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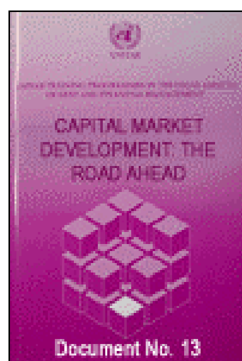
# CAPITAL MARKET DEVELOPMENT: THE ROAD AHEAD

**Papers written following a UNITAR Sub-Regional Workshop on Capital Market Development for West Africa (Accra-Ghana, 10 to 14 April 2000)**

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## INTRODUCTION

This paper presents a synthesis of presentations and discussions at a Joint UNITAR/ WAIFEM Sub-Regional Workshop on Capital Market Development for West African Nations (Accra, Ghana, 10-14 April 2000). The workshop drew on the expertise of resource persons from the U.S.A, Poland and Nigeria. As part of this initiative UNITAR had the privilege of collaborating with the West African Institute for Financial and Economic Management (WAIFEM, Lagos), for which it is grateful.

This workshop was addressed to 25 senior and middle-level participants from The Gambia, Ghana, Nigeria and Sierra Leone. Participants were targeted as those who formulate policy and play important roles in the development of the Capital and Securities Markets within their respective countries.

One of the significant areas of underdevelopment in finanical management in developing countries is domestic capital market issues. In most developed countries the domestic capital market is regarded as an important source of funding by the state and has many advantages over the use of foreign sources of debt financing. UNITAR's workshop on Capital Market Development dealt with enhancing primary and secondary market participation in African economies. Major concerns, issues and policy questions as well as the fundamental factors necessary for a successful capital market were always kept in the forefront of discussions during this five-day workshop.

The objective of the workshop was to expose participants to the nature, structure and functions of Capital Market Development as well as the legal and regulatory framework for effective participation in primary and secondary markets . The workshop also focused on the pivotal role of Capital Markets in fostering economic growth and development, promoting competition among financing resources, resulting in greater efficiency, furthering privatization initiatives and in the transmisson and implementation of macroeconomic policies. Some time was devoted to the roles and responsibilities of market participants in capital market development issues.

This document is a logical outcome of the issues discussed at the Accra workshop. It comprises three chapters, written by the workshop speakers -- Prof. Stuart Cohn, Prof. Jozef Okolski and Chief Dennis Odife. We are thankful to them for their interest in our activiites and for their valuable contribution to this particular training activity.

We hope that this document will be useful as well as challenging to the readers.

Marcel A. Boisard
Executive Director of UNITAR

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# CHANGING TRENDS IN STOCK EXCHANGE AND CAPITAL MARKET DEVELOPMENT: LESSONS FOR AFRICA

By Chief Dennis O. Odife

## ABSTRACT

The state and extent of stock exchange and capital market development in sub-Saharan African have come under scrutiny arising from increased global interest in emerging markets. Recent changes in stock exchange and capital market development all over the world and especially in the emerging economies of Eastern Europe contain lessons, which African nations need to imbibe for their benefit. These changes are in the area of ownership and operation of stock exchanges, distribution of stock exchanges worldwide, trends towards alliances between stock exchanges in Europe, and in economic literature concerning economic growth. This paper examines some of these changes and suggests new directions for African economies in their quest for more rapid and broad based sustainable economic development.

## INTRODUCTION

The classic view of the stock exchange is that of a club or association formed by brokers. On being licensed by the state or an agency thereof responsible for such matters, the association receives a monopoly right to operate markets for admitting securities to listing, for dealing in securities, stocks and shares so listed, and for regulating the conduct of their members.

Stock exchanges were expected to operate in the national interest and enjoyed their monopoly only so long as they operated at all times as such. The exchange regulated itself and its members and was truly a self-regulatory organization. "Ownership" of the exchange was in the form of membership rights to trading and participation in a select, exclusive and potentially lucrative business. To be a member of this elite club, that is to be a stockbroker, was a lifetime ambition and a guarantee [almost] of success in life. In an age of regulation stock exchange dealing licenses were sought after almost as much as import licenses. Assured of success in life and dealing exclusively with wealthy clientele, the word of the broker was his bond and he remained at all times an epitome of respectability.

The development of stock exchanges followed logically from the discovery of the joint stock company as an instrument for carrying on commerce and for sharing the risks of enterprise. The stock exchange facilitates the refinancing and perpetuation of joint stock companies which no longer need to be dissolved after one venture, no matter how successful or disastrous. The resulting framework for the orderly exchange of securities enabled those wishing to join the company to do so and those wishing to leave to do so as well. The pricing mechanism ensured that joiners and leavers could do so at prices as much as possible determined on basis understood by all. The buyer does not need to know the seller, nor does the business of the company need to be interrupted for this exchange to be consummated.

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In nearly every country of the world where there are stock exchanges, there have been occasional deviations from this ideal, occasional market failures, crashes or scams. In each case, the markets quickly rise up to the occasion, and right these wrongs with the help of their supervisors thus restoring confidence in the integrity of the market and its efficacy as an economic instrument. It was never always exactly agreed what the instrument was to achieve, whether merely to serve as a trading platform, to provide liquidity or both, but the health of the stock market, epitomized by the market index appeared to mirror the health of the economy, or even to serve as a surrogate for it.

That is the theory, and to a large extent the practice as well. **But that is not exactly how stock exchanges developed in the most advanced nations of the world from which the rest of the world is obliged to learn.**

We have it on the authority of Michie R C, (1967), that

> **"…Until the mid-19th Century, the London Stock Exchange was largely occupied in providing a market for government securities, mainly those issued by the British government……………For example, of the (STG) 1.3 billion in securities known in the London market in 1840, only 11 per cent had not been issued by governments, and, of that, much consisted of such quasi-government organizations as …"**

The pattern differed somewhat in the United States perhaps largely on account perhaps of the size and diversity of that country. As Michie R C (1967) has it,

> **"…During the nineteenth century approximately 250 different stock exchanges were formed in the United States, with all major centers of population coming to possess at least one."**

Though most of these stock exchanges died in the speculative bubbles of the period the breadth of participation, which it generated, cannot be wished away. By 1914 however, the New York Stock Exchange was responsible for nearly 45% of the trading volume in the country, larger than its nearest rival, the Boston Exchange by at lest four times in equities and nearly 8 times in bond trading. Overall, as in the UK, bonds again accounted for over 65% of the securities listed. Many of the exchanges that survived in the United States specialized in particular securities or securities related to specific commodities, but in time New York came to dominate them all and also to become the preferred exchange by international investors.

European stock exchanges may not be as famous as those of the UK or the USA, but they have been quite busy as well. In every country there are several stock exchanges, catering to rural or other regional interests in addition to the main stock exchange in the capital. Whether in Italy, Germany, France or Switzerland, the pattern is the same. In the UK the number of exchanges has narrowed from over twelve several years ago to two or three at present.

Among developing nations India currently leads in stock exchange development not only in terms of number but also in variety. Following the 'PHERWANI REPORT' a few years ago, the Reserve Bank of India (RBI), the nation's central bank encouraged a number of development finance institutions to establish the National

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Stock Exchange of India at Mumbai (NSEI). They duly established the exchange with sophisticated electronic networks with technical assistance from the Tata Consultancy of Bangalore, also Indian, and one of the largest software houses in the world. India had over twenty other stock exchanges including the over 100 years old Bombay stock exchange, but in a few short years, the NSEI became the leading stock exchange in India with a depository acceptable to the SEC of the USA, making it one of the most modern stock exchanges in the world.

Another nation that has used the multi stock exchange format to drive development is Argentina, with over twenty stock exchanges.

## DEVELOPMENTS IN AFRICA

For African nations without such a class of wealthy potential brokers, who would autonomously commence trading by some 'kerb', as the legend of the London Stock Exchange had it, stock exchange development had to be different. In addition, lacking in industries whose securities would be traded, the logic appeared to be to wait until such a class arose and until sufficient industries had been established whose securities would have matured and be available for trading. This is conventional wisdom and such logic has guided or misguided stock exchange development and official thinking in Africa even to this day.

Predictably, stock market development in sub Saharan Africa has lagged behind developments in other parts of the world in the past few decades.

According to Keith Jefferies (1995)

> **"…the need for new stock markets to establish public confidence and keep the risks of investors low makes them mainly suited to large well established firms…"**

One may complete the statement by adding that since such firms are few in Africa, capital market development must await them.

After examining the objectives for the establishment of stock exchanges in Africa, he concludes correctly that

> **"… there is perhaps the perception that stock markets have little to offer at this juncture in Africa's economic development process…"**

These views explain the lack of capital market development in sub-Saharan Africa.

To lament this state of affairs is therefore a contradiction. Both the international agencies and African governments themselves believed that finance is neutral and passive in economic development. African economies have naturally not bothered to develop their capital markets and where stock exchanges existed as in Nigeria, they were largely ignored. On their part such exchanges seldom fulfilled their obligation of reporting their activities to the government ministry responsible for finance. (Odife Panel 1996) Nor was it likely that African governments would have received international funding for capital market development, as they did for the development

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of the banking sector at a time that informed opinion held the views described above. This may explain in part, why exchanges such as Nigeria's under-performed the Singapore stock exchange, which was established at about the same time.

Until substantially more research is done on this subject, the reasons why stock market development in sub-Saharan Africa has lagged behind developments in other parts of the world must remain shrouded in mystery.

In the interim, attempts to describe stock market development in sub-Saharan Africa in terms that make sense to the Western world reveals a major and fatal weaknesses in both the analysis and the efforts. For example, Michie R C showed that stock markets in England and the US were initially developed to fund the state. This development appears to be mimicked by the Nigerian stock exchange of which Ogwumike and Omole (1994) reported that it was predominantly a '…means for government to raise loan finance rather an instrument for mobilizing industrial finance…'. Nothing could be further from the truth.

For the past sixteen years [since 1986] the Nigerian government through its banker and financial adviser, the Central Bank of Nigeria, has not raised any finance through the stock exchange. Before then whereas the CBN was on record to be raising development funds from the capital market, the truth was that all the issues were very substantially under subscribed and were taken up by the Central Bank itself. In effect, the Central Bank of Nigeria was lending its own funds to the Federal Government. These funds were for distribution, described as on lending, to the state governments of Nigeria.

Another measure which is derived from the statistics of the Paris Club to which Nigeria is heavily indebted is that the bulk of the loans (85%) were taken by Nigerian state governments. They obtained these loans from the export credit agencies of European Union [EU] member states for the execution of projects of questionable utility and viability out of the view of the Nigerian capital market, which would probably have raised doubts regarding the projects and the facilities. It is on record that these facilities were guaranteed by the Federal Nigerian government, which would not till date, issue similar guarantees on the domestic market. In the event, today, Nigeria has a huge debt burden that is a danger to its economic recovery while it lacks a bond market for either corporate, mortgage or municipal securities. Democracy sorely needs such markets.

Another example is in order. Discussion of stock market development in Africa appears to ignore the fact that most of Africa only recently became independent. Most Africans were [and still are] impecunious and whatever resources they had were unlikely to be targeted at the shares of the large expatriate companies which alone appear to meet the description of securities considered suitable for stock exchange listing. The authors are obviously thinking of investments by foreign investors rather than by Africans. If investment by Africans was contemplated, a different size of investment and standard of stock exchanges would have been called for.

It is clear from the available literature and from the economic policies and practices of the developed countries that the efficacy of stock exchanges and capital markets were recognised well before most dependencies achieved independence. Unfortunately,

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with the possible exception of India, there is little evidence that the colonial powers made efforts to promote the development of capital markets in their colonial territories.

The leaders of the emerging countries themselves also hardly gave any serious thought to the establishment of markets apparently on account of the intense ideological conflicts of the cold war era. Capital markets and stock exchanges were then seen as trappings of capitalist economies which socialist-minded leaders of the emerging countries could not embrace. It is therefore reasonable to conclude that the development of stock exchanges and capital markets had more sympathy in the post cold war era, as is clearly the case in eastern Europe.

In the case of Nigeria whereas several Nigerian securities were actually listed in London before independence, it was only in 1961 that a local market for dealing in stocks and shares was considered worthwhile and established. It was almost an expression of nationalism. The establishment of the Lagos Stock Exchange notwithstanding there remains a large informal sector in Nigeria. In addition, the capital flight, which the colonial administration noticed when it arranged for the first development stock issue for Nigeria, [sold simultaneously in London and Lagos in 1946,] continues. Statistics provided by the Central Bank of Nigeria (1999) showing that 89.45% of the currency in circulation is outside the banking system indicates, at the least, that past attempts at driving economic growth in Nigeria mostly through the money market with little attention to the capital market must have been wrongly focused. More thorough and cautious analysis is therefore needed to determine why African stock markets have not developed to the desired level.

## RECENT TRENDS WORLDWIDE

It is to the collapse of the Eastern Block that the world owes the recent rethinking of the economics of growth, especially as it concerns Africa. The collapse especially of the Soviet economy presented an opportunity for financial re-engineering in Eastern Europe and lots of it have taken place and are still continuing. One such trend is the formation of at least one stock exchange in each of the new nations of Eastern Europe, and the attempt to build up capital markets with mass participation therein. Privatization of state owned enterprises is the method being used to achieve such mass participation. The results have been impressive and hold out promises of rapid and broad based economic growth for those nations.

Similar trends are taking place in the European Union as the French, the Dutch and the Germans privatize erstwhile state owned enterprises, through mass participation by the people. Such mass participation had been achieved in the United States by virtue of the process of capital market development, including the extensive corporatisation of municipalities and the existence of an efficient municipal securities market in that country. In the United Kingdom, mass participation was achieved in the privatization of the Thatcher years.

Privatization and commercialization of state owned enterprises are also ongoing in Africa, and simultaneously in most countries. This is happening not because of any ideological convictions but at the prompting of the International Monetary Fund, (IMF) and in response to the current economic fashion. The exercise will swell the

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ranks of individual and corporate shareholders, as it will also hopefully replace the state with new core investors. Information technology will hopefully be adopted in the stock exchanges and also hopefully modern depositories will be established to take the burden of share transfers off paper-based registrar systems and hence speed up securities settlement and delivery in nations with notoriously poor postal systems.

The privatisation of state owned enterprises is the main reason now for the promotion of stock exchanges in Africa. The existence of a stock exchange makes it relatively easy to achieve broad based privatisation, and to enable small investors to participate in the results of enterprise when other companies approach the emerging capital markets for capital. Privatisation boosts stock market capitalisation but unless the stock market is able to attract substantial new business in the future, the desired impacts on the economy are unlikely to be fully realised. The Nigerian stock market is another good example; it has continued to grow largely through state sponsored drives under which first, foreign companies and then state owned enterprises were obliged to quote their shares on the market. It has still not been able to attract substantial new indigenous business for reasons which may not be entirely endogenous to it. Official policy still makes quotation of one's shares on the stock market an exercise of questionable utility (Odife 1981) The Ghana stock exchange has not fared better or differently.

Continued failure to achieve growth in Africa therefore, even with the allocation of substantial resources in the banking sector gives considerable cause for concern. In addition, it makes a strong case for the re-examination of economic theories that have sought to explain growth or lack of it, in Africa.

## DISTRIBUTION OF STOCK EXCHANGES

It is no surprise that the leading stock exchanges in the world are in the advanced nations. In sheer numbers of stock exchanges that have ever been developed, the leading capitalist nation of the world takes the pride of place, though correlation between this and achievements of the US economy may be more difficult to establish. However, the index of prices and trading in the leading exchanges have come to symbolize the state of health of not only the respective economies, but also of the world economy.

Cross border stock exchange alliances have also become fashionable. Advances in information technology have made it increasingly possible for stock exchanges of the developed nations to consider the formation of alliances to take advantage of economies of scale and permit their investors to build and enjoy portfolios having greater diversity of securities. These alliances which are still in their exploratory and formative stages are also to enable investors in one market partake in the securities in other markets and vice versa.

In each country, even though one stock market gained preeminence and was often thought of as the only exchange in the country, the truth is that each nation maintained a multi stock exchange format. There were exchanges for major or for minor securities and in some cases exchanges specialized as to securities, which they listed or traded, such as for example the **'cash market'** in France and the **'government stock market'** in Italy. The potential for alliances would thus be greater between such

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specialized markets, and between markets with similar IT infrastructure making linkages easier to achieve.

## OWNERSHIP CHALLENGES AND REGULATION

The discussion continues here with the examination of another area which has undergone substantial change. Recent trends in stock exchange development are combining with advances in technology to create new operating as well as ownership challenges. First is that the cost of setting up a new IT enabled stock exchange is too high for a number of gentlemen brokers to fund. Nor are their individual or collective personal guarantees likely to be adequate so that the exchange could be **'limited by guarantee'**.

In an economy coming out of mass poverty and in which concentrations of economic power are few and suspect, it is only the state that would be eligible to set up the stock exchange. This the state did, in Poland, for example, as well as in the other erstwhile socialist countries.

Second, is that the trading operation of a stock exchange by itself is initially and until substantial volumes are achieved scarcely a profitable activity if the public interest is to continue to be served.

Third, and resulting from the foregoing is that the stock exchange is now seen increasingly for what it really is, namely an **essential financial infrastructure** for any economy. It is this view of the exchange as infrastructure that motivated the Indian government to encourage the establishment of the National Stock Exchange of India at Mumbai, which in a few short years completely revolutionized the Indian capital market. The transparency of the price discovery process which results, especially in technology driven stock exchanges encourages participation in economic activity and enhances the efficient utilization of resources. In addition, the stock market is increasingly perceived as an electronic marketplace for buyers and sellers of securities to transact their business, under the full view of observers.

Trading therein is facilitated by the existence of a depository system, a modern mechanism for the effortless and efficient transmission of title to securities.

It is possible for some Africans to oppose to the development of stock exchange in Africa now because of the to widely held suspicion that the development is being promoted now by the West because it is in the interest of foreign investors to do so. There may be merit in the suspicion but the argument is a sound one. Foreign investment is hardly charity and will only go where it is wanted. Stock exchange development in Africa is now being promoted, not only to enable investors from the developed nations to peacefully participate in and enjoy erstwhile commanding heights of colonial economies. They are also being promoted to enable Africans themselves to participate and to enjoy the benefits of liquid and clean markets. African economies should look beyond such foreign participation and to the very substantial benefits which accrue from setting up and running efficient stock exchanges. Foreign participation contributes immensely to the price discovery process, to the standards of trading and to market efficiency.

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In summary, the view of the stock exchange as infrastructure and its large capital requirements have meant that the role of the state is seen now less narrowly than hitherto. The state and its agencies may now validly play a role in its establishment. Indeed, they have always done so, but rather indirectly, as the Nigerian experience with the Lagos stock exchange and the Indian experience with the National Stock Exchange of India showed. In Poland and other eastern block nations, the state has done so directly, being the only economic unit in a position to do so. The indirect approach to the ownership of stock exchanges is still preferred with the ultimate being a public company owned by countless investors.

These trends now permit the **listing by exchanges of their own securities**, a situation totally unthinkable and perhaps even unacceptable a few years away.

The **dominance of the state in the bond market** meant that there was an element of subsidy therein in that the state alone (or predominantly) provided the business on which the brokers lived. Work was done on all sides and benchmarks were put in place to guide the rest of the financial system as to the relative costs of money of varying durations.

**Regulation of stock exchanges and capital markets** is still a state affair, usually by an agency akin to the **Securities and Exchange Commission** of the USA. Everywhere, the emphasis is on setting up and operating clean, competitive and efficient markets. **Judicial Tribunals** of capital market assessors are increasingly being resorted to as an aid to self regulation and regulatory enforcement. The importance of **associations of stockbrokers** and issuing houses to exercise an oversight function over the management of the stock exchanges and to draw public attention to any instances of regulatory excesses including tyranny, cannot be underestimated. **Any one who knows Africa should therefore treat the absence of reports of regulatory tyranny from African stock exchanges and capital markets with suspicion.**

## NEW ROLE IN ECONOMIC GROWTH

Changes in the ownership and operations of stock exchanges are occurring side by side with changes in the perception of their role and the roles of capital markets in economic growth and development. It used to be that the role of the stock market in economic development was all but ignored in economic literature. It is suggested that this may have derived in part from the fact that such fathers of modern economics as Ricardo and Keynes ignored the stock market in all their prescriptions notwithstanding that they made fortunes trading on the stock market.

The traditional view that the stock market was the handmaiden of industry has thus changed to the view that industry is the handmaiden of the stock market [capital market and financial intermediation] Notwithstanding the findings of Gelb. A, (1995) that the role of the stock exchange in raising capital in most countries is still negligible, Kitchen (1986) welcomes their establishment as a way of broadening and deepening the local capital markets.

The new view, Robert G King & Ross Levine (1992), places substantial premium on the role of entrepreneurs, on the role of financial intermediaries in assessing and

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allocating resources and in the role of the stock market not only as a signal of performance but also as a barometer of economic condition and a vehicle for mass mobilization of people and capital for development. The view is that

> **"…Sustained economic development originates, …in a nexus that involves (i) entrepreneurship (ii) intangible capital investment and (iii) financial intermediation.."**

Growth is predicated on the ability of the entrepreneur to mobilize resources and to develop intangible human capital. Africa may not have lacked entrepreneurs, but it has lacked any kind of market for such entrepreneurs to raise capital except in the informal capital markets where costs and rates of return are usuriously exorbitant.

## FINANCING AFRICAN ECONOMIES

The way and manner in which African economies themselves have been financed may have impacted negatively on capital market development therein. For example, for some, the bulk of their funding came through aids and bilateral credit., and scarcely impacted the local money and capital markets.

For other nations like Nigeria, it was easier for their municipalities, in the absence of any local market for municipal securities such as the US has, to seek and obtain loans in the money and capital markets of Europe with the guarantee of the federal government. It was thus possible for nations such as Nigeria to earn billions of dollars in oil revenues and for these financial flows to have insignificant impact on the domestic capital market and on the lives of the citizens of the country.

The return of African economies to democracy and the ongoing privatization of state owned enterprises constitute very strong reasons for embracing stock exchange and capital market development in Africa. All African nations are obliged to seek broad based sustainable development and to pay the democratic dividend to their people as soon as possible. As the nations embark upon privatization as part of deregulation and the effort to achieve private sector leadership of the economy, they encounter opposition from both the public sector and the private sector.

First, there is the feeling in all sectors that a private sector capable of replacing the role of the state in the commanding heights of the economies hardly exists. Second, both the current leaders of the private sector, several of whom are retirees from the public sector, and the still serving public servants mistake the current incumbents of private sector positions as the 'people' to whom control of the economy is to be handed. It is true that most African nations lack the robust private sector that can hope to lead their economies, but it is not true that their economies are to be handed over to any particular set of people. It is to the control of the market place that the commanding heights of the economies are being handed over. The market must therefore first be set up, and should permit and enjoy broad based participation so that no segment of society feels alienated from it.

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## LESSONS FOR AFRICA

The foregoing scenario and trends contain grave lessons for Africa. One is that African economies must embrace capital market and stock exchange development more aggressively than they have done so far. They need to do this not only to facilitate privatization but as an instrument for unlocking the vast potential embedded in their most valuable economic resource, their people.

In so doing, African nations must appreciate the message of the new theory of growth centered around capital markets, financial intermediation and entrepreneurship, and undertake significant and relevant financial reforms. African nations should also imbibe the lessons of the new forms of stock exchange establishment, ownership and financing and hence of the possible roles of stock exchanges in their economies. They will no doubt find that they need to redefine and domesticate the stock exchange in their economies as a way of overcoming the dichotomy between the formal and the informal sectors and their respective capital markets.

Building stock exchanges and capital markets in African is often complicated by the fact that there is often a large and informal traditional market for capital operating along ethnic or racial lines or in specific localities. It is also often the case that cooperation between entrepreneurs of the same racial stock is easier than with people of different nationalities. Movement of capital is thus constrained along these lines. Foreign investors are often surprised to find that African businessmen are more willing to sell their shares or participation in their business to a foreign investor than to an African of different ethnicity.

African nations need also to revisit the histories of the leading capitalist nations of the world to note that all of these nations without exception operated and still operate multiple stock exchanges. They would probably find that their ethnic diversity may require that they operate multiple stock exchanges with substantial informal sector involvement until advances in Information Technology (IT) and growth in volumes and profitability require them to merge them. An Independent national stock market attractive to foreign investors may be operated independently of the smaller domesticated stock exchanges, which will encourage indigenous entrepreneurship and grass roots capital mobilization.

African nations will thus find that the racial diversity of their populations probably implies that they already have fragmented traditional capital markets which will form ready channels for capital market development along western lines for integration in due course on a national basis. The development of entrepreneurship along these lines, and the formation of mini stock exchanges to cater to the interests of such groups is therefore likely to speed up development and yield huge dividends to such nations. In any event the capital needs of most African entrepreneurs are so small that they are unlikely to be available from the major national stock exchanges which will at all times aim to operate at the same level of sophistication as the leading exchanges of the world.

The alternative is to wait for all parts of each African nation to be as developed as the capital cities, which by themselves are often already as developed as parts of Europe. This would thus be to postpone growth and development indefinitely.

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The message here is that mini stock exchanges based in the rural areas are more likely to promote entrepreneurship and may thus be the way to achieve mass participation and more rapid development.

## THE ENTREPRENEURSHIP IMPERATIVE

Another lesson is that entrepreneurial training can and should be speeded up and the provision of micro credits speeded up in traditional markets which will form the bases of the mini stock exchanges.

African nations must also find some way to tap into the wealth of their nationals in the great African Diaspora in the development of these lean, clean and efficient mini stock exchanges appropriately IT enabled.

### NATIONAL ECONOMIC AND FINANCIAL POLICIES

Finally, in formulating economic policies there is need for African governments to bear in mind the contribution which properly structured and functioning stock exchanges and capital markets can make to national and even regional economic development. They should also note that the tendency to operate government finances entirely outside the national financial system defeats the goal of achieving rapid economic growth and development.

There is need therefore for both African ministries of finance and central banks to note their integrative roles in achieving market efficiency and in delivering higher standards of living to their people.

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# CONFIDENCE BUILDING IN SUB-SAHARAN STOCK MARKETS

By Professor Stuart R. Cohn

## INTRODUCTION

Stock markets have been a growth industry in sub-Saharan Africa. Securities exchanges now exist in 16 sub-Saharan countries, including Botswana, Ghana, Kenya, Malawi, Mauritius, Mozambique, Namibia, Nigeria, South Africa, Sudan, Swaziland, Tanzania, Uganda, Zambia, and Zimbabwe. In 1998, Africa's first regional exchange, the Bourse Regionale des Valeurs Mobilieres (BRVM), opened in Abidjan, Ivory Coast, replacing the pre-existing Ivory Coast Exchange and creating a single exchange linking the French-speaking members of the West African Economic and Monetary Union (Benin, Burkina Faso, Cote D'Ivoire, Guinea Bissau, Mali, Niger, Senegal, and Togo). The growth has not ended. Plans are in place for new exchanges in countries such as Gambia and Sierra Leone. Most of the exchanges are of recent vintage, with the exception of exchanges in Kenya (1954), Nigeria (1960), and much older exchanges in South Africa and Zimbabwe.

The dominant impetus for the recent creation of securities exchanges has been the privatisation programs that have swept across Africa. Privatisation has been the watchword and constant theme of the World Bank and IMF. Whether by prodding from international institutions, or stemming from the realization by governments that the time has come to undo the effects of the nationalizations of the 1960's and 1970's, privatisations are progressing across Africa. Privatisations are effected either by the government disposing of its 100% of its shares to public and institutional investors, as in the case of Uganda Clays Limited in 1999, or by government selling a portion of its equity ownership interest, as in the case of Kenya Airways in 1996. Whatever the amount or percentage of shares being sold by the government, the result is the same -- a shift in equity ownership from government to private hands.

Privatisation offerings attract a variety of investors, including domestic and foreign individuals, institutions (such as pension funds, insurance companies and banks), employee share ownership plans (ESOPs), and collective investment schemes such as unit trusts and mutual funds. None of such investors would be attracted to an offering without some assurance that there is a secondary market in which to dispose of the shares at a later date in order to cash in on market appreciation or to change investments. This is the requisite element of liquidity. An investment is liquid if a secondary market exists on which the investment is regularly traded. Without liquidity, few investors, if any, would be interested in buying shares of a company, whether a former parastatal or a private company seeking equity capital. Perhaps the company could sell debt instruments, such as debentures or bonds, as such instruments can be held until maturity or marketed to third parties on a negotiated basis. But equity shares have no maturity date and are not redeemable by the company. Holders of equity securities have no exit mechanism for their investment without an established secondary marketplace. Thus the stock exchanges. The exchanges provide the resale market, commonly known as a secondary market (as

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distinct from the primary market, which is the company issuance of shares to the public).

## IMPEDIMENTS TO THE GROWTH OF STOCK EXCHANGES

As noted, the growth of stock exchanges in Africa has been primarily driven by government privatisation programs. No offering of parastatal shares could effectively be undertaken until a stock exchange was in place. Without such a secondary market medium, there would be no readily available means for stock purchasers to resell their securities. If a stock exchange did not exist, or shares were not listed on the exchange, an investor desiring to sell shares would be left to finding a buyer on his or her own, or finding a stockbroker willing to invest the time and energy to seek out a buyer. The so-called over-the-counter market is not well developed in sub-Saharan countries. There is, therefore, little or no liquidity for shares not listed on an exchange.

Despite the stated merits of a stock exchange, it must nevertheless be emphasized that a stock exchange does not *ipso facto* provide or ensure liquidity. It would be a *non sequitur* to conclude that, because an exchange exists and securities are listed thereon, there will always or even usually be ready and willing buyers whenever there are ready and willing sellers of securities. A stock exchange is by far the best opportunity for liquidity to occur, but an exchange is not a guarantee of liquidity. One of the unfortunate characteristics of most sub-Saharan stock exchanges is that they do not create as liquid a market as one would hope. In other words, there is often such little trading interest in a listed security that placing a sell order on an exchange often fails to be met with a matching buy order, and *vica versa*. Sometimes there is a dearth of sellers, sometimes a dearth of buyers. Usually there are too few of either category. In developed, vibrant markets, a shortage of buyers or sellers is usually a temporary, short-term phenomenon. Market forces cause share prices to rise or fall based on investor demand, higher if there are more buyers than sellers, lower if more sellers than buyers. As share prices move up or down, the information is broadly disseminated to broker-dealers and the investing public. Before long, holders of shares who are willing to cash in for a profit come forward to sell, or potential buyers who find the lowering price to be attractive enter the market to buy. Inevitably the price movement creates trading. However, normal market forces do not seem to operate as easily in African exchanges. One problem may be the lack of widespread communication facilities, which inhibit the dissemination of knowledge of timely market movements. A second problem is much more fundamental B the tendency of many of the newer investors within sub-Saharan countries to view their share holdings as long-term property, not to be sold except for extraordinary circumstances. Additionally, most exchanges have adopted internal constraints on the price change that a stock might incur in any given trading period. With very little trading activity, and exchange constraints in place, stocks are much more likely to remain at a relatively stagnant level rather than drift downward for want of buying activity, or upward for want of selling activity. Without such movement, potential sellers or buyers remain on the sidelines.

The lack of significant numbers of listed companies is a major cause of the paucity of daily trading and the concomitant lack of liquidity within the stock markets. With few investment options available, it is no wonder that investors do not engage in trading one security for another, moving in and out of stocks in the manner seen in developed

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markets. Ghana is an excellent example of this problem. Although there are 22 companies with securities listed on the Ghana Securities Exchange, only a very few of those companies experience daily trading activity. The largest company, Ashanti Gold Mines, is formally listed but does not trade at all on the Ghana exchange, as its shares are dollar-traded in the United States. In other exchanges, often no more than a handful of stocks are active, the rest being quite dormant unless major developments occur. The two fundamental questions of (i) how to attract more listings, especially from privately-owned companies, and (ii) how to develop greater public interest and participation in stock trading are inextricably linked. Privately-held companies do not find an illiquid market attractive, and until there is more market listings and trading, public interest is difficult to develop.

Beneath all of these problems lies a more basic impediment to stock exchange development - a lack of public confidence in the integrity of the securities markets. Throughout sub-Sahara Africa there is a profound distrust of government and centralized financial institutions. Government corruption is notorious and rampant. But corruption has not been confined to government offices. Across the continent there has been a stream (some might suggest a river or torrent) of bank failures, collapse of corporations, and mismanaged pensioned provident funds. This unfortunate history has caused many to believe, not without reason, that bedrooms and closets are safer repositories of savings than banks and other commercial institutions. Now place into this historical formula a stock exchange, and it is not difficult to understand that the exchange is perceived by many as combining the worst of two worlds - government control and a centralized financial institution. When broker-dealers in Uganda were seeking to generate public support for that country's first privatisation, Uganda Clays Ltd., in 1999, they were frequently met with intense public skepticism. Given the history of past corruption and failures, why would anyone think that a government -regulated stock exchange would behave any differently or have any different results than prior government or government-regulated institutional failures? Given history, it is difficult to fault the public skepticism. Nor will the public readily perceive the distinction between government agencies and the albeit self-regulated, but government-agency controlled stock exchange. Although in technical legal terms a stock exchange is a private, usually non-profit limited company, with its own set of internal rules and owners, government has its hand in exchange matters through the review and approval powers of the government-appointed capital markets authority or securities commission. Regardless of whether the public is aware of the particulars of how stock exchanges are created or organized, there is a strong perception that exchanges are linked to government and thus they suffer from the taint of public distrust.

Building public confidence is central to market development . Without active, continuous public support and participation, markets will flounder for lack of products and liquidity. With relatively little trading, downturns can be magnified, as there is a very thin supply of buyers to begin with. This exacerbates the problem, as even those in the market begin to doubt the wisdom of their choice and must face the criticism of skeptical family and friends.

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## MEASURES TO ACHIEVE GREATER PUBLIC CONFIDENCE

Despite the obstacles, I do not see the problem of public confidence building as insoluble. I am in part confident because of my personal experiences in both West and East Africa, where I have met many dedicated, intelligent, and devoted public and private sector individuals who recognize the value and necessity of capital market development. Their numbers may be in the minority, and the capital-building tasks daunting, but their influence will unquestionably grow as their numbers and public education increase.

Development of public confidence cannot await the slow process of increasing numbers within professional and educated classes. Steps should be taken now. Among the principal measures that could assist in confidence-building are:

1. Cross-listing securities on exchanges;
2. Adoption of "merit review" standards by securities agencies;
3. Increasing media understanding and reporting on business matters;
4. Increasing the enforcement authority of government agencies;
5. Committing to public education as a primary goal of the public sector;
6. Enlarging the capacity for institutional investing by pension and retirement funds;
7. Encouraging issuance of preferred shares and corporate notes by private companies; and
8. Eliminating the second-tier labeling of listed securities.

Each of these recommendations is discussed below. Some have already been implemented in limited ways in some countries. There is much more to do. The recommendations should not be viewed independently but rather as part of a whole fabric, as essential units to a process dedicated to the goal of capital market improvement.

## CROSS-LISTING OF SECURITIES

Good quality, publicly-listed companies exist across sub-Saharan countries, spread among the various exchanges. Cross-listing of securities will accomplish several important goals. It would immediately increase investor choices , raise the level of public interest, create the likelihood of increased market activity, and stimulate domestic companies to consider joining the listed companies on their local exchange. Cross-listing has begun in some limited circumstances, with the South Africa exchange entering into dual listing agreements with both Namibia and Nigeria, and it is being examined by exchange officials in many African nations, but the process is at the putative stage and needs a much stronger push from regulatory agencies.

Cross-listing is a step beneath the creation of regional exchanges. Regional exchanges may well be the future, at least for the smaller exchanges in West Africa and East Africa. But for the time being, regionalisation is a long-term possibility, not a short-term solution. Although there has been considerable progress in the harmonization of laws and regulations, there is no serious movement toward a single exchange for an entire region. Currently there are too many factors working against such a move, including the national pride developing in countries that recently established exchanges, a pride that will not permit giving up an independent identity quite yet.

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Other problems also prevent regionalisation, such as political instability among neighboring countries, political distrust, and lack of adequate communication networks. Hopefully these impediments will be eliminated in time. But today's markets should not languish waiting for regionalisation. Cross-listing is the logical alternative.

Problems besetting regionalisation do not necessarily apply to cross-listing. Each exchange retains its own identity. Indeed, each exchange is enriched and strengthened by the addition of quality-level listed securities. The serious concerns with cross-listing have to do more with converting share prices into differing currencies and concerns regarding arbitrage based on differing currency rates. These are not insurmountable problems. Computer technology permits real time knowledge of currency rates, permitting exchanges to make adjustments as appropriate and prevent trading where differentials in currencies would create inequities for the buyer or seller. Even if not all exchange variables can be avoided between the trade and settlement dates, traders of cross-listed securities should be adequately informed of the risks of currency fluctuation. Cross-listing will be enhanced by the growth of computerization, which will provide real-time quotations. Moreover, the movement towards paperless transactions includes the elimination of old-fashioned share certificates (a loss for no one but the nostalgia buffs), which in turn can lead to centralized clearinghouses within a region that will handle the recording and settlement of all of the region's transactions.

A different problem involves encouraging companies to list on more than one exchange. Under current listing provisions in each of the various exchanges, there are listing fees and periodic reporting requirements. To encourage cross-listing, listing fees should be substantially reduced or eliminated for such companies, and the home state's reporting requirements should control the disclosure requirements. Cross-listing could also be advantageous for the companies, as they would have access to much wider markets and could see much greater trading activity in their securities. Greater activity translates into higher liquidity, which in turn means that the company could utilize its stock for multiple purposes, such as employee benefit programs and other stock utilisations that depend on a liquid secondary market.

Cross-listing offers the hope of a substantial boost to local exchanges. Many of the leading companies on various exchanges are well known throughout sub-Saharan countries. For example, Standard Chartered Bank is listed on the Ghana Securities Exchange, but branches of the bank are located in many countries. It would be a well known stock on many exchanges. Firestone East Africa Ltd., listed on the Nairobi Stock Exchange, is also a well-known company in several countries. If each exchange chose companies that were relatively strong financially, public confidence in the domestic exchange would likely increase. One possible downside might be that trading in domestic companies would decrease as investor interest moved to the cross-listed stocks, but that is a risk worth taking. There is already such low trading in domestic securities that any drop would not have a significant effect. More importantly, it is much more likely that increased market activity will benefit all companies, domestic and cross-listed, in keeping with the maxim that a rising tide raises all ships.

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## ADOPTION OF "MERIT REVIEW" STANDARDS

The securities agencies in each of the sub-Saharan countries have authority to review the prospectus of companies engaging in a public offering. No offering may go forward until the agency has completed its review and given the company the authority to proceed. Agency review power is related to determining whether the prospectus satisfies disclosure requirements. There does not appear to be any other basis for the agency to deny an application. In particular, there does not appear to be any grant of authority to the agency to review an application based on the agency's determination of the merits of the offering, i.e., so-called "merit review". It appears that the agency must allow the offer to go forward if disclosure is satisfied, regardless of the existence of factors that suggest that the offering is very high risk or indeed an unwise investment opportunity. One might argue that an offering of little merit is not likely to find an underwriter, but the statutes do not limit public offerings to underwritten offerings, nor is a company obliged to list its securities on an exchange. A company that chooses to go forward without a sponsoring underwriter has the full right, under current statutes, to prepare a prospectus and make a public offering of its securities.

The problem of non-meritorious offerings was faced in the United States in the early days of its capital market development. The present size and success of the U.S. securities market belies its early history. It is a history of abuse and enormous investor losses during a period of relatively little public regulation. As a result of a concern that the securities laws were being used to raise capital for companies of little or no worth, most states adopted "merit review" standards for their securities agencies in order to protect the local citizenry from the excesses of securities salesmen. The term "blue sky", now used regularly to refer to state securities laws, dates from this era and refers to the fact that securities salesmen were known to sell anything they could, even "the blue sky above".

A crisis of public confidence existed in the United States in the early 20th century, just as one exists in African countries today. In particular, there was a great concern that a gullible investing public would not be able to discern the meritorious public offerings by viable companies from public offerings by companies that, for whatever reason or reasons, were beyond the pale of risk. The solution adopted in most states was to create a judgmental standard for the state agency to consider whether the offering was economically sound. In addition to disclosure, state agencies would have the authority to consider the "merits" of the offering and the power to deny a registration application for those it found wanting. Florida's statute is typical of the traditional merit review standard, authorizing the state agency to deny registration unless it finds that the proposed offering is "fair, just, and reasonable" for the investing public. Although many states have moved away from this broad traditional standard, nearly every state continues to allow its agency to deny registration in limited circumstances.

The result of merit review is difficult to determine. Very few offerings are rejected by state agencies. On the other hand, one has no way of knowing how many weak or non-meriotious offerings have not even been attempted because of the knowledge that they would not pass merit review muster. At a minimum, the merit review standards permit agencies to deny registration when it believes that to do so is in the best interests of the citizens of its state.

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Adoption of merit review in sub-Saharan countries could help develop a degree of public confidence in the offering process. If the public was aware that the agency was screening offerings not only on the basis of disclosure but also in terms of economic viability, there might be more willingness to invest in new offerings. Looked at from a different perspective, an offering by a company that is too high risk to be viable, or by a company with inexperienced management, could poison public confidence in the entire market. Smaller markets cannot afford non-meritorious offerings. Merit review offers the chance of avoiding that result.

It is very important to stress that merit review is not an agency "stamp of approval" or a recommendation to buy the proferred securities. It is nothing more than an assessment by the agency that, based on the facts provided to it by the registrant, in the opinion of the agency the offering is a reasonable one for investors to consider. The offering might have a degree of risk -- nearly all do -- but it is a risk that is within an acceptable range. The factors that impact upon an agency's decision would include:

- expertise of the principal directors and officers;
- personal and business histories of directors and officers;
- strength of the competition;
- whether the product or service has been tested for market acceptance;
- whether the company will be adequately funded to meet expected challenges;
- whether the securities are being sold at a price that fairly reflects its book value;
- the ownership of the controlling block of shares;
- the company's financial history;
- potential dilution of equity interests through future stock issuances;
- the anticipated use of the proceeds of the offering;
- whether sufficient surveys and engineering evaluations have been made;
- the likelihood of the company being able to pay dividends;
- whether there are debt obligations that would impact adversely on equity;
- international economic and monetary factors that could impact the company; and
- other factors, the list is not exclusive.

Merit review raises the legitimate concern regarding agency favoritism and administrative capriciousness, to say nothing of the potential for corruption. Securities professionals, including broker-dealers, lawyers, and others can play an important role in this regard, keeping alert for instances of inappropriate agency action and bringing them to public attention. In addition, particular standards can be adopted that create objective guidelines. An excellent source for such standards are the Policy Statements created by the North American Securities Administrators Association (NASAA). NASAA is the trade association of state securities administrators in the United States. Over the years, NASAA has developed policy positions regarding a wide variety of "merit review" concerns. Many states have formally adopted those positions as part of their own regulations. The policy positions are quite detailed and cover numerous areas such as affiliated transactions, dishonest or unethical business practices, promoters' equity investment, and unequal voting rights. The policy positions may be reviewed by those interested through NASAA's Internet home page at

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www.nasaa.org.

Merit review is no guarantee that only high-quality offerings will be made to the public. Agencies only know what is told to them in the disclosure documents -- they do not engage in field investigations. The disclosure documents might overstate the chances of success or understate the risks. Moreover, every offering, no matter how meritorious, is subject to unforeseen market or other factors. But, merit review at least provides a filtering process. It is the existence of such a process that could raise public confidence in the securities markets. Equally important, if merit review succeeds in keeping off the market some offerings that are destined for failure, that is a positive result that cannot be discounted, given the current state of public uncertainty about securities offerings generally.

## INCREASING MEDIA UNDERSTANDING AND REPORTING ON BUSINESS MATTERS

Potential investors receive information from several sources. Perhaps the most important source in terms of daily impact is the print media. Newspaper reports on economic factors and stock market developments can play a substantial educational role. Potential investors may be wary of advice or reports received from investment advisers and stockbrokers, as they know that such advice could be self-serving for the purposes of obtaining commissions or remuneration. They are much more trusting of media reports and analyses if those are perceived as coming from non-biased sources.

Before one places too much trust in media reporting, it is essential to assure that those engaged in the reporting process are knowledgeable of market developments and are not simply parroting company or government press releases. In my several trips to West and East Africa, I have yet to see any sustained effort being made to educate media personnel to the nature and subtleties of the capital market, to provide to the media a basis for appropriate analysis, and to bring the media into the overall public education process. If the media was in a position to give timely analyses of why securities markets are performing well, or performing poorly, or why paticular economic sectors are performing better than others, there would develop a greater public awareness in the overall process.

To be sure, there are dedicated print and broadcast journalists who report on economic matters, and I do not mean to denigrate them. I am suggesting that there be a greater effort to provide training and education to media personnel. With increased knowledge will come better reporting, and with better reporting will come a higher public awareness of how the markets in fact operate. There will even be a chance for a growing number of journalists to engage in analysis of companies, which in turn may whet the public appetite for investment opportunities. Without information there can be little chance to raise public confidence. Information alone might not raise public confidence, but it is a step along the right path.

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## INCREASING THE ENFORCEMENT AUTHORITY OF GOVERNMENT AGENCIES

Securities laws work on the carrot and stick basis. The carrot is the ability to raise much needed capital. The stick is the threat of punitive damages or criminal liability if the process is abused. Unfortunately, in many countries the "stick" exists much more as a matter of theory than practice. That is because the enforcement agencies are underfunded and do not have the personnel necessary to investigate instances of wrongdoing or to take the time and effort to seek appropriate remedies through judicial means. In some instances, statutes creating the agencies do not give them adequate investigative powers. Whatever the reason, there is a dearth of effective enforcement powers and capabilities. The public is well aware of such shortcomings. Accounts of misdeeds in the public and private sector abound, but they are not regularly matched by accounts of prompt and effective judicial imposition of sanctions and penalties. An example comes from Uganda, where a well-known private commercial bank floated shares in a unit trust several years ago (before the creation of the Capital Market Authority), selling shares to over 7,000 investors through use of a prospectus that may have been deficient in disclosure aspects. Unfortunately the public lost most of their investments. Even though it is quite possible that there were violations of the disclosure obligations contained in the Company Act, and perhaps other violations as well, there has been no government action based on any possible violations. The public is painfully aware of both the financial losses and the government inaction, and these factors create a festering wound that exacerbates the public confidence problem.

Public confidence is a fragile reed, and it cannot exist in an atmosphere where the common perception is that abuse goes unpunished. If a potential investor realizes that there will be no help from the government agency to root out violations of the law and prevent or stop abusive tactics, the result will be to turn one's back on stock offerings. My experience with government agencies in the securities field is that they are staffed by well-intentioned, intelligent, and motivated individuals. But they are woefully understaffed. To be an effective enforcement arm, there must be a team of investigators, there must be persons with financial and accounting know-how able to discern financial manipulation, there must be adequate subpoena powers to aid investigations, and there must be staff attorneys capable of quickly seeking judicial sanctions. Finally, there must be the political will to carry through the investigations, no matter who the company or its management may be.

If the public perceives that there is activity in the enforcement area, that government regulators will act promptly in situations of possible abuse, the result will be an increased awareness that the agency is on the public's side, not the side of the promoters of securities offerings. This is an important shift in attitude. It is a shift that is essential before we can expect the public to have faith in the government agency overseeing stock market development.

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## COMMITTING TO PUBLIC EDUCATION AS A PRIMARY RESPONSABILITY OF GOVERNMENT

Everyone connected with stock market development agrees that public education is a crucial factor. There is enormous uncertainty within the public realm regarding such matters as the nature of stock, the rights of shareholders, the payment of dividends, how stock appreciates, how the market works, and how securities are traded. To the extent that savings have been invested at all, they have generally been put into bank savings accounts or certificates of deposit. These are relatively easy investments to understand, banks are visible institutions within the community, and savings accounts are not subject to market risks. To enter the world of securities trading requires a much different mental picture of the nature of the investment and the risks that are involved. A common refrain throughout sub-Saharan Africa is that much of the public is reluctant to engage in securities purchases or trading because of a fundamental lack of understanding of the investment or the process.

The question is not whether public education is necessary to create public confidence in the markets, rather the question is who will foot the bill for such education. Securities agencies have engaged in education efforts, but they operate on already too-meager budgets and cannot afford to finance the large-scale education that is needed. Nor should the burden be put on the privatisation units. They are already over-worked and under-staffed. Moreover, the public perceives them as having a vested interest in selling off government companies and begins with some distrust of the messenger. Broker-dealers and the stock exchange also do not have adequate financial resources.

What is needed is (i) much enhanced government funding for education programs (ii) to be run by qualified NGOs that are not seen as having an agenda other than the public interest. This recommendation is thus twofold. It suggests that the government commitment to capital market development requires significant budgetary assistance for a public education program, and it places the responsibility for education on a non-governmental unit that is not perceived by the public as having a vested interest in the outcome of the securities market. Such NGOs exist in every country or could readily be created within existing private sector organizations. Training materials should be prepared for use in community meetings, and close coordination with newspapers should be developed to sustain a steady flow of informational material. The lack of liquidity in current markets is in part due to the small percentage of people ready and willing to participate in securities trading. Education is an essential tool in creating a more favorable public attitude to the market process.

### ENLARGING THE CAPACITY FOR INSTITUTIONAL TRADING BY PENSION AND RETIREMENT FUNDS

In every developing country there exists state-controlled pension and retirement plans that have available large amounts of assets that could be used for local investment. The ministries responsible for management or supervision of such funds should assure that there are no legal impediments to investing in domestic stocks, as sometimes the governing instruments are written in restrictive manners that restrict investment in ordinary shares. Secondly, the funds should be encouraged to invest in domestic companies. The buying power of such funds could be very important in creating support for the issuance of company shares and debt instruments. As noted by Keith

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Jefferis, AThe Development of Stock Markets in Sub-Saharan Africa,@ (Vol 1 Makerere Business Journal 1996):

> **"Most of the domestic savings flowing into stock markets may well be through improving the ability of institutional savers to diversify their portfolios, and improve earnings, especially if combined with a relaxation of requirements that such institutions invest predominantly in government securities. In Botswana...institutional investments underwent a major shift away from property towards shares; between 1988 and 1992 institutional holdings of shares rose by 680%, whilst that of property increased by only 157%."**

Equally important is enabling legislation to permit the creation of private pension and retirement funds accessible to both government and non-government employees. A state monopoly on retirement programs does not serve capital market development purposes. Individuals should be given a choice of investment opportunities for their pension funds, and competition among investment funds rewards good management and keener analyses of investment alternatives. A multiplicity of funds will lead to increased market activity, rather than reliance on a single, national fund, and increased activity will enhance liquidity and in turn promote greater public interest. As governments find that it is not in their continuing interest to be invested in parastatals, they should also examine the merits of insisting upon a monopoly on employee retirement funds.

## ENCOURAGING ISSUANCE OF PREFERRED SHARES AND CORPORATE NOTES BY PRIVATE COMPANIES

In most sub-Saharan countries there continues to be a problem in attracting private companies to list securities on the exchange. Yet, in every country there are numerous private companies that are bona fide candidates for high quality securities listings. A principal drawback for private companies is the concern over loss of control through sale of ordinary shares. That drawback need not be a deterrent, however, if private companies were encouraged to offer securities other than ordinary shares, such as preferred stock or corporate notes. Such offerings would stimulate the market and would be a visible indication of domestic confidence in the exchange.

How would private companies be encouraged to engage in such offerings? Tax incentives could be one useful form, such as a reduction in corporate income taxes for publicly-listed companies. A sliding scale could be developed that gives a greater tax incentive for the listing of ordinary shares rather than preferred shares, but in any case there would be an economic benefit to the company for bringing securities onto the exchange. There may be other means of encouraging such listings, such as reduction in import duties, licensing fees, or modification of other government fees or controls. Companies going onto the exchange early might be given better incentives than companies going later. The nature of the incentives is best determined by local officials considering their own market and private company situation. Incentives will be a "pro-active" response to the market problem, a much better response than continuing to wait for private companies to come to the market eventually if at all.

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## ELIMINATION OF THE SECOND TIER LABELING OF LISTED COMPANIES

What is meant to be a well-intentioned method of attracting smaller companies to the exchange, a second tier for those unable to meet the higher listing standards, has turned out to be public-relations problem. First tier listings are perceived as the "blue chips" of the exchange. Second tier listings are perceived as their weaker cousins. As a result, there is very little trading in the few second tier stocks that exist. In my judgment, there is a serious flaw in the system, a flaw that is based on the labeling itself. Where relatively few investors exist, it is very unlikely that they will be steered by investment advisers towards second tier companies. The second tier has a stigma to it that is unerasable. If one is ready to take the plunge into the waters of securities investing, one must have an unusual disposition to be willing to bypass the "blue chips" in favor of a second tier company. That is the psychology at play, even where some second tier companies are just as good if not better investments than their larger cousins on the first tier.

There exist in all countries a fair number of smaller companies that could benefit from public offerings and exchange listing. Those companies probably do not meet the size qualifications for the first tier, and they are naturally reluctant to be branded a second tier company and become dormant fixtures on an exchange. The result is no listing at all.

Is such branding necessary? I do not think so. The fact is that once a company is listed on the exchange, all exchange requirements regarding transparency, timeliness of disclosure, and broker-dealer obligations regarding the quoting and trading of those securities are the same, regardless of tier. It is entirely appropriate to impose identical disclosure and other requirements on all listed companies, as investor interests are exactly the same in all instances. If companies are treated the same by the exchange once they pass the qualification stage, why brand them at all? Why not have a single qualification standard, albeit lower than the current first tier requirements, and all companies would be regarded as equal? I am not concerned that there would be a rush of weak companies to the exchange. The costs of offerings, and the transparency demands of listing, will continue to assure that only serious, growth-oriented companies will submit themselves to the regulatory processes of offerings and listings.

In the United States, there are no tiers on the New York Stock Exchange. A company either qualifies or it does not. If a company does not qualify, it might be traded over-the-counter, such as on the National Association of Securities Dealers Automated Quotation system (NASDAQ). Investors appear to have no qualms about investing in over-the-counter securities. Indeed, there are many more over-the-counter stocks than exchange-listed stocks. In sub-Saharan countries, there has not yet developed an effective over-the-counter market. The stock exchange is effectively the only game in town. That being the case, it is appropriate to encourage smaller companies to engage in public offerings and to list on the exchange, but there is no compelling reason to brand such companies with second tier status. Before an investor makes a decision, he or she will presumably do sufficient homework to know the fundamentals of the company. There is no justification to burden any company with the second tier label when full disclosure of all fundamentals is available to all potential investors.

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If the two-tier labeling system is eliminated, it is quite possible that private companies will be more willing to become listed on the exchange. Moreover, the stigma will be removed from their shares, and potential investors will look at a company's economic factors to make their investment judgments, just as it should be.

## CONCLUSION

Across sub-Saharan Africa one can sense enormous frustration at the laggard pace of stock market development. All the pieces are in place, but the lack of public confidence in the market is a major detriment to both privatisations and private company public offerings. Moreover, the lack of public confidence is reflected in low market liquidity, as potential investors sit on the sidelines rather than enter the trading arena. Governments continue, by and large, to be committed to market development. However, it is not enough to pass enabling statutes for securities exchanges, agencies, and stock listings and then leave the rest to privatisation units and the private sector. Government must do more than provide a framework B it must take an active role in the entire market promotional process. As stated by Anita Spring and Barbara McDade in "Entrepreneurship in Africa: Traditional and Contemporary Paradigms" (African Entrepreneurship, University Press of Florida 1998) at 9:

> **"The development of an African, capital-endowed, entrepreneurial class may require alliances between the state and private interests. For example, in the Cote D'Ivoire a tripartite political alliance is developing that consists of the Ivorian bourgeoisie ruling class with the political support of the Ivorian peasantry and the external support of foreign capital. The state here assists indigenous entrepreneurs, especially in the formal sector, by providing a favorable environment for capital accumulation."**

In most sub-Saharan countries there is so little history of successful investing in domestic enterprises, of capital raising through public offerings, and of stock market activity, that the mere inauguration of stock exchanges and the listing of former parastatals is far from sufficient to assure an active and growing stock market. Steps must be taken outside of the normal course of market development, beyond merely adding to the list of securities by new privatisations or the floating of government bonds. What is required is a change in how the government views the stock exchange as well as a commitment to capital growth. Although the Lagos Stock Exchange is one of the oldest and largest in Africa, a 1994 study concluded that:

> **"...the NSE remains predominantly a means for government to raise loan finance rather than an instrument for mobilising industrial finance."**

F. Ogwumike and D. Omole, "Mobilising Domestic Resources for Economic Development in Nigeria - the Role of the Capital Market," Final Report presented to African Economic Research Consortium (Nairobi:AERC) at 44. If government's perception of a stock exchange is so narrowly drawn, it will have little incentive to take the remedial measures necessary to foster greater public confidence in the capital market. Perhaps there has been a change in perception in Nigeria since the above quoted study, as the recent opening of a second exchange in Abuja and its dual listing agreement with South Africa reflects at least in part a desire to expand public interest and participation in domestic stock exchanges.

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The suggestions that have been discussed in this article are designed to build public confidence by creating greater interest, education, trust, and investment opportunity. Public confidence in the market process and integrity is an essential attribute to a successful market, but it is an attribute that is not readily achieved. The history of financial problems throughout Africa weighs heavily in the public mind. Considerable effort that goes well beyond formal creation of statutes and regulations is needed, especially at the government level. The effort must be given the attention and financial support consistent with purported goal of capital market development.

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# THE ROLE OF PRIVATIZATION IN THE DEVELOPMENT OF THE CAPITAL MARKET IN POLAND

*By Prof. Josef Okolski*

When in 1989 Poland was the first European country to regain its political independence, it faced a disastrous economic situation resulting from 45 years of communist rule. Due to the Yalta declaration, which left Poland under Soviet control, and of the basis of the falsified referendum of 1946, the communist authorities carried out a hasty nationalization of the means of production and marginalized the so-called "private initiative".

The principal that individuals could only possess consumer goods, whereas production goods could be owned solely by the state or the organizations included in the category of socialized economy units, was an unquestioned truth of the Marxist doctrine. This model was not fully implemented, as individual farmers still owned a large acreage of land and there existed private craftsmanship, nevertheless state-owned enterprises and production co-operatives dominated the economic relations. However, the rights to the means of production vested in these entities had to be executed in a specific way. The socialized economy units had neither the liberty to dispose of nor to use the property they were entrusted with. In particular, as far as state-owned enterprises are concerned, the principal of unity of state property was a very important factor. According to this principal, state organizational units were not the owners but merely the "trustees" of the assets in their possession. Superior units could at any time separate the individual constituents of property of a given enterprise (or other unit) and transfer them to another entity. They could also reorganize the enterprise or even reserve to themselves the right to dispose of its fixed assets.

This was closely related to the constitutional principal of planned economy and the hierarchical system of planning acts. Its most important element was the 6-year plan, passed and controlled by the Seym on the model of the Soviet five-year plans. Its execution was supervised by an extensive economic administration, and the whole system is justly referred to as an "order-control" one. Its disadvantages quickly resulted on the one hand of a decrease of work efficiency and waste of means and on the other hand in many failed investments. Let us just bear in mind that in 1989 the Polish debt towards foreign governments and banks reached the staggering amount of USD 40 billion.

This gave rise to growing dissatisfaction in the society. This sentiment manifested itself for example in the indifference towards the economic policies of the state, including the methods of the national economy management. In early eighties this forced the authorities to significantly change the political "course" through limiting the number of directive indexes communicated to an enterprise by its superior unit, and soon replacing them with economic parameters.

This took place within the confines of a reform, which provided, among other things, for greater self-dependence of enterprises and subjected them to market mechanisms in order to improve their efficiency. Such solutions agreed to a large extent with the demands of the opposition, represented most of all by the "Solidarity" trade union.

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Consequently state owned enterprises became self-dependent, self governing and self financing economic entities. Any disputes between the enterprises and their founding bodies were to be resolved by courts. The authority over the enterprises was transferred from the state officials to the workers. (It is worth noting that today we still have to cope with the consequences of this situation.) However, the naive hopes of the reform's authors have not come true; the expected increase of commitment of employees to the development of the employing institutions has not taken place. Instead, the aberrant system in which the employee imposes his will upon the employer has become established.

The second, better thought out tool of the reform was the hesitant acceptance of private business entities and an attempt at attracting foreign investors. The legislative amendments made in 1982 made possible the creation of the so-called "Polonia companies", based on solely foreign or mixed capital. This trend was reinforced with the Act of 1986 on Companies with Foreign Participation, and the whole process found its culmination in December 1988, in the proclamation of economic freedom.

As it can be concluded from the above, private initiative ceased to be a taboo already at the times of communist rule (it is worth noting that the same happened in Hungary). Nevertheless, the attempts at reforming the Polish economy could not prevent the collapse, which the country faced in early 90s.

Therefore, the first non-communist governments after the war were burdened with repairing the mistakes of the fifty-year-long dictatorship. The program announced in October 1989 provided for the creation of a market economic system, modeled on the systems existing in the developed countries of Western Europe.

As the experience has shown, market economy may not function in an efficient way without private ownership. Therefore, privatization became one of the most important instruments of the systematic transformations. Privatization is commonly understood as the entirety of actions aiming at the development of the private sector, or just the ownership transformations of the existing public sector. The former process takes place through creating, and expanding the potential of the existing private companies by virtue of e.g. appropriate credit, taxation and customs policies. It is worth mentioning here that during the declining years of the communist system there existed a phenomenon of 'informal', 'nomenclature' privatization, which is hard to assess. Is consisted in a discreet transfer of assets of state owned enterprises and production co-operatives into private hands, most often for the benefit of persons managing these entities. This resulted from the weakness of the state supervision and the considerable freedom of decision-making by socialized economy units.

At this point it should be noted that the Polish privatization model has since its beginning aimed at achieving both economic goals, such as improving the economic efficiency, counteracting monopolization, and attracting foreign capital, and political ones, including the following:

- creating a numerous, strong middle class, constituting the basis of the newly created system;
- creating the economic conditions for the stabilization of the new socio-political and economic system.

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This last factor heavily influenced the transformation strategy adopted in 1989. At that time the Polish government had two major options. The first one consisted in reestablishing, before the privatization, effective control of the state over the enterprises of which it was the nominal owner. This option could be implemented through commercializing all the state owned enterprises at once. This would eliminate the workers' councils and consequently the autonomy introduced in1981. The second option went into the opposite direction, i.e. advocated increasing the powers of the enterprise management, including the right to co-decide on the initiation and manner of privatization of 'their' enterprise. Finally the second option was selected due to the fear that a new social conflict could emerge right at the moment when the economy was undergoing shock therapy. This therapy included an abrupt rise of prices and liquidation of savings resulting from hyperinflation. Consequently, privatization in Poland, at least in its initial period, was characterized by a large amount of negotiations, giving prominence to the role of the trade unions, which oftentimes blocked the governmental privatization efforts for many months.

An equally important characteristic of these processes is the diversity of the used privatization methods, forms, paths and programs. To some extent this was also a consequence of the fact that the different political forces could not agree on one common privatization policy.

The first privatization model was the liquidation for economic reasons, performed under the Act of 1981 on State-Owned Enterprises, which gave the Establishing body the right to liquidate an unprofitable enterprise. Amongst other things, such as a decision results in asset disposal. The assets usually get into private hands, as in the case of liquidation proceedings. It is obvious, though, that it would be hard to consider such situations as resulting from rational privatization intentions. Moreover, they constitute a marginal part of the entire process.

The first legal act to regulate the privatization of the Polish economy was the Act on Privatization of State-Owned Enterprises passed in July 1990. It provided for two basic forms of ownership transformations:

- capital (indirect) privatization consisting in transforming an enterprise into a sole shareholder company of the State Treasury, and subsequently making the shares available to third parties;
- liquidation (direct) privatization, consisting in selling the entirety or an organized part of an enterprise, contributing it to a company or letting it for paid use.

A few thousand state-owned enterprises were privatized in this way. At the same time, the demands for the universal affranchisement of the society using the coupon method, which at the same time was implemented in Czechoslovakia, were still very strongly voiced. These slogans very quickly became the tools of political fighting, and were frequently transformed into populist promises, which did not facilitate the process of curing the Polish economy. Nevertheless, they influenced the above mentioned act itself, as it provided for the possibility of making by the Seym, upon a motion of the Council of Ministers, a decision on issuing privatization coupons granted free and in equal number to all the citizens of the republic of Poland residing within the country. (The current regulations also provide for this possibility). These

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coupons could be used to pay for the shares of companies created as a result of transformation of state owned enterprises, for purchasing titles of participation in financial institutions possessing such shares, and in order to buy enterprises in direct privatization.

The somewhat similar Common Privatization program was actually put into practice. The Act on the National Investment Funds and Their Privatization was passed in April 1993. It provided for the creation of the National Investment Funds (NFI), joint stock companies established by the State Treasury which brought into the NFI contributions in kind in the form of shares of singles shareholder companies. In practice, this happened in 1995, when the Minister of Ownership Transformation created 15 National Investment Funds. In 1995 the shares of companies taking part in the program were allotted to the individual funds on the following principals: in total, 60% of shares of the 'ground-floor' companies were distributed; 33% shares were possessed by one, the so-called leading NFI, and 27% in roughly equal parts by all the other funds. The State Treasury kept 25% of the shares and 15% were granted free of charge to the employees of the company and, in some cases, to farmers and fishermen who had been supplying it with raw materials for a sufficiently long period of time. The next stop was the distribution of general participation certificates exchangeable for NFI shares, one for each adult citizen. The certificates were admitted to public trade in April 1997, which meant that the conditions for exchanging them for shares (one certificate for one share of each NFI) and listing of these shares had been fulfilled. The above privatization procedure has therefore drawn to an end. Now we can only observe the efficacy of fulfilling by the NFI their statutory goal, i.e. expanding their assets, in particular by increasing the value of the companies of which they are shareholders. It should also be noted that the NFI program resulted in a significant acceleration of the capital market development. This is both a consequence of the increase of capitalization of the stock exchange by nearly 30% after the introduction of participation certificates to the stock exchange trade and the fact that the new securities (participation certificates, NFI shares) were introduced into public trading. Also there emerged new forms and institutions of trading in securities (a regulated market beyond the stock exchange), which were created in order to serve the program.

The diversity of privatization forms and programs mentioned above also manifests itself in the separate statutory regulations on the transformations of different branches of economy. This regards state owned enterprises believed to be of crucial importance for the state, i.e. those dealing in:

- mining and wholesale trade of hard coal;
- mining of brown coal;
- production, distribution and sales of electric power and heat; and
- production of weapons or military equipment.

In principle the above categories of enterprises may only be commercialized.

A similar solution was adopted in relation to the state owned enterprises of the sugar industry. The State Treasury created four shareholder joint stock companies, the so-called sugar companies, in which the capital was brought in as contributions in kind. These contributions consisted in 51% of the shares of the sole shareholder companies

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of the State Treasury created as a result of commercialization of the sugar factories and refineries. These shares are not subject to privatization. As far as the remaining part of shares of such companies is concerned, they may be purchased on preferential terms by the employees of the transformed enterprises and by farmers growing sugar beet.

A separate act regulates the transformations of state-owned agricultural enterprises. Their assets are generally not subject to privatization and are managed by the Agricultural Property Agency of the State Treasury.

Finally, the privatization of state banks, which by the way had not had the status of state-owned enterprises, was regulated separately in the Act of 1989, Banking Law (which is no longer in force). One should also mention the special acts relating to commercialization of Panstwowy Zaklad Ubezpieczen and Polish Airlines „Lot".

However, this is not a complete picture of the legislation regarding privatization. A new Act on Commercialization and Privatization of State-owned Enterprises, which replaced the previous act of 1990, was passed on August 1996. Although in principle the new act reproduced many of the earlier solutions, it introduced considerable innovations.

The act no longer stipulates that the authorities of an enterprise must give consent to its commercialization and direct privatization, which should definitely make these processes easier and quicker.

The act sets forth the notion of spontaneous commercialization, performed in other purposes than privatization, which sanctioned the procedure used in practice.

In the case of direct privatization, the possibility to dispose of the "organized part of an enterprise" was replaced with "all the tangible and intangible components of its property". The requirement of prior liquidation of the state-owned enterprise was also waived.

The right of the employees, farmers and fishermen (if applicable) to obtain shares of the privatized economic entity was considerably widened. At present, they are entitled to receive, free of charge, up to 15% of the initial capital, which can be considered as a form of 'extortion' paid in return for an undisturbed course of the whole process.

Finally, a significant innovation is constituted by the controversial institution of "commercialization with conversion of claims". Namely, the Minister of the State Treasury may transform the most indebted state-owned enterprises into limited liability companies with the participation of the State Treasury and the creditors. The latter obtain titles of participation in the company for one third of their 'convertible' claims. The remaining claims either expire, or are amortized in 70%, as long as they constitute civil law liabilities. The idea of converting debts into shares is nothing new, but what is criticized is the possibility to perform the conversion even if most creditors object to it.

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Apart from the characteristics of the Polish model of privatization discussed so far, we could also point to the overwhelming trend towards ensuring the participation of a strategic investor (in practice usually a foreign one) in the executed projects. This is connected with better development prospects for the privatized entity, due to the bigger investment and modernization possibilities possessed by such an investor. On the other hand it is hard to imagine that such obligations (and all the more obligations regarding maintaining a relatively high employment level) could be undertaken by an entity, which would not take over the control of the enterprise in question.

It is also worth noting that the proceeds from privatization are treated as an important item in the state budget, which is of great significance taking into account the commonly known difficulties in covering the budget deficit. The income generated by privatization will be also be used for the purposes of the currently implemented reform of the retirement pension system.

Finally one should not overlook the various connections of the discussed ownership transformations with the observed development of the capital market in Poland. The latter is justly considered as one of the most important elements of privatization: it is for its needs that the Warsaw Stock Exchange started its activities in April 1991, and the legislation regulating public trading in securities, the Securities Commission, brokerage firms and trust funds were created. On the other hand, it was the sale of shares of companies owned by the State treasury in a public offering that made possible the initiation of stock exchange quotations, and subsequently heavily influenced the quantitative development of the capital market, in particular in the initial period of its existence.

The privatization of state owned enterprises and the development of the stock exchange allowed for a dynamic expansion of the capital market, the backbone of the market economy. The Warsaw Stock Exchange provides an efficient and regular forum for trading securities after a primary offering and is therefore an important factor contributing to capital market development.

One of the biggest problems connected with this expansion is the paradoxical necessity of state intervention and control. Ironically, the creation and development of free market economy, with the emerging ‘self-regulating institutions’ requires an extensive participation of the state administration on an unprecedented scale[1]. Both the privatization of state-owned enterprises and the development of the capital market are organized and controlled by the government pursuant to the adopted regulations.

These regulations are and have been modeled on those of other states, in particular France (in the scope of organization of the stock exchange) and the United States. This trend towards standardization is also visible in the interpretation of the law: in the case of doubts in this respect, Polish bodies frequently check what solutions are used in other states and aim at adopting a similar interpretation in Poland, so that the regulations concerning the Polish market depart as little as possible from those of the developed capital markets. All these efforts are generally made with the view of ensuring the participants of the capital market the freedom of making deals with a high level of trading security.

[1] cf. J. Rajski: *Privatization of State-Owned Enterprises in Poland*, Hastings International & Company. L. Rev. Vol 17:741

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The principal leading acts in this scope were passed in 1997: the Law on Public Trading in Securities (which replaced the defective act of 1991), the Act on Investment Funds, and the Act on the Organization and Operation of Pension Funds. The Act on Bonds was adopted in 1995.

These acts have introduced four basic rules, i.e.: a) the duty to obtain the approval of the Securities and Stock Exchange Commission for the introduction of securities into public trading; b) the principle of dematerialization of securities in public trading; c) the principle of concentration of public trading; d) the principle of compulsory agency of brokerage firms.

a). Giving consent by the Commission for introducing securities into public trading requires that the issuer has fulfilled many obligations before the consent is given, as well as after obtaining it. The goal of this institution is to ensure that when securities are offered to a wider group of investors, the latter have continuous access to all the information which may affect the price of such securities. Such information includes both data on the financial standing of the issuer, its management, and events such as concluding agreements by the issuer or suits filed against him.

In principle, while admitting securities to public trade, the Commission does not investigate whether buying them will be a good investment (the investors have to make this decision by themselves), but it makes sure that the buyers of securities are provided with all the information, in particular on risk factors. That is why there exists the institution of the issuing prospectus, which is scrupulously examined by the Commission. Upon obtaining its consent, it is published and made available to the public in brokerage firms, and, in its shortened version, announced in two nationwide dailies. During this whole period the issuer is under the obligation to submit the so-called current and periodical reports. With the exception of specific cases, it is inadmissible to disclose this information only to selected persons.

The competencies of the Securities and Stock Exchanges Commission discussed above are not all the tasks which it is to perform. Some of its other duties are the following:

- entering persons into the list of brokers and investment advisors, removing them from these lists and suspending the licenses;
- granting, suspending and withdrawing permits for carrying out brokerage activities;
- granting permission for buying blocks of shares exceeding 25, 33 and 50% of votes at the general meeting of shareholders;
- granting permission for initiation of activities by investment funds; and
- imposing fines on entities infringing regulations on public trading.

b). Securities in public trading are not in a material form, but function solely as book entries. As they are not in the form of documents, their transfer may not take place at the moment of delivery, as set forth in the Civil Code. Therefore the law on public trading stipulates that the rights in securities admitted to public trading emerge upon entering them for the first time into a securities account, and are vested in the possessor of the account. The transfer of rights takes place at the moment of making an appropriate entry in the relevant accounts. This procedure required the creation of

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an entirely new organizational system, its main element being the National Deposit of Securities.

The deposit, initially managed by the Stock Exchange, is presently a separate joint stock company, with a major interest of the State Treasury. The company carries out activities ascribed to the public administration: registers securities admitted to public trading, supervises the volume of issuance (in particular as regards its conformity with the number of securities in circulation), attends to the realization of obligations of the issuers towards holders of rights in securities and finally settles the accounts in relation to the transactions concluded on the regulated market and handled by brokerage firms.

The main advantage of the discussed system is the fact that the securities are not transferred materially, which makes trading faster, cheaper and more secure.

c). The secondary trading in securities (i.e. sale of securities by an entity not being their issuer or sub-issuer) may in principle take place only on the regulated market, currently formed by the Warsaw Stock Exchange (a joint stock company) and the Central Table of Offers established in 1996. These institutions are supposed to ensure the concentration of securities supply and demand in order to create common prices, ensure a sake and efficient course of transactions and disseminate unified information on prices and turnovers.

In order for securities to be sold at the Stock Exchange or the Central Table of Offers (‘CeTO’), they must be admitted to trading on a given market. The criteria and conditions of admittance are specified in the rules adopted by the Stock Exchange Council and the supervisory board of the CeTO respectively. It is also these two bodies which take the decisions on admitting to trading, upon a motion of the Management Board. The proceedings usually last a few weeks and during this period the securities are practically excluded from trading.

d). The principle of compulsory agency of brokerage firms is substantiated by the need for state supervision over trading as well as by technical considerations. The latter result from the fact that the whole trading is concentrated on the stock exchange and the CeTO and must be cleared within a unified computer system created by the National Deposit of Securities. The only exception to the above rule regards trading in securities issued by the State Treasury or the National Bank of Poland and related securities.

Leaving aside the details of the legal regulations concerning the Polish capital market it may be concluded that despite the existing loopholes or imperfections the system is characterized by high quality and efficacy.

The main goal of economic transformation is the conversion or liquidation of all the state-owned enterprises. The former enterprise structure, in which it was virtually impossible to establish one single owner, was appropriate for socialist, centralized planned economy. However, this structure is absolutely unsuitable in the market economy conditions. Consequently, the main task was the commercialization of state-owned enterprises, consisting in transforming them into commercial law entities: limited liability or joint stock companies. Obviously, the joint stock company is the

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most important entity from the point of view of capital market development, due to the fact that the sale of its shares is less constrained and to the possibility of going public.

Even the sole act of commercialization – transformation into a joint stock company – results in an improvement of the management methods. Centralized management, exercised directly by the state is replaced with instruments of the commercial law, pursuant to the principles set forth in the law on companies.

In a new company, created as a result of transformation, the ownership relations are much clearer. At first the sole owner of the capital is the state, represented by the Minister of Treasury. Before the shares may be traded in public, it is necessary to perform valuation of the company assets and fix the price for the shares in the so-called Initial Public Offering. This stage is a very complex one, and gives rise to controversial problems, which cause many disputes. The valuation of assets and shares is difficult most of all due to the fact that in the past, as there was no market, there were no market prices and those fixed by the state could not be verified. At this stage there also exists considerable risk of corruption, which resulted in the necessity of the costly employment of reputable global companies such as PricewaterhouseCoopers, Arthur Anderson, KPMG, etc. in the role of experts.

Finally, after the completion of the 'evaluation of assets' stage and fixing the price, there is the Initial Public Offering, which usually comprises a small percentage of shares. The so-called controlling interest is destined for a strategic investor, searched through a public invitation and further negotiations. Fifteen percent of the shares are available free for the employees of the company, which may be considered as an element of the Employment Stock Ownership Program. Upon selling a part of the shares and receiving consent of the Securities Commission and the Stock Exchange Council, the company may be admitted to public trading and it becomes a public, listed company. This is advantageous both to the company and for the development of the capital market. Most importantly, companies get easier access to capital. By issuing securities to the public, a company can raise long-term capital. This is a crucial factor in the 'emerging market' conditions of post-socialist economy. Being listed on the stock exchange improves the financial standing of a company. It enhances its prestige, image and reputation, which is undoubtedly of considerable significance for the development of the market economy and growth of the employment level.

Close connections between privatization and the capital market development are undoubtedly one of the most important accomplishments of the Polish privatization model. These connections allowed to achieve a relatively high quality of privatization processes in comparison with other countries and made possible commencing the implementation of the discussed programs, which would be unfeasible without properly developed capital market institutions. Clear rules pursuant to which this market functions and effective solutions in the scope of bank supervision allowed Poland to avoid many problems encountered by other countries, in which these issues were neglected (the most spectacular example here is the Czech Republic). These rules have also attracted foreign capital to Poland. It may therefore be concluded that the privatization of  the roughly 3500 state-owned enterprises still existing in Poland should take place within a reasonable period and without any major problems.

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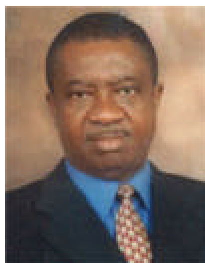

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# About UNITAR

UNITAR is an autonomous body within the United Nations which was established in 1965 to enhance the effectiveness of the UN through appropriate training and research. UNITAR's programmes in the legal aspects of debt, financial management and negotiation are among a wide range of training activities in the field of social and economic development and international affairs carried out, generally, at the request of governments, multilateral organizations, and development cooperation agencies. UNITAR also carries out results-oriented research, in particular research on and for training, and develops pedagogical materials including distance learning training packages.

UNITAR's **Training and Capacity Building Programmes in the Legal Aspects of Debt, Financial Management and Negotiation** are conducted for the benefit of over 35 partner countries mainly from sub-Saharan Africa and Vietnam. These programmes aim at meeting the priority training needs of senior and middle-level government officials through a wide range of seminars, workshops, and training of trainers workshops. In parallel to training activities, the programme also assists in strengthening local capacities of governmental and academic institutions through distance learning training packages, up-to-date publications as well as networking activities.

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- Training government officials through short-duration regional seminars and workshops on various aspects of debt, financial management and negotiation;
- Developing On-line Training Courses (in parallel with its traditional regional training) with a view to tapping a wider audience and reducing cost of training per participant;
- Strengthening existing ties with regional training centres and offering joint courses with partners in the field;
- Creating awareness among senior government officials of the importance of the legal aspects in the borrowing process and of putting together a multidisciplinary team for loan management and public administration;
- Providing in-depth training and skills development for accountants, economists, financial experts and lawyers coming from government ministries and departments involved in negotiation, financial management and public administration; and
- Developing and disseminating training packages and 'best practice' materials directly related to the practicalities of legal aspects of debt and financial management, with a view to strengthening existing human resources and institutional capacities at the national level.

A description of UNITAR's latest activities and training programmes in the area of debt and financial management is available on its website at: www.unitar.org/dfm.

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