Securities Laws Enforcement in Transition Economies

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Abstract

We argue that two key conditions for good enforcement in transition countries are *predictability* and *common sense* in the law enforcement authority. The case evidence from 28 transition countries suggests that certain trade-offs arise in the process of adopting international "best practices" in securities market regulations and their enforcement. We point towards the effect of society's risk tolerance on legal reform, the risks of introducing criminal liability for insider trading and market manipulation too early in transition, and the necessity to raise the securities market related knowledge of the courts and market participants.

JEL classification: G18, G3, G38, K22, O16, P51

1. Introduction

Enforcement has been a popular buzz-word ever since the earliest writings of law and finance literature (e.g. La Porta et al., 1997, 1998; Coffee, 1999; Pistor et al., 2000). Many meanings have been associated with this term. Often such concepts as regulation, rule of law, and institutional quality are used as synonyms for *enforcement*. In this paper, by enforcement we mean practical actions to implement the law (particularly, securities laws), while by regulation we mean the set of rules, codes and laws.

One of the goals of this paper is to define *good enforcement* in transition countries. Our research covers twenty eight Central and eastern European (CEE), South-eastern European (SEE) and Commonwealth of Independent States (CIS) countries. We argue that two key conditions for good enforcement are *predictability* and *common sense*. As regards predictability, the relevant laws for any involved party should be enforceable and market participants should be able to predict the outcome of the law enforcement process and price it respectively. This holds even if the provisions of the law are controversial, e.g. if they provide much higher powers for the controlling shareholders vis-à-vis minority shareholders, the law has to be followed because the controlling shareholder should be able to make the decisions using the rights provided in the law, and the minority shareholders respectively can put a price on the unfavorable condition, i.e. require higher return.

Common sense has to be the hallmark of the law enforcer who should not follow blindly the letter of law, but keep in mind that besides the literal interpretation of the law there are also other methods which aim to establish the purpose of the respective legal norm. This is especially important in cases where literal interpretation results in absurd outcomes which contradict common sense. By common sense we also mean that the law enforcer shall provide appropriate feedback to the law maker and foster the change of such law which by its implementation causes adverse effects to market participants.

To illustrate the point, take the following example. In some countries, at a cross-roads without traffic-lights the law requires drivers to follow the right-hand principle (i.e. you can go if there are no drivers approaching on your right side), while in other countries the law stipulates that the driver who arrives at the cross-roads the first, can go first. Somebody from the second law system standing at the cross-roads in a first law system country for five minutes waiting for the cars on his right to pass might think that this rule is bad. However, it is the *predictability* that everyone will follow this rule that avoids an accident. Now imagine a man arrives at the cross-roads first in a system where his obligation is to go first but then he explicitly lets a nice lady who arrived second to go ahead of him. *Common sense* tells the policeman standing near the cross-roads and seeing this not to fine the man since no one could be harmed.

The research resulted in eight lessons that give supportive arguments for the importance of *predictability* and *common sense* by the law enforcement authority. The methodology for our research was unstructured personal and email interviews with Supervisors[1] in transition countries and a review of their publications (e.g. annual reports). We have reached the conclusion that it is particularly difficult to quantify the quality of law enforcement as the requirements for enforcement are country specific thus rendering any enforcement ranking across countries meaningless, theoretically flawed and often misleading. The transition countries face their own challenges which are summarized in the following eight lessons.

First, the culture dimension, particularly the level of risk tolerance in the society, should be taken into account during legal reform. There exists a regulatory choice between stringent “best-practice” rules that when enforced appeal to investors but reduce the willingness of companies to go public, and less stringent rules that encourage companies to go public but may not appeal to investors with lower risk tolerance. Second, in the spirit of

Bhattacharya and Daouk (2005) we argue that good laws may have a negative short-term effect, because, for example, by establishing the law on insider trading the incidence of insider trading can increase as insiders who did not realize they could use company information for private gain learn about the concept and its potential “benefits”.

Third, if the courts are either incompetent or under undue influence, introducing criminal liability for securities-related abuses (e.g. insider trading and market manipulation) too early in transition can be harmful. The enactment of these laws may give a certain economic and political elite a very strong weapon to wield against those who would stand between them and their objectives. Fourth, self-regulation can play a substantial role in the time it takes the courts build the necessary competence to handle securities market cases. Fifth, the Supervisors face a choice between disclosing enforcement activities (including sanctions imposed) thereby disciplining market participants and increasing transparency, and not disclosing specific companies’ regulatory non-compliance for fear of creating anxiety, even panic among investors, thus leading to unwarranted economic harm to the companies. Sixth, there can be a need to protect *against* minority shareholders, thus reinforcing the importance of exercising common sense in cases where a minority shareholder exploits protectionary laws to the detriment of the controlling shareholder or other minority shareholders. Seventh, good law enforcement can foster efficient out-of-court settlements. Finally and probably most importantly, there is a strong need in transition economies to raise the professional capacity of the court system; one of the solutions being the introduction of designated financial markets courts presided over by judges having basic economic knowledge.

With this paper we attempt to contribute to the new comparative economics literature (surveyed by Djankov et al. (2003)) that deals with the positive and normative aspects of institutional diversity. By illustrating the trade-offs companies and regulators in transition countries face by adopting the international “best-practices”, we also contribute to the literature that illustrates the challenges with law transplantation (e.g. Berkowitz et al. (2003)).

Our paper is organized as follows. In Section 2, we provide some descriptive statistics about the securities markets, as well as discuss the legal reform process in the sample countries. Section 3 presents a brief overview of the law enforcement alternatives described in the previous literature and points towards the problems with measuring enforcement. The main law enforcement challenges facing the transition countries are described in detail in Section 4. We conclude in Section 5.

2. Securities markets in transition: 2005

Evidence shows that the three pillars of transition (democracy, economic reform, and legal reform) are highly inter-related. We can use the *GDP per capita* as a measure of economic development, the *Voice and accountability index* as a measure of democracy, and the *Rule of law index* as a measure of the progress in legal reform.[2] Table 1 shows these three variables for the twenty-eight transition countries. Indeed the correlations between these three pillars in transition countries are highly significant: between economic reform and democracy 0.76, between economic reform and legal reform 0.88, and between legal reform and democracy 0.94.

The transition countries can be classified into four subjective groups as shown in Table 1. The first group includes the eight new European Union (EU) members that joined in 2004. The second group includes three EU accession countries as of July 2006. The third group includes the countries which have reached full-fledged democracy but which are not (yet) on the EU accession path. And the fourth group includes the countries that continue to struggle with providing complete political rights and civil liberties to their citizens, with the extreme being dictatorships or authoritarian presidential rule. The border between the third and the fourth group is sometimes blurred. Particularly the placement of Albania, FYR Macedonia and Ukraine is not exactly clear. According to the *Freedom House* (2005) classification Ukraine is regarded as ‘free’, while according to the *Voice and accountability* index (2004) Ukraine scores much worse than Albania and FYR Macedonia.

Within each of these groups there are certain common patterns regarding the securities markets and law enforcement (see Table 2). Overall, the first three groups have reached a stock market capitalization as a percent of GDP of at least 10 percent in every country. The domestic credit to private sector (as per cent of GDP) is at least 20 percent (with the exception of Romania). The fourth group (the countries with limited democracy) either have no stock exchange or a limited stock exchange trading only in government bonds.[3] Only three of the fourteen countries in this group (Bosnia and Herzegovina, Russia, and Kazakhstan) can boast a market capitalization above USD 1 bn. The market capitalization in Bosnia and Herzegovina is enhanced by the forceful listing of privatized companies.[4] Russia stands out in this group with the highest market capitalization in the region (USD 228 bn), a high market capitalization as a percent of GDP (39 percent), and a high stock trading volume. The main dynamic driving these results is the huge increase in oil prices throughout 2004 and the ensuing increase in the value of oil and gas companies which dominate the Russian economy and stock market. Moreover, the market capitalization was to some extent determined by a political decision to privatize the largest companies through a mass privatization scheme (vouchers). In these fourth group countries, the domestic credit to private sector (as per cent of GDP) with a few exceptions is below 20 percent.

All the countries except two (Tajikistan and Turkmenistan have no stock exchanges) have established a Securities Market Supervisor (see Table 3) and can boast membership in the IOSCO, thus signaling a willingness to follow the best international practices in securities market regulation or cooperate with other Supervisors.

Evidence shows that the level of rule of law and the political regime type correlates with the level of stock market (and credit market) development. The correlations (not reported here) between the *voice and accountability index* and the *rule of law index* with the market capitalization as a percent of GDP and the domestic credit to private sector as a percent of GDP are highly significant (above 0.6). We can also argue that in the transition economies included in our study the political regime type determines the viability of securities laws and the quality of their enforcement. Presumably it is hard to talk about investor protection in securities markets where basic human rights are grossly violated, when fundamental investor protection laws are not yet in place, or when the authoritarian regime may break apart at any time as a result of a popular democratic uprising.

Returning to the four country groups described above and shown in Table 1, we can discern certain patterns of securities market law design and enforcement. The following observations were ascertained from the reading of the securities markets laws and the annual reports of the Supervisors in the sample countries. In the first group (the EU-8), the laws covering the national securities markets closely follow the minimum requirements set in the relevant EU directives.[5] Given that minimum EU requirements regarding, for example, a new security issuance prospectus or market abuse are rather elaborate, the national laws rarely impose additional requirements. The second group (EU accession countries) also continuously transpose the EU directives in their national laws and for the most part view compliance with EU legislation as one of their main regulatory objectives. In both groups, we can largely say that the laws on the books in these countries meet and, in some cases, even exceed the standards set by those in developed markets. Ensuring the implementation and ongoing enforcement of these laws is a major challenge facing the first and second group countries. As many of these laws are new and numerous concepts (e.g. insider trading and market manipulation) are novel to the court systems, the lack of case precedent is a common impediment.

Looking to the third and fourth groups, several of these countries experienced a remarkable increase in their stock trading volume, market capitalization and stock index value throughout 2004 and 2005 (e.g. Armenia, Bosnia and Herzegovina, and Kazakhstan). Investors understandably seem eager not to miss the train that may lead towards replicating the success of the Central and eastern European stock markets. These fledgling stock exchanges place compliance with international best practices as well as the continuous education of the public high on their agenda. Yet, many of these countries have only just introduced fundamental investor protection laws and will soon experience their first law enforcement issues. Overall, the present optimism towards future success of the stock exchanges of the transition economies belonging to the Federation of Euro-Asian Stock Exchanges is noticeable (FEAS, 2005) and they are the ones that can benefit the most by evaluating and analyzing the enforcement hurdles that the front-runners have already experienced.

3. Law enforcement alternatives

The enforcement of laws largely has to balance between two extremes. Particularly, it has to settle between the left wing (e.g. Stiglitz) emphasizing the role of state regulation and the right wing (e.g. Chicago School of Law and Economics) emphasizing the power of market self-regulation (*laissez-faire*). It has been argued that the inclination towards one or the other end of the scale depends on among other things a country's social capital endowment, legal origin, level of law and order, and the level of "inequality of weapons" held by different market participants (Glaeser and Shleifer, 2003; Shleifer, 2005).

A well-functioning enforcement system usually consists of numerous overlapping enforcement mechanisms ranging from private ordering via private law enforcement and government-enforced regulation to full government control (Djankov et al., 2003). We will illustrate the four basic strategies aimed at enforcing good conduct in the case of issuance of securities to the public (Glaeser and Shleifer, 2003). One must particularly emphasize that these strategies are parallel, not exclusive, and can coexist with each other.

First, under *market discipline* the market is free of public enforcers and relies on reputational incentives of the issuers themselves, or their underwriters, to disclose the truth about the securities. This approach could be especially applicable to transition countries with low law and order as, according to Glaeser and Shleifer, investors and companies operating in these countries could tend to resort to unlawful means to avoid prosecution or increase their chances in a court proceeding when faced with a high regulatory environment thus undermining the official legal process. In these countries there is also a risk of overzealous enforcement (i.e. 'show cases' by judges or politicians exerting undue influence over judges) and a severe problem of following the letter of the law on the books instead of interpreting and applying the substance of the law.

Second, the market can rely on *private litigation* in which buyers of securities can sue under the general doctrines of contract or tort when they feel they have been cheated.

Third, under *government regulation* the supervisory agency inspects the disclosures, penalizes those issuers and underwriters who fail to conform to securities regulations, and in some cases mandates further disclosures. An intermediate strategy is *private litigation using public rules*, e.g. the government or parliament can enact legislation specifying disclosures by an issuer but then rely on dissatisfied investors to sue, thereby encouraging regulatory compliance. The argument behind this approach is that it may be cheaper and easier for investors to establish through litigation a company's failure to reveal specific information whose disclosure was mandated by law, than to prove issuer negligence in the absence of such a law.

Finally, the government can nationalize all security issuance (*state ownership*).

Each of these enforcement mechanisms have their costs and benefits and tradeoffs exist. Private and public initiatives are often complements, rather than substitutes. The effectiveness of private enforcement mechanisms often depends on the success of public enforcement mechanisms, while public enforcement tends to lower the costs of private enforcement. Hay and Shleifer (1998) have claimed that "*public enforcement* is surely the ultimate goal of any legal reform", while more recently strong evidence suggests that laws facilitating *private enforcement* benefit stock markets (La Porta et al., 2006). This example illustrates that the debate over the effectiveness of private versus public enforcement mechanisms eventually has to be settled empirically.

In transition countries, large numbers of laws and regulations have been adopted over a very short time period. Courts and enforcement agencies struggle to keep pace with the rapid speed of regulatory transformation and ensuring the implementation and sustained enforcement of these laws is a challenge requiring backing from the political process. If political leadership is lackluster in its support for the advancement of securities laws and their enforcement, the results are often failed policies. Recently several attempts at reforming investor rights in Poland have been unsuccessful because strong opposition has overcome the efforts of a competent and well-regulated Securities and Exchange Commission weakened by the absence of staunch political support (Berglöf and Pajuste, 2005).

It has been argued that the first incidence of law enforcement (operationalized as the first successful or unsuccessful prosecution of insider trading) sends a positive signal to the market, much stronger than only the introduction of the law per se (Bhattacharya and

Daouk, 2002). In the case of securities markets law this first incident is still missing in many transition countries. This is due in part to the constant updating and revising of laws which further complicates the already difficult and extensive job of building court competence.

Pistor and Xu (2003) contend that laws are incomplete; therefore, it is crucial who holds the ultimate law making and law enforcement powers. The two extremes in law design are very detailed, bright-line rules (Black et al., 1996; Hay et al., 1996) versus broad concepts as in common law. Bright-line rules attempt to offer the enforcer clear-cut statutes that command or prohibit specific activities, spell out in detail obligations and rights of all parties, and are free from doubt or dispute. This eases the decision-making of the enforcer but leaves little to no room for interpretation of the law. Broad concepts, on the other hand, attempt to provide the enforcer with a set of guidelines open to interpretation. This allows the enforcer discretion. Pistor and Xu illustrate that regarding fiduciary duty neither of these extremes (such as the phrase "the care of a diligent trader" in Polish law nor the detailed rights and obligations of shareholders and directors laid out in Russian law) solves the problem. It is ultimately the capacity of the enforcer that will make the difference in implementing the substance of the law. Moreover, the enforcement is particularly challenging when the laws are transplanted from another country (Berkowitz et al., 2003). Glaeser et al. (2001) present a trade-off between enforcement by *judges*, which are more unbiased in their decisions but can be rather unmotivated to enforce the securities laws, and *supervisors*, which are more knowledgeable and motivated in enforcing the securities laws, but also can be over-motivated to find violations at the expense of doing justice.

In sum, previous literature has pointed towards the choice between laissez-faire and state regulation, between private law enforcement and public enforcement through the Supervisor and the courts. It has emphasized the importance of political will in prioritizing enforcement, the importance of experiencing the first precedent, the role of the enforcer in complicated legal enforcement cases, as well as the challenges of enforcement of transplanted laws.

How to measure enforcement?

Constructing measures to evaluate the laws on the books using some pre-determined "standards" is relatively easy; for example, there exists the *Anti-director rights index* (La Porta et al., 1998), the *Shareholder rights index* for transition countries (Pistor et al., 2000) or more recently the *Disclosure index* (La Porta et al., 2006). Each country's laws are simply examined with 'yes' or 'no' answers about the existence of a particular legal norm (e.g. one-share one-vote, cumulative voting, proxy by mail) and scored accordingly. Still this measurement is important as the quality of the laws on the books has been shown to have a positive effect on financial market development (La Porta et al., 1997; Pistor et al., 2000). However, the definition of a "standard" is, in many cases, still open to debate, in some instances even a transatlantic one.

As soon as the link between the legal system and economic health was established, the literature also began maintaining that enforcing a law actually has a stronger effect than just placing the law on the books (Coffee, 1999; Pistor et al., 2000). Also it appears that it is much easier to formulate (or transpose) good laws, than to make them actually work. Measuring enforcement (enforcement meaning how effectively the laws are upheld) is a much more challenging task than measuring the laws on the books. Attempts have been made to quantify enforcement, many of them not very successful. One of the most popular measures is generating different *rule of law* scores based on survey results or expert assessment.[6] Rule of law indices largely attempt to measure within a particular country the quality of contract enforcement, the effectiveness of the police and the courts, as well as the likelihood of crime and violence. This measure usually has a high correlation with democracy, the level of corruption, and the wealth of the country. Therefore, it is hard to establish causality, e.g. to argue that good enforcement has fostered economic development and not vice-versa. Instead, it appears that these two things reinforce each other.[7]

To quantify the enforcement of securities laws is arguably a difficult task. The EBRD effectiveness of financial regulations is one measure (covering banking and securities markets) obtained through expert assessments (see Table 4). Another measure, the *Public enforcement* index (La Porta et al., 2006) evaluates among other things the focus (depending on whether the securities market supervision is the sole activity of the Supervisor, or if it also supervises other markets, such as banking and insurance) and independence of the securities market Supervisor, the investigative powers (the right to command documents and subpoena the testimony of witnesses when investigating a violation of securities laws), and the availability of administrative and criminal sanctions. However, it should be noted that these assessments do not actually reveal anything about the Supervisor's enforcement activities, but only map its enforcement powers. Not surprisingly, La Porta et al. (2006) find that "no dimension of public enforcement consistently matters for the development of stock markets". Alternatively, one might measure the effectiveness of the Supervisor or court system by the number of cases (scaled by some size measure) initiated or resolved or the number of sanctions imposed. Unfortunately, this is also imperfect because, for example, if the Supervisor has played a pro-active role in educating the market participants and cooperating with them in improving compliance with the laws, the actual number of enforcement cases or sanctions will be lower but the eventual effectiveness of the laws higher. Moreover, the number of sanctions disregards the existence of out-of-court settlements due to predicted enforcement (as we show in Section 4).

A recent measurement attempt was the EBRD Legal Indicator Survey 2005, which took the perspective of a minority shareholder trying to determine if the controlling shareholder had abused its power and how a minority shareholder could obtain redress. Clearly the results of the survey provide valuable qualitative findings (Cigna and Enriques, 2006). Still, the quantitative measures of the effectiveness of corporate governance legislation (even within this limited case study scenario) give little guidance as to which countries might be taken as a role model; nor do they provide any relative assessment of the corporate governance law enforcement in these countries. For example, on a scale from 0 to 100 with 100 being the ideal score, the survey scores the simplicity of disclosure proceedings three times better in Russia than in Estonia (a score of around 82 versus 23) and Russia's enforceability of disclosure rulings rates more than two times higher than in Estonia (a score of around 65 versus 27). In practice, though, academic and professional literature abound with many "horror stories" about related party transactions in Russia (where this definition is so narrowly addressed that it is easy to follow the letter of the law but not the spirit of the law), in which investors have difficulties proving quite obvious related party transactions when there has been some breach of acceptable business practices (e.g. Vostok Nafta against Sibneft).[8] Meanwhile, there haven't been any major disputes regarding related party transactions in Estonia and its stock market is one of the most active (relative to the size of the economy) in the CEE. It just shows how subjective, with an unusually large margin of error, these expert assessments can sometimes be, which arguably makes them very difficult to use for academic purposes.

Likewise, the measures of how institutional environment affects corporate governance in transition countries also raise serious concerns. According to the EBRD Legal Indicator Survey 2005, the impartiality of Estonia's market Supervisor is 0 versus 30 in Belarus and 100 (ideal) in Georgia. Slovenia seems almost ideal in the competence of its courts, the possibility for the defendant to delay proceedings, and the availability and use of precedents; meanwhile, there have been only a few securities markets related cases, and in an interview, the Slovenian Supervisor and business representatives explicitly noted the problems with such cases in the courts (e.g. delays and lack of precedents). The same survey reports zero precedents in Georgia, but gives Georgia a score of 100 (ideal) in the use of precedents by lawyers.

The EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS) has made an effort in collecting comparative data for the transition countries. To date, three rounds of the survey have been conducted (in 1999, 2002, and 2005). The 2002 and 2005 surveys contain a panel component of about 1500 firms. Some of the many questions asked of companies attempt to measure contract enforceability. One question asks "*To what degree do you agree with this statement? "I am confident that the legal system will uphold my contract and property rights in business disputes"*". The respondent can choose from 'strongly disagree' (1) to 'strongly agree' (6). The results, however, show that the respondents most likely did not fully consider the question as the average score for all countries is between 3 and 4 (i.e. between 'tend to disagree' and 'tend to agree'). The fraction of respondents who agreed to this question (the scores from 4-6) in each country has been used as a measure of *enforcement* (Pistor et al., 2000), but the measure has shown no relation to the stock market development (in Pistor et al.) nor has it a significant correlation with any of the measures of rule of law, corruption, or stock market development (our calculations not reported here). Interestingly, the fraction of firms who agreed to the statement in Belarus has increased from 0.47 in 2002 to 0.69 in 2005 (placing the country in the third highest position after Estonia and Croatia both with 0.77). Notwithstanding the increase in dictatorial power, the companies in Belarus seem to be more confident about respect for contractual and property rights (or one might argue that they are just afraid to respond honestly). In summary, the survey data, despite the huge and repeated effort in collecting them, may tell rather little about the workings of a country's enforcement system.

Perhaps the best parties to evaluate the enforcement of laws in different countries are the investment funds actively investing in the regions and having experienced real cases. Even though their evaluations would arguably be subjective, at least they would provide a somewhat consistent measure. Unfortunately, we are not aware of any such rating for a substantial number of countries.

To summarize, several attempts to quantify enforcement have been made, but clearly more work needs to be done in collecting data, constructing indexes, and understanding how to appropriately interpret the gathered data. The experiences and qualitative information about enforcement of securities markets law in transition (and developed) countries should be systematically studied (that is what we try do in the next section). Eventually good enforcement involves a system that is able to implement the existing laws, provides predictability and certainty to market participants, and offers the flexibility necessary to adapt and shape the laws in accordance with the best interest of each particular society (as no countries are equal).

4. Enforcement challenges in transition countries

In transition countries, the requirements for enforcement are country specific. Therefore, we do not attempt to rank the sample countries, but rather to use the experience of the market Supervisors and stock exchanges in the eleven countries that have joined or soon will join the EU, to describe the enforcement challenges they currently face. The lessons learned could also be of importance to the newly emerging securities markets in early transition countries as well as other countries that face securities markets regulatory reform. First, we give a brief overview of the enforcement activities related to securities markets in the CEE, and then describe eight lessons learned that give supportive arguments for why we believe the two key conditions for good law enforcement in transition countries are providing a level of ‘predictability’ and using ‘common sense’ by the law enforcement authority.

Recent enforcement activities: the case of 11 transition countries

By the end of 2004, the securities market Supervisor was an independent agency in seven countries, while in four countries it was integrated into another agency that also supervises banks and insurance companies.[9] Table 5 shows whether or not the regulation and supervision of the securities market is separate from the banking and insurance market, as well as the Supervisor’s yearly budget and its number of employees in each country. Supervisors in Romania and Slovenia have the largest budgets as percent of GDP among the standalone Supervisors, while Hungary’s budget as percent of GDP is the highest among the countries with integrated Supervisors.

Table 5 also shows the number of enforcement activities related to the securities markets in 2004. The number of cases initiated ranges from 7 total cases in Latvia to 2620 cases just for non-compliance with annual report disclosure in Romania. The latter should by no means be taken as an efficiency measure. Rather the number of cases tends to skyrocket after introduction of some controversial or not well understood requirement in the legislation, but then will settle down as the regulated entities (with the help of the Supervisor) learn the rules of the game or occasionally the particular legal requirement (often transposed from some other legal system) is modified as not practicable for a particular country. In Slovenia a high number of non-compliance cases related to disclosure of compensation were found in the extracts of audited financial statements of public companies. The frequency of such cases had a marked effect on the Supervisor’s policy in

2005 and the applicable law was changed again in the beginning of 2006. The number of infractions is expected to be lower in 2006. Overall, this process can be largely described as an iterative fine-tuning of the regulation to fit the country's business environment.

Table 6 describes the recent non-compliance issues by country as reported by each country's Supervisor and Stock Exchange. Given that the market abuse directive (EU Directive 2003/6/EC of 28 January 2003) is freshly implemented in many of these countries, the focus on insider trading and market manipulation is not surprising. Another topical issue is information disclosure (in regular reports, as well as on a continuing basis). Previous empirical evidence has shown that there is quite a bit of deviation between the actual and required corporate governance disclosure in Central and eastern Europe and that the extent of this deviation differs substantially across firms and countries (Berglöf and Pajuste, 2005). Berglöf and Pajuste point out that for many firms in the CEE countries the direct costs of mandatory disclosure seem to outweigh the benefits of attracting minority investors and reducing the cost of external capital. Therefore, the issuers in these countries still remain to be convinced of the advantages of higher transparency.

Regulators in the CEE countries have implemented an overwhelming amount of international "best-practices" in securities market regulation introduced in the national laws over the last decade. Through examining these actual enforcement efforts we have come to eight lessons that we elaborate on below.

Lesson 1: Cultural dimensions should be taken into account

It is argued that extensive disclosure requirements and low burden of proof has a positive effect on stock market development (La Porta et al., 2006). La Porta et al. does not mention, however, that these two factors have a strong correlation with the country's cultural dimension, that is, social values. Particularly, we can see that countries with lower risk tolerance (i.e. high in Hofstede's uncertainty avoidance index) have much lower disclosure requirements and a higher burden of proof on the investor.[10] Among 46 countries from the La Porta et al. (2006) sample that have UAI scores available, the correlation between the UAI and disclosure index is -0.56 and between UAI and burden of proof index -0.35. The significant negative effect persists in a simple OLS regression controlling for the log of GDP per capita (not reported). Data tend to point towards evidence that the societies with low tolerance for uncertainty and ambiguity introduce less stringent rules for disclosure requirements of the issuing prospectus and have a higher burden of proof on the investor. This maybe because the companies (the demand side of capital) have more power to influence the law design than investors (the supply side of capital). Potential issuers may regard the requirement to disclose, for example, 'the terms of *all* material contracts made by the issuer outside the ordinary course of its business' as too risky. Such broad requirements leave the issuer very vulnerable to legal consequences even in cases where non-compliance with these requirements was not intentional. In the same spirit, low burden of proof on investors leaves the issuer vulnerable to legal consequences. In a society with high uncertainty avoidance such a high level of vulnerability towards the issuer may practically shut down the capital market as potential issuers can view the cost of going public too high. On the other hand, investors from societies with high uncertainty avoidance would want more stringent disclosure rules. Eventually, the law makers and Supervisors have to balance between the culture dimension effect on issuers and investors. A low risk tolerance country with a high presence of foreign investors (who have higher risk tolerance) may be tempted to avoid very stringent rules to appeal to domestic issuers. However, this strategy could be counterproductive and short-sighted, as under specific circumstances foreign investors could sue local companies (issuers) in foreign courts.

The cultural dimension also has its implications for law enforcers.[11] It certainly requires common sense in enacting certain laws, particularly the ones borrowed and adapted from other countries. Given that non-compliance with a certain legal norm could have deep roots in the social values of a particular country the law enforcer should carefully assess the reasons for resistance among market participants. In certain situations, as it has been argued before, the non-enforceability can actually be intentional (Berglöf and Pajuste, 2005).

From Table 7 we see that uncertainty avoidance among the transition countries with available scores is very high (on average about the same as for the French legal origin countries). The securities markets laws in these countries are becoming more and more stringent, therefore one should not be too confident that stock markets in transition countries will anytime soon play the major role for capital raising in these countries. For this to happen will probably require a change in the values rooted in these societies.[12] However, this does not mean these countries necessarily have problems finding financial resources. From the BEEPS (2005) study we see that access to finance is not regarded as an obstacle in, for example, Latvia where the stock market is very inactive; instead bank financing is easily obtainable and cheap (see Table 8).

In sum, the culture dimension introduces a regulatory choice between stringent "best-practice" rules that when enforced appeal to investors but reduce the willingness of companies to go public, and less stringent rules that encourage companies to go public but may not appeal to investors with lower risk tolerance, nor to local and foreign institutional investors who favor maximum transparency. Probably the first alternative is more appropriate and the transition countries should not be obsessed with "hitting the numbers" by striving to increase their stock market development measured by market capitalization to GDP or the number of listed firms at the cost of avoiding international "best-practice". The cultural dimension after all is very enduring, and the reluctance of companies to go public may persist and should be respected. Given the low tolerance for risk, the importance of predictability in enforcement activities thereby limiting uncertainty cannot be underestimated.

Lesson 2: Good laws may have adverse short-term effects

Bhattacharya and Daouk (2005) (BD) claim that there are situations when no law is better for the market than a good law that is not enforced, particularly taking the insider trading law as an example. We tend to agree with this argument from an intellectual point of view, but argue that this conclusion cannot be used for transition countries as a roadmap for reasons which we will explain. In short, good laws will need to be adopted anyway, even if it will take years for enforcement to catch up. BD claim that before introducing the insider trading law, everybody was doing it and therefore the prices were efficient. In transition countries, however, many insiders actually do not know what insider trading is. They do not realize that good news about the company will result in a higher stock price (how would they if they have never heard about efficient market theory?) nor do they have free cash to buy the company shares (and indeed in thin markets there may not be any correlation between disclosing (any) news and stock price development).

Also it is practically impossible to enforce the law immediately after its introduction. Very few countries experienced the first insider trading case soon after the law's introduction. For the US, it took 27 years; for Canada – 10 years. This is natural, as the enforcement agency needs to build experience with the particular issue and perhaps even adjust the law if it proves hard to implement in practice. Besides building experience, Supervisors in transition countries also have to educate market participants about the new concept. It would actually violate our *common sense* condition for good enforcement to start severely sanctioning market participants immediately following the introduction of the law. In Slovenia, for example, there have been cases where managers did not realize their actions are called 'illegal insider trading'. Consequently, the Slovenian Supervisor together with academia organized a seminar for the managers of the listed companies to talk about these issues.

Simply by establishing the law on insider trading the incidence of insider trading will often increase as insiders who did not realize they could use company information for private gain learn about the concept and learn to appreciate its potential “benefits”. So, shortly after the introduction of the law and before the Supervisor builds the competence to enforce it, there might well be a rise in the occurrences of insider trading. This is, however, an inevitable part of the process towards a better equilibrium in the future, and emphasizes the importance of law enforcement. If no law is better than a good law not enforced, and enforcement sometimes takes years to achieve, then, if we follow Bhattacharya and Daouk to the extreme, the best recipe for emerging markets is to do nothing. Such interpretation of the results, however, would be clearly flawed. The only way to have good laws is to adopt good laws. Making sure enforcement works is certainly necessary, but this cannot be achieved without having laws in the first place.

Lesson 3: Criminal liability for securities related offences should not be introduced too early

Many countries in Central and eastern Europe have introduced criminal liability for securities-related abuses, particularly insider trading and market manipulation. We argue that such liability should not be introduced too early in transition countries. Both concepts, as illustrated above, are novel and not well understood, neither by many of the market players nor by the courts. It can be argued that in a situation where judges are either incompetent or under undue influence, criminal liability for insider trading and market manipulation is actually dangerous as some influential market players, or other powerful economic actors could use their undue influence to ‘get rid’ of opponents and competitors.

Experts from Russia point out that it is not unusual to unlawfully engage police and other law enforcement agencies in corporate conflicts (Kochetygova and Shvyrkov, 2006).

In such situations three scenarios are possible: 1) the accused person is guilty and is convicted, 2) the person is guilty having done what everybody else is doing, but there are selective enforcement practices when, for example, prosecution of political opponents is prioritized, and 3) the person is not guilty, but the prosecution, following exertion of undue influence, is started anyway resulting in a personal upheaval for the accused even if the person may be found not guilty some years down the road. In our view, the criminal liability for securities markets abuses can be introduced only when the possibility of the third (and preferably the second) scenario is reduced to a minimum. Here again the condition of using common sense in the work of enforcement authorities – courts, Supervisors and the police - plays a crucial role.

Lesson 4: Self-regulation can play a substantial role

It has been argued that pure law transference usually does not work (Berkowitz et al., 2003). Instead, time must be taken to adjust the laws to the local conditions taking into consideration, among other things, the cultural dimension. Time is needed also for building the competence of the court system; therefore, legal reform should not be done in haste. In the interim, different self-regulation initiatives could fill the gaps in legislation.

Voluntary corporate governance codes (EU)[13] are a useful regulatory tool. Even though voluntary, codes still deliver specific messages concerning acceptable and ethical corporate behavior. Compliance with codes is often driven by concern over corporate image and often drives the development of greater discipline within the corporate governance structure. However, codes also serve a righteous purpose as they afford companies the opportunity to argue that certain corporate governance best practices are not reasonable (or even value destroying) in their particular case, therefore balancing the needs of the companies with the needs of the marketplace. The corporate image itself may serve as an effective deterrent against misusing the right to deviate from the best practices, while at the same time such deviation in certain instances can also be legitimized without incurring public sanctions.

Non-binding model laws with a flexible package of legislative provisions allow countries to benchmark their laws against the best practices, but at the same time take into account any regional specifics.[14] This demonstrates a gradual introduction of standards.

A corporate governance rating system is another alternative introduced, for example in Armenia (Stepanyan and Petrosyan, 2006) and the Baltic States (the Baltic Market Award initiative). The aim of the system is to improve the quality of financial disclosure and to increase the awareness of corporate governance principles while generally securing the implementation of these principles. Through the Baltic Market Award initiative the best companies are rewarded. All participating companies receive a detailed report of their scoring vis-à-vis other companies but only see their place in the rankings and the name of the winning company. They do not see the rankings of any other companies. In this way, the aim of the initiative is not to penalize the companies that do not follow the best practices but rather to praise the best and raise the awareness of the others.

Lesson 5: There is a trade-off between confidentiality and transparency

Transparency is a fundamental principle of western financial markets and quite often comprises the full disclosure of regulatory sanctions taken against companies or individuals. Many Supervisors in transition countries, though, are reluctant to adopt this practice for fear of creating anxiety, even panic among investors and instead only give overall market statistics concerning sanctions. In Slovenia, for example, the market Supervisor believes that disclosure of a company’s regulatory non-compliance can result in unwarranted economic harm to the company as uneasy investors sell off their interests and is also concerned that sanctioned companies may take retaliatory legal actions for publishing the information. However, some other transition countries do believe in the importance of transparent enforcement actions, although in every case that we are aware of where sanctions can be publicized, the Supervisors generally have the discretion whether to make sanctions public or not. For instance, in Estonia, “the FSA [Estonian Supervisor] has the right to publish its resolutions, including those imposing sanctions. Increased transparency ensures lawfulness of market activities and disciplines the participants.” (Estonian FSA Annual Report 2004).

Lesson 6: Sometimes there needs to be protection against minority shareholders

Another vital area of legislation introduced into the transition countries involves the protection of minority shareholders. While common sense dictates that laws are needed to protect the rights of the smaller shareholder against the more powerful majority shareholder, there are cases in which the minority abuses such legislation and damages the organization. Therefore, the focus of such legislation need not be solely on the protection of the minority, but on providing a balance in protecting all shareholders.

This trade-off has been pointed out already in Berglöf and Pajuste (2003). The research data and rich anecdotal evidence from transition countries suggest that strengthening minority protection is of paramount importance in combating fraud and bringing down financing costs. A main concern of this policy priority is that protection of minority incumbents during takeovers may discourage strategic investors and badly needed restructuring in these countries. The mandatory bid rule obliging owners acquiring large controlling stakes to make an offer to buy out remaining shareholders also forces firms to delist, undermining the sustainability of these fledgling stock markets. Here we present additional evidence by showing two illustrative examples where minority shareholders have possibly used their power to the detriment of the company or its dominant owner.

In Latvia, the law regarding the squeeze-out of minorities is quite strictly defined to aid in its enforcement. The law stipulates that an owner of more than 95 percent of a company's shares has the right to buy out minority shareholders and in that case has to pay the highest of three prices: the balance sheet value of the equity, the price at which the bidder acquired its equity stake, or the last quarter's average price on the stock exchange.

Swedish bank SEB acquired over 98 percent of shares in Latvia's Unibanka. As the law requires, SEB offered minority shareholders the highest of the three prices, the current balance sheet value of the equity. A foreign investment fund holding less than 0.5 percent of the Unibanka shares subsequently sued the market Supervisor for authorizing this offer; the complaint being that the equity's pricing, although priced according to the law, in the view of the minority shareholder was not fair. The shareholder argued that the shares in Unibanka were priced comparatively low as banks in neighboring countries were selling at a higher premium to the balance sheet value. SEB placed the mandatory squeeze-out bid in mid-2004 but more than two years later SEB has still not succeeded in taking the company private. The initial court decision upheld the Supervisor's approval of the offer. However, the investment fund appealed this decision and a second ruling on the case is due in late 2006, although the legal process, considering possible appeals, could take up to three more years. As a result SEB has had to follow the rules governing open joint stock companies rather than closed joint stock companies increasing the companies reporting duties and financial costs.

The squeeze-out requirements in Latvia have not changed since the introduction of this provision in the law; so in principle the fund managers should have been aware of this legal norm and priced it accordingly. The tactics applied by the minority shareholder possibly were to take advantage of the reputation of the majority shareholder to achieve a better squeeze-out price. Despite the fact that the majority shareholder has followed the law (which arguably is narrowly defined), the minority shareholder attempted to increase its personal gains (as well as the gains of other minority shareholders), meanwhile precluding the majority shareholder from exercising its legitimate right to take the company private.

Another example, borrowed from Pistor and Xu (2003), is from Germany. It is particularly of value as it illustrates that these issues are not only a phenomenon of transition countries. "When the Girmes Corporation became insolvent, a shareholder meeting was convened to decide on a 5:2 decrease in corporate capital. The editor of a shareholder rights journal obtained proxies from minority shareholders to block this decision, arguing that a ratio of 5:3 would still save the company while lessening the effects of dilution on minority shareholders. Because an agreement could not be reached, the refinancing arrangement failed and the company soon entered into bankruptcy proceedings. Shareholders voting with the majority sought damages for the loss of their stake in the corporation, arguing that if the change in corporate capital had been implemented, the company would not have been bankrupted." (Pistor and Xu, 2003, footnote 39). The court ruled that in this case the exercise of veto power by minority shareholders constituted a breach of their fiduciary duty vis-à-vis other shareholders.

Both cases support the contention that what must drive the protection of shareholders is predictability (the first example) and common sense (the second example) in the enforcement of securities laws. Whether a law is particularly good or bad, broad or narrow ultimately the enforcer's ability to provide a level of consistency in its enforcement will provide shareholders with a sense of stability. Likewise, exercising common sense in ruling on ambiguous cases helps to limit the uncertainty that investors avoid.

Lesson 7: Good enforcement can foster efficient out-of-court settlements

If parties have a high degree of certainty about how the court system will interpret and apply the law they can reach out-of-court settlements before going to court, or start a court process to signal the seriousness of their strategies, but later to opt for an out-of-court settlement. At least three cases in Latvia involving minority shareholders' claims have been satisfied in this way. In Latvia, there have been occasions in which controlling shareholders attempted to avoid the mandatory share buy-back from minority shareholders (the mandatory buy-back kicks in when a 50 percent ownership threshold is reached). Such avoidance usually occurred by splitting the shareholdings between seemingly unrelated parties. By the time the Supervisor ruled that those parties were indeed related, and a threshold of 50 percent was reached, the ownership structure of the company has normally changed again. However, the ruling of the Supervisor created legal grounds for minority shareholders to claim damages from the (former) majority shareholder. In practice, reverting to courts was the last option. These minority shareholders (e.g. "Neibergs&Partneri" vs. the controlling shareholders of "Ditton Nams" and BTB vs. the controlling shareholders of "Staburadze") have successfully used different legal tools provided by the law, some not even directly related to the mandatory buy-back (e.g. blocking the shares, freezing the bank accounts, nullifying the board decisions, etc.) to force controlling shareholders to settle their claims. In all these cases the courts were involved in the process but eventually the claims were withdrawn and settled privately.

In the Vostok Nafta Investments Ltd. case[15] the minority shareholder was able to "persuade" the majority shareholder to settle the claim only after resorting to foreign jurisdiction (the case eventually was resolved out-of court in the middle of the process; the managing director of Vostok Nafta announced on December 8, 2004: "Instead of staying on as minority shareholders in Megionneftegaz, we have made the decision to sell our shares. We got a favourable price and this is a deal that is clearly beneficial for our shareholders").

These cases demonstrate some of the various legal options available that allow minority shareholders to block the operations of the controlling shareholder and force restitution. They also make evident the need for common sense from the judiciary to distinguish between situations when minority shareholders are blocking controlling shareholders for viable reasons and situations where they are abusing their powers for their own gain and to the detriment of other shareholders. The empirical evidence shows that cases in which a controlling shareholder makes a judgement that continuing (or even starting) the court process with an uneasy minority shareholder is economically unreasonable tend to end with an out-of-court settlement. However, it also shows a malicious practice by controlling shareholders of employing different quibbles so as not to immediately compensate minority shareholders who have received a favourable ruling by the Supervisor; the minority shareholders only get restitution after having shown their teeth, which often means resorting to the legal option has become unavoidable. In this respect, corporate governance culture in transition countries has room for improvement.

Lesson 8: There is a strong need in all transition countries to raise the professional capacity of the court system

In law design, countries can choose between very detailed bright-line rules versus broad open-ended concepts. However, it has been shown that with such issues as fiduciary duty it is difficult to spell-out each and every detail required of the bright-line rules and therefore these duties generally require open-ended concepts. In these cases the effectiveness of a law and its enforcement is contingent on how a legal system assigns the right to determine the content and meaning of the conceptual law when future contingencies arise (Pistor and Xu, 2003). A legal system may allocate these powers to the courts or to Supervisors, or a combination of the two. Pistor and Xu argue that courts are optimal holders of law making and law enforcement power for the area of fiduciary duty.

Several Supervisors in transition countries pointed out that prosecutors and judges in their countries often do not yet have adequate knowledge about capital markets and are often not well-prepared to face complicated cases. The Supervisors also stressed that generally a case resolution is facilitated if the Supervisor has put significant effort into preparing a well-argued and elaborate description with clear reference to particular laws, although it may not result in a speedier legal process. In this respect, transition governments can play a significant role in raising the court competence and the Supervisors may facilitate establishment of a precedent. Several Supervisors have pointed to an explicit need for the establishment of designated financial market courts presided over by judges having basic economic knowledge. Slovenia has moved a step closer to this end by shifting certain first instance court functions within the scope of the Supervisor's authority.

As Glaeser et al. (2004) have argued, it is human capital that drives economic growth and increases the quality of institutions. Market economics cannot be learned overnight and it will take a generation to broadly spread basic economic knowledge throughout the transition societies. The empirical results in Glaeser et al. are derived from a sample with quite diverse human capital levels (measured by different education variables). The transition countries, on the contrary, are quite uniform on the basic human capital dimension as the literacy rates are very nearly 100% and the enrolment ratios are high. [16] In this respect, the transition countries have a high potential to add market knowledge to the general education and ultimately a high potential for growth as already shown by the remarkable development observed in the transition countries that have joined the EU.

5. Conclusions

Conventional procedures advocate the implementation of "best practices" in securities laws among transition countries. Specifically, laws concerning transparency, controlling market abuse, and protecting minority shareholders (long considered safeguards for investors in developed economies) have already been put in place in most countries vying for EU membership. The evidence illustrates certain trade-offs that arise in transition economies that directly adopt these regulatory procedures. We have pointed out several cases in which these “best practices” have caused harm to investors, thus emphasizing the point that legal reform should not be done in haste.

Admitting that evolution towards international “best practices” in securities laws is an inevitable process, we strongly argue that two key conditions for good enforcement in transition countries is *predictability* and *common sense* in the implementation of securities laws. The cases observed in transition countries have shown that irrespective of whether the law is particularly good or not, broad or narrow, it is ultimately the enforcer’s ability to provide a level of consistency in its enforcement which will provide investors and companies with a sense of stability. Likewise, exercising common sense in ruling on ambiguous cases helps to limit the uncertainty that investors avoid.

Evidence indicates that the role of the market Supervisor within the transition countries is very strong as it should be. To date private enforcement is not a well-developed option as the judiciary lacks knowledge and familiarity with securities law and private investors are small and lack adequate resources. Certainly what need to be facilitated are designated financial market courts with appropriate expertise in resolving financial market disputes. The current court systems have little case precedent for securities law and are often unfamiliar with the legal requirements of a market system; that is where the market Supervisor can play a crucial role in setting the precedents.

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Table 1: Democracy, economic development and legal reform

Country	GDP per capita (in current international USD PPP) (2004)	Population in mln (2004)	Voice and Account-ability (2004)	Rule of law (2004)	Freedom House classification (2005)	TI Corruption perception index (2005)
Czech Republic	19 311	10.2	1.03	0.69	Free	4.3
Estonia	13 740	1.4	1.13	0.91	Free	6.4
Hungary	16 596	10.1	1.16	0.85	Free	5
Latvia	11 962	2.3	0.96	0.48	Free	4.2
Lithuania	12 994	3.4	0.97	0.60	Free	4.8
Poland	12 876	38.2	1.13	0.51	Free	3.4
Slovak Republic	14 549	5.4	1.10	0.49	Free	4.3
Slovenia	20 853	2.0	1.12	0.93	Free	6.1
Bulgaria	8 026	7.8	0.58	0.05	Free	4
Croatia	12 336	4.4	0.46	0.07	Free	3.4
Romania	8 413	21.7	0.36	-0.18	Free	3
Montenegro	3 800	0.6	0.12	-0.72	Free	2.8
Serbia	4 400	8.3	0.12	-0.72	Free	2.8
Ukraine	6 414	47.3	-0.62	-0.83	Free	2.6
Albania	4 929	3.2	0.03	-0.80	Partly	2.4
FYR Macedonia	6 767	2.0	-0.02	-0.44	Partly	2.7
Georgia	2 914	4.6	-0.34	-0.87	Partly	2.3
Bosnia and Herzegovina	7 168	3.8	-0.14	-0.76	Partly	2.9
Moldova	2 170	3.4	-0.47	-0.65	Partly	2.9
Kyrgyz Republic	1 931	5.1	-1.06	-1.04	Partly	2.3
Armenia	4 006	3.2	-0.66	-0.58	Partly	2.9
Azerbaijan	4 185	8.3	-0.97	-0.85	Not	2.2
Tajikistan	1 181	6.5	-1.12	-1.18	Not	2.1
Russia	9 721	144.9	-0.81	-0.70	Not	2.4
Kazakhstan	7 436	15.1	-1.21	-0.98	Not	2.6
Belarus	6 894	9.8	-1.54	-1.31	Not	2.6
Turkmenistan	5 326	6.5	-1.90	-1.43	Not	1.7
Uzbekistan	1 867	26.0	-1.75	-1.30	Not	2.2

GDP per capita in current international USD (PPP) and population (in millions) as of 2004 is from the EBRD Transition Report 2005. The *Voice and accountability* index is a measure of political, civil and human rights with higher scores indicating higher democracy; the *Rule of law* index is a measure of the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence with a higher score indicating more law and order (both measures are aggregates from different sources summarized by Kaufmann et al. (2005)). The *FreedomHouse classification* is a measure of freedom done by the Freedom House based on an assessment of a country's political rights and civil liberties (downloaded from http://www.freedomhouse.org). The *Corruption perception index* (on a scale from 0 to 10) ranks countries by their perceived levels of corruption, as determined by expert assessments and opinion surveys with a higher score indicating lower perceived levels of corruption (downloaded from http://transparency.org/policy_research/surveys_indices/cpi). The first eight countries are the new members of the European Union (EU) since May 2004, the second three countries are the EU accession countries (as of July 2006), the third group of three countries are classified as *free* by the Freedom House but are not EU accession countries, and the fourth group of fourteen countries are regarded as *party free* or *not free* by the Freedom House as of 2005.

Table 2: Development of capital markets

Country	Number of companies listed, end 2004	Market capitalisation mln USD, end 2004	Stock market capitalisation (in per cent of GDP), end 2004	Stock trading volume in 2004 (mln USD)	Stock trading volume (in per cent of market capitalisation), 2004	Domestic credit to private sector (in per cent of GDP), 2004
Czech Republic	120	26 891	25	20 167	75	27
Estonia	13	6 292	54	896	14	43
Hungary	49	28 300	28	13 005	46	46
Latvia	39	2 568	19	119	5	50
Lithuania	43	6 423	29	424	7	25
Poland	230	71 547	30	16 269	23	23
Slovak Republic	302	3 919	10	750	19	26
Slovenia	140	9 677	30	1 479	15	48
Bulgaria	332	2 801	12	572	20	23
Croatia	241	10 952	32	439	4	52
Romania	4058	11 938	16	747	6	10
Montenegro	211	313	13	21	7	.
Serbia	406	3 281	15	435	13	.
Ukraine	80	11 664	18	.	3	.
Albania	0	0	0	0	.	6
FYR Macedonia	146	413	8	86	21	18
Georgia	277	206	4	25	12	10
Bosnia and Herzegovina	1132	3 691	45	174	5	19
Moldova	1075	574	22	55	10	21
Kyrgyz Republic	240	34	2	54	159	3
Armenia	196	18	1	2	11	7
Azerbaijan	47	0	0	22	.	5
Tajikistan	0	0	0	0	.	11
Russia	229	228 095	39	118 688	52	25
Kazakhstan	68	3 941	10	1 181	30	23
Belarus	.	425	2	0	0	9
Turkmenistan	0	0	0	0	.	3
Uzbekistan	145	4	0	40	930	0

The numbers of companies listed are taken from three sources: World Federation of Exchanges, the Federation of Euro-Asian stock exchanges, and the home-pages of national stock exchanges. All the other variables are taken from the EBRD Transition Report 2005. These numbers are approximate as methods of measurement tend to differ from source to source.

Table 3: Stock exchanges and securities market Supervisors

Country	Stock Exchanges (membership)	Supervisor (membership)
Albania	Tirana Stock Exchange (FEAS). *No shares listed.*	Albanian Securities Commission (IOSCO).
Armenia	Armenian Stock Exchange (FEAS, IACISE).	Central Bank of Armenia Department of Securities Market (IOSCO).
Azerbaijan	Baku Stock Exchange (FEAS, IACISE). *Share trading minimal*.	State Committee for Securities.
Belarus	Belarusian Currency and Stock Exchange (IACISE). *Share trading minimal*.	National Bank of the Republic of Belarus.
Bosnia and Herzegovina	1. Banja Luka Stock Exchange (FEAS). 2. Sarajevo Stock Exchange (FEAS).	1. Republic of Srpska Securities Commission (IOSCO). 2. Securities Commission of the Federation of Bosnia and Herzegovina (IOSCO). *No English website*.
Bulgaria	Bulgarian Stock Exchange (FEAS).	Financial Supervision Commission (IOSCO).
Croatia	1. Zagreb Stock Exchange (FEAS). 2. Varazdin Stock Exchange.	Croatian Agency for Supervision of Financial Services (IOSCO).
Czech Republic	1. Prague Stock Exchange (WFE correspondent). 2. RM-System.	Czech National Bank (CESR, IOSCO).
Estonia	OMX Tallinn (WFE).	Financial Supervision Authority (CESR, IOSCO).
Georgia	Georgian Stock Exchange (FEAS).	National Securities Commission. *No English website*.
Hungary	Budapest Stock Exchange (WFE).	Hungarian Financial Supervisory Authority (CESR, IOSCO).
Kazakhstan	Kazakhstan Stock Exchange (FEAS, IACISE). *Share trading minimal.*	Agency on Regulation and Supervision of the Financial Market and Financial Organizations (IOSCO).
Kyrgyz Republic	Kyrgyz Stock Exchange (FEAS, IACISE).	State Agency for Financial Surveillance and Accounting (IOSCO). *No English website.*
Latvia	OMX Riga (WFE).	Financial and Capital Market Commission (CESR).
Lithuania	OMX Vilnius (WFE).	Lithuanian Securities Commission (CESR, IOSCO).
FYR Macedonia	Macedonian Stock Exchange (FEAS).	Securities and Exchange Commission (IOSCO).
Moldova	Moldovan Stock Exchange (FEAS).	National Securities Commission.
Montenegro	1. Montenegro Stock Exchange (FEAS). 2. New Securities Exchange Montenegro.	Montenegro Securities Commission (IOSCO).
Poland	Warsaw Stock Exchange (WFE).	Polish Securities and Exchange Commission (CESR, IOSCO).
Romania	Bucharest Stock Exchange (FEAS).	National Securities Commission (IOSCO).
Russia	1. MICEX – the largest (WFE, IACISE). 2. RTS Stock Exchange (WFE). 3. Saint Petersburg Stock Exchange. 4. Moscow Stock Exchange.	Federal Service for Financial Markets of Russia (IOSCO).
Serbia	Belgrade Stock Exchange (FEAS).	Securities Commission (IOSCO). *No English website.*
Slovak Republic	Bratislava Stock Exchange (WFE correspondent). *Share trading minimal.*	National Bank of Slovakia (CESR, IOSCO).
Slovenia	Ljubljana Stock Exchange (WFE).	Securities Commission (CESR, IOSCO). *No English website.*
Tajikistan	*No stock exchange.*	.
Turkmenistan	*No stock exchange.*	.
Ukraine	1. PFTS Ukraine Stock Exchange – the largest. 2. Ukrainian Stock Exchange (FEAS).	Securities and Exchange Commission (IOSCO). *No English website.*
Uzbekistan	Republican Stock Exchange "Tashkent" (FEAS, IACISE).	The Center on Coordination and Control of Functioning of the Securities Market (IOSCO).

Table shows the name(s) of the national stock exchange(s) in each country, and the name of the national authority responsible for the regulation and supervision of the securities market with their membership in international networks (in parenthesis). FEAS is the Federation of Euro-Asian Stock Exchanges. IACISE is the International Association of Exchanges of the CIS countries. WFE is the World Federation of Exchanges. IOSCO is the International Organization of Securities Commissions. CESR is the Committee of European Securities Regulators.

Table 4: EBRD Legal transition indicators

Country	Financial regulations extensiveness (the laws on the books) in 2002[1]	Financial regulations effectiveness (enforcement) in 2002
Czech Republic	3.3	3.0
Estonia	4.0	3.3
Hungary	3.3	3.7
Latvia	4.0	3.7
Lithuania	3.7	3.0
Poland	3.7	3.3
Slovak Republic	3.0	2.3
Slovenia	3.3	3.0
Bulgaria	3.0	3.0
Croatia	3.0	1.7
Romania	3.7	3.0
Montenegro	2.0	1.7
Serbia	2.0	1.7
Ukraine	3.0	2.0
Albania	2.0	1.0
FYR Macedonia	2.7	2.7
Georgia	3.3	2.0
Bosnia and Herzegovina	1.0	1.0
Moldova	3.7	2.7
Kyrgyz Republic	2.0	1.0
Armenia	3.3	2.0
Azerbaijan	1.0	1.0
Tajikistan	3.3	1.7
Russia	2.7	2.7
Kazakhstan	3.0	2.7
Belarus	2.0	2.0
Turkmenistan	.	.
Uzbekistan	2.0	1.7

The extensiveness and the effectiveness of the financial regulations represent the perceptions of lawyers and other experts familiar with the region. Extensiveness assesses whether the banking and capital market legal rules approach minimum international standards, such as the Basel Committee on Banking Supervision's Core Principles or the Objectives and Principles of Securities Regulation developed by the International Organization of Securities Commissions (IOSCO). Effectiveness of legal reform measures the degree to which financial legal rules are clear, accessible and adequately implemented, both administratively and judicially. The variables range from 1, 1+, 2-… to 4-, 4, 4+. The numbers in this table are constructed as follows: eg 3+ is 3.3, 4- is 3.7, and round numbers remain intact. *Source:* EBRD Transition report (2002).

[1] As of mid 2006, these are the latest available EBRD financial regulations effectiveness and extensiveness indicators.

Table 5: Enforcement activities in securities markets

Country	Securities market related *enforcement* activities by the Supervisor in 2004	Supervisor is a separate agency (as opposed to consolidated Supervisor) (end 2004)[2]	Budget expenses ('000 EUR) in 2004[3] as percent of GDP (in brackets, $x10^{-3}$)	Number of employees (end 2004)[4]
Croatia	91 court decisions including 14 high misdemeanour court decisions imposing pecuniary sanctions	Yes[5]	810 (0.03)	25
Czech Republic	117 administrative proceedings initiated 97 cases (mainly from preceding years) resolved by imposition of sanctions	Yes[6]	3,900 (0.05)	133
Lithuania	18 cases initiated by the Supervisor 17 cases resolved by imposition of sanctions 1 lawsuit started related to public company	Yes	973[7] (0.05)	46
Poland	44 administrative proceedings initiated 18 cases resolved by imposition of sanctions 17 cases where Supervisor acted as a subsidiary prosecutor 44 notifications sent to the public prosecutor 14 prosecution acts forwarded to the courts 5 penal sanctions	Yes	5,519 (0.03)	178
Romania	2620 issuers (on RASDAQ) sanctioned for not complying with annual report disclosure requirements 764 resolutions appealed	Yes	5,500 (0.10)	200
Slovakia	490 inquires initiated by general public and supervised entities 48 cases resolved by imposition of sanctions 11 notifications sent to the public prosecutor	Yes[8]	na	34
Slovenia	22 orders issued to the issuers	Yes	2,300 (0.10)	37
Bulgaria	183 statements ascertaining administrative violation related to securities issuers	No	2,003 (0.11)	215
Estonia	43 cases initiated 3 cases resolved by imposition of sanctions 1 complaint received	No	2,399 (0.27)	69
Hungary	14 cases resolved by imposition of fines 117 complaints received	No	30,880 (0.41)	547
Latvia	7 cases initiated 4 cases resolved by imposition of sanctions 1 notification sent to the public prosecutor 12 complaints received	No	3,398 (0.34)	87

[2] "Separate" means that the securities market Supervisor is separate from banking sector and insurance sector supervisors.
[3] For consolidated Supervisors, the total budget of the agency is reported.
[4] For consolidated Supervisors, the total number of employees of the agency is reported.
[5] Until November 2005, afterwards not a separate agency.
[6] Until March 2006, afterwards not a separate agency.
[7] Information from 2005.
[8] Until January 2006, afterwards not a separate agency.

Table 6: Recent law non-compliance issues related to securities markets

Country	Recent non-compliance issues
Bulgaria[9]	The most typical non-compliance cases regarding the supervision of the public companies and the issuers of securities are the violations of the current and subsequent disclosure of information.
Croatia	*No response.*
Czech Republic[10]	Market manipulation, insider trading, market transparency, client treatment principles. Providing of investment services without a license. Failure to make a mandatory take-over bid. Failure to announce acquiring of certain volume of voting rights.
Estonia[11]	Failure to disclose material information. Lately broader discussions with issuers have arisen due to insufficient details (e.g. comparison data) in the interim financial reports. One of the priorities is the deepening of securities market abuse supervision, especially focusing on market manipulation.
Hungary[12]	Market influence (transaction concluded at an out-of-market price); insider buying during a forbidden period; failure to announce the change in ownership stake. Firms and companies providing unlicensed investment and/or financial services. Several insider dealing investigations and about the same number of manipulation cases occurred.
Latvia	Companies previously listed on the unofficial market had to decide whether to stay public (and comply with official market requirements) or to go private (and the shareholders who voted for going private had to buy out shares from the shareholders who wished to stay public). The main recent non-compliance relates to this legal norm, i.e. companies failing to decide on staying public or going private, as well as the failure to disclose material information, and the failure to make a mandatory share buy-out offer in cases where a shareholder has acquired over 50 percent of the voting shares.
Lithuania[13]	Failure to provide the periodic information stipulated by legal acts or the auditor's report, failure to comply with the regulations governing the accounting of securities, and failure to comply with the requirements governing internal control. Recently more attention is paid to the activities of pension accumulation companies.
Poland[14]	Insider trading and market manipulation. After recent changes in law, a broader range of financial instruments is restricted to licensed brokerage houses only. As a result, there have been cases of conducting brokerage activity without a license.
Romania[15]	Non-compliance with reporting requirements as stipulated under the legal framework. Non-compliance cases related to the documents used by investment firms in relation with clients. Market manipulation and insider trading.
Slovakia[16]	Failure to submit a mid-year, annual and ongoing information report to the Supervisor. Market manipulation and insider trading.
Slovenia[17]	Due to change in legislation in force from August 2004 and which affected the Agency's supervision in 2005 for 2004, there has been a higher number of non- compliance cases related to disclosure of compensation in the extracts of audited annual financial statements of public companies. However since the law changed again in the beginning of 2006 it is expected that this figure is much lower for supervision in 2006 for audited annual reports from 2005.

[9] Contribution by Dimitar Zhilev (FSC).
[10] Contribution by Jitka Drizhalova (PSE) and Hana Senkova (CNB).
[11] Contribution by Ingrid Arumagi (FSA) and Kalle Viks (OMX Tallinn).
[12] Contribution by Peter Janoska (BSE) and Toth Janos (PSZAF).
[13] Contribution by Jovita Sutkute (VPK) and Gediminas Varnas (OMX Vilnius).
[14] Contribution by Lukasz Dajnowicz (KPWIG).
[15] Contribution by Cristina Dumitrescu (CNVM).
[16] Contribution by Sona Chuda (NBS).
[17] Contribution by Sabina Bester (ATVP).

Table 7: Uncertainty avoidance (Hofstede)

	Number of countries	Average Uncertainty Avoidance Index (UAI)	Median Uncertainty Avoidance Index (UAI)
English legal origin countries	16	47	49
French legal origin countries	20	80	84
German legal origin countries	6	73	70
Scandinavian legal origin countries	4	40	40
China		30	
Bulgaria		85	
Czech Republic		74	
Estonia		60	
Hungary		82	
Poland		93	
Romania		90	
Russia		95	
Slovak Republic		51	
Transition countries	8	79	84

The table shows Hofstede's uncertainty avoidance index (UAI) by legal origin and by transition country. The legal origin classification comes from La Porta et al. (1998). The countries for average scores are the same as in La Porta et al. except Jordan, Sri Lanka, and Zimbabwe, for which UAIs are not available. The eight transition countries are the only ones with available UAI scores. The Uncertainty Avoidance Index (UAI) focuses on the level of tolerance for uncertainty and ambiguity within a society, i.e. unstructured situations. A High Uncertainty Avoidance ranking indicates the country has a low tolerance for uncertainty and ambiguity. A Low Uncertainty Avoidance ranking indicates the country has less concern about ambiguity and uncertainty and has more tolerance for a variety of opinions. This society more readily accepts change, and takes more and greater risks. Source: http://www.geert-hofstede.com/.

Table 8: Access and cost of financing (BEEPS)

	Ease of access to financing			Cost of financing			Loan rate	
Country	2005	2002	1999	2005	2002	1999	2005	2002
Czech Republic	2.46	2.45	3.09	2.62	2.53	2.87	9.8	10.3
Estonia	1.66	1.94	2.52	1.72	2.01	3.05	6.7	9.4
Hungary	2.44	2.22	2.62	2.67	2.31	2.91	13.1	12.5
Latvia	1.64	1.85	2.74	1.88	2.01	2.96	7.0	10.2
Lithuania	1.64	1.62	2.89	1.91	1.99	3.32	5.9	9.5
Poland	2.75	2.65	2.37	3.04	3.17	3.36	12.7	14.9
Slovakia	1.67	2.50	3.32	1.85	2.58	3.43	7.8	11.8
Slovenia	1.94	1.82	2.29	2.08	2.20	3.25	6.3	9.2
Bulgaria	2.05	2.80	3.08	2.46	2.88	2.69	11.1	13.9
Croatia	1.99	2.18	3.29	2.23	2.27	3.71	7.6	10.2
Romania	2.42	2.55	3.29	2.55	2.80	3.79	17.9	36.8
Serbia and Montenegro	2.80	2.43	.	3.12	2.78	.	13.3	20.4
Ukraine	2.31	2.44	3.38	2.76	2.62	3.57	20.5	25.5
Albania	2.18	2.07	2.82	2.53	2.59	3.10	9.8	12.0
Armenia	2.50	2.34	2.64	2.64	2.52	2.76	15.1	19.7
Azerbaijan	2.17	2.16	2.77	2.28	2.20	3.11	14.6	20.5
Belarus	2.46	2.47	3.25	2.40	2.78	3.26	17.3	56.1
Bosnia and Herzegovina	2.41	2.53	3.20	2.79	2.79	3.66	10.0	11.6
FYROM	2.45	2.08	2.94	2.74	2.38	3.65	11.2	11.3
Georgia	2.29	2.21	3.25	2.46	2.53	3.57	18.5	21.7
Kazakhstan	1.97	2.00	3.01	2.39	2.16	3.27	15.9	19.7
Kyrgyz Rep.	2.07	2.24	3.42	2.58	2.40	3.78	18.8	31.1
Moldova	2.43	2.49	3.42	2.80	2.95	3.68	20.6	23.8
Russia	2.03	2.31	3.18	2.35	2.24	3.28	17.5	23.2
Tajikistan	1.88	2.62	.	1.96	2.69	.	24.4	25.9
Uzbekistan	1.96	2.45	2.75	2.06	2.40	2.94	22.9	29.4
Total average	2.26	2.33	3.00	2.51	2.53	3.30	14.1	19.2

For 2002 and 2005, the *ease of access to financing* and *the cost of financing* shows the average score (across companies that answered the question) in each country on how companies evaluated how problematic is access to financing (Q.54a in 2005 and Q.80a in 2002) and the cost of financing (Q.54b in 2005 and Q.80b in 2002) respectively, for the operation and growth of their business. The scores are: 1 (no obstacle), 2 (minor obstacle), 3 (moderate obstacle), and 4 (major obstacle). For 1999, the questions were different; here the answer to the question whether lack of access to long-term bank loans is a problem (Q.41, c33) is taken as a comparative for access to financing, and the answer to the question whether high interest rates are a problem (Q.41, c24) is taken as a comparative for the cost of financing. The loan rate shows the average of companies' answer on the question *"What is the loan's annual cost (i.e., rate of interest)?"* in each country (Q46d in 2005 and Q.65d in 2002).
Source: EBRD/ World Bank Business Environment and Enterprise Performance Survey (BEEPS) from 1999, 2002 and 2005.

[1] As in La Porta et al. (2006), we define the *Supervisor* as the main government agency in charge of supervising stock exchanges. We do not look at prudential supervision in this paper, but limit ourselves to only market conduct supervision.

[2] *GDP per capita* in 2004 is at current international USD (PPP) from EBRD Transition Report 2005; the *Voice and accountability index* in 2004 and the *Rule of law index* in 2004 are from Kaufmann et al. (2005).

[3] See Table 3 for a list of stock exchanges in each country.

[4] This is similar to the evidence from the Czech Republic, Slovakia and Lithuanian that showed high number of (forcefully) listed securities early after privatisation and then a sharp wave of delistings by the companies that did not fit the public company status (see Berglöf and Pajuste (2003) for details).

[5] For example, the EU Directive 2003/6/EC of 28 January 2003 on insider dealing and market manipulation (Market abuse Directive), and the EU Directive 2003/71/EC of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading (Prospectus Directive).

[6] Rule of law ratings have been published by ICRG, Central European Economic Review, and Kaufmann et al. (2005), which aggregate different data sources to arrive at the rule of law rating.

[7] Another rather appealing approach contends that ultimately it is human capital that fosters growth, improves institutions, and enhances law enforcement (Glaeser et al., 2004).

[8] Vostok Nafta Investments Ltd (VN) in 2004 was a minority shareholder in the Russian oil company Megionneftegaz. VN's investigations showed that three Cypriot companies that voted "for" all related party transactions (selling oil to related parties) were ultimately owned and controlled by the majority shareholder (Sibneft). The courts in Russia dismissed the case several times for different reasons. Only after VN filed a claim against Sibneft in the British Virgin Islands, and the court dismissed Sibneft's application for hearing the case in Russia instead, did VN manage to settle with the controlling shareholder and sell their stake for a favourable price. Source: http://www.vostoknafta.com/eng/index.html different press releases in 2004.

[9] In Bulgaria, the securities market Supervisor is under one umbrella with the insurance market, but the banking supervision is separate.

[10] Uncertainty Avoidance Index (UAI) focuses on the level of tolerance for uncertainty and ambiguity within the society, i.e. unstructured situations. A High Uncertainty Avoidance ranking indicates the country has a low tolerance for uncertainty and ambiguity. A Low Uncertainty Avoidance ranking indicates the country has

less concern about ambiguity and uncertainty and has more tolerance for a variety of opinions. This society more readily accepts change, and takes more and greater risks. Source: http://www.geert-hofstede.com/.

[11] We are not the first to point towards the link between culture (or more specifically, social capital) and economics. Such link has been recently documented by eg Guiso et al. (2004, 2005).

[12] Also on a small sample of OECD countries it has been shown that stock markets are relatively more important in countries where inhabitants accept more uncertainty (low UAI) and regard competition as a good way of interacting (De Jong and Semenov, 2002).

[13] A good overview of corporate governance codes in European (particularly, transition) countries is presented by Wymeersch (2006).

[14] For example, two model laws approved by the Inter-parliamentary Assembly of the Commonwealth of Independent States (CIS) are the Model Securities Markets Law (approved in November 2001) and the Model Law on the Protection of Investor Rights in Securities Markets (approved in April 2005). See Zverev (2006) for details.

[15] See footnote 8 for more details.

[16] From the UNDP Human Development Report 2003, we see that the average combined primary, secondary and tertiary gross enrolment ratio in our sample countries is 76%, ranging from 60% in Armenia to 89% in Estonia. This is compared with the world-average of 64%, the OECD average of 87%, and the developing country average of 60%.