Stimulation of the Development
of Emerging Securities Markets

by

Development Committee of IOSCO

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RECOMMENDATIONS OF WORKING GROUP III

STIMULATION OF THE DEVELOPMENT OF EMERGING SECURITIES MARKETS

EXECUTIVE SUMMARY

At the 14th Annual Conference of the International Association of Securities Commissions and Similar Organizations (IOSCO) in Venice, Nigeria was nominated by the Development Committee to chair the Working Group on "Stimulation Policies for Securities Market Development". Other members of the Working Group are Bolivia, Egypt, Mexico, the International Finance Corporation (IFC) and the Arab Monetary Fund, the latter as a correspondent member. At the initial stage, Nigeria called for inputs from all members. At the time a draft report was written for a May 1990 meeting of the Development Committee in Mexico, only four members of the Working Group, namely the Arab Monetary Fund, the IFC, Mexico and Egypt had forwarded their inputs to the Nigerian SEC.

The inputs were categorized into three broad categories: supply-side policy measures, demand-side policy measures and other policy measures. The draft report was circulated to all members.

In order to give members another opportunity to comment, finalise and adopt the draft report before being forwarded to the Development Committee of IOSCO, a meeting was held in Nigeria on 15th and 16th of March 1990. Attendance at this meeting was not very encouraging as only the representatives of Mexico and Nigeria were present. However, the meeting was held as planned and the report was finalised and adopted for presentation at the May 1990 meeting of the Development Committee in Mexico.

At the Development Committee meeting held in Mexico from May 23rd to 25th 1990, the Director-General of the Nigerian Securities Commission presented the draft report of Working Group III. At the end of the presentation, the members urged the Working Group to reclassify the policy measures as follows:

I. Measures that are within the purview of the securities commissions' control based on the power conferred on them by their enabling laws/decrees and rules and regulations and;

II. Measures that require governmental approval.

The following policy measures were identified as being within the power of a securities commission:

1. Two-tier Market
2. Single Stock Exchange
3. Over-the-Counter Market
4. Financial Intermediaries
5. Cost of Raising Capital
6. Promoting Venture Capital Companies and Funds
7. Institutional Investors
8. Financial Instruments
9. Establishment of Collective Investment Vehicles
10. Transaction Costs
11. Market Infrastructural Facilities
12. Introduction of Margin Loans and other Purchase Support Forms for Investors
13. Information of the Public
14. Other Operational Mechanisms, and
15. Market Surveillance Systems

While the following policy measures were identified as those that need governmental approval:

1. Tax Incentives for Companies
2. Tax Incentives for Investors
3. Mandatory Measures
4. Credit Policies
5. Review of Corporate Law
6. Telecommunications Facilities
7. The Establishment of a Proper Legal and Regulatory Framework
8. Privatisation
9. Debt/Equity Conversion Programmes
10. Internationalisation Strategies, and
11. International Support

Some of the measures in these two broad categories, however, require joint cooperation of both the governments and securities commissions. These include:

1. Single Stock Exchange
2. Promoting Venture Capital Companies and Funds
3. Institutional Investors
4. Establishment of Collective Investment Vehicles, and
5. Market Infrastructual and Telecommunications Facilities

Members were encouraged to discuss in detail the mechanisms used in the implementation of any of the measures listed in the report which their respective countries had adopted and implemented. This was to enable members to compare notes and to learn from experiences and mistakes of their colleagues. As at the time of writing this report (August 1990), Nigeria had yet to receive any specific proposal or practical recommendation from members.

Also, at the meeting in Mexico, Working Group coordinators were urged to make recommendations on what should be the future role of each Working Group. Since most members showed a particular interest in Working Group III's topics, it was agreed that every member of the Development Committee who wished to do so could join the Working Group III which would then constitute a relatively permanent body. It was agreed that Nigeria should continue to act as the Working Group's coordinator. Also, Nigeria was requested to draft a questionnaire that would be sent to members at regular intervals. The first questionnaire will be circulated to members at the IOSCO 15th Annual Conference scheduled for November 1990 in Chile.

RECOMMENDATIONS OF WORKING GROUP III

STIMULATION OF THE DEVELOPMENT OF EMERGING SECURITIES MARKETS

REPORT

INTRODUCTION

At the 14th Annual Conference in IOSCO in Venice in November 1990, the Development Committee's earlier review of various aspects of emerging securities markets was re-assigned to several member countries. Nigeria was nominated to chair the Working Group on "Stimulation Policies for Securities Market Development" with Bolivia, Egypt, Mexico and the International Finance Corporation (IFC) as members and the Arab Monetary Fund in a correspondent capacity. In performing its functions as coordinator of the group, Nigeria, as an initial step, called for inputs from all member countries. To facilitate coordination, the inputs were categorised into three broad areas. These were: supply-side policy measures, demand-side policy measures and other policy measures which had been adopted by member countries or which member countries would like to see adopted.

At the meeting of the Development Committee held in Mexico from May 23rd to 25th, 1990, it was agreed that the various recommended policy measures report should be re-classified into two broad categories which are discussed in detail below:

I. Measures that can be applied directly by securities commissions by virtue of powers conferred on them by their enabling laws or those in which they have a substantial or partial say and which are a part of their developmental role; and

II. Measures that require government approval through legislation or the substantial or primary involvement of others.

It was clearly recognized, however, that several of the measures require joint efforts of both governments and securities commissions. These include matters such as the creation of a single stock exchange and the promotion of institutional investors, collective investment vehicles, a venture capital industry and telecommunications.

It was also agreed that, to the extent possible, examples should be drawn from countries that have applied specific measures with brief discussions of the procedures employed in implementing such measures. This was to enable other emerging markets learn from other countries' experience. This has not yet been accomplished in this paper and should be the subject of further work.

A suggestion for prioritisation of the measures listed in the report was rejected after a thorough debate. The suggestion was rejected on the ground that what is important to country A at a particular point in time, may not be relevant to country B. Prioritisation of measures, therefore, depends on the stage of development of a country's capital market, government policies, economic programmes, etc.

I. MEASURES WITHIN THE POWER OF SECURITIES COMMISSIONS

1. Two-Tier Market: To increase the supply of securities in the capital market, a two-tier market system should be introduced with two distinct types of listing requirements. The first or main market should list larger companies which meet the more stringent requirements while the second market should be accessible to small- and medium-sized companies.

2. Single Stock Exchange:

   The general trend in the world's securities markets is the merger of stock exchanges. The possible reason being the low trading volume and value which appear not to justify the high overhead costs of operating several stock exchanges. Cautious of the fact that the impact of securities market development needs to be felt in all parts of the country in a developing economy, it is advisable to encourage the establishment of stock exchange branches. All the branches should be linked to ensure easy monitoring.

3. Over-the-Counter Market

   A well regulated over-the-counter market could be encouraged in emerging markets as a means of boosting the supply of securities in these markets.

4. Financial Intermediaries

   Financial intermediaries are very vital in the process of developing a securities market and the financial system as a whole. Without adequate, efficient, innovative and competitive financial intermediaries, the level of development of the securities market and indeed the financial system would remain rudimentary. Emerging markets should, therefore, endeavour to improve the number (if necessary), type, innovativeness and activities of financial intermediaries.

5. Cost of Raising Capital

The high cost of raising funds in the securities market vis-à-vis other alternative sources, such as the money market, would discourage companies and other bodies from utilizing the facilities of the market. This would have adverse effects on the supply of securities in the market. It is, therefore, recommended that securities commissions, in collaboration with other market operators, strive to achieve the lowest possible cost structure comparable to those in the money market and other external capital sources.

6. Promoting Venture Capital Companies and Funds

One other means of possibly stimulating emerging securities markets is by encouraging the development of venture capital companies and funds which hopefully with time will go public or seek quotation on the Stock Exchange.

7. Institutional Investors

Investment activities of some institutions such as insurance companies and pension funds are vital to the securities markets, since some their surplus funds are invested in securities market instruments. Therefore, their participation should be strongly promoted.

8. Financial Instruments

The availability of a wide array of instruments traded in securities markets should provide prospective investors with varied investment choices. On the other hand, when few instruments are available for trading, investors will be quite limited as to instruments to choose from, which may have a discouraging effect on some prospective investors.
The introduction of a wide variety of types of securities will not only stimulate demand, but also the supply of securities in the market.

9. Establishment of Collective Investment Vehicles

The creation of unit trusts and mutual funds should be encouraged in developing markets.

10. Transaction Costs

Transaction costs in securities markets should be kept at the barest minimum.

11. Market Infrastructural Facilities

Adequate infrastructural facilities such as a well-functioning telephone and telefax system and efficient trading, clearance, settlement and depository systems are essential for the development of a securities market. Securities commissions, together with stock exchanges and other market operators should, therefore, make a continuous effort to improve these facilities.

12. Introduction of Margin Loans and Other Purchase Support Forms for Investors

The provision of margin credits and other mechanisms such as employee ownership schemes could help to increase the demand for securities and trading in the market.

13. Information of the Public

In many emerging markets the level of awareness about the securities market is relatively low. Without awareness, these markets are not likely to develop reasonably well as both demand for and supply of securities would be impaired. To improve knowledge about the market, securities commissions as well as the stock exchange and other market operators should constantly carry out public information programmes about the benefits of the use of and investment in the capital market.
In general, all avenues must be exploited to disseminate information to the public and consequently enhance the overall knowledge about the securities market.

14. Other Operational Mechanisms

Emerging markets must arrive to increase the liquidity of listed securities. Therefore, other operational mechanisms may be introduced according to their particular circumstances, among them: short sales, specialists or market makers, circuit breakers, rating agencies, market stabilisation funds, etc.

15. Market Surveillance Systems

Efficient and effective surveillance systems are also important for the development of securities markets. It should be one of the priorities of securities commissions that such systems be well developed.

II. MEASURES THAT REQUIRE GOVERNMENTAL APPROVAL

1. Tax Incentives for Companies

(a) Introduction of a two-tier corporate tax rate in favour of publicly-held companies.
(b) Introduction of corporate tax exemption for newly quoted companies.
(c) Deduction of a percentage of the cost of going public or seeking public quotation.
(d) Deduction of a percentage of corporate profits distributed to shareholders.

In more general terms, tax systems should be neutral in their treatment of equity and debt financing and not favour the latter of the former.

2. Tax Incentives for Investors

Tax incentives for investors are perhaps one of the most effective methods of increasing the demand for securities. Specific measures can include:

(a) Elimination of withholding tax on dividends earned on equity investment and interest income on bonds. In the alternative, withholding tax on these investments could be brought significantly below the prevailing rate for competing investments.
(b) Capital gains on securities market investments should also be tax free.
(c) Investors should be allowed to deduct up to a prescribed limit of the amount invested in capital market instruments, or at least in new issues, from income tax.

3. Mandatory Measures

Legal and regulatory measures such as requiring limited stock companies to go public, withholding credit to companies which refuse to do so, moral suasion, etc. may be required in certain countries under certain circumstances.

4. Credit Policies

The provision of "cheap" or subsidized credits directed to certain preferred sectors of the economy has adverse consequences for securities market development since companies and institutions in such sectors will tend to show a preference for such credits rather than utilising longer term market rate funds. It is suggested that developing countries discard or at least minimise such forced credit allocation practices which not only deter the development of the securities market but also misallocate resources and may impede economic development.

5. Review of Corporate Law

In countries with stiff corporate law requirements and cumbersome procedures with respect to acquiring public status, such requirements and procedures could be modified to make it easier for private companies to go public without, however, jeopardising disclosure and accounting requirements expected of public companies and other investor protection measures.

6. Telecommunication Facilities

Adequate telephone, telefax, postal and other communications systems, as well as a regular power supply, are essential for development of a securities market, and their improvement should, therefore, be encouraged.

7. The Establishment of a Proper Legal and Regulatory Framework

This should embrace all aspects of market activities i.e. participants, trading, etc., in order to instill confidence. Indeed, for any securities market to be well developed, there has to exist confidence by all participants in the market.

Emerging securities markets should ensure that proper auditing and accounting standards and procedures are put in place while the disclosure of information is adequate and accurate enough to protect investors.

8. Privatisation

For countries embarking on certain economic reform programmes such as privatisation, the capital market should be used as an avenue for implementing such programmes.

9. Debt/Equity Conversion Programmes

Debt/equity conversion programmes can also aid the development of the securities markets if conversions are affected through the capital markets and they, therefore, should be encouraged.

10. Internationalization Strategies

Internationalisation strategies which open local securities markets to foreign portfolio investors can considerably stimulate development of emerging markets. There are various forms of capital market internationalisation which individual countries can critically examine with possibilities of adoption such as: global investment funds, neutral investment schemes, country funds, foreign listing, flight capital repatriation schemes, etc.
It is also recommended that auditing and disclosure requirements should be in line with international standards.

11. International Support

International and bilateral agencies should be encouraged to increase their support of emerging securities market development.

III. MEASURES THAT REQUIRE JOINT EFFORTS

These include the promotion of:

1. Single Stock Exchanges with Branches.

2. Venture Capital Companies and Funds.

3. Collective Investment Vehicles

4. Market Infrastructural and Telecommunications Facilities, and

5. Institutional Investors.

CONCLUSION

The implementation of policies to encourage securities market development requires the involvement of the regulatory authorities, the market operators and the government itself. In emerging markets, a strong political will is likely to be necessary to successfully introduce and carry out such policies. All in all, it is strongly felt that stimulation policies are of fundamental importance for the development of securities markets and it is, therefore, recommended that they be given due and continuous consideration.