DEVELOPMENT OF SECURITIES MARKETS OF DEVELOPING COUNTRIES: THEORIES AND POLICIES*

*Enrique I. Quiazon***

Of late, much interest has been generated by the development of so-called emerging securities markets.[1] Developing countries or third world countries[2] have seen the importance of securities markets in mobilizing savings and allocating investments while the

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**LL.B. (1985), University of the Philippines, College of Law; LL.M. (1989), Georgetown University School of Law; *Senior Associate*, SyCip Salazar Hernandez & Gatmaitan Law Offices. The views expressed are personal and do not necessarily reflect those of the firm.

[1]Most of these emerging markets are located in developing countries in Asia, Latin America, the Middle East and Africa. The securities markets in Kuwait, Hongkong and Singapore are sometimes included because of their location although strictly speaking these countries belong to the industrialized world on the basis of their *per capita* income. VAN AGTMAEL, EMERGING SECURITIES MARKETS, INVESTMENT BANKING OPPORTUNITIES IN THE DEVELOPING WORLD (1984).

[2]The terms "developing", "third world" and "underdeveloped" shall be used interchangeably in this paper.

The term "third world" was coined in 1952 by Alfred Sauvy at the height of the cold war and applied to non-aligned developing countries that remained outside the two power blocs but belonged to the non-communist world. Since then, the term "third world" has acquired a broader meaning to cover all "underdeveloped" or, as adopted by international agencies, "developing countries". The definition "underdevelopment", in itself, has been subject to controversy due to the extreme diversity of the degree of underdevelopment or backwardness of countries but the United Nations uses three criteria as an appraisal of the state of time. These are: (1) the level of production of goods and services measured by Gross National Product; (2) the level of economy to deliver the needed goals and services in the future. *See* ANGELEPOULUS, THE THIRD WORLD AND THE RICH COUNTRIES, PROSPECTS FOR THE YEAR 2000 9-10 (1972).

internationalization of securities markets has prompted institutional investors in developed countries with the financial wherewithal to invest in these markets. Emerging markets, although not as fully developed and not as efficient as their counterparts in developed countries, have generally enjoyed higher growth rates and returns on capital during the past decade. Indicators suggest that during the period from 1970 to 1974, the rates of return on equity securities investments in developing countries have yielded three to six per cent higher than the return on equity investment in the United States.[3] In the 1980s, emerging equity markets have grown to an aggregate total market capitalization of $130 billion, representing 10% of all markets outside the United States.[4]

It is important to mention that international agencies have shown special interests in developing the capital markets of developing countries. The International Finance Corporation[5] (hereinafter referred to as the "IFC") has conducted some studies on emerging capital markets and has created an Emerging Markets Database which provides detailed statistics on stock markets in developing countries.[6] The IFC selected a sample of stocks from nineteen markets[7] based on trading activity and market size to establish two types of representative indices, namely the Price Index[8] and the Total Returns Index,[9] to measure stock market performances in these countries. A comparison of the Total Returns Index for the year 1987 of the emerging markets showed that several emerging

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[3]Joint Ministerial Committee of the Board of Governors of the Bank and the Fund on the Transfer of Global Resources, the International Bank for Reconstruction and Development and the International Monetary Fund, Developing Country Access to Capital Markets 91 (1978) [hereinafter Developing Country Access].

[4]AGTMAEL, *supra* note 1.

[5]The International Finance Corporation is an international development institution which was established in 1956 to promote the growth of private investment and business in developing countries. It is an affiliate of the World Bank.

[6]INTERNATIONAL FINANCE CORPORATION, EMERGING STOCK MARKETS FACTBOOK, 1988. INTERNATIONAL FINANCE CORPORATION AND THE WORLD BANK 4 (1988) [hereinafter Emerging Stock Market Factbook].

[7]These securities markets include the securities markets of the United States, Japan, Argentina, Brazil, Chile, Colombia, Mexico, Venezuela, India, Korea, Malaysia, Pakistan, the Philippines, Taiwan, Thailand, Greece, Jorgan, Nigeria, and Zimbabwe. *Id.*, at 8.

[8]The Price Index is based on changes in prices, adjusted for changes in capitalization that affect price per share, such as stock splits. EMERGING STOCK MARKET FACTBOOK, *supra* note 6, at 4.

[9]The Total Returns Index include the changes from adjusted prices as well as cash dividends received as the dividend implicit in rights issues when subscription prices are below prevailing market prices. The latter is a common method in developing countries of rewarding shareholders with instant capital gains, which are often tax-free in contrast to cash dividends which are usually taxable. *Id.*, at 4.

markets, like Greece (152.2), Taiwan (121.1), Colombia (80.4), Zimbabwe (94.7), Venezuela (52.8), and the Philippines (50.5), outperformed major developed markets like the United States (5.2) and Japan (57.3), while others, like Chile (33.4), Korea (40.1), and Thailand (37.9), performed fairly well. Other emerging markets did poorly during the said period, like Brazil (-63.0), Mexico (-8.7), India (-15.3), Jordan (-4.6), and Nigeria (-13.2).[10] These indices, based on statistical data gathered from the various emerging markets, may act as indicators of the efficacy of certain policies adopted by governments on their securities markets. Undoubtedly, improving political and economic stability in developing countries have contributed to the extraordinary performance of some of the mentioned emerging markets. Arguably, the amount of attention devoted by policy makers to the development of their respective securities markets have also contributed to their performance.

These emerging markets are, however, very vulnerable to sudden and uncontrollable economic and political changes which are endemic to developing countries. This can be seen from the performances of these emerging markets during periods of recession or political instability. During the first nine months of 1990, based on percentage gains, some of the mentioned emerging markets have been found to fare much better than developed markets while others languished:

> The winners (with percentage gains) were: Venezuela (326.9%), Greece (127.4%), India (55.9%), Turkey (39.2%), Colombia (19%), Mexico (7.9%) and Chile (6.6%)....
>
> Taiwan (off 70.4%) took the booby prize. Other losers (with percentage decreases) were the Philippines (55.3%), Brazil (51.8%), South Korea (36%), Argentina (30.8%), Thailand (29.3%), Portugal (27.1%), Malaysia (21.6%) and Jordan (5.8%).[11]

While genuine interest about these markets have been expressed by policy makers of developing countries, international agencies, and private investors of developed countries, there are but a few existing conclusive economic studies on the development and operation of these markets. Much of existing financial economic studies have concentrated on theories which are applicable only to already developed markets like the United States, United Kingdom and Japanese securities markets. One

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[10] *Id.*, at 7-9.

[11] Du Bois, *The International Trader, Eight Bourses Beat the U.S. ... A Gorilla Beauty Contest*, Barrons National Business and Finance Weekly, Oct. 8, 1990 at p. 65.

commentator laments that the bulk of literature regarding portfolio theory, market performance and asset pricing has mainly focused on, or implicitly assumed, developed equity markets and that analysis of emerging markets has eluded the interest of renowned financial and macro economists.[12]

To begin with, existing traditional economic theories cannot just be applied directly to the formulation of policies of developing economies. While traditional economics is concerned with the efficient least-cost allocation of scarce productive resources and with the optimal growth of these resources over time so as to produce an ever expanding range of goods and services, development economics has a greater scope in that in addition to being concerned with the goals of a traditional economist, it must also deal with the economic, social and institutional mechanism of a country, both public and private, necessary for bringing about rapid and large scale improvements in levels of living for the masses of poverty stricken, malnourished and illiterate peoples of third world countries.[13] Similarly, there is a dearth of legal studies on the regulation of developing securities markets. With the incompatibility of traditional theories and the lack of development economic theories, policy makers of developing countries are provided with very limited guidance in their formulation of economic and fiscal policies with respect to the development of capital markets. Promulgation of laws and regulations to implement these policies have been haphazard at best. Some critics even characterize attempts to develop securities markets in third world countries as misguided efforts to graft western institutions onto entirely different social and economic systems while others criticize such attempts as naive assumptions that the mere establishment of a securities market would result in a significant impact on the allocation of financial resources.[14]

Nevertheless, third world countries have attempted to establish and develop their securities markets based on whatever available economic theories. This paper looks at existing economic theories and policies, both traditional and developmental, which are relevant to the

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[12]Calderon-Rosell, The Structure of World Stock Markets, paper submitted to the First Annual Pacific Basin Finance Conference, Taipei, Mar. 13-15, 1989 at 47 (available at the Joint Library Services of the World Bank).

[13]TODARO, ECONOMIC DEVELOPMENT IN THE THIRD WORLD, AN INTRODUCTION TO PROBLEMS AND POLICIES IN A GLOBAL PERSPECTIVE 8 (1977).

[14]DICKIE AND LAYMAN, FOREIGN INVESTMENT AND GOVERNMENT POLICY IN THE THIRD WORLD 168 (1988).

development of a securities market and at how third world governments have used, or at times misused, these theories or policies.

I. ROLE OF SECURITIES MARKETS IN DEVELOPMENT

The basic issue of whether or not the development of securities or capital markets assists in the development of the general economic well-being of a country is in itself not settled. As a general hypothesis, stock markets assist in the allocation of investments and the mobilization of savings just like any other financial intermediary. The level of savings and investment is, however, only one of the many ingredients that determine the rate of economic growth in developing countries.[15] While there is consensus of the view that general financial development leads to economic development, no conclusive evidence has been provided so far for the contribution of securities markets to economic development.[16] One conclusion is that the development impact of capital markets in developing countries has been small and that although they can play a positive role in development, such role would be modest but increasing.[17] Critics of stock markets suggest that the stock market encourages speculation and dishonest activities and that it encourages unequal distribution of wealth by enabling those who are sufficiently wealthy to invest passively with a view to increasing their wealth.[18]

For developed countries, securities markets have been viewed to serve an important economic purpose by providing a vehicle through which capital can be obtained from the public and by providing a mechanism for price setting:

> It is generally believed that the securities markets serve an important economic purpose; they provide a mechanism by which business enterprises obtain equity capital and long term debt from the public. ...

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[15] U TAN WAI, FINANCIAL INTERMEDIARIES AND NATIONAL SAVINGS IN DEVELOPING COUNTRIES 77 (1972).

[16] CALDERON-ROSELL, *supra* note 12, at 39.

[17] SUDWEEKS, EQUITY MARKET DEVELOPMENT IN DEVELOPING COUNTRIES 30 (1989) *citing* U. TAN WAI AND H. PATRICK, *Stock and Bond Issues and Capital Markets in Less Developed Countries*, (International Monetary Fund Staff Papers), 301, July 20, 1973.

[18] *See*, KITCHEN, FINANCE FOR THE DEVELOPING COUNTRIES 148 (1986).

> The economic function of trading markets is to create liquidity - a market characteristic that enables investors to dispose of or purchase securities at a price reasonably related to the preceding price. For the sale of a new issue of securities to succeed, prospective purchases must have a reasonable assurance of liquidity in the market for the security. Thus, the success of new-issue markets is dependent in the effectiveness of trading markets. In addition since trading markets are a price setting mechanism, they facilitate the use of securities as collateral for loans, determine the price at which a company is able to issue additional securities and establish a basis for the valuation of securities for taxation and other purposes.[19]

On the other hand, securities markets in developing economies, aside from providing a price fixing mechanism, are believed to ensure stability in the economy. The IFC believes in the importance of developing the domestic capital market in furtherance of economic stability and concludes that:

> If ever there were any doubts about the important role of domestic capital markets in ensuring balanced economic growth, the history of the 1980s to date must surely dispel it. The chronic problems of country and corporate overintebtedness have brought home the dangers of combining too much short-term debt with too little long-term equity. The resulting crisis has produced the biggest setback to economic development in many decades.
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> For too long, policymakers in many countries have tended to think of total flows of savings into investment in a macroeconomic sense and have paid insufficient attention to the form or the quality of those savings. A more balanced pattern of financing would not perhaps have prevented the international debt crisis. But stronger domestic and international securities markets would have left the financial system much less vulnerable to economic recession. The adjustment paths of debtor countries, and debtor companies, would have been substantially less painful.[20]

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[19] POSER, *Restructuring the Market· A Critical Look at the SEC's National Market System*, 56 N.Y.U.L. REV. 883 at 885-886 (1981).

[20] INTERNATIONAL FINANCE CORPORATION, IFC OCCASSIONAL PAPERS, CAPITAL MARKETS SERIES at 1 (J. Hakim ed. 1985).

The problem of overintebtedness has also been traced to the fact that past work on financial market building by many developing countries and organizations, such as the World Bank, emphasized development finance institutions and the banking system, and that until recently, risk capital, financial markets, and non-banking financial institutions were largely ignored.[21]

Despite the absence of conclusive proof that capital markets contribute to economic development, a number of developing countries have, nevertheless, established securities markets and endeavored to develop them. Among such countries are Brazil, Korea, Malaysia, Mexico, Nigeria, Pakistan, the Philippines, Singapore, Taiwan and Thailand.[22] The government of India has seen the importance of moving toward a more market-oriented economy and developing its capital market as a means of mobilizing funds for both the private and public sectors.[23] To be sure, some third world countries, at least initially, had other motives in mind, other than economic development, in establishing and developing their securities markets:

> Securities markets in the United States and Western Europe evolved in response to the need for capital generated by the industrial revolution. Third world securities markets, however, have typically sprung less from private economic needs than from governmental decisions to pursue political and economic goals, such as financial deepening.
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> A common goal of third world countries in establishing securities markets has been to diversify ownership of companies, and, thus to democratize the economic system. In some third world countries, the governments have focused on foreign-owned companies in pursuing their goal of transferring ownership of corporate securities to a broader group. In the Philippines and Indonesia, for example, the securities markets provide the means for foreign firms to comply with the government's equity sharing requirements; their compliance, in turn, contributes to further development of the securities markets. This emphasis on broadening the ownership of foreign corporations seemingly conflicts with the policy in many third world countries of discouraging

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[21]SUDWEEKS, *supra* note 17, at 385.

[22]DICKIE, *Development Third World Securities Markets: An Analysis of General Principles and a Case Study of the Indonesian Market*, 12 LAW & POLICY IN INT'L. BUS. 177, at 178 (1981).

[23]KHAMBATA AND KHAMBATA, *Emerging Capital Markets: A Case Study of Equity Markets in India*, THE JOURNAL OF DEVELOPING AREAS, April 23, 1989 at 426.

> foreign access to local capital markets in order to preserve the available local capital for domestic use. But in fact, permitting foreign firms to raise capital in local markets may not remove capital from the local economy. Moreover, one expected benefit of democratization is that it will diminish local criticism of foreign investment and allow the host government more freely to approve new foreign-owned projects that will attract technology, management skills and capital to third world nations.[24]

Aside from enabling private companies and the government to raise capital, equity markets have been said to perform other functions like increasing efficiency of the financial system, fund term matching, mobilization of savings, effective allocation of investment, control of money supply, indigenization of investment, and privatization of productive activities.[25]

II. THEORIES AND POLICIES

In developing their securities markets, developing countries have adopted general policies to develop their financial sector as a whole or certain specific strategies aimed towards the development of their securities markets. General policies have included the adoption of financial liberalization while specific strategies have been aimed at increasing the supply and demand of the shares through tax and other incentives and direct government participation. A healthy securities market has been said to need a sound primary market - the market where the shares are initially sold to the public.[26] A healthy secondary market to assure investor liquidity must also exist so that a sound primary market will develop.[27] Increasing the supply of shares, on the other hand, helps create more market liquidity and ensures that measures to stimulate demand will not simply inflate prices of existing equities.[28]

These policies and strategies are adopted and carried out by governments based on economic theories, studies, or beliefs which may or may not be conclusive or may have been blindly grafted into the economic system of developing countries.

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[24] DICKIE, *supra* note 22, at 178-179.

[25] SUDWEEKS, *supra* note 17, at 38.

[26] SECURITIES AND EXCHANGE COMMISSION, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc No. 95, 88th Cong., 1st Sess. pt. I, at 9-19 (1963), *reprinted* in Jenings and Marsh, Securities Regulation at 1-6 (6th ed. 1987).

[27] DICKIE, *supra* note 22, at 191-192.

[28] *Id.*, at 181.

A. Financial Repression, Fragmentation and Liberalization

Two basic traditional macroeconomic theories with respect to financial development used by both developed and developing countries alike are the monetary and Keynesian theories. Monetary theory works on the hypothesis that the aggregate supply of money is directly related to the level of economic activity in that a greater supply of money induces expanded economic activity by enabling people to purchase more goods and services with their extra funds.[29] The monetary theory may work well for a developed country but not for a developing one:

> [T]he ability of developed country governments to expand and contract their money supplies and to raise the costs of borrowing in the private sector (i.e. through direct and indirect manipulation of interest rates) is made possible by the existence of highly organized, economically independent and efficiently functioning money and credit markets.... By contrast many markets and financial institutions in most developing countries are highly [un]organized, often externally dependent, and spatially fragmented.
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> The second major limitation of standard (Western) monetary theory and policy when applied to the structural and institutional realities of Third World nations is the assumption of direct linkage between lower interest rates, higher investment and expanded output.... In reality,... there may be severe structural supply constraints... inhibiting the expansion of output even when the demand for it increase.[30]

On the other hand, Keynesian theory works on the argument that expanded supply of money in circulation increases the availability of loanable funds which, if in excess of demand, leads to lower interest rates and as interest rates fall and credit becomes more available, investments also increase; increased investments raises aggregate demand leading to higher levels of economic activity.[31] Like the monetary theory, the Keynesian theory, was developed for an industrial economy and not for an underdeveloped country. For the system to work, there should be both unemployed capital and labor and all the other complementary factors of production. In an underdeveloped country, there may be unemployed labor but not unemployed capital.[32]

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[29]TODARO, *supra* note 13, at 382.
[30]*Id.*, at 383-384.
[31]*Id.*, at 382.
[32]TAN WAI, *supra* note 15, at 77.

Accepted theories of monetary and financial processes - whether they be Keynesian or monetarist - cannot explain the dominance of real money balances in the operation of capital markets in developing countries.[33] Both these prevailing traditional theories assume that capital markets operate perfectly and costlessly to equate returns on all real and financial assets (other than money) with a single real rate of interest (the nominal rate of interest that reflects expected inflation accurately) or a term structure of interest rates, whereas the brute fact of underdevelopment is overwhelming fragmentation in real rates of interest.[34]

Fragmentation of real rates of interest rates have been the result of a conscious effort on the part of policy makers rather than an immediate consequence of economic underdevelopment. Some developing countries, in their rush to industrialize, have followed a policy of inflationary financed industrial growth in which expansionary monetary policy is used in conjunction with budgetary deficits, resulting in negative real interest rates.[35] A discriminatory inflationary financing of chosen sectors of the economy was intended to result in rising relative prices in certain sectors which means greater profits and a higher return on investments, which if coupled with negative real interest rates induced firms in the chosen sectors to expand their capacity, expand their investment and thereby increase industrial output and growth.[36] These policy makers have generally believed that if interest rates are kept low through interest rate ceilings, the number of investments which have a net positive value when discounted at the borrowing rate will increase and therefore increase the number of investments. The consequence of financial repression through interest rate controls is that actual interest rates are distorted from the equilibrium interest rate which would prevail in a competitive market for money.[37] This financial repression policy argument assumes that adequate funds will still be forthcoming from savers to meet the demand of investors in spite of the ceilings on the deposit rate. However, if the supply of savings and the demand for investable funds are both functions of the real rate of interest, the effect may be to raise demand for funds above the equilibrium level, and to depress the supply of funds below the equilibrium level. The effect is to lower both savings and investment.[38] Logically, lower levels of savings

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[33] McKINNON, MONEY AND CAPITAL IN ECONOMIC DEVELOPMENT 3 (1973).

[34] *Id.*, at 3.

[35] *Id.*

[36] KITCHEN, *supra* note 18, at 81.

[37] *Id.*, at 79.

[38] *Id.*, at 81.

and investment in an economy will adversely affect the supply of and demand for securities.

There are other reasons for governments to adopt a policy of financial repression like historic antipathy to usury, deficiencies in control of the growth in nominal money and rates of change in the price level, and deficiencies in guides to financial policy.[39]

Financial repression leads to financial fragmentation. Fragmentation occurs where different sectors of an economy of a country face different effective prices for land, labor, capital or produced commodities and do not have access to the same technologies.[40]Some favored bank borrowers are given low cost finance while others with potentially high-yield projects are often completely excluded.[41] Firms engaged in the export of goods may be given tax incentives, tariff protection or subsidies while other firms are not. The end effect would be a higher rate of return for the favored firm or sector.

Government intervention in the form of restrictions or biases which discourage the development of financial institutions and instruments lead to incomplete or fragmented markets.[42] As earlier discussed, financial repression results in lower levels of investments and savings. This will consequently discourage the supply and demand for securities. Financial repression, with its distortion of interest rates, and financial fragmentation, with its varying interest rates among different sectors, discourages companies to sell its shares to the public. One disincentive for companies faced with a decision to go public, i.e., to sell its shares to the public, is that the effective cost of equity may be significantly higher than the cost of debt.[43] Before resorting to a public offering of shares as a means of raising a revenue, a company will compare the benefits of a public offering with advantages from alternative sources of financing such as loans from banks and other financial intermediaries, reinvested earnings or further investment by its parent company. Repressed or distorted interest rates and fragmentation may mean that favored, credit-worthy firms have ready access to bank loans at low interest rates.[44] These firms would naturally choose to borrow at the

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[39]SHAW, FINANCIAL DEEPENING IN ECONOMIC DEVELOPMENT 92 (1973).

[40]KITCHEN, *supra* note 18, at 5.

[41]MCKINNON, *Financial Repression and the Liberalisation Problem within Less Developed Countries*, in the World Economic Order Past and Prospects 365 (S. Grassman and E. Lundberg eds. 1981).

[42]KITCHEN, *supra* note 18, at 79.

[43]KHAMABTA, *supra* note 23, at 431.

[44]KITCHEN, *supra* note 18, at 150.

preferred rates of interest from banks rather than raise money by offering its shares to the public due to the latter alternative's higher costs. Some firms, rather than raise money from the public, may even utilize self-financing by reinvesting its earnings. These factors lead to the thinness in the supply of stocks in some emerging markets. Financial repression and fragmentation also affects the demand for shares. Should firms choose to raise money from the public, they would logically do so at or just slightly higher than the preferred repressed rates. Investors would not be very eager to invest their funds with such repressed rates. In India, for example, loans by development finance institutions to priority sectors at some time were at subsidized rates and most companies could meet their long-term funding from these development finance institutions.[45] In Korea, the availability of alternative sources of funding, such as bank credit, kerb (unregulated) market financing, and corporate bond financing has inhibited the supply of equity.[46] In Malaysia, banks were so liquid in the late 1970s that borrowing was generally more attractive to corporations seeking to raise additional capital than public equity offerings.[47]

The main instrument of repression is generally interest rate controls, although exchange controls, high reserve requirements of commercial banks and institutional repression can play a significant role.[48]

If interest rate controls are the instruments of repression, a suggested solution is the liberalization of the financial system:

> Numerous decentralized economies with low levels of per capita income and wealth have been attracted at times to a development strategy that results in "shallow" finance. By distortions of financial prices including interest rates and foreign-exchange rates and by other means, it has reduced the real rate of growth and the real size of the financial system relative to non-financial magnitudes. In all cases this strategy has stopped or gravely retarded the development process. A new strategy that has the effect, among others, of "deepening" finance - a strategy of financial liberalization - has invariably renewed development. Liberalization matters in economic development. It is not our theme that only financial liberalization matters. On the contrary, financial

[45]KHAMBATA, *supra* note 23, at 431.
[46]SUDWEEKS, *supra* note 17, at 166.
[47]DICKIE, *supra* note 22, at 189.
[48]KITCHEN, *supra* note 18, at 80.

> liberalization is appropriately linked with complementary measures that reach beyond the financial sector.[49]

By liberalization, interest rate controls would be removed or at least be minimized such that interest rates would be at equilibrium level where the level for savings and demand for investable funds are equal. Liberalization of the capital market could also be achieved by the reduction of the great dispersion in social rates of return to existing and new investments and the unification of the capital market.[50] In short, with financial liberalization, both firms and investors would theoretically be faced with the correct level of interest rates.

Financial liberalization has been recommended to, and adopted by, a number of developing economies[51] as a solution to financial repression. However, there are still some doubts as to its contribution to economic development:

> The theory that financial development leads to economic development coupled with the recognition of a state of financial repression in many developing countries, leads to a policy recommendation of financial liberalization, and particularly, interest rate liberalization. The most striking example of the implementation of this policy prescription lies in the package of measures which the IMF designs for borrowing countries. Such a package frequently contains a recommendation to raise interest rates, partly to tighten credit and partly to increase savings and thereby increase investable funds and economic growth. However, neither theory nor the empirical research is unambiguous on the direction of causality between financial and economic development, and some studies have raised doubts about the very existence of such causality.... However, for a country which wishes to encourage private sector investments the theoretical policy advice would seem to be one of removing

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[49]SHAW, *supra* note 39, at 4.

[50]MCKINNON, *supra* note 33, at 9.

[51]A number of countries, both developed and developing, have taken steps to liberalize their financial systems during the past decade. Interest rates have been liberalized in Argentina, Australia, Chile, France, Ghana, Indonesia, Japan, the Republic of Korea, Malaysia, New Zealand, Nigeria, the Philippines, Sri Lanka, Turkey, the United States, and Uruguay. In other countries, such as Thailand and Yugoslavia, interest ceilings have been managed more flexibly than before. Several countries such as Chile and Korea, privatized their commercial banks. Argentina, Chile, Pakistan, and Turkey reduced their directed credit programs, and interest rate subsidies were reduced or abolished in Korea and the Philippines. *See* INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT/WORLD BANK, WORLD DEVELOPMENT REPORT 1989 at 122.

> controls on the capital market. The freeing (not fixing at higher level) of interest rates, reduction of reserve requirements of commercial banks, and the removal of investment direction and interest rate subsidies would appear to form a major part of this package.[52]

There are empirical researches on financial repression and liberalization focusing on attempts to estimate the impact of interest rate controls on economic grounds.[53] In a survey of twenty-five Asian and Latin American countries, for example, it was concluded that the role of interest rates, on its own, in stimulating economic growth may be limited and should be accompanied by measures to encourage the growth of the financial sector.[54]

In spite of the perceived benefits of financial liberalization, many countries still hesitate to liberalize their financial systems and others have returned to financial repression after limited periods of liberalization attempts.[55] Even the World Bank which has highly recommended financial intermediation realizes that there are certain limitations and pitfalls to liberalization:

> The clearest lesson is that reforms carried out against an unstable macroeconomic background can make that instability worse. Complete liberalization of interest rates in countries with high and unstable rates of inflation can lead to high real interest rates and wide spreads between lending and deposit rates. Furthermore, it did not prove possible in unstable economies to prevent the real exchange rate from appreciating or to keep interest rates in line with the productivity of the real sector. As a result, the removal of capital controls allowed volatile capital flows and undermined monetary control.[56]

Financial liberalization, is therefore, not a cure-all and should be used by policy makers only after careful evaluation of the economic situation.

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[52]KITCHEN, *supra* note 18, at 95.

[53]For a list and summary of some empirical studies on financial repression, *see generally* KITCHEN, *supra* note 18, at 89-95.

[54]*Id.*, at 92 *citing* GUPTA, FINANCIAL AND ECONOMIC GROWTH IN DEVELOPING COUNTRIES (1984).

[55]*See* SUDWEEKS, *supra* note 17, at 19.

[56]INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT, WORLD BANK, *supra* note 51, at 127.

B. Financial Intermediation

A perceived beneficial effect of financial liberalization is its impact on the expansion of financial intermediation between savers and investors. Financial intermediation is generally viewed to raise real returns to savers and, at the same time, lower real costs to investors by accommodating liquidity preference, reducing risk through diversification, reaping economies of scale in lending, increasing operational efficiency and lowering information costs to both savers and investors through specialization and division of labor.[57] There are three major ways in which efficient financial intermediation is said to help in the development process: by the collection of additional savings, by the allocative function, and by redistributing the benefits of larger returns on capital investments. First, financial intermediation offers individuals different modes of savings. Financial intermediation allows individuals a broad choice between physical assets, on one hand, and interest-bearing financial claims, on the other. Second, an efficient financial intermediation system not only improves the collection of savings but also is able to select more rationally between competing uses of funds. As investment decisions become more complex, this allocative function of savings, mortgage and development banks is increasing in importance. Third, the social distribution of savings achieves a redistribution of wealth because the people who did not receive any return on savings when it was in the form of goods or currency are now able to share in the return on investments by obtaining interest or dividends if the funds are invested with mutual funds.[58]

The causal relationship between the expansion of financial intermediation and economic development has still not been clarified. Some economist are of the view that the lack of financial institutions in underdeveloped countries is simply an indication of the lack of demand for their services.[59] Under this view, lack of financial intermediation is the result of underdevelopment. On the other hand, others are of the opinion that underdevelopment is the result of the lack of financial intermediation. In underdeveloped countries:

> (1) [I]ndividual economic units issue relatively few primary securities as a proportion of savings - thus indicating the greater reliance placed on self-finance by firms within the

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[57]FRY, *Money and Capital or Financial Deepening in Economic Development*, 10 Journal of Money, Credit and Banking, November 464, at 471 (1978).

[58]TAN WAI, *supra* note 15, at 31-32.

[59]PATRICK, *Financial Development and Economic Growth in Underdeveloped Countries*, 14 Econ. Dev. and Cultural Change 74 at 174-175 (1966).

> developing country in comparison with firms in wealthy countries (2) most of this limited flow of primary securities is acquired by financial institutions rather than being placed directly with financial savers and; (3) the liabilities of the monetary system - the central bank plus deposit banks - account for about two-thirds of all claims on intermediary financial institutions that are held by the public. Apparently there are few organized markets for such primary securities as bonds, mortgages, or common stock, since they require economies of scale that are generally not present in less developed countries. In short, there is little direct contact between the primary borrower and ultimate lender....[60]

Under the "demand-following" phenomenon, financial markets develop as a consequence of economic growth. On the other hand, some are of the view that the creation of financial institutions and supply of their financial assets, liabilities, and related financial services in advance of the demand for them, specially the demand for entrepreneurs, induces economic growth.[61]

The kind of financial superstructure that should be established by developing countries depends partly on the opportunity cost of setting up a particular financial institution and partly on the benefits that would be derived from increased savings and a better allocation of funds for financing investment.[62] Some have even theorized that it is not necessary for developing countries to encourage the establishment of stock exchanges to foster direct financing of investments since they could instead take a shortcut by leaving it to specialized banks, mutual funds, and even government lending funds to finance private investments directly.[63]

Another key issue concerning the appropriate institutional structure for a securities market is whether banks and securities firms should have separate functions, or whether what are called universal banks or multibanks should be allowed to perform both types of business. One of the most important trends in financial markets in recent years has been the spread of "universal banking."[64] The argument for universal

[60]McKINNON, *supra* note 33, at 37-38.

[61]PATRICK, *supra* note 59, at 174-175.

[62]TAN WAI, *supra* note 15, at 30.

[63]*Id.*, at 29.

[64]This term has different meanings but usually refers to the combination of commercial banking (collecting deposits and making loans) and investment banking (issuing, underwriting, placing, and trading company securities). (*See* INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT, WORLD BANK), *supra* note 51, at 50.

banking is based on economies of scale and scope enjoyed by large and diversified financial institutions as well as the importance of universal banks in monitoring corporate performances and controlling the behavior of corporate managers.[65]

It is the IFC's belief, however, that securities markets tend to be more efficient, more competitive, and more able to meet the financing needs of businesses if the financial system is specialized. The IFC has conducted several studies which has shown that with a specialized structure there is greater competition (both among the securities firms themselves and between securities firms and banks) than where universal banks dominate the securities market. According to IFC's findings, costs of intermediation tend to be lower in a specialized structure and investors are generally better served by a wider choice of financial instruments.

The first study covered six industrial countries (Canada, Federal Republic of Germany, France, Japan, Netherlands and United States) and two developing countries (Republic of Korea and Venezuela) where it was shown that the industrial countries with universal banking systems had less overall financial depth (defined as the sum of bank assets and securities outstanding as a proportion of the countries' gross national product) than industrial countries with specialized financial institutions. In particular, France and Germany, with their universal banking systems, have shallower securities markets. Among the developing countries, Korea (which as a specialized financial system) has a deeper and more efficient financial market than Venezuela (which has a "mixed" system; i.e., a system that falls somewhere between pure universal banking and pure specialization). These conclusions appear to disprove the thesis that universal banking allows for important economies of scale and leads to deeper and more efficient markets.[66]

A second IFC study looked at the financial systems of sixteen developing countries where it found no correlation between universal banking and a strong securities market. Some of these countries have an abnormally deep or shallow financial sector relative to their per capita income. India, Jordan and the Philippines all have relatively developed securities markets where the market grew up on an environment where the banking and securities-market businesses were conducted by distinct institutions.[67]

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[65] *Id.*, at 50.
[66] INTERNATIONAL FINANCE CORPORATION, *supra* note 20, at 5.
[67] *Id.*, at 6.

A third study tried to measure the efficiency of different financial structures more directly by comparing the cost of raising capital for corporate borrowers and equity issuers in sixteen different countries.[68] The IFC concluded that a specialized, competitive system of financial intermediaries is clearly the best way to achieve low intermediation costs.[69]

The choice of having specialized banks over universal banks has not entirely been based on economic concerns such as specialization, competitiveness or low intermediation costs. The best example is the evolution of the United States' specialized banking system, the existence of which has not been based on economic efficiency needs but on a perceived necessity to protect bank depositors from abuses. After the Great Depression, the Glass-Steagall Act[70] was passed which prevented national banks from engaging in the business of issuing or selling securities. The purpose of the United States Congress in passing the Act was to keep commercial banks out of the investment banking business since it believed that the promotional incentives of investment banking was destructive of prudent and disinterested commercial banking and of public confidence in the commercial banking system.

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[68]The countries were divided into three groups:

Developed countries with specialized financial institutions, where securities-market competition is strong (Canada, Japan, United Kingdom, United States).

Developed countries with more concentrated financial institutions, where securities-market competition is minimal (Belgium, Federal Republic of Germany, France, Netherlands, and Switzerland).

Developing countries with varying degrees of specialization but where the securities markets are nonetheless competitive.

[69]INTERNATIONAL FINANCE CORPORATION, *supra* note 20, at 8.

[70]12 U.S.C. sec. 24, 78, 377, 378 (1933). The Glass-Steagall Act is the popular name for four provisions in the U.S. Banking Act of 1933. The provisions were enacted in the wake of the 1929 stock market crash with the general purpose of separating as completely possible commercial from investment banking. Board of Governors of the Federal Reserve System v. Investment Co. Institute, 450 U.S. 46 (1981). Section 16 of the Act prohibits commercial banks from purchasing or selling securities except upon the order, and for the account of customers. Section 20 prohibits commercial banks from purchasing or selling securities except upon the order, and for the account of customers. Section 20 prohibits member bank affiliation with corporations engaged principally in certain securities activities. Section 21 bars any person, firm, corporation, association, business trust, or other similar organization from engaging in securities activities while engaged in the business of receiving deposits. Finally, section 32 prohibits corporate interlocks between member banks and entities primarily engaged in the securities activities listed in section 20 thereof.

> The legislative history of the Glass-Steagall Act shows that Congress also had in mind and repeatedly focused on the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments. This course places new promotional and other pressures on the bank which in turn create new temptations. For example, pressures created because the bank and the affiliated are closely associated in the public mind, and should the affiliate fare badly, public confidence in the bank might be impaired. And since public confidence in the bank is essential to the solvency of the bank, there might exist a natural temptation to shore up the affiliate through unsound loans or other aid. Moreover, the pressure to sell a particular investment and to make the affiliate successful might create a risk that the bank would make its credit facilities more freely available to those companies in whose stock or securities the affiliate has invested or become otherwise involved.
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> Congress was also concerned that bank depositors might suffer losses on investments that purchased in reliance on the relationship between the bank and its affiliate. This loss of customer good will might "become an important handicap to a bank during a major period of security market deflation.
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> Another potential hazard that very much concerned Congress arose from the plain conflict between the promotional interest of the investment banker and the obligations of the commercial banker to render disinterested investment advice.[71]

Recent economic experiences, specially the growing serious competition posed by European and Japanese banks to U.S. banks, have prompted the U.S. banking industry to clamor for a relaxation of restrictions imposed upon them to conduct securities related activities.

Developing countries may have to determine whether there are similar potentials for abuses in their banking system and securities market and whether similar prohibitions would be effective to protect the public

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[71]Investment Company Institute v. Camp, 401 U.S. 617 (1971) at 630-633.

from such abuses. Given, however, the limited number of financial intermediaries in developing countries, the need for universal banks may outweigh the concern for potential abuses. In third world securities markets, the lack of institutions willing to underwrite public offerings is a major obstacle to stock offerings.[72] Encouraging financial intermediaries to flourish in third world economies would establish institutions that will provide underwriting facilities. In Korea, Brazil and Mexico, private institutions have acted as underwriters with government incentives to do so.[73] In Brazil, subsidized credit is provided which encourages underwriting and equity purchases by individuals in open-capital companies.[74] The South Korean government encourages financial institutions to underwrite offerings by providing them with low interest loans.[75] Primary markets have been found to be more active in those markets where commissions of underwriters are left to be determined by negotiations between underwriters and seller, as in Korea, and not fixed by the government.[76] In India, the terms and conditions are set by the government's Controller of Capital Issues particularly the pricing of issues; this acts as a dampening effect on going public.[77] The best approach would be to minimize government intervention.

C. Regulation of the Emerging Securities Market

A major cause of the reluctance of small investors to enter a Third World securities market is a mistrust of, or inability to understand available financial statements and a concomitant inability to evaluate independently the investment risk.[78] Lack of confidence in the securities markets may also deter the participation of large, sophisticated investors.

To meet the problem of the small investor's inability to understand the market and evaluate investment risk, education of the public becomes an important duty of a capital market or regulatory agency:

> To educate the public, the [securities] commission may organize seminars, print pamphlets, and publicize the securities market using radio, television, and the press. The commission may also work with the business community to

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[72] DICKIE, *supra* note 22, at 189.
[73] *Id.*, at 190.
[74] SUDWEEKS, *supra* note 17, at 120.
[75] DICKIE, *supra* note 14, at 171.
[76] *Id.*, *supra* note 22, at 190.
[77] KHAMBATA, *supra* note 23, at 432.
[78] DICKIE, *supra* note 22, at 177.

> develop training programs for employees of the stock exchange and brokerage firms. Eventually, the commission may decide to set professional examinations for those market operators who deal with the public. A sound legal framework goes hand in hand with this process of building up investor confidence in the securities market and the commission should be active in pressing for this.[79]

But perhaps, this duty to educate should not be borne only by the governmental regulatory body but by the financial community as well. Investment banks, investment houses, stock brokers and dealers, must also assist in the education of the public and in building investor confidence.

Mistrust of the market is a more formidable problem. Both small, unsophisticated investors and sophisticated institutional investors may be reluctant to participate because of their lack of confidence in a securities market caused by past experiences of stock market abuses and manipulation. In Taiwan, the purchasing of securities on rumors spread by speculators and manipulators is seen by many as being partially responsible for the excessive rise and decline in the securities market there in 1964.[80] The experience of Hong Kong's stock market collapse in 1973 was partly due to its reputation for abuses.[81] An executive of the Inter-American Development Bank emphasized that "the first step in building capital markets in Latin America is to win the confidence of the saving public by the passage of pertinent legislation and the effective and equitable enforcement thereof."

Mistrust of the market causes[82] uncertainty in the securities market giving rise to inverted yield curves- where the yield on short term debt are higher than those on long term debt. Uncertainty is often high in the third world, which also creates a bias in favor of short-term returns.[83]

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[79]INTERNATIONAL FINANCE CORPORATION, *supra* note 20, at 13.

[80]DICKIE, *supra* note 14, at 169 *citing* EISZRIK, *The Role of the State in Regulation of the Securities Markets: The Brazilian Experience*, 1 J. OF COMP. L AND SEC. REG. 211, at 222 (1978); FERRIS, *The Creation of a Favorable Climate for the Investment of Private Savings and the Role of Taiwan Securities Market*, unpublished paper (1967) at 23-24.

[81]INTERNATIONAL FINANCE CORPORATION, *supra* note 20, at 15.

[82]POSSER, *Securities Regulations in Developing Countries: The Brazilian Experience*, 52 VA. L. REV. 1283 at 1284 (1966) *citing* address of Upton to the Executive Committee of the Inter-American Council on Commerce and Production, Caracas, Venezuela, Oct. 26, 1965 at 418.

[83]DICKIE, *supra* note 14, at 176.

The consequence of investor preference in favor of short-term gains over long term has been explained as follows:

> The bias toward the short term makes it difficult for these countries to develop an intermediate or long-term debt market and, in turn, makes it difficult for companies to obtain intermediate or long-term capital for expanding productive capacity. Moreover, the bias leaves investors little incentive to buy equity securities. In Third World countries, investors tend to heavily discount the possibility of capital appreciation, causing them to be very yield conscious and to compare the dividend rate with the yield on other forms of investment, such as bank deposits. Because the benefits of capital appreciation are poorly understood or because uncertainty implies a high risk of little or no capital gain, equity offerings are very difficult to sell unless the dividend rate exceeds the rate on time deposits or savings accounts.[84]

There are many sources of uncertainties in a third world market like economic and political stability over which the government has little, or absolutely no control. The government, may, however, do something to allay any misapprehensions of investors on the market due to stock market abuses through some form of regulation and enforcement.

Governments have a variety of means available to deal with these issues by enacting anti-fraud statutes, by requiring disclosures of material information, by screening of offerings based on their merit, by enforcement of private contracts between market participants, or by defining and enforcement of property rights, taxation, and direct ownership.[85] Some definition of the relationship between the shareholder and the company and assurance of the rights of shareholders vis-a-vis the corporation and its officers must, at the barest minimum, exist. There must also be some kind of system of regulation of the securities market in place to provide protection to investors.

Governments have generally adopted anti-fraud provisions which impose liability on certain acts or omissions deemed to be fraudulent or manipulative. The prospects of criminal and civil liabilities for fraud in connection with the purchase or sale of a security may deter manipulation and abuses of the capital markets. In Korea, the government has vigorously enforced securities laws that prohibit insiders from selling

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[84] *Id.*, at 173.

[85] *See* BEAVER, *The Nature of Mandated Disclosure* in POSNER AND SCOTT, ECONOMICS CORPORATION LAW AND REGULATION 317 at 319 (1980).

short and entitle the corporation to recover short-swing profits received by insiders on trading in the issuer's stock.[86] Mexico's Securities Market Law prohibits manipulation of stock prices and insider trading and a person damaged by another person's insider trading may bring a lawsuit for rescission of the trade and payment of damages.[87] The Philippines' Revised Securities Act has general anti-fraud provisions and specific prohibition against insider trading.[88]

Governments have also devised systems for assuring the accuracy of information available to the investors. In this area of securities regulation, there exists two philosophies or systems: a full disclosure system and a merit system. The philosophy of full disclosure has been chosen by the United States Congress in passing its federal securities acts. As stated by the United States Supreme Court:

> The Investment Advisers Act of 1940 was the last in a series of Acts designed to eliminate certain abuses which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's. It was preceded by the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, and the Investment Company Act of 1940. A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.[89]

In choosing a mandated disclosure system, the U.S. Congress was conscious of Louis D. Brandeis' urging that publicity is a remedy for social and industrial diseases generally and for excessive underwriter's charges specifically.[90] The immediate purpose of full disclosure was to promote fairness in the securities industry.

The disclosure philosophy has been criticized on the ground that those needing investment guidance would either lack the intelligence or training to understand the financial reports and other disclosures, or would be so concerned with a speculative profit as to consider them

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[86] DICKIE, *supra* note 22, at 210.

[87] WOLFF, *A Study of Mexico's Capital Market and Securities Regulation*, 20 VAND. J. OF INT'L. L. 388 at 425 (1987) *citing* the Securities Markets Law, art. 16 Bis., sec. IV.

[88] PHIL. REVISED SECURITIES ACT, Batas Pambansa Blg. 178, sec. 29-30 (1982).

[89] SEC v. Capital Gains Research Bureau 375 U.S. 180, 186; 11 L. ed. 2d 237, 243 (1963).

[90] LOSS, FUNDAMENTALS OF SECURITIES REGULATION at 31-32 (1988).

irrelevant.[91] It has been said that in the United States, many investors who are the intended beneficiaries of the full disclosure securities acts usually do not read nor receive the mandated filings or reports under the law and that there is an implicit reliance on the functioning of the professional investment community to justify the system as an effective mechanism for disclosure.[92]

A theory which has acquired prominence in financial economics is the Efficient Capital Market Hypothesis (the "ECMH"). Under the standard formulation of this theory, a market is efficient if prices "fully reflect all available information."[93] Thus,

> In such a market, the impact of each new event that bears on the expected risk or return of an asset is reflected in the asset's price virtually instantaneously. If a particular market has this quality, important practical and policy implications follow. On the practical level, if new information about an asset is incorporated into an asset's price this quickly, then it would be very difficult at best to make a living by searching out new information about an asset with the intent of buying or selling the asset, depending on whether the information is good or bad, before the rest of the market learned of it. In an efficient market, there is no before. The implications for choice of investment strategy are apparent.
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> The implications of the ECMH are no less significant on the policy level. Much of the current regulation of the capital market is really an effort to remedy perceived shortcomings in the quality and accuracy of the information that is available to the capital market.[94]

An efficient market is important to encourage stability and confidence in the market by assuring investors that the price prevailing or quoted in the stock market is the correct price and truly reflects all available public information and that no person, by virtue of his better access to information, may profit from such information. Efficiency of the market is a pre-requisite for one of the purposes of a securities market - to establish a dependable price setting mechanism. An efficient market also minimizes transaction costs in that an investor will not have to expend efforts in searching and discovering the real price of a security from other

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[91] *Id., at 29 citing* DOUGLAS, *Protecting the Investor*, 23 YALE L. REV. (N.S.) 521 (1934).

[92] BEAVER, *supra* note 85, at 317.

[93] GILSON, THE LAW AND FINANCE OF CORPORATE ACQUISITION 156 (1986).

[94] *Id.*, at 156.

sources since all available information has been impounded into the price. Emerging markets, however, are often characterized as being not efficient:

> The majority of developing countries have unorganized capital markets in that securities are traded directly between institutions and individuals without stockbrokers and market-makers. The major inefficiency is the lack of information otherwise available in an organized market. Many emerging markets tend to be small, with only about half of the developing countries with stock exchanges having over 100 companies quoted. This is due to the scarcity of industrial and commercial companies in developing countries since developing economies tend to be largely agricultural. The volume of transactions also tend to be low which suggests that the reaction of share prices to new information may not be immediate, and prices therefore may not fully reflect all available information. Lack of adequate market regulation and inadequate disclosure standards by companies, poor communication and lack of competent analysts and professional advisors mark these emerging markets. Another inefficiency can be traced to significant transaction costs.[95]

Given the characteristic inefficiency of developing markets, a greater task would be required on the part of developing market regulators to improve the quality and accessibility of information available to the capital market participants. This may be achieved through mandated disclosure requirements or by providing incentives to individuals to search for or produce non-public information and bring this information to the market.

Non-public information may be viewed as a resource which has not been considered as a property right in most developing countries. Non-recognition of property rights in non-public information may result in negative externalities, which occur when the actions of one party have effects on other parties who are not charged or compensated via the price mechanism.[96] In connection with the disclosure of information, a negative externality could occur when corporations and shareholders of the corporation are discouraged to produce and publicly disclose information because disclosure of that information would benefit non-shareholders who have not contributed to the costs of producing and disclosing the information. Another negative externality could occur where analysts, who have incurred costs in searching for information are

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[95]KITCHEN, *supra* note 18, at 48-49.
[96]BEAVER, *supra* note 85, at 320.

not compensated for their costs of search and disclosure of the information. These externalities would discourage the bringing of information to the market and, therefore, hinder the efficiency of the market. Governments can often aid in achieving efficiency by assigning property rights to resource use and developing methods that allow the exchange of those rights at low transaction costs.[97] Following the Coase theorem, "when transaction costs are negligible, externalities can be internalized by government's establishment of property rights to resource use and allowance of free exchange of those rights."[98] According to one author, recent economic analysis of the United States market suggested that considerable incentives exist to search for and obtain non-publicly available information for trading purposes where information flows from management to the analysts and then passed along to the latter's investor clients.[99] These investor clients pay for the analysts' services, thus giving the incentive to the analysts to obtain more non-public information. Investor clients would then bring the information into the market when they trade. Investors will keep on purchasing analyst's services until their benefits from trading on the information diminishes to zero:

> At the margin, investors will purchase analysts's services to that point where investors are indifferent between being more informed or less informed, given the costs of becoming more informed. In other words, the expected benefits of being more informed (e.g., in the form of expected superior returns due to better information) are equal to (or offset by) the costs incurred to obtain additional information. A common argument is that some investors cannot afford to purchase the services of analysts. However, the existence of financial intermediaries makes the force of this argument unclear. Moreover, it ignores several alternatives open to relatively less informed investors. One such alternative is to partially insulate themselves from more informed traders via buy-and-hold strategies and index funds. Also the actions of the more informed may signal their information to the less informed and as a result prices may partially (in the limit, fully) reflect the information.[100]

By recognizing the property rights of these analysts over the information they have produced through research and allowing them to profit and recover their costs, governments would be able to encourage

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[97]HYMAN, MODERN MICROECONOMICS, ANALYSIS AND APPLICATION 645 (1988).
[98]*Id.*, at 645.
[99]BEAVER, *supra* note 85, at 323.
[100]*Id.*

disclosure of information and consequently achieve efficiency of the market and supplement or even supplant mandated disclosure.

Another means by which governments could achieve efficiency in the market without resorting to mandated disclosure is by recognizing and encouraging the establishment of stock exchanges. Stock exchanges have played an important role, not only in providing the marketplace for trading securities, but also in disseminating information. Since efficiency of a securities market can be achieved by assigning property rights to resource use and developing methods that allow the exchange of those rights at low transaction costs, the establishment of stock exchanges and the recognition of the property rights of those exchanges over the price information will achieve efficiency.

A stock or financial exchange can be defined from a transactional cost point of view as:

> [A] firm that creates a market in financial instruments. The product of this particular type of firm is accurate information, as reflected in the prices of the instruments traded on the exchange. The provision of the product is facilitated by offering standardized items.[101]

Under this definition, an exchange is where investors discover what the relevant prices are; such price discoveries entail substantial search and information costs, bargaining and decision costs, policing and enforcement costs.[102] It has been viewed that the growth of financial exchanges in the United States has been promoted by having a legal system that recognizes quotes of prices on financial instruments offered by an exchange as property of that exchange which has allowed the exchanges to establish rights to such property and reap gains from technological innovations.[103] Policy makers in developing countries should, therefore, also recognize the property rights of exchanges in price quotes and information they produce.

As an alternative to a disclosure system, merit regulation, on the other hand, has been adopted by various states into their blue sky laws. Merit regulation has been defined as "a discretionary power allowing the

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[101] MULHERIN, *Netter and Overdahl, The Organization of Financial Exchanges from a Transaction Cost Perspective*, paper presented at the conference on Contracts and the Activities of Firms, Chicago, Illinois, June 14-16, 1990 at 4 (available at the Office of the Chief Economist, Securities and Exchange Commission).

[102] *Id.*, at 4.

[103] *Id.*, at 47-48.

administrator to pass on the investment merits of an issue of securities proposed to be offered to the public" and as a "device which attempts to lessen the investment risks for investors in newly promoted firms."[104] Some countries, including Indonesia and Brazil, have essentially screened new offerings on their merits and have not relied on disclosure alone.[105] Even when the government screens the merits of public offerings, however, problems may arise because exchange authorities in developing countries often function as both regulators and promoters of the market such that in their eagerness to promote the markets, the exchange authorities occasionally approve offerings that expose investors to risk.[106] A disadvantage of the merit system of regulation is that it involves a slow process whereby the regulator is duty bound to thoroughly review and analyze each public offering before granting approval.

Developing countries have adopted numerous means in regulating the stock market and, at times, regulators themselves have acted as promoters of the securities. The Bedan Pelaksana Pasar Modal (Bepepam), Indonesia's equivalent of the U.S. Securities and Exchange Commission which, in theory, is responsible merely for assuring proper disclosure, has screened offerings on the merits and at times tended to place its duties as a promoter of the market ahead of its duties as regulator.[107] A state-owned corporation, P.T. Danareksa, buys shares from companies or shareholders and resells those shares in small lots to investors, thereby acting as a market maker, stabilizing the secondary market hoping to protect small investors from losses.[108] In India, where the Securities Contracts (Regulation) Act governs the regulation of stock exchanges, trading practices, purchase and sale of contracts, trades on an exchange and the listing of securities, the government has reserved the right to intervene and in practice does so actively resulting in a curious blend of government intervention.[109] South Korea has a similar set-up with agencies having separate regulatory and promotional functions; the South Korean securities system consists of a Securities and Exchange Commission, which overseas the issuance and fair trading of securities and the operations of securities institutions, and a Securities Supervisory Board, which promotes new securities offerings over the Exchange.[110]

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[104]Ad Hoc Subcommittee on Merit Regulation of the State Regulations of Securities Committee (ABA), REPORT ON STATE MERIT REGULATION OF SECURITIES OFFERINGS, 41 BUS. LAW 785 at 795 (1986).

[105]DICKIE, *supra* note 14, at 178.

[106]*Id.*, at 178.

[107]DICKIE, *supra* note 22, at 215.

[108]*Id.*, at 215-216.

[109]KHAMBATA, *supra* note 23, at 427.

[110]DICKIE, *supra* note 22, at 178.

Where securities agencies of the government screens the merits of public offerings, problems may arise because exchange authorities in Third World nations often function as both regulators and promoters of the markets and, in their eagerness to promote the markets, may approve offerings that expose investors to serious risks.[111]

The issue, however, is not simply whether to use merit regulation or follow a full disclosure policy:

> Legislators evaluating their state securities regulatory schemes should realize that the issue is not simply deciding whether or not to implement merit regulation. There are actually a great many more choices. Legislators should first fundamentally determine whether the state can or should adopt a rigorous consumer-protection-oriented regulatory posture toward securities issues.... If legislators are particularly concerned with specific abuses in connection with penny stocks, tax shelters, Ponzi schemes, or fraudulent commodity programs, they should consider whether these abuses can be remedied without adopting a full-scale merit regulatory system uniformly applicable to all offerings registered in the state. For example, states should first determine whether the existing antifraud remedies and provisions for regulating securities professionals are adequately enforced by an appropriately financed, trained, and supervised blue sky office. If the state's problem is enforcement, then more resources should be devoted to that. If a state determines that its securities laws need revision, it should decide whether the wholesale adoption or expansion of merit authority is the most appropriate solution, or rather committing to SEC-like disclosure review, redefining existing civil or criminal liabilities, expanding the administrator's enforcement powers, imposing greater restraints or closer supervision on securities professionals, constricting existing exemptions, targeting only specific kinds of transactions for detailed merit or disclosure review, or a combination of these regulatory techniques.[112]

There are three models for the regulation of market professionals and exchanges that can be found in emerging markets. These are the U.S., the British and the "new" model.[113] The United States model was introduced during the 1960s and 1970s in most of Latin America, Korea,

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[111] *Id.*
[112] *Id.*, at 852.
[113] VAN AGTMAEL, *supra* note 1, at 25-26.

the Philippines, Pakistan, Indonesia, Nigeria, Egypt and Turkey.[114] Under this system, there is a comprehensive capital market law which covers the regulation of both primary and secondary markets, and under which the stock exchanges, underwriters, dealers, brokers and investment managers are monitored. Securities commissions are established and issue further, more detailed rules and regulations. The stock exchanges may have its own listing requirements and other self- regulatory functions, but these are usually less comprehensive than those of the securities legislation. Unlike the US model, however, the emphasis is usually on the approval of new issues, or a merit system, rather than registration of new issues based on sufficient disclosure to the investor.[115]

The British model, used with modifications in Hong Kong, Singapore, Malaysia, Zimbabwe and Kenya, relies not on comprehensive securities legislation and a securities commission, but on listing requirements, other rules of behavior of the stock exchanges, and self-regulation by their members. An advantage of this system appears to be its greater informality and flexibility while disadvantages include the lack of regulatory clout to discipline those who abuse the system.[116] The British model has undergone major changes with the passage of United Kingdom's Financial Services Act of 1986 (the "FSA"):

> The FSA provides for the creation of a multi-tiered system of securities regulation. The bottom-tier is comprised of a number of self-regulatory organizations (SROs) that make and enforce rules with respect to their respective member's activities in the financial services industry. At the top of the structure is the Department of Trade and Industry which, however, as contemplated by the FSA, has delegated many specified regulatory powers to a private sector designated agency, the Securities and Investments Board (SIB). The SIB in turn, authorizes the SROs, Recognized Investment Exchanges (RIE) and Recognized Professional Bodies (RIBs) and approves their rule books. The SIB also has the responsibility of establishing rules for, and regulating the activities of, persons engaged in the investment business who choose to apply directly to it for authorization, rather than become members of an SRO or RPB.
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[114] *Id.*
[115] *Id.*
[116] *Id.*

> The SIB is a private body, its members are appointed (and may be removed) by the Secretary of State of the DTI and the governors of the Bank of England acting jointly.[117]

In several recently reorganized markets, like Thailand and Jordan, a new approach has been followed by 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.[118]

Due to the marked disparities in information in a non- efficient market, more regulation and its enforcement may be required. However, too much disclosure requirements and too strict regulations may suffocate the market by increasing the costs of public offerings and discouraging companies from going public. It has been said that if the United States Securities and Exchange Commission "had had jurisdiction during the early days of the development of the west [they] would have no mining industry in the United States today."[119] Some developing countries have resorted to re-regulation and deregulation of their securities markets. In April of 1987, the Buenos Aires Stock Exchange, sought to revert the trend of public companies delisting their shares due to the burden of complying with existing stringent stock exchange regulations by reducing the requirements which corporations must meet to list their shares and the periodic information which they must file.[120] The number of companies quoting their shares in the Buenos Aires stock exchange was reduced by half in the last ten years due to too much disclosure requirements.[121] A delicate balance must, therefore, be maintained between too little regulation and over regulation.

D. Incentives to Go Public

Policy makers of developing countries have adopted several measures to encourage companies to sell their shares and for individuals to invest in the shares of these companies. Usually, the majority of the shares of companies in developing countries are still held by the original

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[117] BLOOMENTHAL, SECURITIES LAW HANDBOOK (1988-1989) ed. at 743.

[118] AGTMAEL, *supra* note 1, at 26-27.

[119] LOSS, *supra* note 90, at 28 *citing* Telegram from Secretary of Arizona Small Mine Operators Associations in opposition to American-Canadian extradition treaty covering securities, violations, Canada, Minutes of Proceedings and Evidence before H.C. Standing Comm. on External Affairs, No. 6 (Nov. 23, 1945) 147.

[120] BOMCHILL, *Recent Developments in Securities Law - 1 Argentino*, 16 INT'L. BUS. LAWYER, January, 1988.

[121] *Id.*

founders, by the government, one or more family groups, banks, foreign companies and other insiders.[122]

Some governments have privatized government-owned companies and offered its shares to the public. A number of government-owned companies in Korea, such as the Korea Electric Company, have successfully distributed a portion of their shares to the public.[123] Government-controlled companies have gone public in Hong Kong, like the China Light and Power Company, Ltd; in Taiwan, including the China Development Corporation, Chang Hua Bank, First Bank and Hua Nan Bank; in the Philippines, like the Philippine Long Distance and Telephone Company and in Malaysia, like the National Equity Corporation.[124] Some governments have also required privately held companies to go public. The 1980-81 boom in the stock market of India was attributed partially to the Foreign Exchange Reparations Act of 1973 which effectively required foreign multinationals to reduce their stakes in Indian subsidies to forty percent.[125] In Jordan, new businesses are allowed limited liability status only if they offer a minimum percentage of their equity to the general public. The rationale is that limited liability is a privilege and that controlling shareholders must be prepared to allow the public to buy shares at the same price as the promoter of the company.[126]

E. Tax Incentives

Some countries have attempted to establish tax incentives for companies going public which may range from lower corporate income tax rates, exemption from dividend taxes, eligibility for tax holidays, special depreciation allowances and special allowances for bad debts.[127] For instance, Indonesia promulgated in March 1979 regulations that reduced tax rates on a permanent basis for companies selling 20 percent of their shares to the public and the rates were further reduced for companies selling 35 percent of their shares to the public, and still further reduced for those selling at least 51 percent to the public.[128] In Thailand, companies whose shares are listed have a lower corporate tax rate of thirty-five percent instead of the regular forty-five percent.[129] In Sri

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[122] *Id.*, at 22.
[123] DICKIE, *supra* note 22, at 181.
[124] *Id.*, at 183.
[125] SUDWEEKS, *supra* note 17, at 142.
[126] *Id.*, at 45.
[127] *Id.*, at 63.
[128] DICKIE, *supra* note 22, at 203.
[129] VAN AGTMAEL, *supra* note 1, at 94.

Lanka, listed companies are subject to a lower corporate tax rate of forty per cent instead of fifty percent.[130]

Tax incentives could also make investments in shares of stock attractive by effectively increasing the return on equity. This has been a popular remedy used by several governments.

Brazil has the best known and most successful tax-credit plans where individuals are allowed to offset against their income taxes part of the costs of buying listed stocks or convertible bond, quotas in fiscal mutual funds, or equities of companies in underdeveloped regions of Brazil.[131]

Some countries have reduced or removed taxes on dividends distributed by corporation to lessen the impact of double taxation on income earned by corporations. In the Philippines, dividends received by individuals from a domestic corporation is subject to a zero percent tax effective January 1, 1989[132] and intercorporate dividend taxes, or taxes on dividends received by a domestic corporation or a resident foreign corporation from another domestic corporation, have been done away with.[133] A tax disincentive which discriminates against equities like capital gains taxes. In an inflationary environment, capital gains taxes on nominal returns can sharply reduce, or even eliminate, the real return on equities. To encourage the demand for listed securities, some developing countries have adopted specific tax incentives. In the Philippines, a tax of only one-fourth of one percent is levied on the gross selling price of the shares of stock as a tax on capital gains which are presumed to have been realized from the sale, exchange or disposition of shares of stock listed and traded through a local stock exchange.[134] Under Korean tax laws, capital gains are not taxed but there is a one- half percent sales tax payable by the seller, and two-tenth's percent transfer tax on most sales.[135]

Other taxes which may operate as disincentives are transfer taxes and documentary stamp taxes imposed on every transfer of ownership of

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[130]*Id.*, at 107.

[131]INTERNATIONAL FINANCE CORPORATION, *supra* note 20, at 22.

[132]NATIONAL INTERNAL REVENUE CODE, sec. 21(d) 2.

[133]*Id.*, secs. 24(e) (4) and 24(a)(6)(D).

[134]*Id.*, secs. 21(d) (2), 24(e)(2)(B), sec. 25(a)(6)(C)(ii) and 25(b)(5)(C)(ii).

If the sale is not made through a local stock exchange or when it involves non-listed security, the net capital gains realized is subject to a tax of ten percent for the first P100,000 and twenty percent on capital gains over twenty percent.

[135]AGTMAEL, *supra* note 1, at 79.

shares since any tax on the sale or transfer of ownership of shares would be an additional cost and affect the liquidity of shares. The elimination of these taxes may encourage the demand for securities and encourage the trading of securities.

F. Collective Savings

A number of governments have also encouraged the growth of contractual and collective savings institutions such as pension funds, insurance companies or mutual funds.[136] These institutions tend to stabilize and deepen the securities markets. The growth in the net purchases of common stock by mutual funds, as well as by pension funds and to a much lesser extent other institutional investors, has been found to be a major development explaining the upsurge of stock prices, price-earnings ratios in the United States stock market.[137] Mutual funds, under the American experience, have been said to stimulate the demand for stock in the following ways:

> First and perhaps most important, to the extent they divert money into stock which otherwise would have been channeled into alternative forms of investment, stock prices must rise particularly in the short run. Second, just as the entry of new money into the stock market shifts the overall demand schedule for stock in a direction favorable to stock prices, the resulting upward movement in prices probably improves the market sentiment of other investors which brings about a favorable shift in the demand schedule of these investors. Third, the publicity attendant upon both the substantial advertising, and other selling effort by the mutual funds and their substantial net purchases of stock may have a similar influence. Not only has the public bought mutual shares heavily but there has been some tendency as a result of the publicity attendant upon fund activities for stock investment as whole to be viewed more optimistically.[138]

In South Korea, insurance companies and other institutional investors have been large buyers, holding over 40 percent of the listed stocks.[139] The Unit Trust of India dominates the Indian capital market as a result of its monopoly status as the sole financial intermediary for the sale of unit trusts in India having established a total of fourteen different

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[136] INTERNATIONAL FINANCE CORPORATION, *supra* note 20, at 21.
[137] H.R. Report No. 2274, 87th Congress, 2d Sees, at 359 (1962).
[138] *Id.*, at 361.
[139] DICKIE, *supra* note 14, at 178.

funds which are widely distributed throughout India by commissioned salesmen.[140]

G. Internationalization of Emerging Securities Markets

There are other means by which developing countries can encourage the development of their securities markets. The increasing internationalization of world securities markets has made emerging markets attractive and more accessible to foreign investors. A government whose goal is to develop its securities market must decide whether it should allow foreign investments in certain areas of activity to supplement local capital. It must make a decision whether to open its capital markets to foreigners and accordingly must adjust its priorities and policies. Foreign investments in emerging securities markets may be direct, through purchases of individual shares listed in the local or foreign stock exchange or indirect, through mutual funds and country funds.

Most developing countries have never formulated laws and regulations to deal specifically with portfolio investments by foreigners while others have controls on such investments which are the result of administrative decisions, guided perhaps by laws regulating foreign direct investments.[141] In most developing countries, foreign equity ownership is often restricted to a certain percentage of an enterprise. Approval from a central authority for investments or the central bank is required in nearly all developing countries. In India, Turkey, Argentina and the Andean Group, there are controls on foreign ownership of enterprises as well as on repatriation of dividends and capital. In Brazil and Greece, foreign portfolio investments have to take place via local mutual funds to ensure free repatriation of dividends and capital. In the Philippines, foreigners could trade on the stock exchange through class "B" denominated in dollars with no restrictions on repatriation. In Mexico, Guatemala and Thailand, so long as restrictions on foreign ownership in enterprises, industries or sectors are observed, there are no controls on investments and repatriation.[142] Liberalization of restrictions on foreign ownership and control, reporting of investments and repatriation of dividends and investments are difficult and controversial issues to be addressed by a developing country since they encompass considerations of other serious problems faced by a developing country like balance of payments and balance of trade problems and nationalist sentiments. Nevertheless, developing countries have started to open their

[140]KHAMBATA, *supra* note 23, at 432.
[141]Developing Country Access, *supra* note 3, at 93.
[142]*Id.*, at 95.

capital markets to foreign investors. In Malaysia, there is no prerequisite of government approval for foreign portfolio investment while dividend income and capital can be freely remitted to any country except South Africa.[143]

In January 1981, the Korean government announced a four-stage "Long-term Capital Market Internationalization Plan" to liberalize indirect securities investment during the first stages and subsequently, during the second and third stages, direct securities investment with greater emphasis on foreign capital inflow.[144] Eventually, this policy of favoring free investment will be extended to domestic capital outflow.[145] The Korean Securities and Exchange Commission has enacted the "Rules on Securities Transactions by Foreign Investment Companies" aimed at effectively administering the foreign investment companies, and to ensuring the stability of the securities market and at preserving the local management of listed companies.[146] Brazil, through Decree Law 1401 and Central Bank Resolution 323 authorized the formation of investment companies or societies which allowed foreign investment and repatriation of capital only on a percentage of the original investment.[147]

Some governments have attempted to tap foreign investments through the establishment of country funds. These country funds have been organized in the United States and other developed markets and its shares listed and traded in these developed countries' stock exchanges. The number of single-country funds in the United States, for example, grew from two, in 1982, (the Japan Fund and the Mexico Fund) to eleven in 1986.[148] During the period from 1983 to 1986, nine additional country funds were brought to the United States market through public offering registered with the United States Securities and Exchange Commission.[149] Capital raised in these developed countries are then invested in shares in selected companies in the developing country. The India Fund, traded in London, and the India Growth Fund, organized in New York, are the two

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143 AGTMAEL, *supra* note 1, at 75.

144 JIN MOO LEE, *Internationalization of the Korean Capital Market*, 9 U. Pa. J. Int'l. Bus. L. 703 (1987).

145 *Id.*, at 704.

146 *Id.*, at 707.

147 SUDWEEKS, *supra* note 17, at 150.

148 Report of the Staff of the U.S. Securities and Exchange Commission to the Senate Committee on Banking, Housing and Urban Affairs and the Houses Committee on Energy and Commerce. Internationalization of Securities Markets, July 27, 1987 at II-79 [hereinafter Report of the U.S. SEC].

149 *Id.*

country funds of India.[150] The Korean government has allowed limited indirect investment in their stock market through mutual funds most significant of which is the Korea Fund traded in the New York Stock Exchange.[151] The Mexico Fund is a diversified, closed-end investment company registered under the United States Investment Company Act of 1940 which invests primarily in equity securities on the Mexican Stock Exchange.[152]

In addition to country funds, many Hong Kong and London based investment managers offer regional Far Eastern Funds and the IFC recently raised $50 million for an Emerging Market Growth Fund to invest in 20 developing countries.[153]

Foreign depositary receipts like the International Depositary Receipts (IDRs) and American Depositary Receipts (ADRs), which are negotiable receipts created by banks and transfer agents to facilitate trading of securities issued by companies from outside the domestic market, have been issued by companies who have outgrown their domestic market and are beneficial to developing countries because they offer an additional source of funds for development without concern for destabilizing capital flows.[154] An increase in U.S. demand for foreign securities is evidenced by the number of foreign companies with securities traded through NASDAQ or on exchanges in the form of ADRs which increased from 85 in 1982 to 110 in 1986.[155] Some large Philippine corporations have their ADRs listed on either the New York Stock Exchange or the American Stock Exchange.[156]

The capital markets of developed countries are openly accessible. It has been official American policy to promote the internationalization of capital markets by permitting open access to American capital markets, the free flow of capital out of the United States and the free flow of capital into the United States except as to limited areas in which national security interest is perceived.[157] Raising capital through offerings in developed countries, however, have often encountered regulatory obstacles. Companies from developing countries who wish to raise capital in the United States must comply with the applicable United States securities

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[150] *Id.*

[151] *Id.*, at 170.

[152] WOLFF, *supra* note 87, at 406.

[153] SUDWEEKS, *supra* note 17, at 92.

[154] *Id.*, at 92.

[155] Report of the U.S. SEC, *supra* note 148, at II-80.

[156] AGTMAEL, *supra* note 1, at 101.

[157] BLOOMENTHAL, *supra* note 117, at 706.

laws and must register its securities in accordance with section 5 of the Securities Act of 1933.[158] The elaborate and extensive registration requirements for the initial public offering of securities under the 1933 Securities Act and the required reporting requirements under the 1934 Securities and Exchange Act[159] may prove to be very costly for the foreign company. It may opt, instead, for an offering under one of the exempt transaction such as transactions by an issuer not involving any public offerings or a limited offering of its securities.[160] Nevertheless, even though these transactions are exempt, informational requirements and very strict restrictions on the resales of these securities are still imposed.[161] Resale restrictions may cause such limited offerings to be unattractive to United States investors. On April 30, 1990, the Securities and Exchange Commission adopted Rule 144A[162] which provided a non-exclusive safe harbor exemption from the registration requirements of the Securities Act for resales to eligible institutions of certain restricted securities.[163] The United States SEC views that Rule 144A would be the first step toward achieving a more liquid and efficient institutional resale market for unregistered securities.

Many third world countries[164] have recognized the significance and contribution of securities markets in economic development and has sought different measures to stimulate the development of their respective securities markets. These measures have been aimed at increasing the demand and supply for stocks. The level of demand and supply of stock, in turn, is influenced by a host of factors like the level of interest rates, levels of savings and investment, the public's confidence in stock markets and the general economy as a whole. As discussed, there are but a few conclusive theories and studies on the development of these emerging securities markets and how policies adopted by developing countries have contributed to the increase in supply and demand of

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[158]15 U.S.C. 77e.

[159]*Id.*, at 78a, *et. seq.*

[160]*Id.*, at 77d(2).

[161]*See* Regulation D, 17 CFR 230. 501-508.

[162]17 CFR 230.144A.

[163]SECURITIES ACT RELEASE NO. 33-6862 (April 30, 1990).

[164]Even the People's Republic of China, a non-market economy has shown interest in capital markets and has started to train financial analysts and even invited Wall Street experts, such as New York Stock Exchange's Chairman, John J. Phelan, Jr. to share information about how capital markets work in the United States. Stamos, *China's Nascent Securities Market: Some Observations*, 10 HARV. J. OF LAW AND PUB. POL. 691 (1981) *citing* Rustin, School at China's People's Bank Trains a New Generation of Financial Whiz Kids, WALL ST. J., Nov. 18, 1986 at 37, col. 2; Chinese Get Wall Street Guide to Capitalist Road, New York Times, Nov. 12, 1986, at 1, col. 4.

shares. Developing countries in adopting policies to develop their securities markets are sometimes faced with conflicting interests. For example, in granting tax incentives to investors to encourage their participation in the market governments are faced with a decision of whether to forego a source of revenue in favor of an increase in the activity in the stock market. In opening its stock markets to foreigners, would nationalist sentiments be antagonized? The benefits and costs of different alternatives may not be easily quantifiable.

There are available standards to measure the effects of a policy on the performance of a market. The IFC's Price Index and Total Returns Index may serve as barometers for policy makers to measure the effects of their policies. One indicator which may be of significance to test the efficacy of policies adopted is the increase in the number of new public offerings in the market after the introduction of a new policy. Performance of new offerings may also be measured by the increase in price-earnings ratio over a period of time. A problem, however, is that there may be extraneous factors which can not be isolated but which affect the performance of the market or a security.

Caution must be observed by governments in formulating policies to develop their securities markets. Greater caution must be employed in borrowing concepts or ideas from developed countries.

It is hoped that more research and empirical studies would be conducted on developing capital markets of developing countries by governments, by international agencies and by financial institutions like banks, investment houses, securities brokers and dealers.