Issues in Regulating Post-Privatization Securities Markets in Transitional Economies

Marko Simoneti

EDI WORKING PAPERS
REGULATORY REFORM AND PRIVATE ENTERPRISE DIVISION
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Securities markets in transitional economies are developing as a follow-up to large-scale privatization of companies. As many innovative methods are used in privatization (on the primary market) the secondary transactions of privatized shares also have some unique characteristics. The key players on the market have different objectives to those in developed economies and, therefore, their behavior is different. The regulations have to take this motivational structure emerging after privatization into account, as applying the standard rules from developed economies might be counter-productive.
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Foreword

EDI's program is articulated in seminars, conferences, and regional and worldwide roundtables. Policymakers, civil servants, regulators, and trainers are brought together to discuss agendas of specific issues and problems, often identified beforehand by the participants themselves.

This paper is a contribution to the regulatory reform discussion in the transitional economies (TEs). Many of these countries have used some variant of voucher privatization along with voucher investment funds. This has raised a host of acute regulatory issues in the securities markets of the TEs which are only partly similar to issues confronting Western markets. This paper represents a "second generation" approach of thinking through the issues in situ as opposed to the "first generation" approach of essentially copying Western regulations.

The author addresses these issues as a practitioner, regulator, and educator. He was previously the first Director of the Privatization Agency of Slovenia, and is currently the Director of the Central and Eastern European Privatization Network (CEEPN) and a board member of the Securities and Exchange Commission of Slovenia. The Division would like to acknowledge the contributions of Asli Demircu-Kunt for her review of the paper and James E. Quigley in design and layout. The views expressed herein are entirely those of the author and do not necessarily reflect the views of EDI and the World Bank.

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Securities markets in transitional economies are developing as a follow-up to large scale privatization of companies. As many innovative methods are used in privatization (on the primary market) the secondary transactions of privatized shares also have same unique characteristics. The key players on the market have different objectives to those in developed economies and, therefore, their behavior is different. The regulations have to take this motivational structure emerging after privatization into account, as applying the standard rules from developed economies might be counterproductive.

How different transitional markets are from developed markets critically depends on the importance of these markets for the financing needs of the privatized companies. The more important the new source of finances, the more similar is the behavior of all market participants to those of developed economies.

Countries in transition are also different when compared to each other and the proper regulation should be country specific. Nevertheless, two basic situations exist: regulation of the market after case-by-case privatization (like in Poland and Hungary) and regulation of the market after mass privatization. In the context of mass privatization the regulation have to take into account different conditions in mass privatization to the public (like in Czech Republic) and mass privatization dominated by insiders (like in Russia and Slovenia).

In this paper regulatory issues on the trading of shares of privatized companies are addressed, taking into account the economic content of these activities irrespective of how they might be called in various transitional countries. The rest of the paper is divided into six sections. In the next section conditions for capital market development after privatization are described. The second section deals with the problems of protection of basic shareholders rights in privatized companies. The next three sections discuss regulation of ownership consolidation, regulation of privatization funds and regulation of public markets. In the concluding section some final obser-
vations concerning the opportunities and threats to a successful long term development of securities markets in transitional economies are presented.

I. Development of Securities Markets in Transitional Economies

Privatization programs use different combinations of privatization methods but generally there are two basic frameworks: case-by-case privatization and mass privatization. Initial conditions for securities markets development, the nature of secondary transactions with shares, as well as regulatory priorities, are very different in these two privatization frameworks.

Case-by-case Privatization Framework

**Initial Conditions.** In the case-by-case privatization program (Poland, Hungary) only those companies that can be sold to investors for cash are privatized through public offering of shares. They are carefully selected from among all the companies to be privatized. Only a limited number of public companies are traded on the public markets. Initial shareholders are not only temporary investors created artificially through voucher distribution, but individuals and institutions who can afford to keep a portion of their financial wealth invested in shares.

The most important difference in the mass privatization situation is that many of these privatized public companies wish to issue new shares in the near future. The main objective of the issuers and their behavior is similar to developed economies. They are interested in attracting investors on the market.

The investors who pay cash for shares in privatization also behave quite predictably. They mainly have a financial interest in shares and they are not interested in corporate control. The market is balanced as investors not only sell but also buy the shares on the market.

The Main Functions of the Secondary Market. Main functions of the market where shares of privatized public companies are traded are the same as in developed economies:

- to provide liquidity to investors,
- to provide opportunities for the companies to raise additional finances through issuing new shares,
- to generate information for investors on alternative investment opportunities,
- to monitor management performance in public companies (corporate governance).

Regulatory Priority. The regulatory priority is similar to developed economies: to protect small investors trading on the public markets with privatized company shares sold for cash through public offerings.

Mass Privatization Framework

Starting Conditions. In the mass privatization program a great number of companies are transferred free of charge to the public through distribution of privatization vouchers. As a result many quasi public companies with tradable shares are created which could otherwise not be public. Many of them have no objective to raise additional finances through the market. Their shares are mostly transacted off the market and it is not likely that they will ever be actively traded on the organized markets.

Almost all mass privatization programs encouraged the development of privatization funds which accumulated most of privatization vouchers from citizens and became major institutional owners in privatized companies. These funds are the most important players in secondary transactions with privatized shares.

In some mass privatization programs, insiders (management and employees) were given spe-
cial privileges when investing privatization vouchers in the company they worked for. In these countries (Russia, Slovenia) a strong conflict of interest between insiders and outsiders exists (Pistor, Frydman and Rapaczynski, 1994). This struggle for control has very important implications for secondary transactions and regulation should take them into account. Many of these companies are only pro forma public, while from the economic point of view they are private. The control is firmly in the hands of an organized group of insiders, while outsiders have only limited voting power and almost no possibility of trading with company shares.

The dominant feature of mass privatization programs is that many temporary shareholders are created who wish to sell shares at the first good opportunity. The situation of many selling and few buying on the secondary market will exist for a long time to come. The large supply on the secondary market will also have a strong negative impact on the primary market. The possibilities of issuing new shares after mass privatization are very limited.

**The Main Objective of Secondary Transactions.** The main objective of secondary transactions with shares after mass privatization, is ownership consolidation needed to improve corporate governance and support the restructuring of privatized companies. From the economic point of view (given their size and difficult economic situation) these privatized companies should have active owners and not passive individuals or institutional financial investors with limited ability and motivation to restructure the company. Many of these quasi public companies will be transformed into private companies owned by active owners before restructuring. There will be no real trading of shares as the new controlling owners will be buying shares from everybody else.

**Regulatory Priorities.** The regulatory priorities (in the order of importance) for the development of transparent and fair market in the framework of mass privatization are:

- Protection of shareholders rights in privatized companies. This is essential in mass privatization dominated by insiders who have strong motives to prevent outsiders from exercising their rights on equal terms.
- Protection of small investors in privatization funds which accumulated most of the privatization vouchers and became the most important institutional owner after mass privatization.
- Protection of small shareholders in the ownership consolidation process following mass privatization.
- Protection of investors trading on the public markets with shares of public companies.

**Different Approaches to Regulation in Transitional Economies**

In the case-by-case privatization framework capital market development starts at the higher end of the market. The first candidates for public offering are carefully selected and trading usually starts at the official stock exchange. Only later less attractive companies are introduced to the market and less structured trading facilities are set up. This top-down approach (Poland, Hungary) is quite conservative compared to the situation in mass privatization framework.

There are two possible approaches in regulating transactions with privatized shares after mass privatization. The first approach is to treat all companies in mass privatization as if they were public companies traded on the public markets. This bottom-up approach has to be very liberal. Initially, regulatory standards are set at a minimum to accommodate all privatized compa-
nies (for example, as in Czech Republic). The development of the securities markets in this case starts at the lower end of the market. Gradually standards are increased to the international level and some companies and markets no longer qualify to be called public.

In the second approach only a limited number of companies from mass privatization are treated as public companies that can be traded on the public markets. For public companies high international regulatory standards are applied, while there is only limited regulation for trading and corporate control transaction for the remaining quasi public companies (for example, as in Slovenia). The development of the market starts simultaneously at the lower end and at the higher end of the market. This is a dual approach to regulation as the conservative rules are used for the public segment and more liberal rules for the quasi public segment of the market (see (Table 1)).

With the dual approach it is possible to capture the advantages of the coexistence of the public and quasi public segment of the market after mass privatization. From the point of view of attracting foreign portfolio investors and selecting the privatized companies able to raise new funds on the market, it is clearly beneficial to have a separate high standard public market. At the same time, it is clearly advantageous for the companies that could never be public to stay under the liberal regime of the quasi public segment of the market as long as required for necessary consolidation of its ownership structure.

In regulating secondary transactions after mass privatization, there is a great danger of regulatory capture. It should be expected that the same pressure groups that influenced initial distribution of shares would demand very restrictive regulation of secondary transactions to preserve this distribution. This time the maxim abused by self-serving and rent-seeking groups will be the

<table>
<thead>
<tr>
<th></th>
<th>Conservative approach</th>
<th>Liberal approach</th>
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<tbody>
<tr>
<td>Accounting, auditing,</td>
<td>international standards</td>
<td>minimum standards for</td>
</tr>
<tr>
<td>reporting, and</td>
<td>for public companies</td>
<td>quasi-public companies</td>
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<tr>
<td>information disclosure</td>
<td></td>
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</tr>
<tr>
<td>for companies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>trading rules, clearing</td>
<td>international standards</td>
<td>minimum standards for</td>
</tr>
<tr>
<td>and settlement, conduct</td>
<td>for public markets</td>
<td>quasi-public markets</td>
</tr>
<tr>
<td>of market participants</td>
<td></td>
<td></td>
</tr>
<tr>
<td>taking private rules</td>
<td>yes</td>
<td>minimum rules only</td>
</tr>
</tbody>
</table>
protection of small investors. From this point of view, a dual approach could be recommended as the standard small investors protection rules could be limited only to the public segment of the market, while for the majority of companies from quasi public segment only minimum standards for trading and corporate control transactions are applied.

II. Protection of Shareholders' Rights in Companies

In transitional economies the priority is to ensure that basic shareholders rights (voting right, right to dividends, transfer of shares) are enjoyed by shareholders in privatized companies. These rights have to be provided to all shareholders on equal terms: majority and minority, small and large, insiders and outsiders. The protection of shareholders in companies is a precondition for any protection of investors trading on the market.

In developed economies the basic shareholders rights are taken for granted. They are defined by the company law and by the company statutes. While the laws are strictly enforced, investors can choose not to invest in the public company if they consider that some of statutory rules are not acceptable. The objective of the public companies in developed economies is to attract investors and there is little interest in violating these basic shareholders' rights.

In the privatization context, the main objective of the managers in the companies issuing shares to the public is often to retain control of the company. Dissatisfied investors are not a major problem as they do not represent a serious threat to the management. It is a common situation in transitional economies that companies privatized through public offering do not wish to be traded on the organized markets and to report to investors, that transactions with shares are not possible as the share register is controlled by the company management itself and that shareholders meetings are organized in a way to discriminate a particular group of shareholders. This is not simply a problem of law enforcement but a much deeper problem of completely different motivation on the part of key players. The standard approach to enforcement would prove counterproductive. For example, delisting of shares for non-reporting is not the punishment but the reward for misconduct of the management of these companies.

In mass privatization dominated by insiders, who are in a much better position to exercise their shareholders rights than outsiders, the problem becomes even more complicated. Laws provide the same rights to all shareholders, but de facto shareholders are in a very different position in such companies. The problem here is not the violation of the laws, but that laws copied from developed economies do not take into account the reality of these quasi public companies: many of them are controlled by insiders, many of them are not interested in outside financial investors, outside investors are not volunteers but are often forced by legislation to be shareholder in such companies, outside investors would like to exit but can not do so without cooperation of the insiders.

The only long term solution for these problems is transformation of quasi public companies into the private or public companies, where the motives of the companies, managers and investors/owners are the same as in developed economies. In what follows we offer some practical rules for protection of shareholders rights in the companies after mass privatization which should take care of most of the abusive practices in the transition period.

Provide Fair Corporate Legal Framework in Privatized Companies

Initial conditions for all shareholders in privatized companies are determined by the company
law, privatization law and company statute. These rules defining shareholders rights and powers, rights of minority shareholders, board structure and disclosure of information are often much more important for outsiders than the percentage of shares they hold. For protection of outsiders is to be recommended:

- cumulative voting on board representation
- two-tier boards,
- super-majority voting on major issues including the large sale of assets,
- high quorum rules,
- not to combine employee participation with inside ownership as this has a cumulative effect on decision-making rights of insiders.

To protect outsiders after mass privatization, it is important to limit the possibilities for statute amendments that would not be in the interest of outsiders and would allow major corporate decisions to be made without their consent. The main problem areas are:

- changes in voting rules in favor of insiders,
- anti-takeover statute amendments,
- asset stripping by insiders,
- introduction of profit distribution schemes for employees.

**Proxy Rules After Mass Privatization**

As most of the outside investors are not active in company matters they can be represented by a proxy at the shareholders' meeting. In the German system, banks which are themselves outside owners of companies, usually act as a proxy for small investors. In the American system small shareholders who are usually not represented do not count and in their absence they de facto support the management proposals. In transitional economies managers have the advantage of controlling the votes of small investors. In many companies dominated by insiders they control the votes of small inside and outside investors.

On the other hand, it would be more logical that PFs as the largest outside shareholders would represent small outside investors on shareholders' meetings.

If the abuse of proxy arrangements by insiders becomes a serious problem, there are some simple proxy rules that would benefit outsiders:

- all shareholders having equal access to the list of shareholders,
- financing of proxy solicitations on equal terms for insiders and outsiders,
- restrictions for managers to serve as a proxy,
- no bianco proxy arrangements,
- no long-term proxy arrangements.

**Shareholders' Agreements After Mass Privatization**

Shareholders' agreements among insiders are used to control their votes and to prevent transfer of shares to outsiders. When such agreements are made after privatization, they can substantially limit the rights of outside shareholders that are less effective in promoting their common interests. Some rules for shareholders' agreements that would benefit outsiders are:

- restrictions for the managers to organize shareholders' agreement,
- equal access to information and financing for all shareholders when organizing shareholders' agreements,
- *ex post* introduction of restrictions on the transfer of shares in the public companies that are traded on the organized markets is forbidden.

**Technical Requirements for the Free Transfer of Shares**

Insiders often have the motive not to provide conditions for free transfer of shares. In addition, there is a problem that registered shares from privatization are not easy to be transferred anyway.
There are two basic principles regarding the transfer of shares after mass privatization:

- The share register should be operated by someone independent of the company.
- Public companies should be listed on the request of investors without the consent of the company.

Dematerialization and central register is a unique opportunity to solve many problems in exercising shareholders rights after mass privatization. There are many choices, all having their advantages and disadvantages:

- Immobilization of securities is less cost efficient than complete dematerialization, but from legal point of view it is much easier to introduce in the existing corporate legal framework.
- Dematerialization of securities can be obligatory or voluntary. For practical reasons it is recommended it be obligatory for privatized companies and all public companies traded on the organized markets.
- Central register of dematerialized securities can hold accounts for brokers who act as intermediaries for individual shareholders or for shareholders directly. Two-level structure provides more confidentiality to investors, while a one-level structure is more operationally efficient.

Different approaches are used in transitional economies to reduce or eliminate the need for the physical transfer of paper share certificates: centralized dematerialization (Czech Republic, Slovenia), decentralized dematerialization (Russia) and gradual immobilization (Poland).

### III. Regulation of Ownership Consolidation

The widespread ownership emerging from mass privatization does not provide for the effective corporate governance nor the necessary support for restructuring of privatized companies. Concentration of ownership through secondary transactions and taking private of many quasi public companies are necessary preconditions to start the post privatization restructuring on a large scale. To postpone this consolidation of ownership would mean to limit the entire privatization to administrative distribution of shares with very modest effects on improving the efficiency in privatized companies. More artificial was the initial distribution of shares more adjustments in the ownership structure would have to be made through secondary transactions to improve the efficiency of companies which is the overall objective of the economic transition.

#### Market for Shares vs. Market for Companies

In the process of ownership consolidation many shares are bought with the final aim to concentrate corporate control in the hands of a strategic buyer. It seems like investors are trading shares but in reality some investors are accumulating shares to obtain control (Morgenstern, 1994). It is difficult to separate these two markets institutionally but from the economic point of view the market for shares and the market for companies are two very different markets. On the market for shares investors buy and sell shares with a mostly financial motive, while on the market for companies many small shareholders sell to an active owner who wishes to control the company.

The rules of the game in these two markets are different and well known in developed economies. Shares of public companies are traded on the public markets for shares and such public-to-public transactions are regulated by securities markets regulation. Shares of private companies are not traded on the public markets for shares. All such private-to-private transactions are done off the market for shares (in the market for companies) and there is no special regulation. When a public company is taken private through accumulation of shares (it is taken
off the market for shares into the market for companies) such public-to-private transactions are governed by tender offer rules. When a private company wishes to be traded on the public market for shares, this private-to-public transaction is governed by initial public offering or going public rules (see Table 2).

For the developed economies these concepts are straightforward and the only problems are in making operational definitions for various transactions so that the standard regulation can be properly enforced in practice. In transitional economies after mass privatization conceptual dilemmas are much more difficult. Most of the privatized companies are quasi public or quasi private with a mixed set of characteristics: they have many shareholders but shares are not actively traded on securities markets. In addition, they are in the process of transformation from quasi public into public or private companies. Transformation of the company, which is the special case in developed economies is the rule after mass privatization (Table 3). Should the government be involved in regulating corporate control transactions where there is no well established secondary market for shares? This is a difficult question for regulators in transitional economies.

The liberal approach would be to treat privatized companies like a private company and the conservative approach would be to treat them like a public company. These extreme approaches are only theoretical, while in practice a compromise has to be found where some, but not all taking private rules apply for privatized companies during the ownership consolidation period.

Table 2: Developed Economies

<table>
<thead>
<tr>
<th>Public company</th>
<th>Market for shares</th>
<th>Market for companies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Public-to-Public</td>
<td>Private-to-Private</td>
</tr>
<tr>
<td>Private company</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Private-to-Public</td>
<td>Private-to-Private</td>
</tr>
</tbody>
</table>

Table 3: Transitional Economies After Mass Privatization

<table>
<thead>
<tr>
<th>Public company</th>
<th>Market for shares</th>
<th>Market for companies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Public-to-Public</td>
<td></td>
</tr>
<tr>
<td>Private company</td>
<td>Quasi-Private-to-Private</td>
<td>Private-to-Private</td>
</tr>
<tr>
<td></td>
<td>Quasi-Public-to-Private</td>
<td></td>
</tr>
</tbody>
</table>
Taking Private Rules After Mass Privatization

Given that the ownership consolidation after mass privatization is important for the necessary restructuring of companies the guiding principles for taking private rules are:

- not to restrict, but to encourage the development of a transparent and fair market for corporate control
- to protect small shareholders, especially in the public companies actively traded on the public markets
- to limit the use of legal and financial anti-takeover defences that can be employed by management or disinterested shareholders.

In regulating taking private transactions there are two different approaches in developed economies: takeover protection for the companies is provided mostly by shareholders or by regulators. In the US practice many financial measures and company statute amendments are used by individual companies to make them less attractive for takeovers. The shareholders are mainly those who have to approve these measures. The same anti-takeover defences (mandatory bids, fair price requirement) are in the Continental European countries usually as part of the general rules applying to all public companies. We recommend that with transitional economies after mass privatization, only a limited number of defensive measures should be part of the regulation applying to all companies and more room should be given to defensive measures approved by shareholders in individual companies. On the other hand, some of the defensive measures should be temporarily forbidden in all privatized companies. The proposed EC directive for taking private rules of public companies is, for example, too restrictive, as it would make takeovers very expensive and it would slow down the much needed process of ownership consolidation.

In each country taking private rules have to be adapted to the initial ownership structure and to the segmentation of the securities markets after mass privatization. We would suggest that for the public markets a complex set of taking private rules is implemented while on the quasi-public segment only some basic rules for the protection of shareholders are used. One possibility on how to make detailed regulatory arrangements for both segments of the market is shown in Table 4.

Transformation of Quasi Public Companies Dominated by Insiders

The most difficult cases for regulating ownership consolidation are the companies dominated by insiders which also have many outside owners. The key question is whether the ownership of insiders is a permanent or a temporary feature in the company. This depends on who controls the company after privatization and whether there is a need and a realistic possibility to finance the company through new issues of shares to the public.

Companies controlled by insiders with no ambition to raise new finances on the market should be encouraged to transform into private companies. For this transformation to be fair for both groups of shareholders the following two principles should be used:

(i) Outside shareholders should be able to exit from the company at a fair price. Since insiders can not pay them out and it is difficult to sell for cash on the market the simplest way of exiting is through equity-to-debt conversions or using seller financing techniques. It is only logical that outside investors with financial interest hold debt instruments in the companies they can not trade on the market and monitor effectively as owners.

(ii) Inside shareholders who wish that employee ownership become a permanent feature of the company, should organize themselves in an ESOP-like structure with non-tradable shares.
Table 4: Regulation for Taking Private Transactions

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Public segment</th>
<th>Quasi-public segment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. disclosure on concentration of shares for every 5%</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>2. disclosure of takeover intent (at 25%, 50%, 75%)</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>3. tender offer</td>
<td>mandatory at 50%</td>
<td>voluntary</td>
</tr>
<tr>
<td>3.1 partial offers, two-tier offers</td>
<td>forbidden</td>
<td>allowed</td>
</tr>
<tr>
<td>3.2 prospectus for tender offers</td>
<td>mandatory</td>
<td>mandatory</td>
</tr>
<tr>
<td>3.3 management opinion on tender offer</td>
<td>mandatory</td>
<td>voluntary</td>
</tr>
<tr>
<td>3.4 independent opinion on tender offer</td>
<td>mandatory</td>
<td>voluntary</td>
</tr>
<tr>
<td>3.5 minimum bidding period</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>3.6 competitive bids</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>4. defending after announcement of intent or tender offer only with supermajority by shareholders</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>5. one share one vote rule</td>
<td>mandatory</td>
<td>mandatory</td>
</tr>
<tr>
<td>6. classified boards</td>
<td>forbidden</td>
<td>forbidden</td>
</tr>
<tr>
<td>7. authorization of securities with special voting rights</td>
<td>forbidden</td>
<td>allowed</td>
</tr>
<tr>
<td>8. squeeze-outs for disinterested shareholders</td>
<td>at 90%</td>
<td>at 75%</td>
</tr>
</tbody>
</table>

but with clearly defined rules for entry and exit, price determination, voting, and a maximum and a minimum for ownership of shares by individuals. This scheme could be structured as internal ESOP through statute amendments or as external trusts for employee shares.

In some countries (Russia, Slovenia) most of the quasi public companies will have to undergo this transformation into private companies. There is no real need for the organized secondary trading of these shares and nor the use of tender offer rules. The buyers and sellers are already in the company as the actual demand by third party investors is very limited. Forcing these companies to follow the rules of public companies and insisting that their shares are traded for cash on
the public market can even be counterproductive for the development of the market. At the same time, this is also counterproductive for the development of a genuine ESOP-like structures in the company. Such transactions can only be done properly off the market through negotiations among both groups. What is really needed is a flexible corporate legal framework (German company law is often too restrictive) which allows for easy changes of corporate ownership structure when the large portion of shareholders agree to do so.

Companies that are not controlled by insiders or have the ambition to raise additional finances by issuing new shares to the public should be encouraged to behave like real public companies, strictly following the international standards on accounting, auditing, regular reporting, disclosure of new information, listing requirements for the public markets and so on. Inside shareholders in such companies should be in the same position as outside shareholders. Any controlling by inside shareholders that would reduce the rights of outside shareholders or have an impact on the price and liquidity of the shares on the market should be forbidden.

**Fallacies in Regulating Taking Private Transactions**

In regulating tender offers in transitional economies, regulators should keep in mind that the purchase of a company can be structured in many different ways: through statutory merger, as an assets purchase or as a shares purchase. If the rules for tender offers are very restrictive the willing buyers and sellers use other less costly and less transparent transaction techniques. The general implication is that restrictive taking private rules can not prevent the consolidation process. They only make it less transparent. The next implication is that too much protection of small shareholders might prove counterproductive for them. The number of tender offers which by definition benefit shareholders of a target company will decrease and the number of asset transactions where small shareholders are less protected will increase.

Tender offers can be addressed directly to shareholders against the will of the management (hostile takeovers) while all the other transaction techniques require a high degree of cooperation from the management of a target company. As poor management is the key problem in many companies privatized in mass privatization it would not make much sense to overprotect their position by restrictive tender rules at the expense of shareholders. Hostile takeovers might often be quite friendly for the shareholders and for the target company itself.

There are attempts to use taking private rules for regulation of direct foreign investment and to protect against “hostile” takeovers by the foreign investors. In the case-by-case privatization framework the government institutions are involved in direct negotiations with foreign investors and some of the broader national interests can be addressed in the sale contracts. In the mass privatization framework newly created private shareholders willing to sell at a low price become the counterparts of foreign investors who were not allowed to participate in the voucher phase of privatization. No government regulation can ex-post reverse this situation which is only the economic consequence of a strategic decision for mass privatization. Restrictive regulation for taking private rules with special government approvals for transactions with foreigners can not improve the negotiating position of domestic sellers but would only encourage foreign investors to structure transactions in a less transparent way.

**IV. Regulation of Privatization Funds**

Privatization funds (PFs) in transitional economies and investment funds in developed econo-
Companies have a similar name and legal structure but their economic rationale is very different. The regulation in the transition period has to take this into account. The behavior of privatization funds is of key importance for the development of securities markets after mass privatization as they are the largest institutional investors on the market and at the same time, the largest issuers of securities to small investors.

Characteristics of PFs
The main objectives of introducing PFs into mass privatization programs are: (i) efficient and quick distribution of property, (ii) diversification of participants in mass privatization and (iii) concentration of ownership and improved corporate governance in privatized companies. From the point of view of corporate governance PFs are designed to be active in the companies to various degrees:

- Passive funds limit their activity to portfolio management.
- Active funds seek board representation in the portfolio companies.
- Restructuring funds are involved in the day-to-day operation of the portfolio companies.

The use of PFs in mass privatization is in line with the general trends in developed economies where the ownership of institutional investor is increasing and institutional investors are becoming more active owners. On the other hand, portfolios and shareholders of PFs are completely different to those in the investment funds of developed economies. In the portfolios of PFs there are mostly shares that will never be actively traded on the public markets. Among the shareholders of PFs there are many temporary shareholders looking for the first good opportunity to sell. (Overview of the use of privatization funds in various countries in transition can be found in Simoneti and Triska, 1995).

Regulatory Issues in Setting up PFs
In the setting up of PFs the bottom-up approach (like in Czech Republic) or the top-down approach (like in Poland) could be used. In the bottom-up approach licensed management companies are competing to collect vouchers from citizens in the first phase and to buy company shares in the second phase. The advantage of this scheme is that the process is market driven like in developed economies. In the top-down approach management companies are selected by the government which is also much more active in setting-up PFs and their portfolios. In this approach, PFs are initially owned by the government and only in the second phase are their shares distributed to citizens participating in the scheme. It is claimed that the advantage of the top-down approach is that the funds can be set up with a restructuring focus, while with the bottom-up approach this will only happen if the management company is motivated to do so. The great danger of top-down approach is the continuous and strong involvement of the government in privatization funds business.

The regulatory framework for PFs can be standard investment funds regulation with some modifications (like in Slovenia) or special regulation like in Poland. It is important that local conditions are taken into account, as simply adopting the rules for investment funds from developed economies can have unexpected results. Given the structure of the portfolios and the motives of investors in PFs it is, as a general rule, advisable to set up funds as closed-end funds with voting rights for investors like in the public joint stock company, while the unit trusts with no voting rights for investors should be forbidden.

To avoid future problems in regulating the operation of PFs there are some institutions and individuals who should not be allowed to set up a management company to run PFs:
• companies and financial institutions to be
themselves privatized in the mass privat-
ization in order to avoid cross-ownership
links and self-privatization
• management of companies and financial
institutions to be privatized in order to
avoid conflict of interests
• state-owned companies and financial insti-
tutions in order to avoid indirect govern-
ment influence in privatized companies.

In all mass privatization programs these
common-sense rules are violated at least to a cer-
tain degree for many reasons. Firstly, there is usu-
ally a strong interest and well-organized political
pressure to include state-owned banks and other
financial institutions in the scheme. Secondly,
there is the problem of enforcement, as those
who are directly forbidden from the scheme are
able to set up bypass management companies.
Thirdly, there is a time pressure to get the mass
privatization program off the ground as soon as
possible. Those who are most interested in par-
ticipating are often the least desirable from the
point of view of the sound corporate governance
in privatized companies. The preoccupation with
short term objectives and the absence of a long
term vision concerning the future ownership
links between companies and financial institu-
tions will have, in most countries, a long lasting
effect on the development of the financial sector
after mass privatization.

In the phase of setting up PFs, policy makers
have to decide how much advertising and pro-
motion should be allowed. On the one hand,
small investors should not be misled by aggres-
sive promotion. On the other hand, with restric-
tive policies on advertising and promotion, in-
vesters might decide not to invest in PFs but di-
rectly in the privatizing companies. Much more
liberal policies than in developed economies can
be recommended, while the funds can always sue
each other for unfair competition practices.

The related issue is the competition in PFs
business. Transparency of the competition
among funds could be improved by the obliga-
tory use of standardized management contracts,
PFs statutes and prospectuses (Simoneti and
Triska, 1995). Minimum quality standards are
enforced through the licensing of management
companies which can also be used to limit the
market share of individual management com-
pany. Similar standards for market concentration
as for other financial services could be employed
in general, but various aspects of competition
should be addressed differently. It is clearly desir-
able to have strong competition among funds
when they are collecting vouchers and selecting
companies, but later there are many good reasons
for allowing cooperation among funds in active
corporate governance of companies.

Regulatory Issues in the Operation of PFs
Most of the standard portfolio restrictions used
for investment funds in developed economies are
simply not realistic for PFs in transition econo-
 mies, while some of them are counter-produc-
tive. For example, there should be no limit on
the percentage of shares of a company that can
be held by PFs if the development of active funds
or restructuring funds is to be encouraged (Co-
fee, 1994 and Anderson, 1994). Standard diver-
sification rules could be applied immediately,
while the rules requiring a certain percentage of
the portfolio to be in listed securities do not
make much sense initially. It is a paradox of a
transition that liquidity of PFs might be better if
they have investments in real estate instead of
shares listed on quasi public markets.

Given the type of companies owned by PFs,
it is clear that they can not act only as diversified
portfolio funds trading shares on the market. If
they wish to increase the value of their portfolios
they have to be much more active owners. If
funds are allowed to become controlling share-
holders in the company and to operate as active funds or restructuring funds the focus of regulation should move from portfolio regulation to regulation of potential conflict of interests:

- conflict of interest arising from commercial activities of PFs' sponsors in the portfolio companies,
- conflict of interest due to cross-ownership relations in the group consisting of PFs managed by the same management company, management company and PFs' sponsors,
- problems of interlocking board membership structures in the group,
- enforcement of arm's length transactions in the group.

These conflicts of interests are very complicated to be regulated and properly enforced, but this should not be an excuse for not addressing them. The least that can be done is to clearly define what is not allowed and provide the procedures to be used by shareholders in self-enforcing these rules. We have no doubt that most of the abusive behavior in PFs business comes from this direction and focusing the attention of regulators on the portfolio issues, is looking into wrong direction.

An important precondition for active ownership by PFs (in addition to limited legal restrictions for portfolios) is the right incentive for a management company. The extra costs due to active ownership have to be covered and additional efforts rewarded. A management fee structure, related more to the current income of the fund (on the basis of realized capital gains and dividends received from portfolio companies) than to the size of the fund (on the basis of the net-asset value of the fund) would provide much better incentives for active ownership. The standard solution of linking the management fee to the net asset value of the fund is encouraging mostly passive ownership and active trading, often to manipulate share prices on the secondary market and to create accounting capital gains (non-realized capital gains). Refinements to the net-asset value methodology can only partially improve the situation, as the problem is much more fundamental: net-asset value is simply a wrong target when the majority of companies in the portfolio are not actively traded and their true value could better be increased by active ownership.

PFs are introduced in mass privatization to improve corporate governance of privatized companies. Once PFs are a major owner of the corporate sector the relevant issue becomes corporate governance of PFs. Who will guard the guardians? In developed economies the pressure for investment funds to act in the best interest of investors comes simultaneously from investors, competitors and regulators. Most of the funds are open-end funds where voting rights for investors are not really important. The possibility for investors to exit the fund at any time is the single most important monitoring mechanism, as management fees are directly linked to the size of the fund. In this setup the competition among the funds and the reputation of the management companies can also play a very important role in corporate governance of funds. In addition, there is strong regulation and supervision of the funds as well as of the trading on the organized securities markets where the funds operate.

In transitional economies the described corporate governance mechanism of developed economies can not work effectively as most of PFs are closed-end-funds. Some alternative mechanisms are needed to protect the interests of small investors. The credibility of the entire mass privatization might be otherwise undermined due to abusive conduct of funds' managers. The main recommendation is that the voting rights of investors should be respected and reinforced during the transitional period. By having voting
rights investors can protect themselves against abusive conduct and self-enforce the rules if and when it is necessary. Some of the following practical solutions could be used:

- Closed-end funds are organized as joint stock companies with voting rights of investors and with an independent supervisory board.
- Personal responsibility of the supervisory board members exit and they can be sued by investors for negligence.
- If funds are not legal persons a similar internal decision-making structure as in joint stock companies could be set up with an assembly of investors and a supervisory board.
- The possibility to terminate or renegotiate the management contract on the initiative of investors is available.
- The possibility to have short term management contracts and open competition for each new contract is available.
- Shares of closed-end-funds are traded on the organized securities markets.
- Mergers of smaller funds and takeovers of poorly managed funds by competitors is to be encouraged.
- Management companies receive at least a portion of the fees in shares of the funds they manage in order to align their interest with the interest of investors. These shares should be nonvoting as the small control package of shares held by the management company in the fund is an opportunity for self-dealings.

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**Regulatory Issues in Transformation of PFs**

Standard regulation of investment funds provides procedures to deal with a situation where the management company does not wish to or it is not allowed to manage the investment fund any more. The management contract could be transferred to the other management company or the fund is liquidated by selling the portfolio on the market and paying out the investors.

PFs are temporary institutions created to support and speed up mass privatization. In the long run they have to be transformed into standard institutions operating in developed economies and they have to be regulated according to international standards for these institutions. Liquidation of PFs is only one possibility of transforming PFs but additional transformation rules are needed given that all PFs should adjust their operation in the long run. There are many possible exit routes for PFs as they can be transformed into:

- closed-end funds with portfolio adapted to international standards,
- open-end funds with limited voting rights but with the possibility for investor to exit or enter at any time,
- holding company,
- venture capital fund,
- real estate fund,
- investment banking arm of the commercial bank.

In some transitional countries that are more advanced in privatization, this transformation is already underway, only that investors and regulators might not be fully aware of the new directions taken by management companies. There are several regulatory issues to be addressed. First, some general rules are needed to define the role of investors in making these transformation decisions, how their interests are protected and what the rights of those investors who disagree are. The next issue is, whether all the alternatives are available and whether some are more desirable than others for policy makers and regulators. This question is more systematic by nature. What sort of financial system development will be encouraged: market based or bank based?
In most countries this strategic decision has not been made intentionally. It would be expected that mass privatization and the development of PFs as major institutional owners is a decisive step towards a market based financial system where securities markets are playing an important role. There is strong evidence to the contrary. When commercial banks control most of the large PFs indirectly through management companies or directly through ownership of funds, these banks start to operate as universal banks providing credit to companies while representing the interest of other shareholders in the same companies. By controlling PFs business commercial banks have become the winners in privatization, while institutional investors, small shareholders and securities markets are not really as important players as expected. The arguments for the market based or bank based financial system are often very academic or even ideological. On the other hand, there is no doubt that internal consistency among various financial institutions, markets and instruments is needed for both types of financial systems to work properly. The regulators can not provide a consistent framework if they only react to what already happened in the real life. Some strategic choices have to be made consciously and in advance. If the regulators have a clear concept of how the financial system should look in the long-run, some of the possible exit routes for PFs might not be desirable or allowed. The management companies and investors in PFs should be given these restrictions in advance.

V. Regulation of Public Markets
The economic rationale for the public market for securities (so called organized markets) are the financing needs of public companies. Active and orderly trading on the secondary market is a precondition for issuing new shares on the primary market. At the same time, the secondary market supports self-financing of public companies through retained earnings as those investors in need of liquidity can always sell some of the shares on the market.

For the public segment of the market in transitional economies the same economic rationale applies. All market participants basically have the same objectives as those operating in developed economies and, therefore, standard western regulation is appropriate for this segment of the market. There are still many open questions, but they are not completely unique to markets in transition. Therefore, only some specific transitional aspects will be discussed briefly below.

Why Regulate?
Channelling private savings into productive investments is important for economic development and the regulation has to provide a conducive environment for encouraging this activity. Various small investor protection measures are used for this purpose:

- accounting, auditing and disclosure requirements,
- requirements of a public offering,
- requirements for trading,
- requirements for professional conduct of intermediaries,
- requirements for transfer, clearing and settlement.

For transitional economies it is very important that regulators do not initially restrict the development of the market with over-regulation. In addition, they should maintain public confidence but the investment risks should clearly stay with investors. It is not advisable for regulators to be concerned with the prices of individual securities as this would give a completely wrong signal to many investors who are entering securities markets for the first time. For regulators in developed economies an important objective is to maintain overall stability of the financial system.
and to reduce the systematic risk in this sector (OECD, 1988). In the context of mass privatization it might well be that initial instability on the market can not be avoided. Taking upon themselves an impossible task would not be a good start for newly created regulatory institutions. They would lose credibility before they even started operating. On the positive side, securities markets after mass privatization are not fully integrated into the financial system and, therefore, potential negative spill-overs are limited.

Legal Framework
The legal framework for securities markets regulation (see appendix) is provided in many different laws: company laws, banking laws, contract laws, investment funds laws, tax laws and securities markets laws. Often the main problems in effectively supervising securities markets have their origin not directly in securities market law but in other laws. The common problem in transitional economies is that these laws are adopted from different legal systems and they are not consistent with each other which in practice makes the enforcement of regulation very difficult.

The fundamental legal difficulty in regulating and supervising securities markets is the traditionally narrow reading of the laws in civil law countries. In a transitional economy, changes are dramatic and many situations could not be foreseen at the time the laws are written. Pragmatic interpretation of the purpose of the law, traditionally practised by the US courts, would be a much more appropriate framework.

Regulatory Challenges
The main challenge in a transitional economy is not to prepare the regulation but to enforce this regulation in practice. When the regulation is under preparation the ability of the institutions to implement the rules properly should be taken fully into account. For the future development of the market, it is better to have no rules than very restrictive rules that everybody violates and nobody enforces.

Well-known problems of overregulation are the creation of monopolies, excessive regulatory costs, limited innovation and constrained market development. All these problems are relevant to for countries in transition which choose a conservative approach in regulating the public segment of the market.

In the environment where the enforcement capabilities of government institutions are limited the emphasis on self-regulation seems very appealing at first glance. It should not be overlooked that such system is based on the assumption that a group of reputable and professional market participants exists, who are motivated and capable of enforcing professional standards fairly and effectively, while maintaining competition and free entry in the business. These conditions are barely met at the beginning of securities market development in transitional economies. Some basic rules provided and enforced by government institutions seem to be the only realistic option in the initial period in transitional economies.

Institutional Framework
Before a decision is taken on who should regulate what, some important conceptual issues have to be solved and the following relationships clearly defined:

- banking business vs. securities business,
- capital market vs. money market,
- government securities vs. corporate securities,
- spot markets vs. future markets,
- regulation vs. self-regulation.

Possible regulatory authorities are: ministry of finance, central bank, securities and exchange commission (SEC) or self-regulatory organizations like the stock exchange and the
association of brokers or other market participants. Different countries use different institutional frameworks: Continental vs. Anglo-Saxon model with the UK relying on self-regulation and the US relying on government regulations. No country is very satisfied with its current institutional arrangement and no ready-made solution which could be adapted exists. Country specific requirements and local institutional capacity should be taken fully into account. For transitional economies one would, in general, initially recommend:

- separation of banking from securities business in the regulatory sense,
- establishment of independent SEC,
- focus of regulation and supervision on corporate securities and spot markets,
- gradual move from regulation to self-regulation.

Market Architecture
Trading systems in the public markets can be different and there are clearly some solutions that are not appropriate for transitional economies. Most of the solutions have their advantages and disadvantages (Pagano and Roell, 1990) and the right choice has to be made taking into account specific conditions in each country. The main choices are the following:

TRANSPARENCY. Transparency means that information about trading is timely, accurate, complete and publicly available. Transparency is the key requirement for efficient and fair markets. Even if the public markets are transparent the problem is that many transactions are done off-market with little or no reporting. The key question is how to reduce the volume and number of direct transactions made off-market. The only appropriate answer is to make it cheaper and more convenient for transactors to use the public markets when trading shares. On the other hand, it can not be realistically expected that corporate control transactions with large block of shares will ever take place on the market for shares.

ACCESS TO THE MARKET. With many small shareholders after mass privatization it makes sense to provide a low cost and an easy access market where individual investors can place their orders directly without the intermediation of brokers (like RM System Stock Exchange in Czech Republic). The alternative is to have even more off-market transactions and door-to-door accumulation of shares by interested buyers. The counter-party risk in such direct access markets is high and pre-trade verification and payments in advance might be required, which slows down the clearing and settlement process. This is initially not the problem for small investors after mass privatization, but in the long run most of the trading by professional investors will take place on the markets where orders can be placed only through brokers.

MARKET CONSOLIDATION. The advantages of the single market might be a better operational efficiency due to economics of scale and better price discovery due to concentration of demand and supply in one market. On the other hand, the advantages of the competition among multiple markets and cross-listing of securities might be lower transaction fees, more innovation and services better adapted to different type of investors.

ROLE OF INTERMEDIARIES. For the stability of the market it is important that in addition to long term investors on the market, there are also short term speculators who buy securities when the price is low and sell securities when the price is high. Brokers act as speculators when they are trading on their own account or when they act as official market makers (dealers) for certain secu-
Issues in Regulating Post-Privatization Securities Markets in Transitional Economies

The capital requirements and skills required for dealers are much higher and, therefore, simply not a realistic choice in most transitional countries. On the other hand, brokers trading simultaneously for themselves and on behalf of clients have a strong conflict of interest (Pohl, Jedrzejczak and Anderson, 1994).

**Price Discovery Mechanism.** Price driven markets (dealers' markets) require market makers who are always willing to buy and sell certain securities on the market at a spread. Price driven markets could improve the liquidity of the market which is the major problem after mass privatization. But this is mostly a theory as only few capable market makers are available. Order driven markets (auction markets) will dominate in transitional economies for a long time to come.

**Trading Period.** In a call market there is one price per trading. Supply and demand are concentrated at one point in time and the resulting price for securities that are not heavily traded is more realistic. The next advantage is simplicity. In a continuous market there is more than one price per trading. This is important for speculators but less so for long term investors. Trading has to be computerised for an efficient continuous market. The biggest problem is that continuous trading can easily be abused and manipulated where the liquidity of the market is low. The paradox is that as simple call markets are replaced by more advanced computerised continuous trading systems it might well happen that transparency, fairness and quality of information received from the market is reduced. To avoid this the following simple guidelines are recommended:

- thinly traded securities are to be traded on the call market or through dealers,
- only heavily traded securities can be traded on the continuous market.

**Clearing and Settlement.** For the clearing and settlement there exist well defined international standards and recommendations (G-30) that transitional economies should try to follow as much as possible at least on the public markets. Given the number of shares issued in transitional economies, physical transfer of shares is not practical even for the off-market transactions. Dematerialization of securities is recommended to improve the security of investors, reduce costs of issuing securities, reduce transaction costs, improve tradability of registered shares from privatization and make the supervision of secondary transactions easier. The major problem with dematerialization is that it should be introduced before the large scale secondary trading fully develops, but from the legal point of view this is quite a complex project.

While the final goal for cleaning and settlement on the public market is clear there is often a long way to go and various ad hoc pragmatic solutions will have to be used in transitional period. For example, many countries simply do not have a quick and reliable payments system to be used by market participants.

**Main Problem Areas for Supervision**

The major problem for effective supervision in transitional economies is the lack of experienced staff in supervising institutions. Supervisors and market participants are both learning on the job. New technical solutions and new practices are introduced in the markets on a daily basis. This is often a very uneven race with supervisors not having the resources to keep pace with market participants. In addition, supervisors are continuously losing the most experienced staff to the
private sector. The main problem areas for supervision in transitional economies are listed below:

- separation of primary and secondary markets to prevent price manipulation on the secondary market to be used in promoting the primary market for particular security and building up of pyramid schemes,
- separation of clients' accounts from brokers' own accounts to limit the conflict of interests,
- activities of non-authorized intermediaries and markets,
- price manipulations and artificial market transactions among related parties,
- abuse of insider information,
- off-market transactions with no reporting,
- off-market block trading,
- pyramid schemes in the mutual funds business
- net assets value calculation for investment funds,
- information disclosure on concentration of shares,
- abuse of shareholders' agreements to restrict transferability of shares.

VI. Conclusions

Regulatory solutions discussed in this paper can only provide a supportive environment for securities market development in transition economies but they can not be a driving force in this development. The key success factor is the ability of the market to support financing needs of privatized companies. The primary and the secondary market have to supplement each other for the normal development of the market. Privatized companies are not really interested in the market when there is only the secondary market for privatized shares while the possibilities of issuing new shares are limited. The role of the government in making the primary market accessible to companies is decisive and it requires a long term commitment to complete the economic transition in some key areas.

The first condition is to provide a long term macro economic stability as investors are not willing to assume the risks of buying shares in the unstable and sometimes chaotic economic environment.

Related to macro economic stability is the long term fiscal discipline of the governments in transitional economies. The current practice of many countries to finance their huge budget deficits by offering very attractive financial instruments to the public is crowding out privatized companies. It is a paradox of transition that many of the newly established financial institutions are initially not supporting the private sector development but a continuation of irresponsible government macro policies.

The next big task for the government is to complete privatization. When the primary market is oversupplied with shares from privatization, new issues of already privatized companies are crowded out. Even if privatization is carried out for vouchers the situation is not any better. Investors with cash are taking advantages of good opportunities on the secondary market created by the exit of temporary shareholders on a large scale. With mass privatization in effect the entire primary market for cash is crowded out by the secondary market for cash.

The most difficult and the most important task in developing the market is to increase private savings and channel them into the securities market. Vouchers are the solution for the problem of the small purchasing power in privatization but when secondary trading starts the problem of small available savings comes back. In the privatization process only the supply side of the market is created. For the normal development of the market the demand side is needed as well. A transformation of the national pension scheme...
from the existing pay-as-you-go system to at least a partially funded system is the opportunity to build up the demand side of the market. This important link between privatization and a reform of the social security system has not been successfully established in any of the transitional economies yet. The reform of the social security system might be even more complex task than privatization, as the interests of everybody will be an even more directly effected. A partial transfer of the responsibility for social security from the government to the individuals is consistent with the overall objectives of economic transition. A lot of savings in western economies can be contributed to this sharing arrangement in the social security area. The most important players on the securities markets in developed economies are private and government sponsored pension funds and insurance companies. There is no good reason why transitional economies should be any different in the long run.
Annex 1: Structure of a Securities Market Law (Topics Which May Be Covered)

Objectives
- To promote the development of the securities market
- To regulate the securities market (fair and orderly training, adequate disclosure)

Definitions
- Securities: negotiable financial paper which may be offered to the public (e.g., shares, bonds, commercial paper, treasury bills, etc.)
- Public company (minimum percentage of share capital, minimum number of shareholders, restrictions on transfer of shares)
- Primary market: public offering, private placement, prospectus, registration
- Secondary market: securities exchange, dealer market
- Intermediaries: broker, dealer, underwriter, investment manager
- Shares: common shares, preferred shares, participation certificates (in Islamic countries)
- Bond: corporate, government, government agency, government guaranteed, mortgage, convertible, municipal
- Short-term financial paper: issued by government, government agency, corporation, bank, other financial institution

Scope
- New issues (primary market)
- Trading in securities (secondary market)
- Securities market activities of intermediaries (brokers, dealers, underwriters, investment managers)
- Repeal of existing laws which are contradictory

Market Supervision
- Securities market development and regulatory agency (SMA)
- Securities exchange self-regulation
- Self-regulation by intermediaries

Accounting, Auditing, and Disclosure Requirements
- Principles of accounting
- Auditing requirements, auditing principles
- Requirements for disclosure at time of public offering and subsequent to public offering on a regular (annual or quarterly) basis, and on a continuous basis for facts deemed to be material to investors

Requirements of a Public Offering
- Type of issuer (limited liability company, public company)
- Registration with SMA
- Prospectus and other information to be filed with SMA and made available to investors
- Restrictions on timing and form of advertising/promotion efforts
- Underwriting procedures
- Listing with securities exchange

Requirements for Trading (secondary market)
- Scope of authority of SMA
- Place(s) where trading is allowed; securities exchange(s), possibly dealer market
- Method of trading, clearance and settlement
- Listing requirements, delisting, trading in different categories (tiers)
- Procedures for public availability of bids and offers, prices, market volumes, and other market information
- Prohibition of unfair, uncompetitive, and disorderly market activities (e.g., manipulation, insider trading, misrepresentation, priority of customer vs. dealer orders, fraud)
- Need for rules and regulations of the securities exchange(s) to be prepared by the exchange(s) and to be approved by the SMA
- Need for rules, regulations, and procedures for dealer market and/or other trading places
- Authority with respect to temporary halts in trading generally or specific securities

Requirements for Intermediaries
- Membership of securities exchange(s) and self-regulatory associations
- Rules of conduct of intermediaries
- Supervision of intermediaries
- Minimum capital, risk assessment guidelines, qualifications of management and staff, reporting requirements of intermediaries. An alternative is authority for the SMA to establish such requirements.
- Restrictions on non-securities market activities of intermediaries

Requirements for Transfer, Clearing, and Settlement
- Security certificates and/or central computerized registrar
- Transfer procedures
- Procedures for clearing between intermediaries
- Settlement procedures (timing, manner)

Penalties and Other Disciplinary Action
- Establishment of a disciplinary committee by self-regulatory institutions, and scope of action by such committee
- Legal suits by SMA, securities exchange, association(s) of intermediaries and investors
- Civil penalties and procedures
- Criminal penalties and procedures
- Appeal against above actions

Requirements for Credit in Connection with Securities
- Margin requirements, limitations, definitions
- Changes in margin requirements
- Margin contracts
- Registration of margin transactions and obligations

Source: International Finance Corporation.
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