weaknesses for emerging markets.

1. Prototype of reliance on criminal enforcement

Government regulators in most countries rely much more on criminal courts and penalties to enforce the securities law than on the civil courts and relief.[50] Criminal proceedings may result in much more severe penalties than the other mechanisms, bringing punishment by large fines and jail sentences of up to ten years. The question of whether to rely on criminal enforcement is different for the issue of who in the government may bring the criminal action. Often, as in the U.S., the securities regulator itself brings the civil action while the justice department or ministry prosecutes criminal cases.

Criminal enforcement appeals for several reasons. It is expected to be useful precisely because it does allow severe penalties, including jail. These presumably deter undesirable behavior better than lesser penalties. In some emerging markets, the criminal law system works better than the civil law system. China is often cited as an example. Judges take criminal violations seriously, adhere to criminal procedure, and enforce the rules. Here one finds the predictability that law is supposed to provide. Judges are often reported to be much more lax in their decisions about cases in the civil courts. They may be more open to bribery or influence. Someone who is sued in civil courts for breaking the securities law may be able to escape serious penalty. Here the outcome is unpredictable. Indeed, the 1999 Chinese securities law relies significantly, though not exclusively, on criminal enforcement. Transitional countries in Eastern Europe, such as Romania, also rely on criminal enforcement.

Because not all securities law violations are enforced with criminal sanctions, the country must decide what to criminalize. One of the more extensive lists is found in the 1999 Chinese securities law. It provides criminal sanctions in the form of imprisonment, fine, or both for the following acts[51]:

a. Acts by market players

1. Securities issuance without the commission's approval.
2. Disclosing false or misleading information and failure to disclose information required by law.
3. Setting up or operating a stock exchange illegally.
4. Setting up an unapproved securities company.
5. Using fraud to urge investors to buy securities.
6. Insider trading.
7. Manipulating market prices.
8. Misappropriating public funds to trade shares.
9. Creating or disseminating false information about or affecting trading in securities.
10. Misusing clients' funds.

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50 Steinberg (1996), at 724.

51 Freshfields, A Commentary on the Securities Law of the People's Republic of China, June, 1999.

b. Acts by those who service market player

11. Falsification of serious financial or legal information by accountants, auditors, or lawyers, either deliberately or negligently, whether or not in return for a bribe, or demanding a bribe to do so.

c. Acts by the regulator

Granting the securities commission approvals to issue or list securities or to set up financial intermediaries, when the applicants have not met the regulatory standards.

Specifying sanctions for acts that have been identified as criminal turn out to be a major problem for emerging markets in developing and transition countries. The problem arises where the practice is to define the illegal acts in the securities law, but to specify the criminal penalties in the general criminal code of the country. Former socialist countries with legal systems based on the European system of code laws repeatedly encounter this problem. In its worst form, illegal acts are identified as criminal in the securities law but nothing is done to amend the criminal code; no penalties are prescribed, and none can be enforced through criminal prosecution. This was a major problem in Estonia. The securities law explicitly stated that the criminal code would provide penalties for violations of the securities law. But, legislative drafters failed for some time, to coordinate their activities to change the relevant statutes, and no penalties were established. The government should have appointed one person to ensure consistency among the laws (Burke 1994). Yet, the problem may be more than organizational. China deliberately took many years to enact a securities law. During that period, it had the time to coordinate the criminal and securities laws. When finally passed, the securities law had thirty-six articles criminalizing activity. Of these, nineteen articles had counterpart provisions in the criminal law that set penalties and the other seventeen had no counterpart. For these seventeen, a person would not be able to know the severity of any penalty (Freshfields 1999). This silence creates a less clear deterrent to behavior that the law has identified as harmful to securities markets. General criminal provisions in the criminal code, such as penalties for fraud, would still apply.

It is common for countries to separate the enforcement of criminal laws from other laws, but this separation creates difficult problems for emerging markets in developing and transition countries that lack a market oriented legal system. Crimes involving securities markets can be sufficiently complex to require from any prosecutor, a sophisticated understanding of financial markets. But almost by definition, the only possible governmental home for such sophistication is the securities regulator, which works with the markets and players daily, and even there it may be spotty. How much more difficult, then, to raise the understanding of financial markets by criminal prosecutors and, perhaps even more seriously, the judges in criminal courts.

Reliance on criminal penalties and proceedings to enforce violations of the securities law has its critics. The major criticisms are listed below:

- Where the infractions are modest, criminal proceedings may be too ***heavy-handed***. Certainly "judges and juries are reluctant to criminally convict supposedly reputable business persons for practices that were part of the societal mainstream a short while

ago."[52] To the extent criminal prosecution or judgment create a moral stigma, enforcement may also be reluctant and therefore inconsistent

- Criminal proceedings are ***constrained by procedural rules***, often based in the country's constitution, that protect the defendant at the expense of the prosecutor's ability to make a case by setting high standards of proof and limiting evidence. But financial fraud is often difficult to prove without recourse to circumstantial evidence.[53]
- Criminal law may be ***too simplistic*** for sophisticated financial scams.[54] Certainly financial economists often believe that the law is at least one step behind the market, prohibiting yesterday's crimes but missing those of today or tomorrow. This may be particularly true in emerging markets, where government prosecutors are usually paid a small fraction of the money people can earn in the financial markets.
- Securities regulators in developed as well as emerging markets sometimes find that they ***cannot rely on the prosecutors*** situated in another agency of the government to enforce the law as thoroughly as the securities agency would want. Prosecutors often decide themselves the extent of resources to be allocated to any proceeding, and the prosecutors' priorities may not mirror those of the securities regulator. This happened in the UK during the 1980s before the Big Bang in 1986, when the stock exchange as a self-regulatory organization had to rely on the Department of Trade and Industry to prosecute insider-trading violations. The DTI's conviction rate, against the cases submitted for prosecution by the securities regulator, was very low: of the cases referred to it, DTI prosecuted 5% and won convictions on only 3% (Fitch 1991).
- It is difficult to impose criminal ***sanctions on organizations and their staff*** in an even-handed way. Part of the problem is in the nature of the sanctions. Staff can be jailed or fined, but the organization itself can only be fined. Punishing an organization, through fines, may not deter its individual employees from illegal acts. Part of the problem arises because the illegal act may not benefit both the firm and the employee doing it. This problem does not arise so much when a staff member, without the knowledge of his superiors, takes advantage of the firm that employs him. The problem arises when a staff member does illegal acts that benefit only the firm, not him, and it is compounded when a superior of the staffer orders him to carry out the act. This dichotomy of interests and penalties must be resolved in developed and emerging markets, but it may be particularly vexing in developing countries where relations among owners, officers, senior managers, and staff are complicated by family and other relationships that may be seen as mitigating the penalty for the offense. China carefully designed penalties for both individuals and organizations, which the law referred to as units. Units included any form of business firm, state agencies, and other associations. Penalties could range up to life imprisonment in some circumstances (when someone steals a huge amount of money) and large fines for the organization (when, for example, it issues shares without authority).

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52 Steinberg (1996), at 724.

53 Steinberg (1996), at 725.

54 Rider (1996), at 360.

- The ***choice of sanction***—fine or imprisonment—is complicated in securities markets, because the possible gains from violating the law can be huge. If fines allow one to buy one's way out of the violation, their deterrent effect is nil. In emerging markets, fines can be set too low because the lawmakers lack the experience (or the political will) to set them higher. But even where the fines are set high, the deterrent effect may quickly evaporate. This is the problem in emerging markets with high inflation. A fine that is reasonably high when set by law becomes trivially low after a few years, but because amending laws is difficult the fine remains unchanged. One solution—to index the penalties—may not be consistent with the rules of criminal law in the country. Another solution is to retrieve a multiple of the ill-gotten gains. While the U.S. triples the illicit gain in some cases, China applied a multiple of five for serious violations (e.g., misappropriation of customer funds). Yet a third proposal is for the government to assess "equity fines" on organizations, taking an equity stake in the firm that violates the law and only releasing that ownership when the firm has solved its internal problems (Ho 1996, citing Coffee).

The most fundamental criticism, however, is that criminal law is reactive and general. The regulator must wait for the law to be broken before it can move. The law is necessarily general. Preventive regulatory measures, it is argued, are much more effective. The trend in the U.S. has been toward increased reliance on these preventive measures, particularly by financial firms policing themselves (Walsh 1997). This is discussed below.

2. Prototype of private civil enforcement

Rather than enforce the securities law primarily through criminal processes, a regulator can rely on the people who are most immediately affected by violations of the law to enforce the law. This prototype recognizes that a securities regulator lacks the resources to police all securities markets itself. The opportunities for wrongdoing are numerous and diverse, and the techniques used to violate the law can be so complex that detection becomes extremely hard. So the regulator, while continuing to play a direct administrative role in enforcement (see below) and through criminal prosecution, relies on a broad cadre of active private litigants to enforce the law. One can see this as a way to decentralize or privatize enforcement, reducing the cost to the government. Private plaintiffs can pursue a company's "directors, officers, broker-dealers, investment bankers, accountants, and attorneys for allegedly engaging in fraudulent practices."[55] To what extent should securities regulation rely on the private sector to enforce the rules? In the U.S., the answer is to a great extent.

To rely safely on private suits, the U.S. promotes them. Using statute and case law, it empowers shareholders, and others, to sue and it gives them incentives to do so. U.S. securities legislation explicitly, or directly, empowers shareholders to sue, giving them a private right of action. They may do so if they buy shares sold with misleading statements or without fully complying with the registration standards. They may sue senior officers or controlling

55 Steinberg (1996), at 726.

shareholders that profit from short term trading of the firm's stock. In addition, the securities laws state that any contract that violates the statutes is void. From this the courts concluded that Congress intended to give a private right of action to have such contracts declared void. Finally, the statutes say that many activities are not lawful or are prohibited. When a plaintiff was in the group protected by the prohibition, U.S. courts said that he or she had a private right of action when the statute was violated. Many private suits have been based on general anti-fraud provisions in the acts. So, during a time when a prospectus contains fraudulent statements, a person who buys or sells shares (and only such a person) can sue in reliance on the general anti-fraud rules in the acts. However, a problem occurs when the issuing corporation is hurt by actions of a controlling shareholder or officer that violate the securities laws. It is fair to assume that those running the corporation will not let it sue them. To deal with this, the law allows a shareholder to launch a derivative suit, on behalf of the corporation.

The problem for civil suits is that any one shareholder might not have sustained enough loss for an award of damages to justify the very high costs of a lawsuit, so the U.S. gives them incentives that make it possible to sue. It allows a plaintiff to pay its lawyers contingency fees, giving the lawyers an incentive to pick cases that can bring substantial amounts of money in damages, but only if the plaintiff's lawyers win the case. So a prospective plaintiff will not be deterred by the possibility of having to pay very high lawyers fees and still losing the case. Perhaps more importantly, the U.S. allows a plaintiff to sue on behalf of a group like her or him (the class action). Federal rules of procedure set clear standards for a class action. The number of possible litigants is so big that it is impractical to join them all in a single suit. Common questions of law or fact affect the whole class, the plaintiff's claims are typical of the entire class; and other parties in the class will be protected by the plaintiff. The plaintiff must jump other procedural hurdles, as well; all designed to prevent abuse. Having cleared them, the class action suit can claim damages for the entire class, rather than just the plaintiff. The lawyers can be paid.

The right to pursue civil actions for securities fraud generates a big and heated debate. On the supporting side, the organization of securities commissioners, IOSCO, argues strongly that class actions are very useful and a government should not compromise private litigation but even this approach has limits.[56] On the other side are people demanding that class actions be severely curtailed. In a major debate during the mid-1990s, two American legal scholars locked horns over this matter. In favor of curtailing class suits, one argued that they discourage people from investing, which would hurt the economy (Grundfest 1994). It was not clear that the courts were able to separate meritorious suits from frivolous ones. Shareholders were suing a company when its stock dropped, presumably a risk the shareholder had taken into account when investing. Finally, companies were forced to settle huge suits, without paying attention to the merits of the suits, just to hold down the potential costs. Each of these points was refuted in the works of another scholar (Seligman 1995, at 343). To respond to perceived threats to capital markets, Congress passed a law in 1995 to restrict people's use of class actions. Congress concluded that too many shareholders' suits were designed to blackmail the issuing companies into settling out of court. So the U.S. is pulling back.

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56 IOSCO (1998), at 18.

In other countries, the private sector usually plays a very marginal enforcement role. Prohibitions on contingency fees and class actions, and the requirement that losers bear the costs of both sides' lawyers, discourage private litigation. In many countries, civil suits of this sort are unusual. Japan, for example, has an extremely low litigation rate by the standards of most developed countries and most Pacific Rim countries. Many reasons are given: a cultural preference for mediation to resolve disputes, a very limited supply of attorneys because of controls over licensing lawyers, an unwillingness of judges to decide cases against the executive branch (which, by setting the judges' salaries and assigning them to an undesirable location, can penalize a judge who decides "wrong" where wrong often means deciding against a large corporation). Whatever the cause, the absence of civil litigation encouraged the securities regulator to try to protect shareholders by administrative action (see below), primarily licensing (Milhaupt 1996). Japan is not alone. In Eastern Europe, Estonia is reported to be a country in which civil suits are rarely used. But, while this reason to avoid reliance on civil suits can be quite powerful, one should realize that the causes for the low rate of civil litigation can change. In contrast to Japan were two countries with its legal system, Korea and Taiwan. As they developed, the political system became more democratic, and government policy became more market oriented, the rate of civil litigation rose in both countries (Pistor and Wellons, 1999). It may be that civil suits can be fostered despite a practice prevailing at the start that is against civil suits.

Some countries are reluctant to provide shareholders with the power and tools that sustain civil suits in the U.S. The UK is an example. It has been reluctant to imply private rights of action, allow derivative suits, and allow class actions. In the UK, one problem is that implied rights are "nebulous." When a companies law or securities law forbids certain action, UK courts generally will not imply a private right of action against a person who breaks the law. Derivative actions are hard to take. UK courts, with minor exceptions, say that if an action harms a corporation, that corporation is the proper plaintiff, even if the majority of shareholders is the wrongdoer to the corporation. Class actions are also constrained. The UK permits class actions, but limits them to suits to enforce common law or express statutory rights rather than those implied from statutes. Procedural rules are weak and courts are very cautious about allowing class actions (Ho 1997). Some developed countries do use them. The Netherlands' court in the mid-1990s shifted the burden of proof from shareholder to underwriter in cases alleging misstatements in a prospectus, for example.[57] However, one case does not demonstrate reliance on shareholders to enforce the securities law.

Is this prototype useful in emerging markets? It has some strong points. It has the potential to limit the government's role in the securities market, which would limit the ability of the government to exercise power in a harmful way. The use of this prototype may encourage other powerful players to act, even if the little guy cannot. Some emerging markets have passed laws providing a basis in the securities law itself, at least to deal with specific violations of the law. Kenya and Zambia provide for private actions. Bulgaria's law, under certain conditions, gives shareholders a right to sue underwriters and the power to void contracts to buy. Kazakhstan

57 Cornelis, H., and T. Nederveen, Civil Liability for Prospectus Misstatements under Dutch Law, v. 12, no. 12, International Financial Law Review 50, December, 1995.

gives an express right to sue the issuer to share buyers when unregistered shares are sold and when false statements are made in the prospectus. It helps promote civil litigation by not requiring the plaintiff to prove the bad intent of the defendant, only negligence. This is in the context of a civil code that supports such suits by allowing the plaintiff to recover damages for income it did not receive, as well as, for any excess payment made (Bukhman 1997). China appears to rely much more on criminal and administrative enforcement, but it favors civil enforcement when penalties are to be paid. When a violator of the securities laws cannot pay all that suffered loss, China gives parties with civil damages against the violator priority over government's claims for fees and penalties. This is a small step toward encouraging civil suits.

While an emerging market can remedy a deficient legal basis for class action, derivative action, and even contingency fees for attorneys, there seems to be a to give limited rather than broad private rights to plaintiffs. Kazakhstan makes only the issuer liable (i.e., only those who sign the prospectus), imposes very limited liability on professionals, limits the defendant's liability to pay a winning plaintiff's legal fees, and implies no rights of action (Bukhman 1997). Estonia gives the purchaser a right to rescind the purchase if an underwriter changes the terms of the offer and a right of redemption if an offer is suspended by the securities regulator, but does not define damages owed to a purchaser if the issuer suspends the issue. Nepal gives no statutory remedies of any sort (Pyakuryal and Uprety, 1996).

The major problems for civil enforcement are a lack of data and the terrible weakness of the institutions needed to make it work well, corporate governance, and courts. Available data are so limited that private parties cannot meet even a reduced burden of proof. Corporate governance is so weak that minority shareholders lack a basis to sue. The civil courts lack essential human and other resources, leading to very high costs for private enforcement. The cost is high, Steinberg notes, because "judges and lawyers are not numerous, ... their level of expertise on such complex matters is not impressive" and the courts are not remotely able to manage the volume of suit with the sophistication needed for investors to enforce their interests. Instead of accepting the cost of possible litigation, the investor would simply move elsewhere, because few investors would favorably "anticipate [the high probability of having to bring] . . . a lawsuit based on securities fraud . . . ."[58] This assessment leads to the view that, at least for emerging markets, private enforcement is a high cost to be avoided.

The solution may not be for other countries to emulate the SEC and rely more on civil actions. According to Rider, it is the high hurdles of U.S. criminal law that force the SEC to seek civil remedies. Countries where the regulator is not constitutionally so constrained should not need to shift from criminal to civil proceedings. Instead of increasing either criminal or civil proceedings, governments need better prevention, Rider asserts. He recognizes that this means greater administrative powers.

58 Steinberg (1996), at 726.

3. Prototype of administrative enforcement

In this prototype, the securities regulator—commission, agency in a ministry, or central bank—has and uses a full range of administrative tools to enforce the law. A full range includes mediation or arbitration facilities to resolve disputes, suspension or withdrawal of licenses, fines for violations, injunctions through civil courts, and enforcement of criminal sanctions in the courts. Informal tools, such as administrative guidance can be quite powerful and are discussed below. The initiative and power to enforce rest primarily with the regulator, not in criminal or civil courts, although the regulator may use these courts to enforce some of the rules. The government regulator may delegate some of these powers to self-regulatory organizations or market players like securities firms, as discussed in the next part of this chapter.

Administrative enforcement tool: Resolve disputes through mediation or arbitration. One tool for a regulator is to act as a quasi-substitute to the use of the civil courts by private parties, as discussed above. The regulator may provide a mediation service for private parties who believe they are aggrieved by the acts of another private party, such as the share buyer who believes he was misled by the distributor of shares in an initial public offering. The regulator provides the forum for the parties to try to reach an understanding. Or, the regulator may provide the facilities for formal arbitration, and perhaps even a panel of arbitrators skilled in securities law. One or more arbitrators would review evidence submitted by both parties and decide on an appropriate solution. Limited judicial review would be permitted to ensure compliance with the procedures, according to the country's Arbitration Law. This administrative dispute resolution system could fit well with the legal culture of the country. Japan, for example, relies much more on mediation and arbitration to resolve disputes than on the formal court system. For emerging markets, arbitration may be a second best solution, however. Many developing countries lack effective arbitration laws and qualified arbitrators are in short supply. As discussed in the next part, the regulator may delegate this function to the stock exchange (or another professional body) acting as a self-regulatory agency.

For emerging markets, one writer suggested setting up an intermediate body, an administrative tribunal that is part of the regulator, with the power to make decisions and a right to appeal the decision to a court if the country's legal system provides it generally. One advantage of the regulatory tribunal is that examiners would specialize in securities law and develop expertise in it.[59] One major emerging market, India, has a history dating back to before World War II, of using administrative tribunals to circumvent inefficient courts in specialized fields like tax enforcement. Unfortunately, the tribunals in India developed their own inefficiencies, leading them to long delays as well.

Administrative enforcement tool: Suspend licenses. The regulator normally issues licenses to many key market players—the securities firms (underwriters, brokers, dealers) and the stock exchanges, at least. The regulator also has the power to withdraw the license, of an individual or a firm, according to conditions prescribed in the law and, normally, subject to appeal. The threat of using this power can be a strong tool to enforce the law because the law requires a license for a

59 Steinberg (1996), at 727.

person to carry on the business. Short of actually revoking a license, the regulator can intervene in, and run, the business of a licensee that is not complying with the law (Fishman, 1991).

In the view of some analysts, this tool can be quite powerful for emerging markets. Licensing and prudential supervision combine to set standards of conduct. Key general elements of licensing are "integrity and solvency, ... fitness and competence," and sometimes "suitability and even quality."[60] Better prevention means "a form of control and monitoring, which resembles prudential supervision of banks."[61] Rider argues for greater "attention to the institutional aspects of effective supervision and surveillance."[62] Regulators should be serious and persistent in their efforts to police disclosure rules and enforce standards, something they do much too infrequently. In this view, by policing and penalizing violations of these standards, the regulator will prevent violations of the securities law much more effectively than by using criminal or civil proceedings.

Policing of rules that are clear and precise, such as some disclosure rules, would seem to be essential. It is hard to see, however, how securities regulators in emerging markets, hampered by very limited resources and with little or no tradition of securities markets, could exercise effective preventive regulation that is qualitative, without slipping back into the *dirigisme* that their countries are struggling to throw off. Even licensing may not be as effective a screen in emerging markets as in developed ones. Nicholas Leeson, who brought down the venerable firm of Barings Brothers, acquired a license in Singapore after having failed the review in the UK. Singapore has a better reputation for care than many other emerging markets.

Administrative enforcement tool: Fines. Securities laws commonly provide for fines when specified rules are violated. Even in countries with a tradition of code law, the securities law can provide for fines that the regulator can impose. The question is whether the fines are sufficiently high to deter, but not so high that no one—regulator or courts—will enforce them.

Administrative enforcement tools: injunctive and other relief through civil suits. Civil suits allow a regulator to enforce the securities law using tools that are not available to the executive branch operating on its own. So the advantages of seeking relief through civil action depend very much on the structure and distribution of powers with each country's legal system, including its constitution. In the U.S., the advantages for the SEC have been substantial. In the UK, the regulator has similar powers.

The attractions of these tools is that they offer a wide range of relief that includes a court order to stop the illegal behavior already under way, or to not take illegal action that is contemplated. These tools also offer stronger financial penalties than the regulator can impose on its own: prohibition of certain acts by senior managers or directors, repayment of profits that were illegally obtained, voiding of contracts (e.g., with unauthorized investment advisers) and damages plus compensation for loss by the other party, and even receivership (Fishman 1991,

60 Rider (1996), at 355.

61 Rider (1996), at 355.

62 Rider (1996), at 368.

Steinberg 1996). The legal system would not permit the regulator to use these tools on its own, so the regulators look to civil suits. A securities regulator who can in turn draw on the arsenal available in a civil suit, can, at lower cost, get faster results tailored to the infraction, than acting through criminal courts.

The U.S. SEC has been particularly adept using civil actions to enforce securities laws. SEC has used civil remedies well historically. During the 1970s and into the 1980s, the SEC used the courts to appoint receivers, set up special committees on a company's board of directors, force violators to disgorge illegal profits, and remove officers and directors.

The experience of the SEC, however, raises questions about whether these powers are sufficient for the law to be enforced. Experience showed that even after adding new powers to impose civil penalties to their administrative powers, SEC enforcement powers were not adequate. So the trend for the SEC was toward greater use of criminal, not civil, sanctions (Pitt, Rauch, and Straus, 1993).

For emerging markets, Steinberg recommends that the regulator protect investors from fraud through civil proceedings even if "the costs of providing monetary relief to aggrieved investors are acceptable." But in emerging markets, if the use of civil courts is to succeed, the courts have to work effectively, which may not happen in an emerging market. Steinberg misses the terrible weaknesses of the civil courts in many emerging markets.

Administrative enforcement tool: Criminal prosecution. A very basic question is whether the securities regulator should be able to prosecute crimes on its own? This would be difficult or impossible in many countries because the constitution or the legal system separates criminal enforcement from administrative action. IOSCO, which works on a principle of compromise, did not recommend giving the securities regulator the power to prosecute. In Malaysia, however, the power to investigate and prosecute (subject to the consent of the public prosecutor) is given to the securities commission. The commission can compel those under investigation to provide evidence, which could then be used against them.[63] This is another weapon in the arsenal of the powerful securities commission.

Administrative enforcement tool: Informal sanctions and "moral suasion." In practice, financial regulators exercise informal power over those they regulate. The power could be as limited or innocent as "jawboning," in which the regulator tells the market players what action he would like to see but intends to use no formal power to enforce that recommendation. At the other extreme is "administrative guidance" of the Japanese variety, in which the regulator uses general formal powers to get or prevent specific actions from many or just a few regulated firms. This is not just a Japanese invention. The U.S. Federal Reserve Board has been said to threaten non-compliant banks with the loss of overseas branch licenses if they do not come around. But administrative guidance has been more systematic and detailed.

A strong regulator in an emerging markets. While no clear trend exists in major established markets, the trend in emerging markets seems to be toward a strong regulator. In major established markets, as discussed above, the location of the regulator and powers vary. In Japan,

63 Rider (1996), at 370-1.

the ministry of finance has lost its formal enforcement powers and so its informal powers are also waning. The new agency is using a wide range of criminal, civil, and administrative sanctions, but remains weak in its ability to enforce them broadly because of very limited resources. In contrast, the U.S. SEC relies more on criminal sanctions now than ten or fifteen years ago (described above), though the SEC continues to wield its administrative powers.

In emerging markets, the new laws generally give the regulator—which is usually a securities commission—substantial administrative powers. Tools include most of those listed above. One sees this in countries as diverse as Bulgaria, China, Zambia, Romania, and India. In India, in 1988, the Securities and Exchange Board of India (SEBI), which was created with limited power, received a mandate to enforce India's securities laws in 1992, and received a substantial increase in powers in 1995 after a scandal rocked the securities markets.

This prototype appeals in many emerging markets because, compared to the alternatives, it offers much greater flexibility and speed of implementation. A powerful regulator fills a huge gap that no other institution can begin to fill. It can concentrate the government's scarce resources, training people to have skills in dealing with the securities markets, consolidating the experience of government officials and the government's information about the market and its players into one agency. This moves regulators down the learning curve and allows them to deal more as equals with a financial community that includes relatively sophisticated players based in the country and certainly in the form of leading international securities companies from abroad. This concentration of enforcement skill also helps promote markets for securities. Most of the countries lack the traditions of a market-based economy. Many people in the public and private sectors are risk averse. The securities *markets* must grow in a hostile environment. A regulator with strong, diverse, and flexible enforcement powers can help to protect the fragile securities markets from abuse in its early stages.

While regulatory capture is always a danger, in emerging markets the greater danger is the potential for the regulator with these enforcement tools to become much too powerful a player in the country's financial markets. This is not limited to emerging markets. The story of Japan's ministry of finance, described elsewhere, is a case in point. This danger exists in emerging markets too. The power of Malaysia's securities commission is described in various parts of this report. Its substantive powers include the ability to impose merit regulation on issuers, applying resource allocation criteria set by the executive. On top of this, the Malaysian commission has more enforcement powers than British or even U.S. regulators.[64] In its ability to prosecute on its own, Malaysia's commission goes far beyond the power of the U.S. SEC, which must rely on the justice department to prosecute criminal cases. This excessive power can undercut the development of real markets for securities because the players will leave critical decisions about risk and return to the regulator.

The traditional solution to excessive regulatory power is to establish an external review of the regulator's actions, usually through a court. In the U.S., extensive review is possible. In the UK, the Financial Services Act defined and required fairness and due process, with the right to review by a court. The FSA also created the Financial Services Tribunal, an independent body financed

64 Rider (1996), at 370-1.

from the public budget, to investigate possible abuses by the regulator. Persons affected by the regulator's decisions could appeal to the tribunal, which had to follow "detailed evidentiary rules." Investors' complaints, however, could not be heard by the tribunal (Fishman 1991). The tribunal could require the regulator to act. Its decisions could be appealed, on matters of law, to the appellate courts in the UK, but generally were not.

In most emerging markets, the courts can be expected to play a minimal positive role at best. In new legislation in transition countries, courts receive different degrees of review power. Bulgaria provides for limited court review to make sure the regulator complies with the form required by the law. But the Bulgarian courts are not expected to review the substance of a regulatory decision. In contrast, Estonia gives the administrative court substantial power to review a wide range of substantive decisions by the regulator. In some other transition countries, the administrative courts still harbor an ideological bias against economic activity of this sort, making them unpredictable or outright hostile. In emerging markets in countries with long established legal systems, courts may or may not have significant review powers. Despite the tendency to associate judicial review more with common law traditions than with code law systems, the power of the courts varies within both systems. Both India and Malaysia follow the common law, but in India judicial review has been extensive and powerful, while in Malaysia judicial review has been limited by the political power of the executive. India's courts, however, do not act quickly (this is an understatement), so from the fast lane occupied by financial markets the right to judicial review in India offers little comfort against arbitrary action by the regulator.

If so many problems of enforcement in emerging markets resolve to the inadequacies of the country's judicial system, is there an alternative? One proposal discussed above in terms of licensing and prudential regulation would be to keep the strong regulator but focus its attention on prevention rather than criminal or civil proceedings. Perhaps a country could design its securities law this way. To the extent that this proposal would reinforce licensing, it runs contrary to the international tendency to regulate markets rather than institutions, and risks heading the country's regulatory system into the past. To the extent it relies on prudential regulation of risks in the market (rather than types of players), this proposal might be a useful alternative.

C. RELATIVE ENFORCEMENT POWERS OF GOVERNMENT AGENCY AND SROS.

A major debate about relative enforcement powers concerns enforcement by the securities regulator, generally a commission or the ministry of finance, and by self-regulatory agencies, generally stock exchanges.

Enforcement does not here entail a zero-sum balance in which as one regulator (e.g., the government agency) increases its enforcement power the other (the SRO) loses power. However, not everyone sees it this way. An exchange that is downgraded by the appearance of a securities commission does not like the loss of power. The continuing tension in Thailand between the commission and exchange is an example. An acceptable balance has not been struck since the early 1990s, when the commission appeared.

Four prototypes emerge: almost complete reliance on the SRO; active SROs within a decentralized government regulatory structure; most enforcement power in the government agency with clear functions for the SROs; and effective, possibly informal, power in the government with the SROs implementing policy. These are presented below.

1. Prototype #1: Rely primarily on the SRO

While most countries do not use this prototype, some do. A country that chooses to rely almost exclusively on the SRO to enforce the rules has a simple securities market, in which most activity, for which investors need protection, takes place on the exchange. Most, if not all, securities issued publicly are intended for the stock exchange and will be listed there immediately. The securities being traded are mostly the common stock of local companies. Local brokers handle the trades through the exchange. Because the rules set simple standards of disclosure for these securities, simple procedures for the trading and only basic requirements for the member brokers, the exchange can enforce these rules. In Zimbabwe, for example, the stock exchange takes the enforcement initiative, if any is needed; there is still no securities commission but a committee in the finance ministry can discipline and suspend members of the exchange. In Namibia also, the stock exchange as self-regulatory organization carries out all the regulatory functions. Neither has a securities commission. In Estonia, there is a commission but its powers are so limited that one expects the stock exchange to act, by default.

The justifications for this prototype are that it relies on the expertise of people in the market who know market conditions better than regulators could and that SROs can act quickly because they are not bound by the procedural niceties that restrain government officials. In fast moving securities markets, market experience and speed are essential. But, as Ho (1997) points out, government regulators get experience, some are able to move quickly, and at reasonable cost.

This prototype has an important built-in problem. When the government regulator relies substantially on the SRO to enforce the rules, there may be problems of conflict of interest and collusion. According to Rider, dependence on SROs subjects enforcement to the test of "political acceptability."[65] He means that it is harder for the SRO than the government regulator to enforce rules that would severely hurt its members. While a statute can delegate enforcement authority to an SRO that would exceed the contractual authority it would have from its members, most governments would not be willing to grant an SRO a wide range of enforcement powers precisely because of the built-in problems.

Historically, this prototype worked for relatively simple securities markets. The UK's policy, giving SROs as much authority as possible, grew up in simpler times and was relinquished when the markets became too complex. Zimbabwe's market is not complex, even though it was funded by foreign portfolio investors, and experienced rapid growth in the recent past. The prototype does not work as the financial system becomes more complex and players become more diverse or international (see the discussion above). Self-regulation in these markets is done "by a professional body of bureaucrats employed by market practitioners. ... In profile, they are not very different from employees of the regulatory commission" (Ho 1997, at 633).

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65 Rider (1996), at 355.

The failure of this prototype does not mean SROs have no role in enforcement. It only means that SROs should not be the only regulator.

2. Prototype #2. SROs enforce within a formal decentralized regulatory umbrella

This prototype is seen in the UK's effort to formalize self-regulation and subject it to the oversight of government regulation. The experiment began with the Big Bang in 1986 and ended in 1999, when the UK switched to the third prototype. Fishman (1991, at 134) described the structure of this system:

> three tiers of authority over the financial services industry. At the top are the Department of Trade and Industry (DTI) and the Bank of England. At a second level is the Securities and Investments Board (SIB), a private agency to which primary regulatory responsibility has been transferred from the DTI. The third tier is comprised of four self regulating organizations (SROs) [which regulate (a) independent investment intermediaries like brokers, (b) investment managers like pension funds and investment advisors, (c) marketing of insurance policies and collective investments like mutual funds, and (d) investment businesses in equities, bonds, and derivatives], seven investment exchanges, eight professional bodies, and two clearinghouses. These organizations, which are private, functionally-organized industry bodies [including associations of chartered accountants, actuaries, insurance brokers, and law societies], directly monitor the activities of their members.

"SROs are defined as bodies that regulate the conduct of any kind of investment business by enforcing binding rules upon its members or others subject to its control" (Fishman 1991, at 138). An SRO can make a member stop certain activities, take others, and "fine, discipline, expel, or otherwise sanction" the member. It is limited to the member; it cannot force a non-member to give evidence, for example, unless the SIB delegates the power for a specific investigation. The SIB has this power, but its role in enforcement stops when the investigation is complete and the DTI, or the government's frauds office take over prosecution. Although the combined powers of the regulatory agencies are broad, enforcement of certain rules remains outside the statutory system. The DTI, for example, enforces insider-trading rules alone.

In the event, this prototype proved to be a transitional device for the UK as it moved from the first to the third prototype, centralizing authority in a single governmental supervisory body and reducing the power of the SROs, though not eliminating that power. The SIB, as a private entity, was too limited in its ability to enforce the regulations. This regulatory system proved too cumbersome and decentralized for the financial markets in the UK

3. Prototype #3. Most formal power and enforcement in government regulator with some enforcement functions performed by SROs

Even in the context of a strong regulator of securities and their markets, the SROs may play an important role enforcing the rules. In the U.S., the SEC has considerable enforcement power and the SROs, which are either stock exchanges or the national association of securities dealers for the over-the-counter market (NASD), have important enforcement powers within the ambit of their activities. One type of activities consists of rules governing transactions on the exchange, such as listing the issuers of the listed securities, trading by members of the exchange, clearance and settlement, and exchange governance. The other type activities are rules about the members

and their customers, including licensing of firms and staff. The SROs can censure, bar, or fine broker-dealers and their associates who break either federal securities law or the exchange's rules. They can delist the security.[66] They have surveillance powers to support their enforcement of the rules.

Below this level of SRO is another level of self-regulation. In the U.S., each broker-dealer is responsible for regulating itself. It must "institutionalize compliance with [the] firm's normal operations" by making rules that embody those of the exchange and the SEC and then design its own system to prevent violations. This has been described as "a quasi-privatized regulatory regime" (Walsh, 1997, at 168). The SEC can punish a broker-dealer that fails to supervise its operations, and staff, but the firm has a safe harbor if it establishes and enforces internal rules that would reasonably be expected to identify or prevent the violation. Securities firms set up compliance departments and monitor operations to ensure compliance. Special rules, based on legislation, exist for insider trading.

The SROs and their members are both subject to the SEC. It supervises the SROs, having the power to suspend authority for an exchange, a member, or a listed security. The SEC can order the SRO to make or change its rules. As a governmental regulator, the SEC is substantially more powerful than the SIB was in the UK, as described in the past section.

Some emerging markets modified this prototype, increasing the enforcement powers of the securities commission and reducing those of the SROs. Among transition countries, Kazakhstan enacted laws that make the securities commission much stronger than the SRO (the commission is less powerful than the SEC, because it cannot fine or issue cease-or-desist orders), but lets the stock exchange play a moderate role enforcing the rules (it can fine members or suspend licenses, though market players are not obliged to be a member of any SRO). Among emerging markets in developing countries, Zambia also shifted even more power to the commission. Zambia's law placed most enforcement power in the securities commission, which even retained the power to revoke or suspend the licenses granted by the stock exchange. These examples may not be surprising, because the foreign advisors drew their models from the U.S.

4. Prototype #4. Power in the government regulator, while SROs implement

In a variety of ways and for different reasons, countries as different as Bulgaria, India, Japan, and Nepal, put power in their regulators and leave SROs to play a minor role. In each case, legislation was the source of this power. This is a less coherent prototype than the others are.

- Bulgaria's act gave the regulator broad power (except to prosecute), but said little about stock exchanges. Since the exchanges had fought the government during the negotiations for the legislation, perhaps the national assembly would only have passed the act if the exchanges' power was ambiguous.
- India, however, deliberately rejected the SRO power that had been the norm for many years. After scandals in the early 1990s, the national government gave the recently created Securities and Exchange Board of India (SEBI) "complete control" over the

66 Steinberg (1996), at 724.

exchanges. SEBI can intervene directly in an exchange's operations, at its discretion, but the exchange is normally responsible.

- In contrast to both, for decades Japan used SROs to disguise the full extent of the government's power in securities markets. In Japan, for years the finance ministry was the powerful regulator that relied on SROs to enforce rules. This may have been a device used by the ministry, the SROs, and their members to obscure the power of the ministry. Close links between the ministry, the SROs, and the major securities companies meant the SROs could refrain from enforcing regulations that were unacceptable to all three groups but which the ministry could not be seen to ignore, if it had the enforcement power. In about 1995, public attitudes coalesced against Japan's financial sector. When the government changed the rules in 1997, it did not divest the SROs of power as much as it tried to strip power from the regulator.
- Nepal gave the commission power over the exchange, but limited the powers of both. Nepal's law gave the government power to direct the stock exchange and its members to comply with government policy or to act in response to the needs of the capital market. But otherwise, the act gives neither the government regulator nor the stock exchange any special "remedies for statutory violations. The act relies on criminal, civil and administrative remedies outside the" commission to enforce the law.

5. Lessons for emerging markets.

The issue in this section is not the same as the question discussed in an earlier chapter, of where to place the regulatory authority. There, the debate has often been presented as a matter of ideology: less government is better, and the SRO enforcement is less government. The UK has been a particularly strong advocate of SRO powers in the past, though it has recently changed its tune. Here, the problem seems to be much more practical: if the government and SROs each should do what is in their comparative advantage, what are their comparative advantages?

SROs can enforce only a limited set of rules. Ho describes what they can do, since they rely so much on goodwill and concern for reputation. Commentators recognize the danger of conflicts of interest because of the SROs dependence on the members they regulate. But Walsh argues that within their limits they can play a vital role preventing abuse. And they can use their own specialized tribunals and arbitration (see discussion above). For SROs to do their job against their own members, they need a sense of professionalism and regular review by the regulator. For an SRO to discipline its own members, its own reputation as an SRO must be at stake. Regulatory review is relevant.

No trend emerges for the emerging markets, though recently among developed markets the UK for certain, and perhaps Japan, are moving toward Prototype 3.

CHAPTER 5. GOVERNANCE OF THE STOCK EXCHANGE

Stock exchanges provide the organized secondary markets where securities are traded. The basic debate about their governance turns on whether they are special entities that provide a public good in the form of a marketplace for trading shares or, instead, are firms that compete and try to maximize profits for their owners. At least since the era after World War II, the former view has guided public policy toward stock exchanges in developed countries and many emerging markets. This is reflected in their laws regulating stock exchanges, which perpetuate the treatment of stock exchanges as public markets. Over the last decade, this dominant view has begun to change. People have come to see stock exchanges as firms that compete with other firms—other exchanges—in their industry. This second view leads people to argue that the laws toward stock exchanges should change to reflect this competitive reality. The debate is not yet resolved, partly because stock exchanges seem to embody elements of both, and partly because it is in the economic interest of some groups to maintain the status quo.

These competing views are the basis for two key prototypes of exchange governance and how a country resolves the debate between them, leads to very different government policies. It affects not only the structure of the exchange, but also the nature of government oversight of the exchange, access by securities companies to the exchange, and the flow of data about trading to investors. These issues are discussed below, after the prototypes. Much of this discussion is informed by the analysis of Ferrarini[67] and the data he supplies about governance of European stock exchanges.

Emerging markets are in a difficult situation when choosing a prototype for exchange governance. There are compelling reasons to opt for a public market view, since the countries are trying to develop their securities markets. The country is likely to be able to sustain only one stock exchange, making that exchange a monopolist within the country, and the government may need to subsidize the exchange for many years. Moreover, most of the world's exchanges grew as public markets so ample precedent exists for this using prototype in start-up markets. On the other hand, the financial world is very different now, compared to when the exchanges in OECD countries began or grew. Stock exchanges compete actively with one another, within the region or world even if not in the same country. They compete for investors and, sometimes, issuers. Foreign exchange controls may have insulated start-up exchanges in the past, but controls provide much less protection now and investors, at least, can look far beyond their home country exchange for markets on which to trade securities. Perhaps it makes more sense for a newly emerging market to choose the prototype of exchange-as-firm at the start, so that the exchange

67 G. Ferrarini, Exchange Governance and Regulation: An Overview, in G. Ferrarini, ed., European Securities Markets: The Investment Services Directive and Beyond, Kluwer Law International, London (1998), at 245. It is remarkable that the literature fails to address these issues comparatively. For example, an article entitled "The Stock Exchange as a Firm" compares the New York and Tokyo Stock Exchanges, but does not describe their legal structure and governance. That is, the reader does not even learn what kind of a firm each exchange is. So this brief chapter identifies the major issues, shows how some of the exchanges are organized, and raises issues for emerging markets.

learns early to deal with its competitors. Yet, many of the emerging markets reviewed for this report have not done this.

A. PROTOTYPES OF EXCHANGE GOVERNANCE.

Stock exchanges vary widely in the way they combine several important characteristics such as ownership, whether the exchange is organized for profit or not, whether it is a public law institution or private law institution, concentrated or diverse ownership, and form of association (meaning whether the exchange is a limited liability company or not, and whether it has the ability to issue shares to the public). This discussion assumes that the government regulates exchange activities; the topic is discussed in the following part of this chapter.

A simple and useful first cut on prototypes of exchange governance is to base them on ownership. Ferrarini makes the case that ownership (assuming control by owners) is critical, though he only identifies two basic categories of owners: members or investors. Emerging markets have other categories of ownership, as well. Ownership seems to be the key to distinguishing types of exchanges because it determines the exchange's behavior on key matters that affect market efficiency. A government owned stock exchange is likely to operate differently from one owned by members, and both are likely to operate differently from an exchange owned by portfolio investors. The reasons are given below.

It is important to qualify these clear-cut categories of exchange governance by several factors, which are treated separately following the prototypes. These factors combine with the type of ownership to affect the exchange's operations in significant ways. It seems to be important whether or not an exchange is for profit, because this determines whether it behaves as the "firm" contemplated by the new theory of stock exchanges. And it also seems to be of importance that the owners of the exchange are few or diverse. If an exchange is controlled by one shareholder, or a small group, and another is controlled by many diverse shareholders, it is likely that each will operate in a different way.

1. Basic prototypes

The basic prototypes of exchange governance are by ownership: government, members of the exchange, portfolio investors, and a mix of members and other investors.

a. Prototype 1. Government ownership.

A country may decide to locate its stock exchange in a government agency or a state-owned enterprise, at least temporarily. Vietnam, for example, gave its securities commission the responsibility to organize and manage stock trading centers. Romania's stock exchange is a public institution. Poland's government owns the Warsaw exchange.

The fact that no stock exchange in Europe is now organized as part of the government suggests that this prototype has limited usefulness. In the past, however, exchanges in some countries had this form. Sweden's exchange was a publicly owned institution with a monopoly until 1993, when it was privatized. The monopoly power argues that the government should directly control the exchange, in order to prevent abuse. For emerging markets, several other

factors might be used to justify this prototype. The country probably lacks other institutions that could discipline the stock exchange, such as a group of investors or issuers with market power. The government probably lacks regulators who would be competent to supervise the exchange. Putting the exchange directly under the responsibility or the government simplifies matters. This was a major issue in Indonesia, for example, where the government owned the exchange for years until it was privatized in 1992. In Malaysia, the finance ministry controls the exchange and appoints its members.

The problem with this prototype is that the exchange needs to operate as a market and the government is not staffed or organized to run markets. Government officials tend to be risk minimizers and are compensated at a rate far below the returns an investor on the exchange would expect from a successful play. Government officials in many emerging markets often take a dim view of market volatility. They are not schooled in managing private entities, let alone exchanges. Ultimately, the Vietnamese law expects the stock trading centers managed by the securities commission to evolve into stock exchanges that are independent of the commission.

b. Prototype 2. Membership owned entity

The members of most major exchanges own their exchanges. This is true in Japan, the U.S., and other industrial countries. The economic logic has several strands, particularly when set in the past during the start-up phases of these exchanges. In the past, for many countries the economies of scale needed for an exchange to work efficiently were sufficiently great that only one exchange could flourish. Like many emerging markets today, only a few companies were large enough to issue shares and the investor community was relatively small. As a monopoly, the exchange could exert considerable market power over its customers, who were the securities companies who trade on it. But when the securities companies own the exchange, they tame this power rather than being subject to it. Once inside as owner-members, the securities companies gain access to the exchange's information about the market, which gave them an information advantage over other firms or investors who were not owner-members. Ownership costs were relatively low. The capital needed by the exchange was not so high that it had to tap a broad group of investors rather than only the members. Members were sufficiently similar in what drove them and their capabilities that they could act as a homogeneous group when they managed the exchange.

Undergirding this analysis is the public market concept. The state can accept this prototype, which includes monopoly power and the possibility of insider control, on the assumption that the exchange will be subject to special regulations that protect the broader pubic interest. That the European exchanges which organized as member owned organizations took the form of public law institutions, subject to state approval and oversight, underlines the relevance of this concept. This prototype is so compelling that the U.S. requires exchanges to be controlled by their members. No exchange can register if it does not meet this rule.

Given the exchange's role as a public market and the economic logic for adopting a membership organization, the determination of who can be admitted to membership becomes important. Exchanges set various rules for qualification as a member. Some permit only individuals (such as the Johannesburg exchange until 1995), others allow corporations, and some (U.S. exchanges) allow both. While the trend seems to be toward broad membership by

companies and individuals, this report does not examine the matter. The important point is that, given the logic of this prototype, if the exchange uses qualification tests to restrict membership in order to impose rents on those securities companies or individuals that are excluded, then it is abusing its special position. This prompts the government to regulate the membership standards of stock exchanges and often keep them open. The U.S., for example, requires June 9, 2000that the rules of the Exchange 'provide that any registered broker or dealer or natural person associated with a registered broker or dealer may become a member of such exchange. . . . '" (Cochrane et al. 1993).

For emerging markets, this prototype brings the advantages it brought securities markets and firms in developed countries in earlier days. Theirs are indeed imperfect markets. Ownership conveys some informational advantages to the members. Because the exchange is unlikely to have local competitors in most countries, member ownership neutralizes the monopoly power of the exchange. A problem in emerging markets is that the start-up costs of exchanges are likely to be much higher now than in the past, so the need of the stock exchange for capital may be more than the small group of local brokers, dealers, and securities firms can supply. One solution, of course, is for the government to subsidize this infant industry. All these factors prompt one to see the logic of applying a public market concept to the stock exchange in many emerging markets. Use this prototype, have members own the exchange, and rely on traditional government oversight of the exchange as a public market.

Many developing countries use this prototype. They include half of the fifteen countries examined for this report: Bulgaria, India, Indonesia, Kenya, Romania, Zambia, and Zimbabwe.

An alternative to this prototype would be to introduce what is missing, competition, which by its absence justifies this prototype: competition. India introduced competition in the form of a national stock exchange and jolted its regional exchanges into a search for greater efficiency. This new exchange competed nationwide using an automated system and was open to all brokers, dealers, and firms. It threatened all existing exchanges, even the largest, the Bombay Stock Exchange. Some, including the BSE, responded by trying to become more efficient. The problem with this option is that it is not open to smaller emerging markets.

c. Prototype 3. Mixed control entity

Prototypes 1, 2, and 4 are ideal types against which the reality of stock exchange ownership is often much more messy. Stock exchanges often mix at least two of these three types of owners—members and outside investors—and add other groups as well. This section about Prototype 3 describes dominant mixtures of members and other stakeholders in the exchange as owners, as well as the role of the government in ownership-like stakes. The section then raises the key issue, which is *who* exercises control over important decisions by the exchange.

In this prototype, the members commonly own a substantial part of the outstanding shares—certainly a large minority and sometimes a majority—while others own the rest of the shares. These other groups include other stakeholders in the exchange and the government. The stakeholders bring constituent representation, if not control, to the exchange and include several groups that are different but important to the exchange:

- Institutional investors hold shares in exchanges in Sweden, the Netherlands (pension funds), and Italy.
- Issuers (listed companies) hold shares in Sweden, Denmark (where issuers are the only minority group, against the members' majority holdings), the Netherlands, and India (in the National Stock Exchange).
- Banks hold shares in India's national stock exchange.
- Competing exchanges hold shares in Germany's Deutsche Bourse, a joint stock company owned 10% by regional exchanges, 80% by banks (which may be members), and 10% by stockbrokers (also members). The Deutsche Bourse hoped to coopt the regional exchanges, which saw it as a serious competitive threat.
- Portfolio investors could also be a group of shareholders, although none of the countries examined for this report had such a group.

The government's role can be problematic. In several ways, a government may exercise the kind of control that normally accompanies ownership without actually being an owner of the exchange. For example, in Kenya, broker/dealer members own the exchange, but the government appoints five of the eleven board members. This is a large block on the board and is an unusual role for the government. In fact, Kazakhstan prohibits government officials from being on the stock exchange's board, which is in the tradition of stock exchange governance. Another example of the government's intrusion is in China. The securities commission now appoints the general manager of each of the two stock exchanges, the recent securities law having taken that responsibility away from each exchange's council, which had made basic decisions about exchange business.

Arguing in favor of such an ownership-like role for the state is that the government presumably represents the country's interest in an institution—the stock exchange—that could become an important part of the economy. The stock exchange is where the shares of privatizing or equitizing companies would be listed and traded. No country wants financial crises and some governments might believe that their direct involvement in the exchange could avoid abuse that might precipitate a crisis. The government is probably subsidizing the exchange. So the government has an interest in the effective operation of the exchange. But it is not clear why this interest would require the government to be represented officially on the board of the stock exchange or appoint its general manager. State regulation is normally quite detailed.

The important question is who among these different groups holds control of the exchange: members, a group of constituents, the government, or no one. Each of the first three has different concerns. Issuers and investors will be concerned about the cost of the exchanges' services to them. But if members have control and the other shareholders are effectively silent partners in a stock exchange that uses Prototype 3, the exchange will not behave much differently from an exchange using Prototype 2. On the other hand, if no single group controls the exchange, conflicts of interest between member-owners and other owners, such as listed companies, could create inefficiency and damage the exchange's ability to compete. Prototype 3, then, requires special rules to protect minority owners.

d. Prototype 4. Investor-owned company

The argument for Prototype 4 is that the conditions allowing member owned exchanges no longer apply. As signaled above, exchanges now compete across borders. They compete with alternative exchanges, such as electronic markets, and even with members who increasingly supply some of the services that exchanges used to provide. The cost of trading and surveillance systems—for hardware and software, and communications—has grown substantially, so the exchange needs, off and on, to tap a broad base of investors to finance projects. The decision-making process of member owned stock exchanges, which is based on one vote per member, gives power to the pivotal voter rather than the majority (Ferrarini 1998), making change difficult. This is a particular problem because members with sunk costs in obsolescing systems may reject innovation, a charge that has been leveled at the New York Stock Exchange for many years. As members become increasingly diverse in their business, they have an increasingly difficult time agreeing on a competitive strategy for the exchange.

An exchange owned by portfolio investors would seem to remedy the problems membership organizations face. With professional managers responding to performance oriented shareholders, the exchange can respond to competition faster and manage greater diversity of member brokers and dealers. It can raise capital more easily.

Few emerging markets use this prototype. Bulgaria stands out as an exception. The law explicitly delinked membership from shareholding. It set capital requirements for membership relatively high and required at least twenty shareholders within the first year of any stock exchange's existence. Its goal was to force mergers among the many small existing exchanges that had sprung up before the securities law took effect.

The major problem that this prototype poses for emerging markets is that their capital markets are, almost by definition, too shallow to provide the broad base of investors needed to make the prototype work. Stock markets in many developing and transition countries are private and many have the corporate form. But it is difficult to get owners who do not have a stake in the stock market, particularly when the exchange is almost guaranteed not to be profitable for some years after it starts up or reforms.

2. Factors that affect the ownership prototypes

The four prototypes seem to be influenced by several factors other than ownership. These include whether the exchange operates for profit, whether (in code law countries) it is a public or private law institution, whether ownership is concentrated, and finally whether its business form allows it to have many owners. These are discussed in the following paragraphs.

a. For profit or not

Some exchanges are organized as non-profit entities (e.g., all the U.S. exchanges). Others are set up as for-profit corporations (e.g., the Deutsche Borse's supporting body is a joint stock

company (see below)).[68] The distinction would appear to have profound implications for whether the stock exchange operates as a public market in the general public interest, or whether it operates as firm in an increasingly competitive industry. If the government wants the stock exchange to concentrate on providing a good place to trade securities, it would seem sensible to make the exchange a non-profit company. If the government wants the exchange to be able to compete with other exchanges, particularly foreign ones, for business from issuers who might list, or from investors, it would seem sensible to make the exchange for profit.

Emerging markets that see their exchange as a public good may prefer the non-profit form over the profit corporation. But only three of the fifteen countries examined for this report made their exchanges not-for-profit and all are African: Ghana, Namibia, and Zimbabwe (where the non-profit exchange is allowed to earn a "surplus" but not for its owners, because it has no owners).

A larger number of the exchanges took the for-profit form. But for some of these, other factors undermined the degree to which the profit motive would guide the exchange's behavior. Bulgaria's government made its exchanges for-profit, but qualified this by prohibiting the exchanges from distributing dividends, giving exchanges subsidies, and placing limits on the extent of member control over their exchanges. Kenya has a for-profit exchange but, as described above, the government appoints five of the eleven directors of the exchange. And it should not be surprising that not-for-profit exchanges can nevertheless try to reap a profit. Sometimes law allows them to earn a profit; the exchange in Zimbabwe is an example. More frequently, the goal of not-for-profit exchanges, like those in the U.S., is to generate profits for their members. The members see the exchange as providing infrastructure for their business operations. The exchange does not need to be profitable. The members do.

So it is not clear that the governance of the exchange is unambiguously affected by whether it is for profit. Exchanges compete, so one would expect the profit motive to be a good impulse. One would expect a non-profit exchange to compete differently from one organized for its owners' profit. But several factors can moderate the competitive impulse of for-profit exchanges or undermine the non-competitive impulse for non-profit exchanges.

b. Public law institution or private law institution

Code countries have a corporate form that raises issues closely related to the previous topic, whether an exchange should be for profit. The legal systems of the code countries distinguish between public law institutions, in which the state has an explicit interest that requires licensing and regulation, and private law institutions, in which the state does not have such an interest. Several countries make exchanges public law institutions. Germany is one; (the Deutsche Borse has been described as such an institution. It has a for-profit joint stock company serving as the association that manages it. Romania has a stock exchange that is a public law institution and its stock exchange association consists of all securities companies that are its members. The association makes decisions like shareholders of a stock exchange, about the exchange's rules, budget, management, auditors, and other basic decisions. China's exchange seems analogous to

68 Some countries mix the types. In Switzerland, some of the exchanges are partly private OECD (1988), at 25.

Romania, because the members' general meeting is the highest authority for each of the two exchanges. Zimbabwe uses a non-profit form based on Roman Dutch law called the *universitas*, which can own a surplus but has no owners in the conventional sense. Private law institutions are found in most of the rest of the code countries.

The point is that one should be aware of this ownership form when considering these issues in code law countries examined for this report.

c. Concentrated or diverse ownership

The exchange is likely to behave differently depending on whether it is subject to concentrated or broad and diverse ownership. Concentrated ownership, such as control by a small number of members or by a few other investors, can open the exchange to capture by one group of its constituents. Because the stock exchange is a self-regulatory organization, it is a form of regulatory capture. This could also undermine its competitive position in the stock market industry if the controlling owner(s) seek to maximize their own returns to the detriment of the exchange. Among the countries reviewed in this report, Zambia's exchange, for example, started with only seven owners, that contributed $100,000 each. When two lost their licenses, ownership was reduced to five members.

Broad and diverse ownership may help regulators to treat the exchange as a firm. Broad diverse ownership means the exchange allows corporate and individual members, full members and others. Exchanges with broad private ownership include Bulgaria and Indonesia.

The degree of concentration or diversification among owners affects both Prototypes 2 and 3. As a member owned exchange gains an increasingly diverse set of members, its governance changes. It often loses its ability to respond to changing conditions in the industry and hence to compete. This does not mean it changes its form; the NYSE is an example of continuity of ownership, despite changing conditions in capital markets. Similarly, if an exchange using Prototype 4 has only a few outside investors, or has one dominant outside investor plus many other smaller ones, its governance will differ from an exchange with a broad group of diverse owners. The shareholders will exert much more control over the exchange's management in the first two cases than in the last.

d. Form of business association

The corporate form is the form of most major exchanges (Ferrarini 1998). The Tokyo Stock Exchange is one of many examples. The four prototypes do not require this form, however. Prototype #1 (government as owner) can be part of a government agency or take the form of a state-owned enterprise. Prototype #2 (member ownership) in its pure form is close to a cooperative venture or partnership, but in practice takes the form of a company. Prototype #3 (mixed ownership) is probably easier to organize as a company, but does not require this form. Prototype 4 (the investor owned exchange) can take other forms, but is most suitable as a company. This is particularly true for an exchange that seeks broad investor ownership, because the joint stock form allows the exchange to issue its stock to the public.

The appeal of the corporate form, of course, is that it limits liability. This is surely important in an industry where simple mistakes—such as errors in settlement—can lead to very high losses.

So it would be unwise for members to use, for example, a partnership form. They could be jointly liable for all sorts of problems, like damages for failures in clearance and settlement. They might have a hard time disciplining one another. There may be tax implications of choosing one form over the other.

These four factors show that very practical decisions about the form and governance of the stock exchange can have important consequences for the development of secondary securities markets. In emerging markets, these decisions are often made by the state when it drafts the laws governing the securities market and exchanges. The state's involvement with the exchanges continues through supervision.

B. SUPERVISION OF THE EXCHANGE

Generally, the regulator—most often a securities commission—supervises the exchange by setting broad rules and reviewing the exchange's rules of conduct. Sometimes it can step in to make basic decisions (India's securities board has this power, for example). The extent and nature of supervision varies a lot across countries.

The way a country resolves the debate about the nature of the stock exchange affects the way the government needs to (or does) supervise the exchange. The debate, explored in Part A, is whether the exchange is a special entity that provides a public good in the form of a marketplace to trade shares or, instead, a firm that competes with other exchanges and tries to maximize profits for its owners. If the exchange is a public market, state regulation is broad. If the exchange is a firm, the government's role as regulator is limited because the exchange can regulate itself, as an SRO, with fewer conflicts of interest. Much of the supervision of exchanges now is based on the former paradigm that the exchange is a public market.

At the heart of this analysis is the extent to which competition keeps the exchange in line, as an alternative to regulation. As a monopoly, the exchange requires regulation. If other exchanges (or substitutes for exchanges) compete with it and force it to be efficient, the state is not needed as much, even if ownership of the exchange is not broad or diverse. So one's analysis of the need for supervision hinges on one's analysis of competition for the exchange.

The view of the exchange as a public market with special powers raises an important question about the rules governing its procedures. Stock exchanges discipline their members. This makes them different from many other corporations. To the extent the exchange as an SRO has power over its members that it exercises because it is performing functions the state delegated to it, must the exchange abide by the rules of procedure governing the state? Is due process an issue for an exchange operating as an SRO? This is important because the exchange needs to be able to act quickly to rectify breaches in its rules; delays could undermine market efficiency. The relative procedural freedom of the exchange gives it a comparative advantage over the securities regulator when enforcing codes of conduct for securities companies and individual brokers and dealers. In the U.S., the 1934 act explicitly described exchanges as self-regulating organizations. It gave them responsibility to enforce some of the law. The existence of exchanges as self-regulating bodies long before the 1934 act justifies the exchanges' power to enforce their own rules independent of the federal due process standards. But when they enforce

the federal laws, they are subject to these standards (Stone and Perino 1995). This reasoning may work for a country in which the exchanges existed before the law, but will not help if the law allows for the creation of the stock exchange where none existed before. Each country has its own rules for procedure where penalties are applied. It is essential to make sure that these rules give the exchange latitude to enforce its penalties swiftly.

This part briefly examines five supervisory issues that affect exchange governance. They are:

1. Listing rules
2. Rules about insider trading and market manipulation
3. Limits on trading the listed shares off-exchange
4. Access to membership by licensed securities companies
5. Transparency of trades

1. Listing rules

The supervisor normally sets broad standards for an exchange to follow when listing shares, reviews the detailed rules as they are formulated, and may hear complaints about how the exchange implemented the rules.

The detail and specificity of the rules will depend on the view of the exchange: public market or firm. The public market view is that listing confers economic benefits that should not be granted solely by the exchange acting with monopoly power. The logic is to set, by regulation, detailed criteria for listing and the procedures to list. For emerging markets the problem is that this approach may resolve to merit regulation if the powers of the regulator or exchange are great.

The view of the exchange as firm, leads one to let the exchange decide for itself the criteria for listing. Listing is a strategic decision for the exchange. It may want to be the blue chip exchange, so it sets high standards. It may decide that it can compete better in regional financial markets by focusing, for example, on high tech or start-up firms. If the securities regulator restricts the exchange's ability to decide the listing criteria, it undermines the exchange's ability to compete. For emerging markets, this logic has at least short-term drawbacks. Probably the country can sustain only one exchange for many years. A focus strategy by the exchange will exclude too many otherwise eligible firms. It may undermine the government's privatization effort. The stock exchange is too important to leave its strategy to its managers, at least in the early years. A common solution is for the government to support several different boards on the one exchange. The blue chips can be traded on one board, small cap listings on another, and high tech firms on a third, for example. Many of the more established emerging markets, such as South Africa and Thailand, do this.

2. Rules about insider trading and market manipulation

The securities regulator commonly sets rules to prevent insider trading and market manipulation, and rely on the stock exchange to implement the rules. The issues about the relation between the regulator and the exchange are discussed in the chapter on insider trading, so they are not repeated here.

3. Limits on trading the listed shares off-exchange

Exchanges protect their markets by rules that prevent a listed share from trading on another exchange or from trading at all off the exchange (i.e., over the counter). One justification for such a limit is that investors benefit from the disclosure of information about all trades as they occur, and the exchange's rule ensures this by requiring all trades to take place on the exchange. The notion is that trading on an exchange is more transparent and priced better than trades off an exchange. A second justification, which can be compelling in an emerging market, is that the rule allows an critical mass of shares for trading by consolidating order flow, which makes the market more efficient (Ferrarini 1998). Listing on many exchanges would dilute the market for the security. An exchange may provide a limited exception for block trades (see below).

The problem for a securities regulator is that limits on trading listed shares off the exchange also protects the exchange from competition. Once the exchange captures the listing, the issuer cannot have the security traded on other exchanges (without delisting), so more new or efficient exchanges cannot break into this market.

The solution to this issue is partly affected by whether a government sees its exchange as a public market or a firm. Either approach could justify limitations on trading, but the former would let it happen and the latter might not. If the exchange is treated as a public market, the regulator may decide that it requires protection and that supervision by the state will offset the dangers of protection. If the exchange were treated as a firm, it would be permitted to limit off-exchange trading provided the limits did not violate competition or anti-trust law. These laws will determine if the exchange-as-firm can impose these limits. As Ferrarini says, the European Union solved the problem by ruling, first, that listing was possible, subject to certain rules, on all regulated exchanges in the union and, second, that investors were not subject to limits on trading off the exchanges. The U.S. treats the limits as rules of conduct that bind an exchange's members (and which the exchange can enforce against them), but not investors. Because the limits do not violate anti-trust law, these qualified rules limiting trading are justified as protecting investors, and investors themselves have the option of trading off exchange (just not through members).

Many new emerging markets have powerful reasons to limit off-exchange trading in order to centralize order flow, assure the best execution of orders, and maximize transparency, whether or not they view the exchange as a public market or a firm. Because they probably have weak competition laws that are rarely enforced, they cannot rely on an anti-trust discipline to prevent abuse by the exchanges. So the exchange's regulator, or perhaps even the law, will need to decide the rule.

4. Access to membership by licensed securities companies

To what extent should an exchange control access to membership by individual or corporate brokers and dealers ("broker/dealers")? The issues discussed above for listing also apply to this issue. If the exchange is seen as a public market, the government may require it to admit any licensed broker/dealer. If the exchange is seen as a firm, it should be able to decide who can be a member. Ferrarini gives the theoretical argument for the latter view by noting the limitations of the former view. Exchange members would prefer to "share the benefits of the investments

made in an exchange with a limited number of other members" (Ferrarini 1998, at 264). If they were forced to admit all licensed broker/dealers, their willingness to invest in the exchange would diminish, hurting the exchange. Second, preventing exchanges from restricting membership could undermine their ability to compete effectively. Even so, the U.S., as described above, requires exchanges to admit licensed broker/dealers to membership.

For emerging markets, the potential conflict is between promoting the exchange and the broker/dealers. An exchange, treated as a firm, might prosper by a strategy that limits access to membership, as Ferrarini says. On the other hand, government policy to promote the growth of viable broker/dealers might want to open exchange membership to all licensed broker/dealers and allow all to compete directly with each other through the exchange. Until the exchange itself, is subject to competition from other exchanges, it would seem to be a mistake to let it limit membership.

The discussion assumes that the entity licensing broker/dealers is not the same entity that manages the stock exchange. The assumption seems accurate for most emerging markets, which place the licensing power in the regulator and make the exchange a separate legal person. In some countries, the assumption does not hold. Until a separate stock exchange is established, Vietnam's securities law houses both tasks in different parts of the commission. There, a decision to license the broker/dealer gives automatic access to membership in the trading unit.

5. Transparency of trades: The exception for block trades

Transparency about the pricing and volumes is critical to a well-functioning exchange and required of them by law as a matter of course, but sometimes an exception is made. The question of who decides—regulator or exchange—whether all trades must be immediately publicized also resolves in part around the idea of whether the exchange is a public market or a firm.

The issue concerns what kind of market the exchange will provide. An electronic auction market, like many in Europe, publicizes all trades immediately, because they are part of the system when they are made, whereas a dealer market, like the London Stock Exchange, does not. The dealer market permits a delay for block trades, which are so big that a seller or buyer— in this case the dealer—who reveals or even suggests the large size of the trade before obtaining counterparties would change the market price of the stock to his or her disadvantage. Subject to strict rules, the stock exchange allows the dealer to delay publicizing these trades. This protects the dealer, a member of the exchange, and could be argued to hurt investors on the exchange. But block trades are unlikely to occur if immediate publicity is required.

A government that treats its exchange as a firm would allow the exchange to decide on its trading system and, of necessity, on whether to make exceptions for block trades. This is more than just a matter of transparency. It goes to the structure of the market and competition among markets. For this reason, the debate between the auction markets of continental Europe and the dealer markets like the LSE reached near crisis proportions in the early 1990s when the EU tried to impose a common framework for transparency rules in member countries. The EU compromised between a rule requiring immediate transparency in all cases (which could be called one prototype) and no rule, leaving it to the market to set the acceptable level of transparency for trades (a second prototype). The EU prohibited long delays, but did not require

immediate publicity in “exceptional transactions” and “highly illiquid securities.” This compromise limited “the exchange’s property rights on information up to a certain point; beyond that point, they [left] room for exchange autonomy and contracting freedom.” (Ferrarini 1998, at 266 and 267).

For emerging markets, the point is that rules about transparency in trades need to reflect the trading system of the exchange. In many Asian emerging markets, block trades are unusual and dealers uncommon. Auction markets prevail for equities. To a large extent, the stock market is a public market and its development is seen as a government responsibility. Basic choices like the kind of trading system will not be left to the exchange, at least early in its life or after crises.

CHAPTER 6. INSIDER TRADING

A. INTRODUCTION

Insider trading is said to undermine investor confidence in the integrity of the securities market. It is known to be a major problem in many emerging markets. This chapter defines insider trading, describes three prototypes for dealing with it, and then examines, to identify prototypes for each, seven specific matters that laws about insider trading must address.

General definition of insider trading

Restrictions on insider trading, or dealing, exist to preserve investors' confidence in the integrity of the market. Wood (1995) defines the prohibited activity as follows:

> Insider dealing occurs where a privileged insider, such as an officer or professional adviser, who has unpublished material price-sensitive information about securities gained by virtue of his relationship with the company, exploits that information to make a profit or avoid a loss by dealing in the securities, the price of which would have been materially altered if the information had been disclosed.[69]

The definition varies in scope and precision across countries. Wood's definition includes the key elements. There must be an "insider" whose status brings access to important information. The information cannot be "published" but if it were published it would affect the price of the securities "materially." Dealing or trading of the securities must occur, bringing profit or avoiding loss. Penalties exist for insider trading. Each of these key elements is examined in more detail below.

B. DEBATE ABOUT COSTS AND BENEFITS OF INSIDER TRADING

Considerable debate surrounds these rules. Arguments against insider trading extend beyond damage to confidence in the market to include the following (Coffee 1992)

1. Insider trading injures corporate property and privacy by signaling the market about corporate plans before the corporation is prepared to announce them. That is, investors who see insiders buying or selling shares will draw conclusions about future share price movements before the issuer releases the information that would affect its share price. Investors' discounting can hurt the issuing firm.
2. A principal (the corporation) needs to control the compensation of its agents' (the insiders). If insiders can trade on their inside information, their income will not be based

69 Wood (1995), at 349.

on the performance targets the company sets for them. The incentive for insiders to meet these targets will be diminished, to the detriment of their employer.

3. Insiders may delay the release of material information to affect stock prices, hurting other shareholders.

This potential damage to the companies and the markets arguably justifies regulation. But countries like Italy seem to be motivated by yet another goal, preventing unequal access to material information, (which Ruggiero believes is a major mistake of the Italian law, because guaranteeing equal access to all information is impossible, 1996, at 191). This adds a notion of fairness or equity to the fear that insider trading damages the financial system.

Several lines of reasoning are used to oppose rules against insider trading. Some opponents argue that if questions exist about market integrity, such as the possibility of insider trading, investors should decide the risk premium they want based on their evaluation of the market and issuer. In other words investors, not the government, should police the market. Others argue that insider trading provides valuable information about a security and should not be prohibited: if insiders sell, other investors can act on that information. The political process in some countries has relied on insider trading. In Japan, the fact that, at least until quite recently, politicians raised money through insider trading (by receiving gifts of share), meant they were not willing to restrict it. The Recruit scandal involved the sale of stock in a company shortly before it went public in 1986, to associates of the prime minister, finance minister, and other senior politicians. They were told to hold the shares, then sell them shortly after public issue. The price disparity was so great that they made millions of dollars in profits. No one was prosecuted for insider trading, though 4 of the over 20 people involved were prosecuted for other violations. Because, then, tips from companies to politicians's aides about material facts soon to be announced, allowed the politicians to invest, because the law did not prohibit action by secondary tippees (the politician), only by primary tippees (the aide) (Lu 1991). Finally, economic analyses have often concluded that insider trading laws, particularly in the U.S., fail to accomplish their purpose of reducing insider trading (Arshadi 1998).

For emerging markets, Rider is scathing in his reaction to those who advocate "vast structures of regulation" to prosecute insider trading:

> Countries that have only recently developed financial markets, such as China, are advised that unless they have laws and enforcement mechanisms to control insiders their markets will be flawed and no one will invest in them. What nonsense! ... [I]n recent years, agencies of the U.S. Federal Government, and in particular the [SEC], are perceived as having launched a 'holy war' on insider dealing . . . . Whilst taking the profit out of the hands of serious criminals is worthy of a *jihad*, it is hard to see that the same justifications and imperatives apply—with any plausibility—to insider dealing.[70]

While much is to be said for letting the markets discipline firms, the experience of many developing and transition countries over the last decade suggests some regulation against insider trading is useful. The volatility in markets that are rife with insider trading makes it difficult for

70 Rider (1996), at 354.

issuers to use them to raise significant amounts of capital for productive investment and for others to price securities well.

These different analyses could lead a country to adopt very different stances toward insider trading. The country could conclude that investors, completely on their own, should decide whether to invest, so no special government action is appropriate to protect against insider trading. Many factors——including primarily weak information systems and extremely limited capacity in both the government and the private sector to enforce laws could combine to prompt such a decision. Alternatively, a country could conclude that investors only need to know that insider trading takes place. The government would then require insiders to disclose their holdings and trading, but impose no sanctions for the trades that might have been made on insider information. The government would impose some penalty if the insiders failed to disclose their trading. A third path for a country would be to decide that investors lose confidence in the market if insider trading occurs, so that some or many forms of insider trading should be prohibited. This chapter examines the major legal choices open to countries that take these approaches.

C. THE PROTOTYPES: THREE REGULATORY APPROACHES TO INSIDER TRADING

Overall, a country can choose among at least three approaches to insider trading. According to the literature, the country can:

1. Have no special laws, relying instead on basic rules against fraud.
2. Have narrow rules that require insiders to disclose their trading or disgorge excess profits through civil procedures by the issuer, for example.
3. Actively prohibit insider trading as a criminal offense. The following subsections explore these three prototypes.

Prototype 1. No regulations (rely on basic rules against fraud)

A country that chooses to have no special laws will rely instead on basic rules against fraud. Even without legislation against insider trading, an "affirmative misrepresentation," .for example, would be prohibited in most common law countries, but most failures to disclose would not be prohibited, unless the trader had a special fiduciary relationship that would require full disclosure and possibly an accounting for secret profits (Wood 1995, at 350). Among the many countries that had no insider trading rules, Germany stood out until 1994. Its universal banks were unwilling until then to give up the opportunity to trade on information obtained from their close relations with major German issuers.

In emerging markets, Hong Kong until the late 1980s was an example of such a country. There, supporters of no or limited regulation of insider trading argued that (Gaylord and Armitage, 1993, at 36-7):

> in Hong Kong there is a greater willingness to accept a stock market that is comparatively loosely regulated and thus may present higher risks for investment, while at the same time promising larger rewards. According to this reading of agency relationships, prudent investors, in recognition of the informational asymmetries inherent in fiduciary

> relationships, endeavor to structure their investments in such a way as to gauge and, to the extent possible, minimize their level of risk. To this end, the Hong Kong stock market's normative order has generally sanctioned the efforts of 'select individuals' to hedge their own risk through privileged access to information which critics insist should be public rather than hidden. In effect, small investors are asked, in violation of the principle of equity, to accept larger risks than others."

The problem with this approach was that though the market lacked government regulation it was not free, since it continued to be controlled by those "select individuals." Some people in Hong Kong saw this control as useful. Major companies acted as market makers for their own shares in Hong Kong. Their officers' inside knowledge was seen as "a different way of looking at trust or fiduciary relations." One broker there is cited as asking "I once told one of my [Hong Kong Chinese] clients about insider trading laws in the United States, and he asked 'you mean people buy and sell stock without knowing anything about the company?'" (Gaylord and Aromatize 1993, at 36). But the collapse of Hong Kong's stock exchange in 1987 revealed such serious problems that regulators concluded a new approach to insider trading was needed.

Prototype 2. Narrow rules leaving enforcement to the players

A country can have narrow rules that require insiders to take limited actions, ranging from simply disclosing their holdings and trades to disgorging excess profits through civil procedures by the issuer, for example. Rider advocates disgorging as a way to "deprive the wrong doer of his ill gotten gains...." He argues that this would discourage behavior that does hurt the market but does not lend itself to civil suits based on "traditional principles" of loss to the plaintiff caused by the defendant's action on which the plaintiff relied, which would be required by the approach in section C1 above. This second approach would require legislation empowering the issuer to sue, since the issuer "has at least some interest in achieving a fair market in its shares."[71]

The appeal of this prototype for emerging markets is that it applies minimal rules in a decentralized way. Among emerging markets, Zimbabwe was an example of a country that left it to the stock market to regulate trading, including insider trading. The power to force violators to disgorge their profits is well established as an action in civil courts in the U.S. and many other common law countries. A person hurt by the insider trade or the securities regulator can, using the powers conferred by Article 10b, can ask a federal court to force insiders or tippees to disgorge their profits.

Prototype 3. Actively prohibit insider trading as a criminal offense or one subject to significant civil damages

The trend in industrial and many developing countries is toward stronger rules against insider trading. Many countries over the last 10 or so years have prohibited insider trading. The U.S. has been the leader, but the SEC only "instituted a key civil enforcement proceeding based on insider trading" in the early 1960s, the appellate court upheld the proceeding in the late 1960s, and only about ten years later did the U.S. Department of Justice start criminal prosecution of

71 Rider (1996), at 376.

insider trading.[72] Countries in Europe strengthened their rules against insider trading in the late 1980s (e.g., France) and the mid-1990s (e.g., Germany and Italy).

Germany is a case in point, perhaps one of the more dramatic ones. It did not make insider trading illegal until 1994 (Second Financial Markets Promotion Act 1994), having relied on a "gentlemen's agreement" from 1970 until then. The consensus was that these moral guidelines did not work because corporations would have to act against their own managers. As a result, investors who were insiders in Germany played the market as insiders while the others tended to avoid the German stock market. So internationalization of investors forced the change in Germany (Pfeil 1996), as well as EC directives.

Germany's 1994 law dealt explicitly and in detail with insider trading. It applied to publicly listed securities, on an exchange (an important difference from the U.S. rules, which apply to all trading, on or off the exchange). The law adopted common definitions of insider, insider trading, and methods of publishing insider information (see below). The securities regulator and the German exchanges were required to supervise transactions on the exchange continuously and investigate suspicious behavior. The regulator had to notify the public prosecutor of possible criminal behavior. Related to this, the law required controlling shareholders and the companies whose shares they held to report changes in their holding of voting shares, in certain increments. This law, and similar ones in other EU member countries, responded to directives from the European Commission.

The major elements of this approach vary across countries. As a general matter, the U.S. law is somewhat stricter than UK or German law, for example, and they are stricter than the EC Directive on insider trading is. Developing and transition economies also strengthened their insider trading laws during the same recent period. But often they acted without the same thoroughness found in the EU countries. Poland, for example, only forbade the employees of its securities commission from disclosing inside information. The following section presents the main options.

D. MAJOR ISSUES FOR REGULATORY PROTOTYPES

Whenever insider trading is prohibited, the law must resolve several basic matters. When important differences exist, this section offers individual prototypes for these issues as examples of how different countries resolve problems they face. These are not, however, conceptually integrated prototypes related to the general prototypes described above. The issues include:

1. Main prohibitions
2. Defining insiders
3. Defining insider information
4. Securities affected by the rules
5. Specifying the illegal action

72 Steinberg (1996), at 724-25.

6. Penalties for insider trading
7. Oversight and enforcement by the executive

On the substantive issues, perhaps the specifics of issues 1-4 are less important than the way they can be enforced. That is, the definitions of insider and insider information should be shaped in large part by the country's capacity to enforce rules restricting the various types of insiders and information.

1. Main prohibitions

An insider cannot (Wood 1995, at 355-56):

- use "unpublished price-sensitive information" to acquire or dispose of securities;
- tell a third party "to acquire or dispose of securities;" or
- intentionally disclose "inside information ... to a third party" except as part of his job.

Overall, countries face the question of how broadly to define each of these items: Germany decided to make its 1994 law comprehensive and inclusive in its definition of insiders (persons with "access to and knowledge of insider information"), of insider information (non-public but not necessarily material or even trustworthy, and able to affect the security's price if published), and of insider securities (even OTC and derivatives).

2. Defining insiders

The basic question is whether a position (e.g., director or shareholder) makes one an insider automatically or whether anyone is an insider who gets access to inside information. The U.S., looking for fiduciary responsibility, finds it in true or quasi-insiders (see below). European countries, like Italy, follow the second approach.

There are usually three classes:

- true insiders—such as directors,
- quasi-insiders—those having privileged access, such as professional advisers, lawyers, auditors, and financial advisers; and
- tippees—those who are given information by an insider (Wood 1995, at 356).

The hard part is to decide at the margin who is not an insider. A typical example is the taxi driver who overhears a company's directors, his fares, discuss their company's performance and who then buys or sell the company's shares. Is the driver an insider? Wood cites the U.S. case holding that a printer who saw as yet unpublished information about an issuer is not a tippee. He describes the EC as basing the distinction on the recipient's "employment, profession, or duties" (Wood 1995, at 356). Insiders generally need to know their status as insiders.

Germany lists three groups: members of management or the supervisory board, shareholders with access to inside information, and people whose profession (e.g., accountant) gives them access (Krause 1996) whether or not they are hired by the issuer. But in Germany, no person may trade with inside information, insider or not, if they know they have inside information. In

the US, some non-insiders can trade with inside information, such as the tippee whose tipper violated no fiduciary duty to the issuer "for personal gain". In Germany, the insider has some duties that non-insiders lack; insiders cannot recommend that a third party acquire the insider security, while a non-insider can (Krause 1996).

Shareholders: The question is whether some minimal degree of control over the corporation is needed to make a shareholder an insider. Should there be a test based on the percentage of ownership? In Italy, a shareholder of only one share may be an insider if ownership of that share gives access to insider information. In Italy, no special fiduciary duties of confidentiality or loyalty arise from being a shareholder (or a quasi-insider); the position is only important in the opportunity it affords for inside information (Ruggiero 1996).

Substantial shareholders may be more easily designated as insiders. Definitions of substantial shareholders vary: 5% of outstanding shares conveyed the status in Singapore and Malaysia, but 10% of voting shares conveyed it in Australia (Leng and Kian, 1987). In Hong Kong, control requires 33% of voting rights (S.W. Leung 1993). This would seem to reach the family groups (although that depends on whether they added the shares of all members or treated them as separate), but not significant minority shareholders. Since family groups could be organized so that no single group member held fully one third of the voting shares, the Hong Kong ordinance broadly defines related companies. There remains the question of their liability. They were not liable to third parties in Malaysia in 1980s, but the reason is not given (Leng and Kian, 1987).

Directors: Director are generally assumed to be insiders. But Italy's securities law does not specifically mention corporate officers or directors as insiders because the definition is so broad to include any person

Officers: Company employees are presumably insiders. The question is whether senior company employees have an affirmative obligation to prevent insider trading. In Hong Kong, the 1991 law requires all officers to make sure safeguards exist to prevent insider dealing in the company's shares (S.W. Leung 1993). This places a duty on a group that can take preventive action and seems novel. It is the sort of rule emerging markets should consider. The problem is that one can impute only so much responsibility, but the rule-makers decided not to require the plaintiff to prove that the officer knew about the insider trading. No dishonest conduct must be found on the part of the officer.

Spouse or children: In many emerging markets, the family is an important business entity. It would seem that family purchases or sales of company shares should be treated as insider transactions. But in Malaysia, directors did not need to notify their company when their spouse or child acquired shares in the company, as if these were likely to be transactions independent of the director (Leng and Kian 1987). This is a serious defect; if a country has rules against insider trading, it should not leave big loopholes. Such an exception would create a huge gap in any country with an economy built on family conglomerates. This includes much of Asia and Latin America.

The structure of the stock market may complicate rules about insider trading. Where, as in Hong Kong, family groups dominate business and traded companies may have as little as 25% of their shares traded on public markets, a serious problem arises when the company itself acts as a

market maker in its shares, providing liquidity. By definition, the company knows insider information. Is it breaking the rules against insider trading when it makes markets in its own shares, taking positions as a dealer would? Rules against insider trading were seen as a possibly crippling the way in which trading took place in Hong Kong. "The potential threat of being accused of insider dealing when no such intention existed could have a chilling effect on so-called liquidity." (Gaylord and Armitage, 1993, at 29). Investors in Hong Kong often solve this potential conflict of interest by not buying before public announcements of a company's performance if the family owning the company does not buy company shares. This is the standard way other shareholders protect themselves when insider trading is a possibility.

3. Defining insider information

Two issues arise: what is the information? What information is inside?

"Information": To avoid prohibiting "mere hunches based on rumors," countries normally require "specific information" that is "material" (Wood 1995, at 357). Germany, for example, requires "facts," not personal opinions or value judgments. The problem is that sharp distinctions between fact and opinion may be difficult to make. In the US, "projections and estimates ... have been held to give rise to liability" (Krause 1996). Germany may need to define inside information more narrowly than the US because German sanctions are criminal only, while in the US sanctions may be civil. But both countries have equally broad definitions of "materiality" (Krause 1996).

The test of whether Information is material varies. In the U.S., the test is that a reasonable investor is substantially likely to consider its disclosure significant (Basic Inc. v. Levinson). For this test to work requires courts familiar with deciding such questions of fact. Italy looks for "significant materiality," according to Ruggiero (1996), by requiring that the influence of the nonpublic information on the security's price is "notable." It is not clear whether this means one can discern an impact through quantitative analysis (which could be quite difficult) or merely that many investors would find the information significant (Ruggiero 1996). Japan listed, by ordinance, the material facts that could significantly affect investors' judgments, including information about stock issues, splits, reduction of capital, dividends, and mergers (Lu 1991). This list is typical of Japanese law; whatever is not on the formal list is not a material fact.

"Inside": Since information that is published is not inside information, another challenge is to define publication. A range of prototypes exists in developed markets. The U.S. is most strict, requiring dissemination with the 'widest distribution." The UK is less strict, allowing as published even (a) information that can only be acquired "with diligence or expertise," by observation, or outside the UK and (b) information that is only communicated to part of the public or "on payment of a fee"(Wood 1995 at 357). The EC Directive does not define "public."

Compliance with disclosure rules means the information is not inside anymore, so disclosure rules play a very important role (this is discussed in chapter 2). The idea is that an insider or a tippee has the option of disclosing the inside information publicly or abstaining from trading. This is the rule in the U.S. under 10b-5 (Arshadi 1998). How can the insider know when it is necessary to disclose information? In Germany, issuers must disclose all information that could move the market. The problem, which arose partly because the insider trading law was new, was

that insiders did not know how to decide if the information had the potential to move the market or to whom to make the disclosure. This ignorance made the government reluctant to fine companies for failure to disclose information (Pfeil 1996). So the policy question is how specific the law should be in determining the market effect of information. As a general rule in developing countries, too much discretion is bad. On the other hand, a specific list is limiting.

A different or supplementary approach is to require, for example, financial institutions to disclose to the financial regulator their daily securities trading in each instrument every day. Germany has this rule. It means that the government does not simply rely on the exchanges to police for insider trading. This is "arguably unwieldy" (Pfeil 1996), but as a response to the market power of the banks in Germany it should be of interest to emerging markets, where banks often also play an important role.

Disclosure need not be to the entire public: In markets where information may not be distributed efficiently, a question is how the public is to be reached. Hong Kong's new rules, which took effect in 1991, did not require that the information be "generally known" but rather that it be disclosed publicly "to those who are accustomed or likely to deal in the securities in question. . . . The information will cease to be insider information if only a small group of investors are likely to deal in that stock and the information has been thoroughly disseminated and become common knowledge among members of this group of investors." (S.W. Leung 1993, at 184).

4. Securities affected by the rules

The question for regulators is whether to make the insider trading rules apply to any security, or just publicly traded or listed securities? Securities that are protected by insider trading rules are, outside the U.S., usually only those publicly traded or listed (e.g. Italy, which requires a listed exchange). Sometimes the act lists the types of securities (e.g. Italy). The reasons for limiting securities include: (1) The regulator may also find it easier to identify violations of insider trading rules when tracking prices in markets with published prices than in non-public markets. (2) It is trades on public exchanges that require investor confidence. In these anonymous, immediate, and impersonal markets a party injured by insider trading would have a difficult time proving either a claim in contracts or tort (Ruggiero 1996). OTC trades are susceptible to insider trading. Japanese insider trading rules do not extend to OTC markets, but trading in them is substantial and should be protected, according to Lu (1991).

For the U.S., any security is protected by insider trading rules. The scope of protection reflects decisions about public policy and practical implementation. The regulator must decide if its interest in market integrity extends only to broad public securities markets or to markets for private placements as well. These matters are discussed in other chapters.

5. Specifying the illegal action.

An insider trading law must decide what action by an insider is illegal. Several issues arise: Is fraud required or just certain behavior? Is a trade necessary? Should the inside information motivate the trade? Does anyone have to benefit for the action to be illegal? How long should

the chain of tippees be before the law does not apply? What should be the status of activities outside the country? The following paragraphs show different solutions to these issues.

Should general fraud rules or defined behavior toward the securities govern? In the US, rule 10b-5 applies only to actions (or non-actions) involving fraud. This presupposes the failure to carry out a duty (e.g., to disclose requires a duty to disclose) based on a fiduciary relationship with the other party. The prohibition fails if no fiduciary relationship is found. The information must be fraudulently acquired (Ruggiero 1996).

Defined behavior does not require a showing of fraud. In European countries like Italy and Germany, the mere fact that at the time of the trade the "trader has information that is unavailable to the market, no matter how legitimately the information was acquired, the prohibitions will apply" (Ruggiero 1996, at 176). The German rule lists affected securities (the list is broad, but still narrower than the US rule e.g., it does not include "partnership interests or shares in limited liability companies" which are not traded on a German exchange). So Italy and Germany do not get caught searching for a relationship between the insider and the plaintiff (Krause 1996). Ruggiero dismisses Italy's reliance on simple possession, rather than requiring proof that of fraud, because it is inadequate and harmful. The conceptual clarity of this approach makes sense for emerging markets.

Is an actual trade necessary? Countries vary. Yes, a trade is necessary, according to U.S. law. The insider must actually have bought or sold a security, since when someone holding stock receives inside information and does not sell, avoiding loss, it is very difficult to prove the person would have sold absent the inside information (Wood 1995, at 359). This narrows the scope of prohibited action compared to Wood's initial definition of insider trading, above. But not all countries require an actual trade. Italy, for example, does not require a trade for tipping, or recommending stock, to be an illegal act.

Is it necessary to prove that the inside information motivated the defendant to trade? The basic debate is about whether it is necessary to prove merely a general intent to trade at the time the nonpublic information is held or rather to prove that the insider relied on the inside information to make the trade (see Ruggiero 1996, at 176-7). Proof of general intent is easy; one merely shows the simultaneous trade and holding of inside information. Proof of specific intent can be difficult. Italy relies on general intent. A general intent rule would seem to make more sense for an emerging market, where courts can often slow down decisions about economic cases such as this.

A criminal suit generally requires proof of intent or knowledge. Hong Kong is an example (S.W. Leung 1993). But Hong Kong allowed a person accused of insider trading to exempt himself from the prohibition by showing his motive in trading was not based on the inside information. (S.W. Leung 1993). South Africa allowed the State two rebuttable assumptions. First, a person in possession of "unpublished price-sensitive information" when the offense occurred was deemed to have knowingly acted on the information. Second, a person who acquired unpublished price sensitive information that is provided ways that are prohibited is deemed to know that the information was obtained in those ways (Van Zyl 1994). A civil action, with lower standards, allows the plaintiff merely to show possession of the information and simultaneous trading.

Does the insider or tippee have to benefit? General Prototype #3, of broad anti-insider rules, would say no, while a narrower prototype would require a benefit. An insider tipper in the U.S. need not benefit if the tippee trades on the information and may be liable for the tippee's profits. In Japan, the insider tipper who does not trade is not liable; tipping alone does not violate the law. The tippee in the U.S. is liable if the insider tipper breached a fiduciary duty to the company or its shareholders, but not otherwise. In Japan, the tippee who trades violates the insider trading law (Matsui 1991).

How far does a chain of tips extend? The broader the general prototype, the more likely it is that the chain of tips is long. In Japan, only the first tippee the person who received the information from the insider is liable for insider trading (Matsui 1991). In the U.S., the second tippee receiving the information from the first tippee, not the insider is also liable.

Are extraterritorial acts forbidden? What if the forbidden acts take place offshore? This is a particularly serious problem for the many small emerging markets that are open to cross border investment flows. Hong Kong does not explicitly prohibit activities outside Hong Kong that could affect the Hong Kong market (S.W. Leung 1993). But given the integration of markets worldwide, it would be a mistake for emerging markets to exclude extraterritorial acts.

Who is exempt from insider trading rules? The laws generally exempt underwriters who stabilize bond markets during issuance and investment bankers who advise during take-overs.

How can an insider trade and protect itself against violating the law? Countries impose waiting periods or a duty to notify. In Singapore, insiders must wait 24 hours after the material information is released to the national press or 48 hours if a more restricted medium gets the information (Leng and Kian, 1987). This seems to be a more reasonable rule for an emerging market, but it does put the directors at a disadvantage in trading. Germany does not require a "post-announcement waiting period" (Krause 1996). Krause argues that this makes sense for Germany, with a small market of listed shares (only 700 listed companies) all closely followed by analysts who will quickly disseminate information to the public. Emerging markets may have few listed shares, but their analysts are probably not so reliable.

Is there a duty to notify? Must an insider notify anyone of its trading in order to be protected against violating the law? Directors had to notify their company but not the Stock Exchange in Singapore (Leng and Kian, 1987). Most types of insiders in Singapore were supposed to register and report all changes in their shareholdings in the company within seven days (Leng and Kian, 1987). The seven days seems like a long break for emerging markets.

6. Penalties for insider trading

Some countries apply only criminal sanctions to insider trading while others allow civil sanctions. These two prototypes raise question about types of enforcement discussed Chapter 4.

a. Criminal sanctions

Reliance on criminal sanctions is one prototype for enforcement of insider trading rules. Germany imposes tough criminal penalties of up to 5 years in jail and requires the violator to disgorge the profits. Unlike the US, Germany has no civil sanctions. Supporters of this approach

say the insider trading law is designed to protect the market's integrity and not to protect investors. They say the law would require civil plaintiffs to demonstrate a nearly impossible line of causality from the defendant's unlawful trading to price developments to damage to the plaintiff. In the US, legislation solved this problem in 1988 expressly giving civil plaintiffs a private right of action that was not so constrained (Krause 1996).

Germany's 1994 law allows only criminal sanctions and enforcement, for example. Pfeil argues that this limits the country's ability to circumscribe insider trading because the regulators have limited resources and, with only one set of entities (regulators) examining them, the inside traders have a simpler time evading detection than they would if civil suits were possible (Pfeil 1996, at 191). Japanese securities law also provides for criminal sanctions but not civil suits (Lu 1991), which makes sense for a country that lacks a tradition of private enforcement of economic rights through the courts.

The problem with reliance on criminal sanctions is that they can reduce the flexibility of the regulator. Standards of proof are higher than in civil suits. Closer attention to procedure limits the scope of maneuver for administrative action. In Italy, when it is possible to make a prima facie case of insider trading, the securities regulator must transfer the case to the appropriate prosecutor. In the U.S., because criminal prosecution is discretionary, the SEC has more scope for administrative action (Ruggiero 1996).

Two issues arise for emerging markets. These follow.

What is the effect of limited information about companies? In many emerging markets, including China, information about traded companies is so poor that regulators have a very difficult time tracking an issuer's performance. This causes problems spotting possible violations of insider trading and reduces the effectiveness of surveillance by the regulator.

Should penalties be a flat amount or based on size of the gain (or avoided loss)? The range in penalties is huge. Nigeria's fine is a very low maximum amount (less than $1000). In the 1980s and early 1990s, at least, Japan allowed fines of up to only Yen 500,000 ($3,850 in 1991) and imprisonment for up to 6 months. Since the fine was so low (compared to the profit to be made on insider trading) and first time offenders did not go to jail, the penalties posed did not deter insider trading. China had no criminal penalties (Daly 1996) until the securities law was passed in 1999. That law imposed fines in a range up to a substantial amount and provided for imprisonment of up to five years. In South Africa, flexible punishment in the form of a multiple of the gain is likely to be a better deterrent than a flat amount (or the threat of imprisonment) (Van Zyl 1994). The U.S. imposes large fines (in 1991, $1 million for natural people and $2.5 million for others) and up to 10 years in prison (Matsui 1991). Onwaeze (1992) argues that the best penalty is a fine that is a multiple of the gain.

b. Civil sanctions applied by private parties

A strong argument exists for relying on private parties—notably those harmed by insider trading—to act in their own interests and enforce the law against insiders. The basic problem with this approach, as discussed in Chapter 4, is that many emerging markets lack a tradition of civil suits about economic matters. Some countries have very low litigation rates. The reasons

go to the heart of the legal system of the country, so merely giving private parties the right by legislation to pursue civil suits does not mean they will do so.

Civil sanctions applied by the government can be another powerful tool, but they do not substitute for private suits because the government's resources are limited. It is not uncommon for the government to have this power, even in emerging markets. For example, in Hong Kong, the commission (as well as the Attorney General) may start a lawsuit against insider trading. One source of power is that damages can be severe. The U.S. in 1984 permitted the SEC to sue for up to three times the profit gained or loss avoided by insider trading. The SEC can pay bounties to informants of up to 10% of the civil penalties it recovers.

Many people do not accept that emerging markets need civil liability for insider trading: Other methods are more effective, it is argued. Self-regulating organizations, adequately empowered, can police members. The company itself has an interest in its public image, so management can be expected to deal with the problems and when it is not, the company should be liable. Disclosure requirements should be increased and enforced. Criminal sanctions should be a fine that is a multiple of the gain (Onwaeze 1992).

The hurdles facing a plaintiff include the basis for the suit; sanctions that discourage such suits, attitudes of the executive branch and the judiciary, and rules of civil procedure that also undercut such suits. The following items identify ways in which the country's legal system can hinder civil suits by private plaintiffs over insider trading and suggest other prototypes that may alleviate some of these problems.

Official hostility to civil suits by private plaintiffs. In Japan, the ministry of finance will not enforce the country's insider trading laws, even to the point of ignoring the Japanese anti-fraud laws (Parker 1995). Parker urges MOF to share its enforcement powers. To the extent that the executive branch opposes a private suit, the private litigant is undercut in many countries. In Japan and Malaysia, for example, judges generally do not act independently of the executive.

Status of a private party to sue: Because of the problems facing a plaintiff basing his case on fraud rules that create a general right, a special statutory right of action for private parties which sets appropriate standards of proof is seen as necessary to encourage this vehicle. Unlike the U.S., many countries do not grant private parties the right to sue. In the US, legislation in 1988 expressly gave civil plaintiffs a private right of action (Krause 1996). In Italy, the securities laws do not confer a private right to sue. However, in order to protect the people harmed by insider trading, the courts construe it "from the existing general contract law, and from the 'open' tort system, which entitles anyone suffering an unjust harm to recovery against whomever committed the tortious action" (Ruggiero 1996, at 167). Germany, as noted above, does not grant the right.

Civil suits by issuing companies against insiders are not a substitute for private suits. Issuers rarely sue insiders because the insiders often run the company. But there are other reasons. These suits are not common in South Africa, because they are based on a principle that is not widely accepted, namely that the insider trading hurts the company (Van Zyl 1994). The more common problem is illustrated by Japan. Japanese law authorized a company to claim short-term profits from a director, auditor, or major shareholder (owning 10% or more of the shares) made with insider information (Matsui 1990). The problem was that the company was

unlikely to sue these people. Moreover, shareholder derivative suits also did not work in Japan (see below).

Structural barriers in the legal system can stymie private suits against insider trading. Rules governing civil procedure, including standards of proof, and limitations periods on suits can undercut a private plaintiff's efforts to win redress through the civil courts. Japan illustrates this in abundance. Generally, in Japan class actions are not permitted, discovery is not effective, and litigation fees are "incredibly expensive" (Parker 1995 at 1415). Given these circumstances, merely empowering an injured private party to sue is not likely to prevent insider trading.

Civil procedure and private suits: Any reliance on private suits requires that one pay attention to the rules of civil procedure, which can undercut the use of civil action to enforce the law. In Japan, civil procedures worked against insider trading suits by shareholders. Lu (1991, at 230) explained:

> A shareholder who sues [a corporate] insider under Article 189 to disgorge short-swing profit has to insure legal fees. Under the civil procedure rules, a shareholder that wants to bring a derivative suit has to buy litigation stamps. If the plaintiff wins the litigation the disgorged profit goes to the company. Professor Takeuchi raises an example. A shareholder of 10 thousand shares of a company of 100 million shares wants to sue an insider for the return of 500 million Yen (about $3.9 million). He has to buy stamps worth three million Yen (about $23 thousand) at the first trial, 1.5 times three million Yen (about $35 thousand) on appeal, and 2 times three million Yen (about $46 thousand) at final trial. If he wins, he gains as a shareholder, but only in proportion to his stake in the company50 thousand Yen (about $385). If he loses the suit he has to pay 13.5 million Yen (about $104 thousand). The stamp system thus deters shareholder derivative suits. There is no doctrine of recovery of attorney's fees and costs.

Basically, Japan has no civil penalties (Matsui 1991).

Standards of proof: Although a civil suit generally has a lower standard of proof than a criminal one, the basis for the suit may set a standard that is too high for almost any private party to seek a civil remedy. Japan's Civil Code would support a private right to sue using tort theory, but the plaintiff bears the burden of proof and would get little help from Japanese discovery procedures. "How can an outsider prove that an insider knew and traded on 'material facts'? How can an outsider prove that the insider traded with the scienter [knowledge] or negligence which are required by the [law]? It is difficult for a plaintiff to prove how much s/he lost on a fluctuating market" (Lu 1991, at 379). Indeed, it is often difficult for a private party to identify, let alone prove, possible insider trading. As stated above, in many countries including China, information about traded companies is so poor that shareholders cannot readily track the performance of the issuing company and therefore spot possible violations of insider trading.

Statute of limitations: Singapore had a two-year limitation running from the "completion of the transaction" rather than its discovery, which was the Australian rule (Leng and Kian, 1987). Nigeria's rule was the same as Singapore's. Both allowed clever insider traders to escape if they could hid the activity for 24 months (Onwaeze 1992).

Privity between insider and plaintiff. Civil suits raise the question of whether to require damaged parties to be legally related to the insider, through direct purchase of the shares, for

example. While some countries require this privity, the U.S. does not. In the U.S., the plaintiff must simply show that it bought or sold the security "in the same period as the insider...." The problem with this approach, according to Wood, is that the insider should not be held liable for "losses to all counterparties in the market (e.g., the difference between the price with and without the information)," since "the liability could be vast and disproportionate to the offence."[73]

Criminal conviction as a prerequisite for compensation in a civil suit to an opposite party to the insider: In Singapore, this was a prerequisite and allows a lower standard of proof than would be required if conviction had not occurred (Leng and Kian, 1987). In Germany, the law explicitly says, "violation of the German Act alone does not trigger tort liability." This was highly debated and the law confers no private right of action (Krause 1996).

Severity of sanctions in civil suits: sanctions in civil actions, as described in Chapter 4, must be adequate to meet the plaintiffs' costs, both for the suit and also for the damages. In the US, courts interpreted Securities Act 10b-5 to allow private antifraud actions, which made 10b-5 quite powerful. 10b protects buyers or sellers of shares from fraud or deceit, which require a breach of duty as a fiduciary or from contract, both of which are based on a special relationship. Sanctions are substantial. Another strong sanction is to make the tipper liable for the profits earned by the tippee, even if the tippee is several steps removed. In Australia, the insider was liable to the issuing company for a tippee's profits too (Leng and Kian, 1987). Not many countries have such a strict rule. Private parties in South Africa bring actions only when "the probability of an award of damages is high and where an award of damages is likely to be quite substantial," and the likelihood of this is not common (Van Zyl 1994, at 94). In Japan, fines are small and victims are not compensated (Parker 1995), which is another reason for the paucity of civil suits there.

7. Oversight and enforcement of insider trading rules

For insider trading, enforcement is the key problem everywhere, including developed markets, but it is specially acute in emerging markets because so few of the tools used in developed markets are available or work well in emerging markets. Limited human and technological resources, weak judiciary, unsophisticated investors, and cultural aversion to the use of courts, as described above. In the absence of effective courts, in China "only administrative sanctions are effective deterrents to, or punishment of, insider trading" (Daly 1996). (The securities law enacted in 1999 may change this.) Some of the emerging markets tried to deal with these problems, changing the rules or techniques of enforcement by the executive branch. They are the most interesting stories here.

Should a special tribunal, the stock exchange (as a self-regulatory organization), or the government regulator enforce the insider trading law? Many of the issues for insider trading are similar to those about enforcement of the securities law generally and are discussed in Chapter 4. As to matters specifically involving insider trading, the exchange may be in the best position to implement insider-trading rules, at least initially, by virtue of its role in the market. Regulators in

73 Wood (1995), at 358.

the UK, for example, rely on the London Stock Exchange to detect and investigate possible insider trading.[74]

a. Special tribunal or administrative agency

Several countries have established special tribunals to enforce insider-trading rules. Their failure is due to their limited powers of enforcement. From 1974, Hong Kong relied on an Insider Dealing Tribunal with powers that were both inquisitorial and investigative powers. These were broad in the sense that the Tribunal could "receive evidence irrespective of whether or not such evidence is admissible in civil or criminal proceedings" (S.W. Leung 1993, at 189). But after finding criminal behavior, the Tribunal could only give the insider dealer's identity. Hong Kong had rejected using criminal sanctions or self-policing; the latter would be "difficult" to enforce (S.W. Leung 1993).

The Insider Dealing Tribunal could only identify the insiders and what they did. The hope of the Tribunal was to capitalize on humiliating the offender by publishing a report, presumably based on some belief that Asian values would make this rule an effective. But this did not materialize. Gaylord and Armitage (1993) explained that Hong Kong's Insider Dealing Tribunal only conducted four investigations of insider trading between 1978 and 1990 because their only sanction was public disclosure of the insiders and their bad deeds. This was so ineffective that Hong Kong in 1990, after the 1987 debacle, allowed the Tribunal to assess penalties up to three times the insiders' profits or bar them from holding corporate office for five years. But the law was not enforced from 1990 to at least 1993 because of "fear of possible adverse effects on market liquidity." (Gaylord and Armitage 1993, at 35).

b. The stock exchange as SRO.

The stock exchange is the best first line of defense against insider trading. The exchange collects information about all trades and is in the position to conduct immediate surveillance. Countries around the world rely on the stock exchange to serve this role. The US relies on its exchanges to police for insider trading. Germany requires each exchange to compile data systematically about their trading, assess the data, and investigate as necessary (Pfeil 1996). It is a bit early to decide if the German approach works well or poorly, but a foreseeable problem is that each *Land* regulates its own exchanges. Not all regulators rely on their exchanges in this way, but the trend seems to be toward such reliance. In the early 1990s, in South Africa, the Johannesburg Stock Exchange did not have rules against insider trading. It lacked the power to investigate and it would be investigating securities of a company in which some of its members have an interest. Instead, it relied then on rules for prompt disclosure (Van Zyl 1994). Then in the mid-1990s, the JSE put in place a computer-based system of surveillance to identify market manipulation and possible insider trading.

In emerging markets, reliance on the exchange to enforce insider-trading rules may fail due to conflicts of interest if the market is shallow. A broad general prohibition against insider trading,

74 Rider (1996), at 354.

supported by weak sanctions, can be damaging, as Poland's experience in the early 1990s showed. There the law prohibited (Budzen and Frankowska, 1994, at 125-26)):

> the improper use of non-public information. It provides that: "Whoever uses confidential information while trading in securities shall be imprisoned from 6 months to 5 years." [It defined] "confidential information" [as] "any information which has not been made public but which after publication could substantially influence the value of the price of a security." The Securities Law includes a provision that may be deemed a prohibition against tipping. . . .

The stock exchange had the power to suspend trading up to three months or even exclude them, as well as the power to suspend brokers from operating on the exchange for three months. But the small number of listed securities, sixteen, meant that the stock exchange would significantly undercut trading if it suspended trades in any single security. The very shallowness of the market worked against a serious attempt by the exchange to enforce rules against insider trading.

c. A government agency.

Adequate powers and the will to apply sanctions are essential if the securities regulator is to enforce the insider trading law. This may seem obvious, but it should not be overlooked. In Malaysia and Singapore to mid-1987 "few actions" were "brought" to enforce clear laws against insider trading (Leng and Kian, 1987). In Poland, the law failed to deter insider trading largely because the enforcement powers of the regulatory agencies were much to narrow. The Commission's only sanctions were to suspend trading in the securities, identifying them to the public, and to suspend brokers' licenses. It could not assess financial penalties. In Hong Kong during the 1970s, the commission was weak for several reasons. The government's philosophy was to stay out of the markets. Resources were few. While the commission was supposed to make policy and the commissioner to enforce it, because the line between the two was fuzzy leadership was weak and the commission was passive. From 1978 to 1993, only four official investigations took place in Hong Kong (Gaylord and Armitage, 1993).

A regulator can take much more initiative. In China, the national securities regulator was small but had grown (to 1000 people by 1996 when it gained authority to act without prior specific authorization from the State Council. The regulator offered rewards to informants about "illegal securities trading" and got examples insider trading (Daly 1996).

CHAPTER 7. PUBLIC AND PRIVATE OFFERS OF SECURITIES

Securities laws commonly set different standards of disclosure for offers of securities made to the general public and offers that are made to narrower groups of potential investors (called private offers here). This chapter examines the prototypes for distinguishing between the two. The topic is particularly important because many newly emerging markets may lack the narrower groups of investors.

Disclosure rules are designed to protect investors by requiring the issuer to disclose all material information so that the investor can make an informed decision, based on data about all possible risks posed by the security. However, not all potential investors need this help. Those who are assumed to need the protection are retail investors, each of whom is assumed to be relatively uninformed about an issuer and its security, probably naive about the market, and devoid of market power to demand information. This is a very large group and is the "public" in the public offer.

Subsets of investors do not need the protection offered by securities rules about disclosure. An insurance company, pension fund, or bank investing a portfolio of billions of dollars should be quite able to identify the information it wants about a company issuing securities. It should be able to get the information either from the issuing company, or from another source, because the investor has the market clout to insist that the information be divulged and because the investor can afford to buy the data. Generalizing, these wholesale or institutional investors are assumed to be sophisticated enough to know what kind of information they need about a security and its issuer, and where to find it, and also to wield sufficient market power to obtain desired data that may not be generally available. The disclosure laws are superfluous and expensive.

When a country's disclosure rules are rigorous, the issuer's cost of complying with the rules can be high. There are different kinds of costs. The issuer bears the cost of gathering and preparing both the quantitative and qualitative data. These include detailed balance sheets, income statements, and other financial statistics, all consolidating subsidiaries at home and abroad and stretching over five or more years. They include, in some countries, similar information by industry segment and geographic region, also historical. This is no minor cost to the issuer. A further cost is that the issuer may be required to publish data that may be useful to the its rivals, placing the issuer at a competitive disadvantage. An issuer will accept these costs if offsetting benefits exist. For example, complying with the disclosure rules is acceptable to the issuer if it allows the issuer to reach a very large group of retail investors in a big liquid efficient market, giving access to substantial funds at a low cost compared to available alternatives. But it makes little sense to incur the expense of disclosure if the investors do not need to be protected, which is presumably the case for institutional investors.

Regulators understand this and make a similar cost/benefit analysis for the markets: when the cost of disclosure outweigh its benefits to financial markets, regulators may waive certain requirements. Most notably, when the target investor group for a new issue does not need to be protected, the disclosure rules may be reduced or waived.

A. PROTOTYPES OF EXCEPTIONS TO THE GENERAL DISCLOSURE RULES

Countries have adopted three different approaches to public and private issues. These are described below. For those countries that differentiate between the two, the critical question is how to make the distinction between a general public offer and a private one. Techniques of making private offers fall into two general types: the offer is limited so that it will not reach the broader group or the offer is made only to investors who are sophisticated and have market power.[75] To some extent, these overlap conceptually. The offer limited by, for example, size, is presumably one being made only to large investors, who are sophisticated, because 10 retail investors could not buy the entire issue. But the distinction holds.

These techniques vary widely across countries, so much so that the International Organization of Securities Commissions (IOSCO) was unwilling to commit to a definition of either public offering or private offering.[76]

Prototype #1. No special disclosure rules for a subset of investors

Some countries make no special exceptions for private placements. For example, Germany in the mid-1980s did not have special disclosure rules for a subset of investors, probably because the country's general disclosure rules were modest. Now, however, Germany exempts sophisticated investors. As discussed below, many emerging markets are in this category.

Prototype #2. Special disclosure rules for offers limited so as not to reach the general public

Since a public offer is by definition general, one way to identify private offers is to use some indicator of a limited offer. Limited offers have been defined in several different ways in developed countries during the last 10 to 15 years: by number of investors, size of the offer, or method of distribution. Many of the following examples are taken from Wood (1996).

a. Limitations based on the number of potential investors

The obvious indicator is a limitation based on the number of potential investors who are solicited. If the number is small, the offer cannot be to the public, by definition. So the question is, what is small? Many countries use a ceiling -- 10, 35, or 100 solicitations -- as the measure. They include Switzerland, the UK, and the U.S. (Wood, at 284). Other countries simply say that "many" solicitations makes an offer public without defining "many." Japan is an example.[77]

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75 See Steinberg (1996), at 730-33.

76 International Organization of Securities Commissions, Objectives and Principles of Securities Regulation (1998), footnote 2, at 25.

77 Comparative studies of disclosure regimes are sparse. Much of the material in these paragraphs comes from Staff of the U.S. Securities and Exchange Commission, Internationalization of the Securities Markets, Report to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Energy and Commerce, July 27, 1987, at III-91 to -242 (Internationalization of the Securities Markets).

b. Limitations based on the size of the offer

A ceiling on the value of the offer, such as $5 million, may be used to identify a non-public offer (U.S.). While one might say that the small amount could not be intended for the general public, the better reason is that the amount is too small to justify the cost of disclosure.

c. Limitations based on the method of distribution

The method of distribution or trading may indicate that the issue is not directed to the general public. Countries use several different indicators, which include:

1. The ***method of solicitation***: contacts using existing channels between the issuer and potential investors could indicate a limited offer, while advertisements to the general public would not. Some countries define and therefore restrict the scope of advertisement, others do not (UK), and others simply make any type of advertisement a public offer (France).
2. The ***use of certain financial intermediaries*** —banks or brokers—to sell the issue may indicate it is public (France).
3. The ***type of trading*** is important in many countries, where listing makes an offer public, while leaving shares unlisted is an indicator that the offer is private.

Prototype #3. Special disclosure rules based on the type of investor.

A different approach to defining a private placement relies on the type of investor rather than using numeric tests based on number of issuers or the security, its distribution, or trading. There are three forms of this prototype.

a. The investor's access to inside information

A regulator could use the buyers' relation to the issuer as the crucial factor for deciding whether detailed disclosure should be required by law. If the buyers are part of the same business group as the issuer, requiring disclosure would probably not offer greater protection than the buyers already have by virtue of their inside status. In Australia, the court considered "the significance of any particular characteristic which identifies the members of the group and any connection between that characteristic and the offer."[78]

b. The investor's presumed sophistication

The offerees' sophistication and market power may be gauged in several ways. Certain types of buyers may be assumed to have financial sophistication. Generally, this would be a person whose business includes the purchase and sale of securities (UK). Specific types of institutions are presumed to be sophisticated. Banks are one example (Canada), institutional investors another (U.S.), and large corporations are a third. Investors may have to meet minimum net worth or net income requirements, or be able to hire advisors with skills and experience that allow them to evaluate the offer. Any investor who can buy securities with a high value may be

78 Internationalization of the Securities Markets, at III-209.

presumed to be sophisticated (e.g., A$500,000 in Australia). A regulator may designate specific investors who qualify. For sophisticated investors, the number of offerees is not limited.

c. The investor is on a list of types of sophisticated investors

According to Wood (1996, at 287-88), "many countries list eligible investors, such a broker-dealers, life insurance companies, public authorities, pension funds, authorized banks, mutual investment funds and the like: Spain, Italy, France, Australia, South Korea, the Netherlands, Singapore, Portugal."

Prototypes 2 and 3 may be combined. A country could allow, for example, a private placement if issuer meets the requirement of number (e.g., no more than 35), method of solicitation (no advertising), and type of trading (unlisted). Or a country could allow limited offers to unsophisticated investors (e.g., a ceiling of 35) combined with offerings to an unlimited number of sophisticated investors.[79] Wood (1996, at 284) summarizes U.S. law as confining the statutory exemption for private placements to

> a limited number of purchasers all of whom (a) are sophisticated investors with respect to the risks involved, usually institutional investors such as banks, insurance companies and pension funds; (b) are capable of bearing the potential loss of their investment; (c) purchase as principals for investment with no view to further distribution (so that resale restrictions are necessary); and (d) have access to information similar to that which would be included in a registered offering.

The U.S. sets out its rules in a detailed regulation.

B. THE CONSEQUENCES OF PROTOTYPES #2 AND #3 FOR ISSUERS AND INVESTORS

The effect of qualifying as a private placement, is to change the issuer's disclosure requirements, but the extent of the change varies. In some countries, no specific requirements exist for offers to sophisticated investors, and the information that the issuer gives them does not need to be registered with the securities commission (e.g., U.S.). Elsewhere, the type of information to be disclosed is much narrower than in a public offering (e.g., the Netherlands). The effect of this exemption is to reduce the fees payable to either the commission or stock exchange.

Limited offerees or sophisticated investors should not resell the securities to the public. The buyer might have to hold the securities for an indefinite or set period of time, such as two years. An exemption may be available if the securities are later registered. This is difficult for an issuer to enforce if it does not register share transfers, so by what standard should an issuer be held accountable if buyers do resell the shares? The standard varies among countries. The issuer

79 See G. Palm and D. Walkovik, "United States: A Special Report," in Issuing Securities: A Guide to Securities Regulation Around the World, International Financial Law Review 62-84 (Supp. July, 1990).

might simply have to believe in good faith that the buyer would not resell this way. The issuer might have to hold a written promise from the buyer not to resell to the public.

C. ALLOWING PRIVATE PLACEMENTS IN EMERGING MARKETS

There are at least three different approaches: (1) the same disclosure and registration rules apply to offerings made to the retail public and sophisticated investors; (2) a limited distinction between the disclosure required for sophisticated and other investors; or (3) use of one set of disclosure rules for retail offerings to the public in general and a second set for private placements to sophisticated investors (or at least a limited number of them). Under what circumstances should an emerging market select one rather than the other?

In emerging markets, the question arises as to whether any distinction between public and private is useful, given the institutional weaknesses in the country. Indeed, many new emerging markets reject the notion of a private placement. They adopt Prototype 1, which makes no special exceptions for private issues. Among the countries reviewed for this report, these markets include Estonia, Ghana, Kazakhstan, Kenya, Nepal, Zambia, and Zimbabwe. Kazakhstan's law explicitly requires all issues to be registered, including those to fewer than 50 investors. Nepal forces all issuers to list. Several other emerging markets, discussed below, do not resolve the issue, allowing some placements without disclosure.

Emerging markets may justify adopting Prototype 1, using arguments from weakness. The prototype makes sense if the country lacks sophisticated investors. In Nepal, as in many other countries, "most investors . . . are unsophisticated and need the protection of the securities law" (Pyakuryal and Uprety, 1996, at 446). Regulators in emerging markets may be unable to implement most of the measures that permit private placements. Perhaps the regulator lacks the technology to trace offers or the political will to pursue violators. Perhaps the courts are so unskilled, or corrupt, that the regulator is reluctant to try to use them to enforce the laws.

A developmental goal, to improve the financial markets in the country, can also justify an emerging market's decision to use Prototype 1. If all securities issued in the country must be made to the public, investors in the country will be channeled to those public markets, increasing the demand for public issues. The supply of public issues should also rise. In a country with few tradable securities, Prototype 1 forces new issues onto public markets where they can be traded. The prototype also prods companies issuing securities to assemble and provide information about themselves systematically and, one supposes, conforming to local accounting standards. This may be a useful way to increase transparency in countries that lack adequate accounting systems. In Kazakhstan, this seems to have been the case (Bukhman 1997, at 570-71):

> the traditions of economic glasnost (full and accurate disclosure of information) can be created and developed only through the rigid government enforcement of disclosure requirements, a goal that can be achieved only through universal registration requirements with no loopholes. It is possible that at some later stage in the development of the Kazakhstani securities market such comprehensive registration requirements may adversely affect the expansion of the market, justifying the introduction of exemptions to registration. Presently, however, the task of preventing fraud and manipulation in the

securities market at the early stages of its development may justify the rigidity of the Decree.

The argument *for* private placements in new emerging markets is those given at the outset of this chapter. Even in emerging markets, a rule forcing all issuers and investors into the public market will exclude issuers and investors for whom the transaction does not justify the cost of full disclosure. If a government in an emerging market decides to exempt private placements from disclosure rules, the question is in what form to exempt, or how to define "private." Some of the indicators of "private" listed under Prototype 2 above, seem best suited to new markets:

- The typical case is the issuance of securities with a relatively small total value, so that the unit cost of disclosure is high. This seems to be the compelling case for emerging markets. Thus India allows private placements for issues of less than Rs. 100 lakhs, granting them an exemption from registration with the securities commission.
- Limits based on the number of offerees are used several emerging markets, ranging from a high of 100 in Brazil to 50 in Indonesia and Hong Kong, and 9 in Malaysia (Wood, at 284). Bulgaria defines a public offer as one made to 50 or more people.
- In Bulgaria, the method of advertising indicates whether an offer is to the public, which also defines as a public offer, one made through the mass media.

Other indicators presented above in the prototypes seem to be less appropriate in emerging markets.

- Steinberg (1996, at 731), however, counsels against using monetary ceilings in emerging markets. Although he does not give the reason, one may surmise that even the smallest issues could be bought by many members of the general public in a country with a very low per capita income.
- It is difficult to argue for exemptions for sophisticated investors, if none exist. Some emerging markets provide this exemption, however. Bulgaria defines as private, placements with persons who are not institutional investors or another investment intermediary.

If an emerging market were to exempt private placements with sophisticated investors, the rule should be simple and leave no discretion in the hands of the regulator. A possible rule could exempt offers to retail investors who buy and hold an issue made in large blocks. One may not be able to ascribe sophistication even to the senior managers of a large but new institutional investor in the country. But one should be able, in most transition and developing countries, to ascribe sophistication, or at least the knowledge that sophisticated advice can be sought, to a retail investor investing his or her own funds in large blocks.

The securities law in an emerging market can create a potentially serious problem. Some countries have laws that introduce a distinction—explicit or implicit—between public and private but fail to define each clearly. One way this confusion occurs, is in laws that are written to apply only, or primarily, to securities traded on public secondary markets. The problem is that the law creates a category of securities—those, which are issued, but not to be traded or listed—that are exempt from any disclosure rules. A company may issue securities to many investors,

whether or not they are sophisticated, and not be subject to legislated disclosure standards, provided the securities are not traded.

This problem arises both for laws that apply to all public secondary markets and for those that apply only to listed securities. Estonia is an example of the first. It is useful to see just how confusing the law can be (Burke 1994 at 568-69):

> The failure to define private placement leaves unanswered questions regarding the size of private offerings and the method of sale and distribution. Taken together, Articles 7 and 8 define a public distribution of securities. The [Act's] definition of public distribution contains three elements. First, a public distribution is a formal decision of the issuer to make a public offering. Second, it is an issuance of securities to investors whose identity the issuer does not determine prior to the distribution. Third, a public distribution of securities qualifies them for trading on the secondary market, that is, trading activity among anonymous investors subsequent to the public offering. Hence, a public distribution is an offer to sell securities, to the public, that does not contain restrictions prohibiting trading on the secondary market.
>
> It follows from this definition of pubic distribution that a private distribution of securities is an issuance of securities to a list of predetermined investors whereby, as a result of the primary distribution, the securities cannot be traded on the secondary market unless registered or exempt from registration. Because the [Act] does not provide any exemptions or exceptions from registration, securities that are privately placed in Estonia cannot be subsequently traded on the secondary market. The issuer must thus establish the terms of redemption or sale prior to making a private offering.

The problem also arises when the securities law applies only to listed securities. If a company issues a security, but does not list it, the issue is not subject to the disclosure rules that govern listed securities. So a company can issue unlisted shares to anyone, including the general public, without being subject to any disclosure rules. This is not a private placement, because the offer can reach the general public. Vietnam is an example.

Finally, the problem can arise even when the law governs both issuance and listing of securities, but sets different rules for the two. In China, the securities regulator must verify and approve public issues of shares (Freshfields 1999). Detailed disclosure rules apply to listed shares. But the underwriter must "verify the truthfulness, accuracy and completeness of public offer documents," which suggests a general standard for disclosure, and criminal penalties attach if documents contain false information (Freshfields 1999, at 12, 36).

One proposal to solve the private placement problem, is to establish a stock exchange that would allow only sophisticated or institutional investors to trade. Disclosure standards would be negotiated between the offeree and the investors or could be set by the regulator at a much lower level than that required for offers to the public. Fraud standards would continue to apply and the regulator should monitor for fraud (Steinberg 1996). This proposal has some appeal, but its deficiencies may seem serious in an emerging market. First, it separates institutional investors from retail investors, segmenting the markets and reducing liquidity in both markets. The number and resources of institutional investors are very small in many emerging markets. In many Asian exchanges, the retail investor is king. This proposed exchange would doom sophisticated investors to an inactive life. As noted above, institutional investors in many

emerging markets may not be sophisticated. It would be unwise to ask the securities regulator to decide on the sophistication of each possible institutional investor. The regulator could lack the capability to act, and the decision could very quickly become political.

CHAPTER 8. CAPITAL ADEQUACY FOR SECURITIES DEALERS AND UNDERWRITERS

The rules setting the minimum capital a financial intermediary needs, to act as a dealer or underwriter have become a key protection against systemic risk in securities markets. This chapter presents the prototypes for capital adequacy rules that govern position taking in equity markets. A firm takes a position when it buys a security. The rules apply to securities firms operating as dealers or underwriters, and also to banks that perform these functions. This is important, because the rules often vary depending on whether the intermediary is a bank or not. Both banks and non-banks are major players in securities markets around the world.

The chapter is organized by the four major prototypes. Three of these have more than one type, so the list of prototypes is long. They include:

Prototype 1. No special capital adequacy rules for position taken by financial firms

Prototype 2. Flat rates based on models for credit risk and set by regulation
- Prototype 2a. Simple flat rate
- Prototype 2b. Credit risk approach: The Basle Accord

Prototype 3. Formulas calculating position risk, set by regulation
- Prototype 3a. Comprehensive approach, based on liquidity
- Prototype 3b. Building Block approach, based on general and specific risk
- Prototype 3c. Portfolio approach, adding portfolio risk to specific risk

Prototype 4. Internal models, set by individual firms
- Prototype 4a. Internal models within regulatory guidelines
- Prototype 4b. Internal models judged against precommitted targets set by the firm
- Prototype 4c. Internal models judged by investors in the firm's subordinated debt

No single standard or prototype for position risk is now commonly accepted around the world. Certainly this is true among regulators of banks and regulators of securities firms. As a result, in many countries, banks take positions according to one set of rules for how to determine their capital, while securities companies follow a different set of capital adequacy rules (even though the two types of institutions compete directly with one another in the securities markets as underwriters or dealers). Also, Securities firms' regulators in different countries disagree about the appropriate standard. Their approaches differ so greatly that the International Organization of Securities Commissions (IOSCO) has not been able to agree on common standards for its members.

Common standards have been agreed for sub-groups. Bank regulators have adopted common standards. Members of the Basle Committee on Banking Supervision, a group of bank supervisors from the major industrial countries, have set common standards for the banks they regulate. Other countries have adopted these standards as well. Finally, to further complicate

matters, members of the European Union are subject to a common standard in securities markets that applies to both banks and securities firms.

These agreements about capital requirements extend beyond position risk for equities to include position risk for debt securities, as well as other types of risk, such as foreign exchange risk and counterparty risk (the risk that the other party in a transaction will fail to perform its agreement to buy or sell at the time of settlement). Many regulators tailor their capital standards to these different types of risk.

This leaves considerable room for regulators in emerging markets to exercise discretion. Should they frame their own rules or try to emulate those used in more developed markets? If they look to developed markets for prototypes, which one do they choose? The prototypes are presented in order from simple to complex. Countries with new emerging markets and financial systems are likely to gravitate toward those early on the list. Regulators of more established, but still emerging, markets place their countries further down the list, with Prototypes 2 or 3. Very few of even the developed countries used Prototype 4, which has only recently appeared as a possibility.

In this chapter, position risks and market risks mean the same thing, notably "the risk of an adverse movement in a security's price."[80] A firm may buy a stock, only to see the market price drop before it can resell the stock. The price may fall because the market learned that the issuer will perform worse than expected or is about to participate in an ill-advised merger. On the other hand, a firm can sell the stock short, promising to deliver at a later date, shares it does not yet own and so must buy before the delivery date. If so, it may see the market price rise so that the share it must buy, costs more than what it will earn when it delivers the share it sold short. Regulators use capital adequacy rules for several related purposes, but the emphasis they give to each varies. Regulators want to protect the firms' customers if the firm fails. They also want to protect the financial system against the risk that the failure of one firm would lead to a collapse of the system. This could happen if creditors of the failed firm, including other securities firms or banks, for example, fail because they are not paid, creating a domino effect throughout the financial system. If, as in the U.S., the goal is to protect creditors (including customers), capital adequacy rules are designed to ensure that a firm's assets always exceed its liabilities by a safe margin. If, as in Japan at least until very recently, the goal is to prevent a failure of the firm, the capital adequacy rules might be less important as a regulatory tool than means to identify problems early and find stronger firms into which to merge a firm on the verge of failing.

When comparing the prototypes, it is important to know that countries may use different measures to apply their rules:

- the value of the securities may be set at the acquisition cost, and not change until they are sold, or may be marked to market, which means that at short intervals of one day or less their value will be adjusted to the current market price;
- capital may or may not provide for settlement risk, which occurs if the counterparty fails to perform on time; and

80 U.S. Government Accounting Office, "Securities Markets: Challenges to Harmonizing International Capital Standards Remain" (1992).

- capital may be constant, regardless of the type of securities business (dealing or underwriting, for example), or it may vary by business.

The capital adequacy rules adopted by emerging markets must clarify these issues as well as set standards.

The problem of capital for securities firms and banks. Banks and securities firms compete directly with each other in securities markets when they take positions as dealers or underwriters. But regulators have very different goals for the two types of financial intermediaries because of their different businesses. First, regulators are more concerned about the systemic risk of failure by a bank than failure by a securities firm. Bank regulators operate against a history of depositor panics and bank runs, coupled with the impact of the reverse multiplier on loans as depositors withdraw their funds from banks (that is, outstanding loans contract in much larger volumes than the drop in deposits), that devastate the economy. To maintain depositor confidence, bank regulators try to keep banks as going concerns. Closing a bank means paying the depositors, an expense the government would prefer not to bear. Capital must allow the bank to remain a going concern. Securities regulators, in contrast, do not have this concern. Securities firms can fail without causing a run on other securities firms (a market collapse raises other issues). But the failed firm could harm creditors, including banks and customers. So while the regulators do not need to keep the securities firm going, they do want to make sure that, if it fails, its creditors will be paid. The capital adequacy rules are designed to ensure sufficient liquidity to pay creditors.

Second, the banks' and securities firms' main lines of business generate very different kinds of risk. Banks use short-term deposits to fund longer term lending. The loans are illiquid, which means one cannot assume that they can be quickly sold at a price appropriate to their long-term value. Banks hold many of their assets to maturity. The regulators' main concern about banks is credit risk, the possibility that debtors will not repay on time. The market value of the loan in the interim, if a market value can be determined, is much less significant to bank regulators. This permits banks to value their assets at cost. Capital must protect against credit risk. In contrast, the securities firms, in the course of trading, turn over their portfolios quickly and often. The market values of the securities in their portfolio are critical to their business and change constantly. To ensure that a firm's assets have enough value to pay all its creditors, regulators require the firm to mark to market frequently.

So the regulators' concerns about systemic risk and the different businesses of banks and securities firms lead to different capital adequacy rules. The problem arises when both types of financial intermediaries compete in the same securities markets. Does the regulator impose the capital requirements for bank credit risk on the bank's portfolio of securities, even though the risks are very different? If so, either the bank or securities firms are at a competitive disadvantage; which disadvantage depends on the two different capital adequacy rules. So does the regulator require banks to operate in those markets through a separate entity and subject it to different capital requirements? If so, is the parent bank really independent of the subsidiary and able to let it fail? Otherwise, the deposit base of the bank is drawn in to protect the security market operations of the subsidiary. So should the subsidiary be subject to two sets of capital rules, those for banks and those for securities firms? In that case, the stricter rule will apply; the bank's subsidiary will almost certainly have higher capital costs than the securities firms, and will be at a competitive disadvantage.

Regulators in various countries arrive at different answers to these questions. In part, their decisions reflect the structure of their financial systems. Countries like Germany, with universal banks, prefer a common standard for banks' operations in lending and securities markets. Countries like the U.S. and Japan, that separate commercial banking and securities activities, are willing to apply different capital adequacy rules to the two lines. But the underlying problems remain how to protect the banks' deposit base when they operate in securities markets.

The prototypes follow. Much of the data about them is from Scott and Wellons, (1998).

Prototype 1. No special capital adequacy rules for position taking by financial firms

Some analysts doubt that securities firms require special capital adequacy rules. After all, few other private firms are subject to rules specifying their minimum acceptable capital. Certainly no regulator sets capital adequacy rules for car manufacturers, even though a failure of General Motors would severely hurt its creditors, including banks, its customers, and the U.S. economy. Moreover, the big U.S. firms maintain much more capital than regulators require.

In this view, the regulators of securities firms are simply, and only, adding to the cost of raising finance. Issuers or investors bear the additional cost. Securities firms at the margin will stay out of the market, reducing competition and thus raising costs to users of these markets.

For emerging markets to accept this argument, the government must be prepared to let securities firms fail and let creditors, including customers and banks, suffer losses. If the government is forced to intervene and bail out either the failing securities firm or the creditors, then the regulator will want capital adequacy rules so that shareholders bear at least a reasonable part of the cost. Ultimately this is a political question in each country. The Asian financial crisis revealed the willingness of some governments to let markets values fall precipitously (or at least their inability to stop the decline), and it highlighted the interest of the body politic in stability. Failures and workouts occurred in the countries, but the governments also intervened to protect financial firms. Certainly the U.S. has not always been willing to let securities companies fail as markets fall; the active role of the Federal Reserve Board, supplying liquidity during the 1987 collapse, is an example. Governments of emerging markets are unlikely to stand aside completely in a crisis.

A variation of this prototype would be to let only foreign securities firms operate in the country and ensure that they remained subject to the capital adequacy rules of their home countries, which would enforce those rules. Most countries would probably find this politically unacceptable because it wold exclude local firms from even the domestic securities market.

Prototype 2. Flat rates based on models for credit risk and set by regulation

In the second prototype, the regulator requires the securities firm to hold capital that is a designated percentage of the firm's equity positions, whose value is determined in a simple manner and, in the second type, weighted according to credit risk. The two manifestations are described below.

Prototype 2a. Simple flat rate

The easiest way to fix capital for position risk is to simply require a fixed percentage, such as 5%, of the position. The position could be valued at cost or marked to market. Required capital could be assessed by the firm at periodic intervals, such as at the end of the trading day or even later.

This prototype is derived from the simple capital standards that many countries used for commercial banks before regulators in the late 1980s, started to weight capital according to the credit risk of the loan. The idea was that the regulatory capital would serve as a cushion against unanticipated default by creditors, for which no provisions for loan losses would have been made. Bank regulators found this approach to banks' credit risk far too simplistic.

When applied to position risk, this prototype assumes that one rate can accommodate the different types of risk associated with an equity position. As described in more detail below, these risks are sufficiently varied to make it extremely unlikely that a single simple rate, such as 5%, could reflect the actual risk of the positions. It is much more likely that the capital is far too high or too low for the risks. If required capital is too high, the securities firm bears the cost and tries to pass it on to its customers. If required capital is too low, unless investors in the firm force it to carry higher capital, the firm lacks adequate capital and the financial system faces the risks that capital adequacy rules are supposed to alleviate.

For a new emerging market, however, this simple rule has tremendous appeal. No real market for equity exists, because few companies have issued and listed shares for trading and little trading takes place yet. It is difficult to speak confidently about a market value of the shares that are traded. The issuers and intermediaries are also so new that there is no history against which to estimate the risk of a portfolio. This is the case in transition countries of Southeast Asia, for example. It is quite understandable that a country like Vietnam would choose such a simple capital ratio. But it does not assure the liquidity needed to wind up a securities firm that fails. One suggestion is to supplement the simple capital ratio with a liquidity measure like that discussed below (interview, T. Chuppe 1999).

Prototype 2b. Credit risk approach: The Basle Accord

Until the European Union forced them to change in 1998, German regulators applied to their banks' position risk, a capital adequacy rule that was generally accepted throughout the world for banks' credit risk. This was approach set by the Basle Accord in the late 1980s and adopted by the EU for the credit risk of banks within the union.

The Accord specified the types of instruments that could make up bank capital. It required that this capital equal at least 8% of the assets of the bank, weighted by risk. The Accord then grouped all types of bank credit into several categories according to their risk. Some, like credit to the bank's home government had no risk and required no capital. For example, when a U.S. bank bought U.S. treasury bills and held them as an investment, it was not required to set aside any capital. There was no credit risk, according to the Accord. Other types of bank credit, like loans to banks from OECD countries, had very low risk and required capital against only 20% of the value of the loan. For example, if a U.S. bank made a $1,000 deposit in a French bank, the U.S. bank had to hold capital of $16, which equals 8% of $200, which in turn is 20% of the

$1,000 deposit. Loans with the highest risk included almost all credit to private borrowers, and required capital against 100% of the value of the loan. Here, a $1,000 loan to a private company required $80 in capital. So the capital a bank held against credit risk varied according to the portfolio of its loans. A country could adopt the Basle Accord rules, then make them stricter; it could not weaken them.

Germany made securities held by its banks for trading, subject to the Basle Accord's risk weighting rules. This meant that the same capital adequacy rule applied if a German bank held a financial instrument for investment or for trading. It is easiest to see the distinction using a corporate bond as an example. The bank might hold a German corporate bond as a long-term investment, in which case it was treated as a credit risk, because the major risk was default by the issuer. Or it might hold the bonds in the hope of making money on short-term price movements, in which case it would normally be treated as position risk, because the risk was that the market price of the instrument would fall. In either case, the bank was subject to the Basle Accord's rule that it must hold capital equal to 8% of the principal of the bond. This was true even though the two risks were quite different. While the long-term risk was supposed to reflect the creditworthiness of the German company, the position risk would reflect both the company's creditworthiness and the general movement of interest rates in the market. The same rule would apply to corporate shares held by the German bank, but more awkwardly, because this was not a loan. The value of the share would be its purchase price to the bank. It was not marked to market.

The awkwardness of using the Accord to set capital adequacy rules should be apparent. The bank that holds a security for trading is concerned about market price movements, and the issuer's creditworthiness accounts for only part of those movements. Indeed, the issuer's financial strength may remain constant, but the value of the instrument could still fall if interest rates shifted the wrong way. The Basle Accord's few simple categories of risk weights, which even the Basle Committee now recognizes oversimplify drastically, are not designed for market risk. Almost all credit to the private sector is weighted 100%. This means the position risk of IBM common stock on the New York Stock Exchange and the recently issued shares of Fly-By-Night Corporation on an obscure regional exchange are treated as identical by the Accord.

Emerging markets may find compelling reasons to follow Germany's lead. Many developing countries adopted the Basle Accord for their large banks. These are often universal banks, which means they can offer any kind of financial service, at least. Their assets consist largely of loans, because most developing countries have bank-centered financial systems. Until the stock markets grow to a substantial size, the banks' trading positions will be a small portion of their total assets. The Accord's simple risk-weighting standard is easy to apply, because it requires no marking to market and no other measures of risk. The bank does not need to separate its portfolio into trading book and investment book. All the bank, and its supervisor, needs to know is the category of obligor and the purchase price of the instrument. If the bank does not compete much in international markets, it need not worry about the competitive effect of using such a simple rule. Indeed, emerging market regulators may decide to apply a similar rule to their securities firms to keep them on the same competitive field as the banks, even though the Accord does not oblige the regulators to do so.

The problem with this approach is that its effect is just as arbitrary as that of the simple flat rate used in Prototype 2a. Assessing 8% of the purchase value of any corporate share is no more appropriate as a cushion against market risk than the 5% used in the example above. Setting aside no capital against the position risk of the home government's security makes no sense, because the market price will certainly fluctuate, falling as well as rising. Yet, the appeal remains: this prototype is simple to use.

Prototype 3. Formulas calculating position risk, set by regulation

To get a more appropriate measure of required capital, regulators in different countries designed several different ways for banks or securities firms to estimate their position risk. In order to apply to many different firms, these prototypes use a few limited parameters and make simplifying assumptions when the basic theory or technology is weak. That the regulators set the parameters distinguishes these three related prototypes from those described in Prototype 4.

This section starts with the Building Block approach, which tries to apply concepts of market (or position) risk in a way that makes up for the deficiencies described above for the credit risk approach used in the Basle Accord. Next is the Comprehensive Approach, which was developed by the SEC years before portfolio theory took hold. Finally is the Portfolio Approach, as embodied in a rule for regulatory capital used in the UK before the European Union's rules for position risk displaced them.

Prototype 3a. Building Block approach, based on general and specific risk

The central idea of this prototype is that a bank or securities company should set aside capital that reflects both the "general risk" and the "specific risk" of each instrument that it holds for trading. The following discussion relies on the rules set out for banks' equity positions by the Basle Committee in the mid-1990s.[81] A nearly identical approach was used by the European Union for both banks and securities companies shortly after the Basle Committee. It is briefly described later.

Each traded instrument, according to finance theory, has specific and general risk. The specific risk is that the market price of the instrument will change because of factors associated with the firm. These could include many factors that would affect its future earning capacity, such as its access to key resources, its management, major contracts, or the possibility of unexpected costs. The general risk is that the market price of the instrument will change because of other factors. Interest rates may rise, affecting the prices of all shares traded in the market. The stock market may collapse, affecting the prices of all traded shares. In neither case did the price change because of the performance of the issuing company; indeed, it may have continued to perform well. Capital must be adequate for specific and for general risk of the security, but the risks differ and so the required capital must be calculated separately for each.

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81 See The Basle Committee on Banking Supervision, The Supervisory Treatment of Market Risks (1993); Planned Supplement to the Capital Accord to Incorporate Market Risks (1995); and Amendment to the Capital Accord to Incorporate Market Risks (1996).

For both general and specific risk, the investing bank's long and short positions in any individual firm are netted. That is, if the bank holds 100 shares of Company A long and 80 shares of Company B short, its net position is 100 minus 80, or 20 shares. This is done because the 80 long and 80 short positions offset one another. If the share's value rises, the long position profits and the short position loses by equal amounts. If the share's value falls, the opposite is true. They exactly offset one another, eliminating market risk. Only on the remaining 20 long shares that are not offset by short shares, is there market risk.

For the Building Block approach, the critical difference when calculating capital for general and specific risk, concerns netting of long and short positions in securities.

To calculate capital for the general risk of its trading portfolio, the bank offsets, or nets, all its net long positions with all its net short positions. It does so because general risk is that the entire market rises or falls, independently of any individual security. So if the market falls, all the bank's net long positions will fall, but all of its net short positions will rise by an equal or offsetting amount. Against this net position on the entire portfolio, the Basle Building Block rules require a bank to assess capital of 8%. If the net position is $1,000,000, required capital is $80,000.

- To calculate capital needed for the specific risk of the portfolio, the bank does not offset net long positions with net short positions. Instead, it adds all net long positions and all net short positions. This is because when a specific risk occurs (something that reduces the issuer's earnings unexpectedly), the value of the stock will fall, reducing a net long position or increasing a net short position in that stock. But there will be no equal offsetting movement in the opposite direction for some other stock. The event was limited to the issuer. Against the combined position for the entire portfolio, the Basle Building Block rules require a bank to assess capital of 8% or, if the portfolio is diversified and liquid, 4%. Liquidity allows the bank to sell its holdings quickly. Market risk to the bank is reduced by diversification, ensuring that the impact of any one security risk is very small. So, if the sum of all the bank's net long positions is $2,000,000 and the sum of all the bank's net short positions is $1,000,000, and the portfolio is diversified, the required capital for specific risk is 4% of $3,000,000, or $120,000.
- The bank then adds required capital for general risk of $80,000 and for specific risk of $120,000 to get total capital required for market risk, $200,000 or 6.7% of the total $3,000,000 portfolio.

It is difficult to compare this to the requirements of the Prototypes 2a and 2b without knowing the overall size of the bank's portfolio. To get a net portfolio of $3,000,000, the bank would probably have total positions (not netted even at the level of the individual stock) that are much higher than $3,000,000. Suppose the total positions were $4,500,000. The simple flat rate of 5% would require capital of $225,000. The Basle Accord would require 8% or $360,000. The Building Block approach would require $200,000 or 4.4%. This simple comparison shows that it is possible for the Building Block approach to refine the calculation of market risk and require a lower amount of capital. Of course, different assumptions about the portfolio would produce different capital requirements for the flat rate prototypes. If the gross portfolio was only $3,000,000, the 5% flat rate would require only $150,000 in capital and the 8% rate of the

Accord would require only $180,000, both less than the $200,000 required by the Building Block approach. The more important point is that as the specific and general risk of the portfolio vary, the capital required by the Building Block approach varies. This is not true of either of the flat rate prototypes.

The European Community also adopted a Building Block approach, modifying it to allow lower rates for specific risk: 4% generally and 2% if the portfolio is diversified. These lower rates were appropriate because the capital requirements applied to securities firms as well as banks. Regulators are, as stated above, prepared to let securities companies fail and so are willing to let them have lower capital requirements. Home country regulators could raise the ratios for banks if they wanted to protect the banks more. Notice that the lower rates of the EU Building Block approach could make the EU securities companies competitive, on required capital, to banks subject to the flat rates, even assuming that the gross positions of the bank were $3,000,000. At 2% for specific risk, the EU rules would require only $60,000 in capital for specific risk and the $80,000 for general risk, for a total of only $140,000.

A criticism of the Building Block approach addresses the very basic assumption that it is appropriate to set net long positions off against net short positions to determine general risk. The U.S. SEC has argued that during the 1987 market crash, airline equities fell much more than railroad equities. This says that net long positions in airline equities would not be fully offset by net short positions in railroad equities.

For emerging markets, the concepts and the methodology is relatively straightforward. Regulators, banks, and securities firms could apply the Building Block approach for equities without much difficulty. Many might find the rules for tradable debt more complicated and harder to implement. This is important in those markets where financial skills are in short supply. The more difficult question is whether the rates—8% general and either 8%/4% or 4%/2%—are appropriate for the market in the transition or developing country. No studies appear to have tested this. For the new emerging markets, no studies would be possible. They would be possible elsewhere. It is unlikely, however, that any financially acceptable rates would have protected local banks and securities firms that held substantial positions in the stock markets of Indonesia, Korea, or Thailand during the Asian financial crisis. Most capital adequacy rules recognize that they cannot protect against 100% of the dangerous circumstances. This is not true of some of the supporters of Prototype 3b.

Prototype 3b. Comprehensive approach, based on liquidity

Many countries use the comprehensive approach, which does not distinguish between general and specific risk. In part, this was because the approach was designed before the concepts took hold in financial economics. These countries include Japan, Australia, France, Italy, Hong Kong, and Holland,[82] as well as the U.S. The U.S. rules are used to explain this prototype.[83]

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82 Dimson, E. and P. Marsh, "The Debate on International Capital Requirements," (The City Research Project, London Business School, 1994).

83 G. Haberman, "Capital Requirements of Commercial and Investment Banks: Contrasts in Regulation," Federal Reserve Bank of New York Quarterly Review, Autumn 1987, at 1; SEC Proposed Net Capital Rule, 17 CFR Part 240 (Release No. 34-39455).

The goal of the comprehensive approach is to ensure that a securities firm (a broker/ dealer) is liquid enough to be wound up and all creditors paid in a short period, such as 30 days, if need be. The SEC lets the firm use only liquid assets to calculate its net worth and requires it to build in what could be called cushions to protect against a substantial drop in the market value of those liquid assets during the period when the firm is being wound up. The SEC defines the firm's total capital (that which is available to wind up the firm), as its total assets reduced by illiquid assets (because these cannot be used to wind up a firm fast), and reduced by total liabilities other than subordinated debt (which is by definition subordinated to the claims of the senior creditors and therefore available to pay them). It then adds another cushion, further reducing assets by what it calls a haircut for market risk, which is described in the next paragraph. The amount remaining called net capital, is another cushion and must equal at least 6.67% of the firm's total liabilities.

The haircut adjusts net worth for the SEC's definition of the market risk of the portfolio. For securities firms with net long positions that exceed its net short positions, the SEC requires a cushion of liquid assets against a 15% drop in the net longs' market value and a smaller cushion against a drop in the net shorts' market value. In fact, if the net shorts are small—less than 25% of the net longs— the firm does not need to hold any capital. This allows for some offset of short and long positions, much as is done by the general risk rule in the Building Block approach. But as the short positions become a relatively large share of the firm's portfolio (25% or more of the longs), the firm must have a cushion of liquid assets to offset a 15% reduction in the market value of its short positions.

So a U.S. securities firm must hold what could be called liquid net worth (liquid assets less total liabilities), plus subordinated debt, which is also liquid. These liquid resources must be more than enough to meet a 15% drop in the market value of net long positions and somewhat less for net short positions. The remaining amount is the last liquidity cushion, no less than 6.67% of total liabilities. The SEC reckons, from experience, that this provides sufficient liquidity to wind the firm down quickly.

One of the major problems of this prototype is that it seems at variance with modern financial theory. It is called the comprehensive approach because it does not calculate capital separately for general risk and specific risk, and because it does not account for the way diversification reduces risk, portfolio risk. This prototype assumes that as net long and short positions become equal in size, the market risk to the firm increases. The Building Block approach reduces the required capital as the firm's net short and long positions come into balance with each other. After all, a decline in the market value of net long positions will be offset by an increase in the market value of net short positions. The SEC haircut has the opposite effect. This runs counter to finance theory. It may reflect the idea that a short position is risky because there is no limit to the loss its holder can incur. Long positions can fall to no lower a price than zero. The SEC may recognize that ignoring financial theory puts it in an untenable position. In December 1997, it proposed a building block method—based on general and specific risk—to calculate capital for market risk on interest bearing instruments.

For some emerging markets, the idea of this prototype may be useful even if it rejects the specific measures used by the SEC, particularly the way to calculate the haircut. When the more complex capital adequacy rules of Prototypes 3a or 3c are beyond the capacity of the regulators

and financial firms to implement, a regulator could add rough tests of liquidity to the flat rate of Prototype 2a. The instruments that actually are liquid will depend very much on the money and capital markets of the country, as well as its legal system. It may be that only a very limited set of liquid instruments exists.

Prototype 3c. Portfolio approach, adding portfolio risk to specific risk.

The portfolio approach reduces the required capital for a firm as its portfolio of securities, diversifies and increasingly balances the net long and net short positions. The UK securities regulator used this prototype until the EU's Building Block approach replaced it.[84]

The idea is that, in addition to specific risk, the risk or variance of a portfolio depends on the diversification of the portfolio, notably the share of each security in the portfolio and the relationship between the returns on each security. To simplify the complexity of these relationships, the UK regulators set common assumptions about them for all firms to follow. Each firm was required to hold enough capital to absorb most of the possible losses (e.g., 95%) in the portfolio during the period in which the firm is winding up. Three periods were assumed for the trade out, depending on the liquidity of the portfolio, of one, two, and three weeks. The capital required depended on the variance of market returns over the tradeout period and the residual risk, for which required capital fell as the portfolio diversified. For each of the two, the regulators set a single variance ratio for all firm's portfolios. They also set the specific risk for each security, in each portfolio, at 1. So, most of the basic parameters were set by the regulators.

The portfolio approach differs dramatically from the comprehensive approach and introduces more complexity than the Building Block approach, for which a portfolio was simply liquid and diversified or not. In a simulation using over 50 actual portfolios, the portfolio approach required substantially less capital than either the Building Block approach or the comprehensive approach, and that while required capital increased directly as the portfolio variance increased for both the portfolio and Building Block approaches, the comprehensive approach's required capital was about the same for each portfolio, regardless of its actual valiance.

In most emerging markets, the portfolio approach may be too complex for regulators and securities companies or banks. It is worth being aware of it, however, because it represents the direction in which capital adequacy rules are heading. To the extent an emerging market wants to enter the mainstream of international finance, it must be able to apply these rules. Indeed, some countries, like Malaysia, have carefully followed the evolution of these rules and considered applying them.

Prototype 4. Internal models, set by individual firms

All approaches in Prototype 3—building blocks, comprehensive, and portfolio—share the fact that the regulators set the parameters and require banks and securities companies to follow those parameters. Critics of these approaches argued that they suffered from oversimplification in their effort to make the rules apply to many different kinds of investors. The solution appeared

84 E. Dimson and P. Marsh, Stress Tests of Capital Requirements, (October, 1996).

to let financial firms design and apply their own systems of risk analysis in setting capital. These are described briefly in the next sections.

Prototype 4a. Internal models within regulatory guidelines

A special dispensation from the Basle position risk rules was authorized by the Basle Committee[85]: sophisticated well-run banks could use their own models if the models met minimum standards set by Basle and were subject to regular tests. Several standards were set to make sure the banks were qualified, including rules about the independent risk control unit and the use of the model in decision making. Each day, at least, the bank had to determine the value at risk in its portfolio. The idea is to have enough capital to meet 99% of the potential loss distribution on one day where the loss would occur over a holding period (the winding down) because of general market risk. The banks were encouraged to integrate their trading book, but most applied the tests to separate portfolios for equities, government bonds, and other major types of securities.

The Basle Committee set threshold standards for frequency of computation, choice of risk factors, confidence level, length of historical observation, minimum length of the price shock, and how long to make the trading out period. Because the committee believed that modeling oversimplified and volatilities changed daily, it required the bank to set its capital at three times the average daily VAR over the last 60 days. This was a substantial and somewhat arbitrary multiple, based more on financial reasoning and less on experience. The Committee required regular backtesting against actual performance over the previous 12 months. If the tests revealed 10 or more failures of the internal model, the bank would have to increase its capital. Finally, within limits, a bank's model could estimate specific risk that stood up under backtesting. If not, the bank had to use the simple method of estimating specific risk described in the Building Block approach.

This prototype has several shortcomings. Its time horizon is short, measuring risk during the day and over the trade-out period, but not over a period of months or even years that should concern regulators. This length of time is beyond the capacity of science and technology today. The backtesting is not reliable because of simplifying assumptions needed to do it. The prototype is complex enough for people to start talking about "model implementation risk," and the danger that the bank would not apply the model correctly.

For regulators in emerging markets, this prototype is too far removed from the realities of their financial system. Banks and securities companies are not sophisticated. Data are inadequate to build the models or backtest even in the limited manner required by Basle.

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85 Bank for International Settlements, The Measurement of Aggregate Market Risk (Basle 1997); Basle Committee on Banking Supervision, Supervisory Framework for the Use of "Back-testing" in Conjunction with the Internal Models Approach to Market Risk Capital Requirements 5 (1996); P. Johnson, Risk Measurement and Capital Requirements for Banks, 35 Bank of England Quarterly Bulletin 180 (1995); P. Kupiec, Techniques for Verifying the Accuracy of Risk Measurement Models 2 (Federal Reserve Board Finance and Economics Discussion Series No. 95-24, 1995); and P. Kupiec and J. O'Brien, The Use of Bank Trading Risk Models for Regulatory Capital Purposes (Federal Reserve Board Finance and Economics Discussion Series No. 95-11, 1995).

Prototype 4b. Internal models judged against precommitted targets set by the firm

The cumbersome parameters and backtesting rules of Prototype 4a led some analysts to propose that regulators shift responsibility for designing internal models onto the banks that use them. The idea is, that the bank would build its own model using the assumptions and promise the regulator, in advance of each period (e.g., every three months), that the capital required by its model would be sufficient to meet a designated "maximum loss exposure."[86] The commitment would be forward looking and, at the end of the period, capital would either have been sufficient, or not. There was no need to backtest. If capital proved insufficient to meet the bank's maximum loss exposure, the regulator would penalize the bank with a fine. The Fed concluded that a precommitment test was feasible, but has not yet authorized its use in the U.S.

Finding the right penalty was a problem. Banks preferred that they simply be required to disclose the failures of their internal model. Regulators believed they should tailor the penalty to the individual situation, making it hard to announce standard penalties in advance.

A more fundamental attack on the precommitment prototype is that it is after the fact. The prototype kicks in after the bank fails to do its job, perhaps with disastrous consequences. The argument is that regulation should be preventive.

For emerging markets, this prototype demands too much of both the regulators and the financial institutions. All lack the resources to make it work. Too much discretion is given to people in government and finance who are not used to exercising that discretion.

Prototype 4c. Internal models judged by investors in the firm's subordinated debt

A third way to shift capital adequacy protection to the financial institutions and markets is to require the bank or security to rely much more on subordinated debt. The idea is that lenders who are subordinated in bankruptcy to the claims of other creditors will carefully assess their risks before making funds available to the bank. The price of subordinated debt, as a market test, will be the best indicator of risk. Banks and securities companies will take pains to assure their capital is adequate in order to satisfy their funders and reduce the cost of capital. This takes the pressure off regulators.

Already, subordinated debt is a key part of funding for capital market intermediaries, particularly in the U.S., but also in other developed markets. The Basle capital rules specify that subordinated debt may be used to satisfy capital requirements for position risk. In the U.S., broker/dealers regularly rely on subordinated debt to finance their operations.

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86 P. Kupiec and J. O'Brien, A Pre-Commitment Approach to Capital Requirements for Market Risk (Federal Reserve Board Finance and Economics Discussion Series No. 95-36, 1996); A. Daripa and S. Varoto, Value at Risk and Precommitment: Approaches to Market Risk Regulation, in Federal Reserve Bank of New York Economic Policy Review, v. 4, no. 3, Oct. 1998, at 137; J. Seiberg, Precommitment System for Market-Risk Capital Said to Succeed in Test, American Banker, March 3, 1997; J. Considine, Pilot Exercise—Pre-Commitment Approach to Market Risk, in Federal Reserve Bank of New York Economic Policy Review, v. 4, no. 3, Oct. 1998, at 131; P. Parkinson, Commentary, in Federal Reserve Bank of New York Economic Policy Review, v. 4, no. 3, (Oct.), 1998, at 155; and K. Engelen, The Basel Capital Accord, The International Economy (March/ April 1998), at 33.

Most emerging markets, however, lack any market for subordinated debt, let alone markets that are sufficiently deep and experienced to exert the discipline this prototype requires from them.[87]

87 See D. Cole, H. Scott, and P. Wellons, "Asian Money Markets," (1995).

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