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Emerging Capital Markets: Proposals and Recommendations for Implementation

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Emerging Capital Markets: Proposals and Recommendations for Implementation

For emerging capital securities markets,[1] is the United States' approach useful when determining the structure and components of such markets? Does the U.S. system serve as a panacea for these developing markets or as an inflexible bureaucratic maze to be sidestepped with impunity? Stated succinctly, the answer is that the U.S. model may be useful in certain contexts, but that each emerging capital market should adhere to an approach compatible with its culture and reflective of the costs and efficiencies implicated.

Today, with the continual need for the infusion of funds and the increased competition of obtaining such funds from traditional sources,[2] countries with

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1. *See* Hal S. Scott & Philip A. Wellons, *Emerging Markets: Privatization and Institutional Investors*, in INTERNATIONAL FINANCE: TRANSACTIONS, POLICY AND REGULATION 965-1004 (1995).

2. Private sources of capital have been reluctant to invest in developing countries' economies as a result of such countries' macroeconomic difficulties, political instability, and/or opaque legal systems. "As a result, the multilateral development banks (MDBs), particularly the World Bank

emerging economies look with ardor to establishing attractive capital markets in order to procure sought-after capital from private sources, frequently from abroad.[3] Countries spanning the globe from continent to continent seek access to a healthful cut of this elusive pie.[4] Even countries within geographic regions join together for this common purpose.[5]

Countries with emerging securities markets are not alone in their quest for inducing the inflow of capital. They compete not only with the supposedly sophisticated securities markets in, for example, New York,[6] London[7] and Tokyo,[8] but also with a host of markets that have strong regional or at least local impact in procuring capital (including, for example, the Singapore, Johannesburg, and

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and the European Bank for Reconstruction and Development (EBRD), have had to provide the majority of the capital to these countries. . . ." Matthew H. Hurlock, *New Approaches to Economic Development: The World Bank, the EBRD, and The Negative Pledge Clause*, 35 HARV. INT'L L.J. 345 (1994) (footnote omitted). For further information on the history of the World Bank and its effect on lending to developing countries, see RECOVERY IN THE DEVELOPING WORLD: THE LONDON SYMPOSIUM ON THE WORLD BANK'S ROLE (1985).

3. "FDI flows to the developing world, which represented roughly a quarter of global FDI flows in 1992, increased from US $500 million in 1965 to US $38 billion in 1992. . . ." IBRAHIM E. SHIHATA, LEGAL TREATMENT OF FOREIGN INVESTMENT: THE WORLD BANK GUIDELINES 2 (1993) (citing THE WORLD BANK, GLOBAL ECONOMIC PROSPECTS AND DEVELOPING COUNTRIES 27 (1993)).

4. In 1992 it was estimated that of the 116 low- and middle-income countries reporting to the World Bank Debtor Reporting System, the percentage of Direct Foreign Investment by region was as follows in billions of U.S. dollars: Latin America, 13.8; East Asia, 15.1; Europe and Central Asia, 5.7; Middle East and North Africa, 2.1; Sub-Saharan Africa, 1.3; and South Asia, 0.4. SHIHATA, *supra* note 3, at 7; *see also* Michael R. Segit, *South Africa Tries to Win Back Investors*, WALL ST. J., May 1, 1996, at 1 (although foreign investors are "fleeing," South Africa's economic potential is "huge" and now presents a "buying opportunity").

5. *See, e.g.*, Angola-Botswana-Lesotho-Malawi-Mozambique-Namibia-Swaziland-Tanzania-Zambia-Zimbabwe: Treaty of the Southern African Development Community, 32 I.L.M. 116 (1993) (Introductory Note by Rosalind H. Thomas). *See generally* MORRIS GOLDSTEIN ET AL., INTERNATIONAL CAPITAL MARKETS: DEVELOPMENTS PROSPECTS AND POLICY ISSUES (International Monetary Fund World Economic and Financial Surveys, 1992); Jane Winn, *How to Make Poor Countries Rich and How to Enrich Our Poor*, 77 IOWA L. REV. 899 (1992).

6. The New York Stock Exchange (NYSE) is the most renowned securities marketplace in the world. The NYSE was founded in 1792 and has become the leader in an emerging global marketplace. There are more than 2500 companies from around the world who list their shares on the NYSE. Approximately 51 million Americans own stock in companies or shares in stock mutual funds, and more than 10,000 U.S. institutions with $5 trillion in securities under management have access to and use the NYSE market. NEW YORK STOCK EXCHANGE FACT BOOK 3, 4 (1994) [hereinafter FACT BOOK].

7. In the United Kingdom there are two markets, the London Stock Exchange and the Unlisted Securities Market. The London Stock Exchange's Official List consists of approximately 2500 companies, including about 500 overseas companies. *See* DOING BUSINESS IN THE UNITED KINGDOM 50, 63 (1994).

8. There are eight stock exchanges in Japan; however, most of the trading occurs on the Tokyo Stock Exchange (TSE). It represents 87% of the nation's total equity trading volume. The TSE had approximately 1641 publicly traded domestic companies and 125 foreign corporations listed at the end of 1991. *See* DOING BUSINESS IN JAPAN 38, 52 (1993).

Stockholm Exchanges).[9] As a result, the challenge facing emerging capital markets is daunting.

Emerging markets compete for a finite amount of private investment in an increasingly competitive world. They must persuade astute investors to impart capital in their respective countries rather than in seemingly countless other venues that provide greater comfort. With the availability of readily accessible capital markets having relatively long-standing stability,[10] what benefits can an emerging market offer to attract investors? Key inducements, for example, are: the realistic lure of impressive profit; a relatively stable political climate; liquidity and negotiability of investment; control over one's investment; and regulation that promotes market integrity and ethical business practices (without unduly infringing upon privacy concerns and entrepreneurial creativity).[11] Of course, the reality may be such that the preceding inducements serve merely as platitudes, incapable of effective implementation. Political instability, inexperience with capital markets, and the absence of funding to establish (and maintain) regulatory oversight may prevail.[12] In such event, successfully inducing the inflow of capital may well depend on the ability of such emerging capital markets to persuade investors that substantial profits are likely to be made. Certainly, this task of persuasion is easier in a country such as China as compared to Macedonia.[13]

Needless to say, there is no fixed agenda to which emerging securities markets

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9. The Johannesburg Stock Exchange (JSE) is the only stock exchange in South Africa. For more information on JSE, see DOING BUSINESS IN SOUTH AFRICA (1994). The Stockholm Stock Exchange (Stockholms Fondbörs) is the only authorized exchange in Sweden as of 1991, and only a limited number of foreign securities are traded on the exchange. For more information, see DOING BUSINESS IN SWEDEN (1991).

The Stock Exchange of Singapore has 26 local member firms and recently admitted seven international members. For additional information, see *Doing Business in Singapore* (1993).

10. The long-standing and well-regulated exchanges reputedly offer desired stability. *See* FACT BOOK, *supra* note 6; DOING BUSINESS IN JAPAN, *supra* note 8.

11. *See* Pardy, *Institutional Reform in Emerging Securities Markets, in* POLICY RESEARCH WORKING PAPERS, COUNTRY ECONOMICS DEPARTMENT, THE WORLD BANK WPS 907 (1992).

12. The Securities and Exchange Commission (SEC) formed the International Institute for Securities Market Development (the Institute) to assist countries in building sound regulatory structures. A seminar was held in 1991 for officials responsible for the creation, development, and supervision of emerging securities markets. Seventy-five officials from 32 countries attended. Yugoslavia was among the countries that attended. This country is a prime example of a country experiencing political instability, inexperience with capital markets, and regulatory funding problems. Efforts have been made by Yugoslavia to improve its markets through additional regulation. *See* James Doty, *Capital Market Developments in Central and Eastern Europe: The SEC Perspective, in* INTERNATIONAL SECURITIES MARKETS 37 (1991); *see also* Daniel F. Roules & Chavdar Popow, *Bulgaria's Bid to Lure Foreign Investments*, 30 MERGERS & ACQUISITIONS No. 2, at 38 (Sept./Oct. 1995).

13. *But see Foreigners Shun New Issues in China*, USA TODAY, INT'L ED., July 24, 1995, at 6B; *see also* James M. Dorsey, *Istanbul's Bourse Has Allure Even as that Streak Is Cooled by Political Perils for Turkish Reform*, WALL ST. J., May 2, 1996, at C12; Stanley Siegel, *The Long March to a Market Economy: An Examination of the New Company and Securities Laws of the People's Republic of China, in* EMERGING FINANCE MARKETS AND THE ROLE OF INTERNATIONAL FINANCIAL ORGANIZATIONS 497 (J. Norton & M. Andenas eds., 1996).

must adhere. A la carte serves as the menu of preference. Given different cultures, political climates, and degrees of access to internal and/or traditional sources of capital, each country's realities call for distinct choices.[14] Hence, rather than designating a "set menu" for emerging capital markets, the more prudent course is to identify those components worthy of consideration. In this endeavor, due to its impact and supposed respect in the world capital markets, the U.S. system is a key source that should be explored.

Irrespective of the contours of the framework ultimately adopted, it must receive approbation by participants in the affected securities market. The system adhered to will be difficult enough to effectuate; skepticism at the outset will reduce such likelihood to virtually nil. Therefore, input, dialogue, and consensus are essential; affected constituencies must "buy into" the framework's sensibility and prospect for success.[15] Also, skilled draftsmanship in formulating statutes and regulations in this complex area should be top priority. A clearly written statute (accompanied by coherent legislative history) will serve as a valuable resource when the meaning and scope of the statute are later questioned.[16]

This article analyzes the ingredients that an emerging capital securities market may embrace. In this task, the U.S. framework serves to some extent as a model for possible adaptation as do models from other countries, such as England.[17] Utilizing this approach, the article addresses several key issues that emerging capital securities markets may wish to consider, namely: (1) the choice between government and self-regulation; (2) personnel and funding needs to enforce the laws and other norms deemed worthy of protection; (3) civil versus criminal governmental enforcement; (4) the merits of a private attorney general approach; (5) opting for a disclosure rather than a merit-based system; (6) facilitating access to and growth of securities markets; and (7) the delicate task of overseeing the activities of financial intermediaries.

Not surprisingly, a number of the foregoing issues are related and should be considered in a unified manner. Given the complexity and wide spectrum of choices facing each respective securities market, the ever-present challenge is to

14. "Hungary began this decade with one of the least centralized economies, but the highest per capita debt, in Central and Eastern Europe." Doty, *supra* note 12, at 10. Many countries like Hungary turn to privatization to promote the development of the private sector by "levelling the playing field" to broaden share ownership so that the public has the tools to save money, and as a means to reduce the government's role in the economy. HAL S. SCOTT & PHILLIP A. WELLONS, INTERNATIONAL FINANCE: TRANSACTION, POLICY, AND REGULATION 967 (1995); G. Spasov, *Starting from Ground Zero: The New Bulgarian Securities Act, in* EMERGING FINANCIAL MARKETS AND THE ROLE OF INTERNATIONAL ORGANIZATIONS at 473 (J. Norton & M. Andenas eds., 1996).

15. Examples of this effort were seen when the Institute held a seminar in 1991. In Budapest, "a group of high level Hungarian officials, outside lawyers, an IFC representative, directors of brokerage firms and an SEC staff representative met to discuss the SEC's report. As a result of the meeting, officials of Hungary's Ministry of Justice, with assistance from the SEC, are drafting a package of amendments to Hungarian securities laws." Doty, *supra* note 12, at 9.

16. *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

17. *See* DOING BUSINESS IN THE UNITED KINGDOM 50-63 (1994).

respond in a cohesive, consistent fashion that adequately addresses the underlying problems cost effectively while not being perceived as either too zealous or too lax by interested parties. To successfully meet this challenge remains an awesome if not impossible task for any capital securities market, let alone an emerging market.

I. Government Regulator or Self-Regulatory Organization?

Irrespective of the sophistication of a particular capital securities market, it is clear that some form of oversight or regulation is appropriate. The options include, for example, (1) a central government regulator having extensive authority; (2) government regulation by means of regional bodies; (3) self-regulation conducted by stock exchanges and/or other self-regulatory organizations (SROs) established to oversee issuers and financial intermediaries (such as brokers, dealers, investment advisers, and clearing agents); and (4) some combination of the foregoing.[18]

Government regulation along the lines of the United States' Securities and Exchange Commission (SEC) may evoke fear of stringent government regulation that impedes capital formation and entrepreneurial creativity. According to such critics, the resulting bureaucratic maze with its accompanying high transaction costs is a burden that emerging and even more-developed securities markets can ill afford.[19]

On the other hand, to induce investors to enter these markets, an oversight authority ordinarily must be in place to help engender much-needed confidence in market integrity. Where sharp practices prevail (or are so perceived), mechanisms should be implemented to enforce applicable law and to deter fraud. In such circumstances, much can be said for speaking loudly and carrying a big stick.[20] In

18. In the United States, federal, state, and SRO regulations are all employed. Of course, the underlying circumstances often will dictate the scope of activity of the applicable regulator(s). *See* LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION (3d ed. 1989); *see also Middle East: Credit Rating Agencies in Pakistan, Arab World Will Expand Interest, Confidence in Emerging Debt Markets*, 9 INT'L SEC. REG. REP. NO. 14, at 5 (1996) (describing that credit rating agencies will be established throughout the Middle East, thus hopefully providing key information relating to company financial performance, both historical and forward-looking).

19. *See* Jan Helner, *Stock Exchange Law: The Need for Legislation and Research, in* STOCK EXCHANGE AND CORPORATION LAW 61, 62 (C. Roos ed., 1984) (stating that "the very detailed regulation in the American Securities Act is not attractive to [Sweden]").

20. Although Russia had adopted certain regulations to govern the process of privatization, control its emerging securities markets, and regulate brokers, these laws were not effective because the Ministry of Finance did not use its authority to enforce those standards.

Despite its authority, the Ministry of Finance did not take proactive measures in the market and, as a result, little enforcement occurred. Brokers receiving licenses had little fear of revocation. Prospectus reviews did not result in meaningful disclosure standards. Therefore, enhancing the Ministry of Finance's oversight seemed unlikely to bring much additional order to the market. In addition, the Ministry of Finance may have had motives inconsistent with an open market. J. Robert Brown, Jr., *Order from Disorder: The Development of the Russian Securities Markets*, 15 U. PA. J. INT'L BUS. L. 509, 552 (1995).

those countries where an SRO by custom or law cannot command such presence, a government regulator is the preferable route.

Regardless of whether a U.S.-type SEC is established or self-regulation or some hybrid, adequate powers should be provided. Such powers include, for example, (1) investigatory authority (such as the ability to issue subpoenas demanding the production of relevant documents and the appearance of individuals to testify under oath); (2) enforcement authority enabling the regulator to seek either directly or efficiently through a different regulatory source remedial relief (such as injunctions, disgorgement, and the appointment of a receiver) as well as punitive measures (including civil fines, forfeitures, and criminal prosecution); and (3) the wherewithal to secure judicial relief (such as criminal contempt) in the event of a subject person's noncompliance with an order previously imposed.[21]

Whether a particular capital securities market opts for a government regulator or SRO oversight may depend on such factors as the applicable country's culture, resources, and level of sophistication in this area. Difficult choices have to be made. It may be argued that a country with little expertise that seeks to develop a securities market would be imprudent, from both a cost and efficiency perspective, to establish a U.S.-type SEC.[22] This putting the cart before the horse approach elevates theory over reality, reflecting waste with little tangible benefit. On the contrary, it may be asserted with some justification that, unless the prospects for economic gain are strikingly encouraging, investors outside of the host country will not enter a market that lacks basic regulatory oversight.[23] Hence, in order to induce the inflow of foreign capital, it may be necessary for a country with an emerging capital securities market to establish a governmental regulatory body.[24]

II. Money and Resources—Seemingly Always a Key Dilemma

Irrespective of a market's level of sophistication, funding and resources for adequate oversight pose a continuing dilemma. When demands are high for such

21. *See* MARC I. STEINBERG & RALPH C. FERRARA, SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT (1985 & 1995 supp.).

22. *See* John J.A. Burke, *The Estonian Securities Market Act: A Lesson for Former Republics of the Soviet Union*, 27 VAND. J. TRANSNAT'L L. 545, 550 (1994) ("The securities laws of the United States, Great Britain, and Canada, for example, would be totally inappropriate for Estonia, given the complexity of their legal systems and the different levels of their economic development.")

23. Poland is a good example of where regulatory oversight and enforcement of applicable requirements resulted in the success of the Warsaw Stock Exchange. "This appearance of a well regulated stock market where liquidity is guaranteed by over 400,000 private local investors has attracted many foreign investors, who often buy and sell shares on the WSE as a hedge." William C. Philbrick, *The Task of Regulating Investment Funds in the Formerly Centrally Planned Economies*, 8 EMORY INT'L L. REV. 539, 547 (1994).

24. *See* Burke, *supra* note 22, at 551 (observing that for Estonia, "a securities regulatory system is essential to encourage foreign investment, to provide adequate investor protection, and to minimize the possibility of corruption").

crucial matters as education, health care, defense, and infrastructure, the zeal for pursuing inside traders and stock manipulators more effectively by appropriating generous funds is not surprisingly chilled. This dilemma is exacerbated for emerging securities markets frequently situated in countries with pressing human and societal demands.

Yet, sufficient funding and resources are key to the success of a securities oversight framework. For example, the most rigorous statutes have little impact if the country lacks funds to hire, retain, and school the requisite number and variety of personnel to competently administer the regulatory regimen. Hence, without the necessary human and financial resources, even egregious violations go undetected and the most elaborate regulatory framework proves futile.[25]

Therefore, a review of key characteristics in this context is warranted. Clearly, the personnel employed by the subject SRO or governmental body must be competent and qualified. They must have the requisite education and training to administer the pertinent framework. Sending employees abroad to acquire the necessary acumen should be a matter of priority, as should inviting experts from abroad to lend their insights.[26] Also, there should be a "critical mass" of employees in both numbers and specialties. In addition to adequate support staff, attorneys, accountants, financial analysts, and investigators should comprise the scene. Personnel alone is not sufficient. Given the ingenuity of those bent on fraud, the requisite technology must be available to the enforcers. Of course, the degree of the technology demanded will depend on the complexity of the particular securities market.

With vigorous investigatory and enforcement powers, competent oversight personnel in both number and specialty, and the use of appropriate technology, much can be accomplished. Nonetheless, the task of attracting and retaining personnel of high caliber remains. Some suggestions are offered. Certainly, employment with the applicable SRO or government regulator should be perceived as a position having respect and status. Salaries (and other compensation benefits) should be set as near as economically feasible to that earned by comparable persons in the private sector. The same holds true for office accommodations. They should be of similar quality as those used by respected professional firms in the host country. To reward those who perform admirably, periodic salary increases and promotion opportunities for more demanding positions should be

25. For example, although South Africa has a fairly detailed insider trading prohibition as well as regulatory personnel to pursue alleged violators, thus far not one prosecution has been initiated. *See generally* Franso H. van Zyl, *South Africa: Insider Trading Regulation and Enforcement*, 15 Co. LAW. No. 3, at 92 (1994).

26. *See* Burke, *supra* note 22, at 578 n.111 (The Estonian Securities Market Act authorized the creation of a Securities Board. The general director of the Board appointed Arno Puskar as the assistant director. Puskar "is on a one year leave of absence from Bankers' Trust where he is a securities analyst." Two other advisors appointed to the Board received training from the U.S. Securities and Exchange Commission on how to conduct inspections of securities firms.)

made available. And last, the objective of achieving excellent performance should be part of the culture and ethos of the applicable regulator as viewed from both within and outside.[27]

The foregoing ideals can be actualized only with strong financial support. Put simply, it will "take plenty of money."[28] With more pressing personal and societal demands facing countries with emerging securities markets, how can these funds feasibly be raised? A number of sources come to mind. First, a registration fee may be collected when an issuer opts to have an offering of its securities. Second, financial intermediaries, such as broker-dealers and investment advisers, may be required to pay an annual or other periodic registration fee to the applicable body as a condition of doing business. Third, companies and other types of business enterprises may be subject to an annual franchise tax. Fourth, the relevant stock exchange may collect a fee from companies listed on the exchange as a privilege of having their securities traded on such exchange. Fifth, the relevant stock exchange likewise may impose a user fee upon broker-dealers to reflect their engaging in business through exchange facilities. Sixth, the SRO or the government regulator may levy (or seek the levying through court order of) money penalties against securities law violators.[29]

Collection of sufficient revenues without posing a disincentive for companies and financial intermediaries to enter the applicable securities market is a delicate task. If the charges levied are viewed as excessive, they will induce the relevant players to divert at least a significant amount of their activity to other less intrusive markets. This point becomes accentuated with respect to the imposition of money penalties, which not only may be costly but also carry a stigma to one's reputation.

In light of the personal and societal needs of countries with emerging securities markets, the distinct possibility also exists that the particular government will make use of the fees generated to serve other more-pressing needs. Leaving the applicable SRO or government regulator with meager funding disserves the long-term economic interest of procuring the inflow of foreign capital. By providing an adequate level of funding for the SRO or government regulator to oversee the applicable securities market, there will exist a greater likelihood of instilling investor confidence.

On the other hand, allowing the applicable regulator to be entirely self-funding from the fees and penalties collected creates the risk that a bloated bureaucracy will emerge and that corruption will serve as the order of the day. Tying personnel

27. *See* Bruce A. Mann, *What Constitutes a Successful Securities Regulatory Regime*? 3 AUSTRALIAN J. CORP. L. 178 (1993); Judith Miller, *S.E.C.: Watchdog 1929 Lacked*, N.Y. TIMES, Oct. 31, 1979, at D1; JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET—A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE (1982).

28. GEORGE HARRISON, GOT MY MIND SET ON YOU (1987).

29. The SEC and the states tap a number of these sources. *See* MARC I. STEINBERG, SECURITIES REGULATION (2d ed. 1993); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

salaries and perquisites to the revenues generated is fraught with risk. For example, if the levying of money fines against alleged violators directly redounds to the financial benefit of the enforcers, nonmeritorious cases may be pursued and excessive fines may be assessed. Such an occurrence would be catastrophic to the success of any emerging securities market (except in those markets where the market players, including investors, expect handsome returns).

III. Government Enforcement—Civil versus Criminal

When an alleged violation of the securities laws occurs, should civil and/or criminal enforcement be pursued? To illustrate, the SEC may bring a civil enforcement action seeking a wide range of relief, such as the entry of a cease and desist order, ordering of an injunction, appointment of a receiver, levying of money penalties, imposition of an officer and director bar, and ordering of disgorgement of ill-gotten profits.[30] Moreover, the SEC may institute criminal contempt actions against those who have not obeyed injunctions previously issued.[31]

In addition, the U.S. Department of Justice may criminally prosecute accused violators of the federal securities laws. Hefty criminal sentences of up to ten years' imprisonment as well as severe money fines may be imposed for many violations (for example, for illegal insider trading, stock manipulation, and filing materially false statements with the SEC).[32] Added to the prosecutors' criminal arsenal under U.S. law are statutes that may be invoked in addition to or in lieu of the federal securities laws. These statutes include the federal mail and wire fraud provisions as well as the Racketeer Influenced Corrupt Organizations Act (RICO).[33]

The state securities laws (or "blue sky" laws) enacted by each of the fifty states also provide for both civil and criminal government enforcement. Indeed, some of the state securities laws are more onerous than the federal statutes. For example, a number of states authorize criminal liability premised on principles of strict liability.[34]

30. *See, e.g.*, Aaron v. SEC, 446 U.S. 680 (1980); STEINBERG & FERRARA, *supra* note 21; George W. Dent, Jr., *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 MINN. L. REV. 865 (1983).

31. *See, e.g.*, United States v. Custer Channel Wing Corp., 376 F.2d 675 (4th Cir. 1967).

32. *See* § 32(a) of the Securities Exchange Act, 15 U.S.C. § 78ff(a); Arthur F. Mathews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes*, 39 GEO. WASH. L. REV. 901 (1971).

33. *See* Carpenter v. United States, 485 U.S. 19 (1987) (federal mail and wire fraud statutes); United States v. Turkette, 452 U.S. 576 (1981) (criminal RICO statute). Nonetheless, violations often go undetected. *See* John R. Emshwiller, *How Career Swindlers Run Rings Around SEC and Prosecutors*, WALL ST. J., May 12, 1995, at A1; Steve Stecklow, *Owing $500 Million, New Era Charity Seeks Refuge from Creditors*, WALL ST. J., May 16, 1995, at A1.

34. *See* Buffo v. State, 415 So. 2d 1158 (Ala. 1982); JOSEPH C. LONG, BLUE SKY LAW § 8.02[2][b] (1995); Mark A. Sargent, *A Blue Sky State of Mind: The Meaning of 'Willfully' in Blue Sky Criminal Cases*, 20 SEC. REG. L.J. 96 (1992).

The SROs in the United States also have significant civil enforcement powers. For example, the stock exchanges may assess censures, bars, and money fines upon broker-dealers and their associated persons who violate the federal securities laws or the respective exchange's rules.[35] An exchange also can delist a security.[36] Moreover, the National Association of Securities Dealers has broad authority to discipline those subject to its regulation.[37]

In contrast to the United States, many countries today, both in emerging and more-developed securities markets, rely chiefly (if not solely) on criminal enforcement. It may be questioned whether this is the most effective approach. Today, in a number of these countries such practices as insider trading are made criminal where less than a decade ago they were viewed as standard fare or at worst a slap against one's reputation.[38] From current experience, it appears at this time that many judges and juries are reluctant to criminally convict supposedly reputable businesspersons for practices that were part of the societal mainstream a short while ago. Indeed, in a number of countries, there have been few if any convictions for illegal insider trading (although the practice continues to occur with some frequency).[39]

Although the climate in the United States points toward increased criminalization of the securities laws,[40] this situation should be viewed from a historical perspective. Insider trading serves as a useful example. Although the major U.S. securities acts were enacted in the 1930s,[41] it was not until the early 1960s that the SEC instituted a key civil enforcement proceeding based on illegal insider trading.[42] A significant appellate court decision based on an SEC civil action was not handed down until the late 1960s.[43] Some ten years later the U.S. Department

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35. *See Report: Broker-Dealer Supervision of Registered Representatives and Branch Office Operations*, 44 BUS. LAW. 1361 (1989).

36. *See* Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 BUS. LAW. 1461 (1992).

37. *See* ALAN R. BROMBERG & LEWIS D. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD § 13.4(1520) (1995); Lee A. Pickard & Anthony W. Djinis, *NASD Disciplinary Proceedings: Practice and Procedure*, 37 BUS. LAW. 1213 (1982).

38. *See* Andre Tunc, *A French Lawyer Looks at American Corporation Laws and Securities Regulation*, 130 U. PA. L. REV. 757, 762 (1982) (observing that in France tipping of inside information is viewed as "a social duty . . . expected of relatives and friends"); *see also Escaping Through the Net*, THE ECONOMIST, Nov. 7, 1992, at 95; Christof von Dryander, *The German Securities Trading Act: Insider Trading and Other Secondary Market Regulation*, 9 INSIGHTS, Jan. 1995, at 26. Prior to the insider trading legislation in Germany, insider trading was proscribed pursuant to self-regulatory rules that became binding upon parties on a contractual basis. *See* Siegfried H. Elsing & Donna Gasser, *Stock Exchange Rules in Germany and the Treatment of Insider Trading*, 14 INT'L BUS. L. 191 (1986).

39. *See supra* note 25 (South Africa). Australia's experience thus far has been similar. *See* Roman Tomasic, *Insider Trading Law Reform in Australia*, 9 COMP. & SEC. L.J. 121 (1991).

40. *See* Ralph S. Janvey, *Criminal Prosecution of Insider Trading*, 15 SEC. REG. L.J. 136 (1987).

41. The Securities Act of 1933 and The Securities Exchange Act of 1934 are the major U.S. securities acts.

42. *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

43. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

of Justice brought the initial criminal prosecutions for insider trading violations.[44] Hence, criminal prosecution was initiated only after successful civil enforcement made clear that the practice at issue was illegitimate from a consensual point of view. Although it seems doubtful that such an enforcement policy was part of a grand strategic plan, the U.S. government's current success in the criminal arena[45] underscores the merits of this approach.

To buttress this proposition, the heavier burden of proof in a criminal as compared to a civil proceeding perhaps has prompted judges and juries to refrain from criminally convicting based on circumstantial evidence.[46] From a prosecutor's viewpoint, financial frauds like insider trading or stock manipulation are not necessarily subject to direct evidence; circumstantial evidence often remains essential for a conviction. With some exceptions, prosecutors in the United States have been more successful in this respect.[47]

Stated succinctly, it is not suggested that regulators in emerging capital markets abandon criminal enforcement efforts. Rather, the point is that civil regulatory remedies should be made available and should be invoked on a frequent basis. Successful enforcement actions in civil suits will encourage compliance, stimulate securities enforcement efforts in other contexts, and facilitate a consensual understanding of sanctionable behavior. Criminal enforcement under this scenario would become the "heavy club" to be swung against those deemed sufficiently blameworthy to deserve imprisonment.

IV. Private Attorney General—Public Benefit or Societal Waste?

Today, in the vast majority of countries having securities markets, complex private securities litigation is a rarity. With prohibitions against attorney contingency fees, the presence of a loser-pays structure, and significant barriers to hurdle for initiating class action or derivative suits, this trend (absent modification) will continue.[48]

On the other hand, the private attorney general approach has gained acceptance in the United States. Over thirty years ago, the U.S. Supreme Court emphasized that private suits based on securities law violations were a "necessary supplement"

44. *See, e.g.*, Chiarella v. United States, 445 U.S. 222 (1980).

45. *See, e.g.*, United States v. Bilzerian, 926 F.2d 1285 (2d Cir. 1991). Nonetheless, even today, the government frequently fails to prevail. *See, e.g.*, United States v. Mulheren, 938 F.2d 364 (2d Cir. 1991).

46. *See* T. E. Bostock, *Australia's New Insider Trading Laws*, 10 COMP. & SEC. L.J. 165 (1992).

47. *See* Testimony of Michael D. Mann, Director of SEC's Office of International Affairs, Concerning the International Antitrust Enforcement Assistance Act Before the U.S. Senate Subcommittee on Antitrust, Monopolies, and Business Rights, Committee of the Judiciary (Aug. 4, 1994) ("As a general matter, the Commission's investigations involve extensive document review and are often predicated on circumstantial evidence gleaned from the documents and from testimony."). *See also* SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984).

48. *See* Paul Redmond, *The Reform of Directors' Duties*, 15 U. NEW S. WALES L.J. 86 (1991).

to SEC enforcement action.[49] With allowance for contingency fees, award of generous attorneys' fees, recognition of the class action and derivative suit as useful mechanisms to redress investor injury, and application of the general rule that each party (win or lose) bears its own costs, private securities lawsuits seeking damages (as well as other relief at times) proliferate the U.S. legal landscape.[50]

To opponents, many of these suits constitute vexatious litigation or, to use a pejorative term, "strike suits."[51] The only clear winners, according to these critics, are the attorneys. Annoyed by the time expenditures involved and ill publicity, defendants opt to settle many of these actions. Shareholders receive relatively modest financial recompense.[52] In reaction to these consequences, the United States in 1995 amended the federal securities acts to make such actions more difficult to bring.[53]

In light of the foregoing, should an emerging securities market authorize aggrieved investors to initiate private actions for damages against such persons as directors, officers, broker-dealers, investment bankers, accountants, and attorneys for allegedly engaging in fraudulent practices? The costs of doing so appear unacceptably high. Having such a system in place would present a strong incentive for issuers and financial intermediaries to take their business to more hospitable surroundings.[54] Although investors supposedly would benefit, it is unlikely that the existence of such a regimen would be influential in their decisions of where to provide capital. After all, investors in emerging markets understand that risk is an integral part of the process; generally, so long as the prospect for profit is reasonable and minimally acceptable regulatory standards are effectively implemented, the venture is given serious consideration. In short, investors in these markets ordinarily do not anticipate bringing a lawsuit based on securities fraud in the host country. Rather, if they seek to protect themselves in this context, they do so through contractual warranties, use of arbitration clauses, or the conducting of negotiations or other aspects of the transaction that cause U.S. subject-matter jurisdiction to apply.[55]

Moreover, most emerging capital markets are ill-suited for the type of complex

49. *See* J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

50. *See* Herbert M. Kritzer, *Searching for Winners in a Loser Pays System*, 78 A.B.A. J. 54 (1992).

51. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (referring to "the danger of vexatious litigation").

52. *See* Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991).

53. *See Senate Overrides President's Veto; Securities Litigation Reform Bill Now Law*, 28 SEC. REG. & L. REP. (BNA) 3 (1996). *See generally* Contract with America (E. Gillespie & B. Schelhas, eds., 1994).

54. *Cf.* Paul H. Baris, *Israeli Securities Law*, 22 DENV. J. INT'L L. & POL'Y 409 (1994) (describing current Israeli securities laws and the movement in favor of greater investor protection as the Israeli economy develops).

55. *See* Richards v. Lloyd's of London, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,801 (S.D. Cal. 1995).

litigation prevalent in the United States. The particular country's goals of efficiency and satisfying more important needs render such a framework imprudent.[56] When judges and lawyers are not numerous, where their level of expertise on such complex matters is not impressive, and where the citizenry and the government must have expeditious access to the courts in order to resolve vital matters relating to the human condition, the prospect of opening up the floodgates of litigation to redress sophisticated investor woes sounds like utter nonsense.

Nonetheless, there are two key countervailing interests: investor compensation and deterrence of fraudulent practices. Provided that the costs of providing monetary relief to aggrieved investors are acceptable, these interests ought to be pursued. The proper forum for doing so may be in the SRO or civil government enforcement setting, or alternatively, by providing for a framework of arbitration.

In the government or SRO context, the applicable regulator should seek an order of disgorgement of the alleged violator's ill-gotten gains. If so granted, the amount disgorged should be held for the benefit of parties defrauded by the violator's conduct. In this fashion, aggrieved investors will be afforded some meaningful measure of relief without undue intrusion upon the judiciary.

To accomplish this objective in hopefully a more effective manner, consideration should be given to establishing an administrative tribunal within the particular securities authority. Hearing examiners with expertise in securities law and having no relationship with the securities authority would be appointed to decide the cases brought. Depending on the norms of the particular country, appeal to a court from an adverse determination by the hearing examiner may be available. Such appeal may be provided as a matter of right or only if the sanctions levied surpass certain levels of severity. Again, the degree of process accorded, of course, is best left to the customs and norms of the applicable country.

Alternatively, a system calling for arbitration in the event of disputes implicating investor losses may be instituted. Conducted outside of the court system and with the availability of qualified arbitrators, this alternative may provide adequate redress without generating undue burdens on the judicial or administrative process. Depending on the prevailing sophistication and resources available in the applicable emerging market, either of the foregoing models may be adapted for implementation.[57]

V. Regulation of Offerings—Disclosure versus Merit Regulation

In securities offerings conducted in their markets, should such emerging markets opt for a disclosure and/or merit-based approach? In a disclosure framework,

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56. *See supra* notes 22-24 and accompanying text.

57. *See generally* MARILYN B. CANE & PATRICIA A. SHUB, SECURITIES ARBITRATION: LAW AND PROCEDURE (1991); C. EDWARD FLETCHER, ARBITRATING SECURITIES DISPUTES (1990); Committee on Federal Regulation of Securities, *Report of Task Force on the SEC Administrative Law Judge Process*, 47 BUS. LAW. 1731 (1992); D. Rhett Brandon & Glenn M. Reiter, *Regulators Move to Harmonize Capital Market Rules*, INT'L FIN. L. REV. 53 (June 1996).

all material information[58] normally should be disclosed in the form of written offering materials. This information should include, for example, (1) material historical information relating to such elements as assets, earnings, nature of operations, and managerial self-dealing, (2) the purposes for which the proceeds derived from the offering will be used, (3) reasonably accurate financial statements prepared in compliance with recognized accounting practices and auditing standards, and (4) forward-looking developments, events, and contingencies that are reasonably likely to occur and to have a material financial effect on the enterprise.[59]

By contrast, merit regulation enables the securities authority, even if there is accurate and full disclosure, to prevent the offering from being conducted if it is determined that such offering is unfair, unjust, or inequitable. Such a determination may be reached, for example, if the insiders purchased their stock at extremely low prices or seek to retain inequitable stock options or warrants, or where the planned underwriter "spread" is deemed excessive.[60]

In the United States, the federal securities laws focus on disclosure. Merit regulation is adhered to by a number of states, perhaps most notably California and Texas.[61] By calling for disclosure, however, the SEC nonetheless impacts upon substantive fairness. If self-dealing transactions must be disclosed, the insiders are less likely to engage in such practices. Moreover, if such disclosure of insider dealings reveals unacceptably abusive practices, the investment community will be far less likely to support the contemplated offering.[62]

For emerging securities markets, it is suggested that a disclosure approach should be adopted to the exclusion of a merit-based system.[63] In a number of such markets, the risk exists that adherence to merit regulation will serve as a subterfuge for government assessments of character, integrity, and goodness—a quasi-return, under the guise of capitalism, to the way business used to be conducted in such countries. Such risk should not be undertaken since merit

58. Material information may be defined as (1) such information that a reasonable investor would consider important in the making of a decision to buy or sell or (2) such information that is deemed price sensitive. *See* Basic, Inc. v. Levinson, 485 U.S. 224 (1988); Australian Corp. L. § 1002G, *discussed in* Bostock, *supra* note 46, at 172.

59. *See* SEC FORMS OF REGISTRATIONS S-1, S-2, S-3; SEC FINANCIAL REPORTING RELEASE No. 36 (1989); *cf.* GOWER REPORT (U.K.) on REVIEW OF INVESTOR PROTECTION (Part I—1984, Part II—1985), with SEC, REPORT OF THE SEC'S ADVISORY COMMITTEE ON CORPORATE DISCLOSURE (1977).

60. *See* Richard B. Tyler, *More About Blue Sky*, 39 WASH. & LEE L. REV. 899 (1982).

61. *See* Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785 (1986).

62. *See* Elliott J. Weiss, *Disclosure and Corporate Accountability*, 34 BUS. LAW. 575 (1979).

63. *See* Burke, *supra* note 22, at 580 (Estonian Securities Board does not adhere to a merit-based system and Securities Board "reviews the application to ensure the completeness of the information provided"); *Malaysia: Securities Commission Pledges to Adopt Full-Disclosure System*, 9 INT'L SEC. REG. REP. No. 14, at 9 (1996) (Malaysian Securities Commission plans "to shift its current merit-based regulatory system to one based on a full-disclosure environment").

regulation's costs exceed the speculative benefits that might otherwise be received. Clearly, implementation of a market-efficient merit system calls for sophisticated and time-consuming judgments to be made. With efficient allocation of sparse resources a necessity for emerging securities markets, such markets should refrain from indulging in the luxury of a merit-based system.

Nonetheless, adoption of a disclosure approach alone leaves a gap that needs to be filled. Although a disclosure-based system calls for revelation of material insider dealings, such a system fails to address the propriety of even blatantly unfair insider rip-offs. Nonetheless, if attractive profits are anticipated, many astute investors will purchase the subject securities regardless of unfair insider dealings.[64]

Irrespective of such investor nonchalance, a regulatory system should not stand dormant. Moreover, the problem is exacerbated after the offering is completed, especially when the insiders sell substantial amounts of stock in the offering while retaining a sufficient percentage to retain control over the enterprise. In such a scenario, these insiders would have even greater incentive to unduly benefit themselves at the expense of the enterprise and unaffiliated security holders.

To rectify this abusive situation in a cost-effective fashion, consideration should be given to directing the SRO or government securities regulator to promulgate rules of fair practice to redress egregious misconduct. Such rules, for example, could provide, after a proceeding before an arbitrator or a hearing officer as described above, that the offending transactions be rescinded and that restitution be made. Although such rules of fair practice should be cautiously adopted and invoked, they may serve as a relatively efficient mechanism to discipline insider abuse.[65]

VI. Facilitating Access to Capital Markets

Facilitating access to initial and secondary capital markets is key to the success of emerging securities markets. Mechanisms should be implemented to allow for the development of attractive markets where issuers, investors, and financial intermediaries are accommodated in a manner that finds acceptance. The balance struck depends on such factors as the type of investor participation (institutional or individual), the applicable market's realistic attainment of some meaningful degree of sophistication, and the deployment of sufficient resources (in terms of funding, personnel, and technology).

With respect to *initial* capital markets, three types of offering scenarios are addressed: (1) limited offerings made to a finite number of investors with some investors having financial acumen; (2) offerings made in markets comprised

64. *See generally* Siegel, *supra* note 13, at 497.

65. *Cf.* Kenneth M. Raisler & Edward S. Geldermann, *The CFTC's New Reparation Rules: In Search of a Fair, Responsive, and Practical Forum for Resolving Commodity-Related Disputes*, 40 BUS. LAW. 537 (1985).

solely of institutional (and other presumably sophisticated) investors; and (3) offerings directed at the general public, thereby encompassing the uninitiated.

Depending on the context, the affected market that develops may be either private or public in character. For example, an initial offering made by an issuer to twenty persons normally is private. However, if those persons thereupon sell their interests to 500 different investors, a public market will emerge. Accordingly, that an initial offering is made to few investors does not foreclose the possibility that a public market will eventuate. This prospect affects issues relating to disclosure, market abuse, resale of securities, and regulatory oversight.[66]

A. "LIMITED" OFFERINGS

Where issuers seek to offer securities to a limited number of investors, questions arise relating to the proper degree of government or SRO oversight. For example, should there be mandated disclosure in this context? Should the issuer's offering statement be subject to review by the regulatory authority? Should there be restrictions on purchasers reselling their securities to avoid the emergence of a public market where a lack of adequate information exists concerning the subject issuer and the securities?

Generally, in a limited offering, unlike one that is public, there is less government or SRO regulation. No disclosure document may be required to be filed with the regulatory authority and, if all purchasers are sophisticated, there may be no mandated delivery of information. Prohibitions against fraud nonetheless should apply in this context.[67] For oversight and fee-generating purposes, a form notifying the regulatory authority of the offering may be demanded of issuers and financial intermediaries.[68]

Generally, a limited offering may be viewed as having certain characteristics depending on the construction given by the affected emerging securities market. In this regard, such offerings are made to a finite number of investors. That number may be ten, thirty-five, one hundred, or some other number that the regulatory overseer concludes meets capital-raising needs without adversely impacting on market integrity. Nonetheless, at some point, the offering of securities on a widespread basis should signify that the offering is public (rather than limited).

Whether a monetary ceiling should exist for an offering to qualify as "limited" is another issue. For example, an offering is limited under U.S. law in certain

66. *See* SEC v. Ralston Purina Co., 346 U.S. 119 (1953); SEC Securities Act Release No. 6389 (1982).

67. *See* Manning G. Warren, *Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U.L. REV. 355 (1984).

68. *Cf.* Form D that (although not fee generating) must be filed with the SEC when a Regulation D limited offering is made. *See* SEC Securities Act Release No. 6825 (1989); Mark A. Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 WASH. U. L.Q. 225 (1990).

contexts if the amount raised does not exceed $5 million during any twelve-month period.[69] Otherwise, registration of the offering with the SEC is mandated.[70] For emerging capital markets, it may be submitted that a distinction on a monetary basis between limited and public offerings should not be implemented. Rather, more relevant criteria focus on the manner of solicitation (for example, by advertisements in newspapers versus by means of preexisting relationships), number of offerees, and restrictions on resale. Also, irrespective of the monetary amount sought to be raised in the offering, needed revenues can be raised by the regulatory authority assessing fees upon the issuer and financial intermediaries for the privilege of conducting the offering.

If the issuer and financial intermediaries engage in advertising or general solicitation,[71] there is good reason to require that an offering document adequately describing the issuer, the terms of the offering, and the securities offered be timely transmitted to all offerees. Otherwise, promoters will have free reign to "hype" the offering, creating a "hot issue," and thereby condition members of the public to purchase the securities without their being privy to sufficient information. Because the prospect for fraud is greater in this setting, it may be prudent to require that the offering statement be filed with and reviewed by the securities regulator.[72]

No doubt, promoters also can "hype" an offering where investors are few in number. Sophisticated investors, however, are more likely to distinguish "hype" from "reality" and to demand the delivery of adequate disclosure. On the contrary, where investors are unsophisticated, such investors need to receive a basic information package. Nonetheless, due to the monetary costs incurred by issuers to generate a formal disclosure document, application of effectively implemented provisions directed against fraudulent practices may be deemed sufficient where the offering amount is relatively small.

An additional concern is that a supposed limited offering may be in reality a public one where purchasers of large holdings "dump" their securities on the market. If adequate information is not in the public domain, a distribution of securities will occur in contravention of investor protection and market integrity objectives. To ameliorate this situation, restrictions on resales may be considered, such as those relating to holding periods (for example, security must be held for a two-year period) and percentage of stock sold during a specified period (for

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69. *See* SEC Rule 505, 17 C.F.R. § 230.505 (1995); Sargent, *supra* note 68; Warren, *supra* note 67.

70. *See* MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 39-57 (2d ed. 1996); *see supra* notes 65-67.

71. Certain SEC rules exempting limited or private offerings from registration prohibit advertising or general solicitation. *See* SEC Rules 505, 506, 17 C.F.R. §§ 230.505, 230.506 (1995); sources cited notes 65-68 *supra*.

72. *See generally* RALPH E. JANVEY, REGULATION OF THE SECURITIES AND COMMODITIES MARKETS ¶¶ 4.01-.02 (1992); Joseph I. Goldstein et al., *An Investment Masquerade: A Descriptive Overview of Penny Stock Fraud and the Federal Securities Laws*, 47 BUS. LAW. 773 (1992).

example, up to one percent of the issuer's outstanding stock during a three-month period).[73]

A sound balance must be struck. Imposing overly stringent requirements on issuers and financial intermediaries in the limited offering setting will dissuade these participants from resorting to this capital-raising device. Nonetheless, there is legitimate concern that many investors in these types of offerings in emerging capital markets will be individual citizens who have relatively modest savings and limited financial sophistication. Loss of individual investors' savings in speculative investments will have repercussions throughout the affected economy and therefore is a matter of serious concern.[74]

B. Institutional Investor Markets

Generally, institutional investors are financially sophisticated. They have the acumen, experience, personnel, and financial wherewithal to make astute investment decisions. They also have the leverage, particularly when acting in concert with other like investors, to induce the issuer to disclose sufficient information. Because there exists a level playing field in this context, there is good reason to allow the various participants to fend for themselves. Hence, arguably only rules relating to fraud need to be applied here.

Under this framework, an emerging securities market may seek to develop a stock exchange where solely institutional (or other sophisticated) investors having a specific net worth (such as U.S. $5 million) may participate. For each issuer that seeks to list its securities on the exchange, negotiations would ensue among the participants (the subject issuer, financial intermediaries, and prospective investors) concerning the degree of disclosure that the issuer would provide to the market on a periodic basis, with the issuer being contractually bound to comply with the negotiated terms. Alternatively, the exchange (or governmental regulator) may promulgate minimum disclosure guidelines that all listed companies must meet, while still enabling the parties to negotiate more rigorous requirements.

The prohibitions against fraud should apply in this setting. SRO or government overseers, therefore, would monitor occurrences of fraudulent practices and, depending on the framework adopted, help ensure compliance with applicable disclosure mandates. Procurement of the necessary fees from market participants to fund this mechanism should be attainable.

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73. *Cf.* SEC Rule 144, 17 C.F.R. § 230.144 (1995) (sets forth certain criteria that a shareholder must satisfy in order to come within the rule's protection). *See* Marc I. Steinberg & Joseph P. Kempler, *The Application and Effectiveness of SEC Rule* 144, 49 Ohio St. L.J. 473 (1988).

74. *See* Richard W. Jennings, *The Role of the State in Corporate Regulation and Investor Protection*, 23 Law & Contemp. Prob. 193 (1958); *see also* Frank J. Fabozzi & France Modigliani, Capital Markets: Institutions and Instruments (1992); Cheryl W. Gray et al., *The Legal Framework for Private Sector Development in a Transitional Economy: The Case of Poland*, 22 Ga. J. Int'l & Comp. L. 283 (1992); Morgan & Kramer, *Investment Fund Structures for Emerging Markets*, 28 Rev. Sec. & Comm. Reg. 157 (1995).

This framework should be attractive to market participants. Costs of raising capital for issuers are minimized. Qualified institutions can fend for themselves, negotiating the requisite degree of disclosure in both the initial and secondary markets as a condition for investing in the subject issuer. Mandated disclosure, if any, imposed by regulators is not overly burdensome. Surveillance directed against fraud remains within the purview of the SRO and government authorities.[75]

C. Public Offerings

When issuers elect to tap unsophisticated investors for funds on a widespread basis, the need for disclosure and surveillance should prevail. Investors in these types of offerings normally are citizens of the country where the emerging securities market is situated. Being uninitiated investors, they more easily are induced to part with their funds on the basis of false hopes and outright lies. Although sound regulation cannot prevent the overly gullible from being manipulated, it can minimize the degree of investor intoxication enveloping such offerings.[76]

Requiring sufficient disclosure and implementing adequate surveillance against fraud should deter sharp practices. If a regulatory authority has been established, the filing with such authority of the applicable disclosure documents transmitted to investors should be mandated.[77] Application of a cost-benefit analysis in this context calls for these measures. Although capital raising may be impeded, this downside is outweighed by the realistic prospect that, absent use of these measures, a significant number of the country's citizenry will suffer financial harm (some of catastrophic magnitude). Such loss would redound to the applicable country's economic detriment in terms of both consumer spending power and savings. Indeed, for those individuals who were to incur severe financial loss, basic needs such as food and housing no longer may be afforded. Hence, unlike offerings made to sophisticated or foreign investors, a far greater likelihood of adverse economic consequences impacting on domestic affairs persists in this setting. Therefore, greater prudence should be demanded.[78]

D. Secondary Markets

In order for an emerging securities market to prove successful, a sound secondary trading market must develop. Without the presence of a liquid secondary

75. *See* Marc I. Steinberg & Daryl L. Lansdale, Jr., *Regulation S and Rule 144A: Creating a Workable Fiction in an Expanding Global Securities Market*, 29 Int'l Law. 43 (1995).

76. *See* Jorge Gonzalez, Jr. & Christopher D. Olive, *Foreign Issuer Disclosure and Accounting Compliance in U.S. Public Offerings and Securities Listings*, 1 NAFTA: Law & Bus. Rev. Ams., Summer 1995, at 39; Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. Corp. L. 1 (1983).

77. *See* Burke, *supra* note 22, at 579-84 (describing Estonia filing and solicitation requirements).

78. Hence, securities regulation is focused at problems "as old as the cupidity of sellers and the gullibility of buyers." 1 Louis Loss, Securities Regulation 3 (2d ed. 1961).

market that is efficient in pricing and maintaining basic standards of fair practice, sophisticated investors will be reluctant to participate.

To develop a sound secondary trading market, certain conditions must be met. First, there must be a sufficient number of buyers and sellers so that liquidity of investment is enhanced. Second, adequacy of disclosure is key to enable market participants to make informed investment decisions. Where the applicable market consists of solely sophisticated investors (normally institutions) having an impressive net worth, then the extent of disclosure called for may be subject to negotiation as a matter of contract between the issuer, financial intermediaries, and affected investors. The understanding reached should be enforceable as well by the subject exchange, with delisting of the issuer an alternative sanction for noncompliance.[79] Third, financial intermediaries, such as broker-dealers, market-makers, and specialists, should exist in sufficient numbers with each having adequate capital to facilitate market liquidity. And, fourth, given the continual threat of abusive activity (for example, stock manipulation, insider trading, and undisclosed excessive brokerage commissions) as well as the lack of financial security (for example, failure by broker-dealers to have sufficient net capital or provide for accurate recording of trades), adequate surveillance and enforcement measures should be implemented.[80]

Fulfillment of the foregoing conditions, of course, will not ensure the presence of an attractive secondary trading market. To induce foreign investment, the value of the securities purchased and the prospect for bountiful profit are key and, depending on the applicable market, may override other considerations. Moreover, cost considerations may prevent an emerging securities market from expending the resources necessary for an optimal secondary trading market to exist. Nonetheless, satisfaction of the above conditions normally should provide great impetus for facilitating the development of an effective secondary trading market.

VII. Overseeing Financial Intermediary Conduct—Indeed a Delicate Task

Financial intermediaries are essential players in capital markets. They provide needed liquidity, structuring of transactions, and, at times, capital to emerging securities markets. Their roles may range from an investment banker orchestrating a distribution of securities on behalf of an issuer to that of a broker acting as agent for its clientele to that of a dealer engaging in transactions for its own

79. *See* James G. Christiansen, *Russia: New Securities Law Brings Welcomed Improvements for Disclosure, Supervisory Methods*, 9 INT'L SEC. REG. REP. NO. 14, at 3, 4 (1996) (describing Russia's new securities laws, which mandate filing of quarterly reports akin to U.S. SEC Forms 10-K and 10-Q). *See generally* David P. Doherty et al., *The Enforcement Role of the New York Stock Exchange*, 85 NW. U.L. REV. 637 (1991). *See supra* notes 68-72.

80. *See supra* notes 21, 37, 72, 79.

account. Because of their function in the structuring and consummation of securities offerings, mergers, and acquisitions (euphemistically called deals), financial intermediaries (particularly investment bankers) frequently hold the "passkey." Phrased differently, financial intermediaries often control the red or green light to the successful completion and marketing of securities deals.[81]

With this power comes the risk of abuse. As alluded to previously,[82] financial intermediaries may engage in improper conduct such as stock manipulation, insider trading, charging undisclosed excessive commissions, and a broad range of other unfair practices in contravention of what is known as the "shingle" theory.[83] They also may run afoul of standards relating to financial integrity. Failure to retain adequate capital, accurately record trades, and provide effective settlement and clearing mechanisms will wreak havoc not only on the delinquent financial intermediary, but, if severe, upon the affected capital markets.[84]

Emerging securities markets therefore must oversee financial intermediary practices from both fraud and financial integrity perspectives. Definitive rules administered by the applicable regulator having sufficient enforcement powers should be effectuated. In this context, three key concepts are registration, oversight, and enforcement.

Registration by such financial intermediaries as investment advisers, brokers, and dealers with the applicable government regulator or SRO should be mandated. Compulsory registration enables the regulator to qualify those meeting defined standards, acts as a tracking procedure for identifying subject intermediaries under its oversight authority, and serves as a fee-generating vehicle for costs incurred. These fees (as well as a tax levied on brokerage commissions) also may be used to establish a system of investor insurance to provide protection against catastrophe should a broker-dealer become insolvent or abscond from the jurisdiction with its customers' assets.[85]

To help ensure market integrity, oversight by the applicable regulator over financial intermediaries is crucial. Such broker-dealer, investment adviser, or other intermediary should be required to subscribe to enumerated rules of fair practice and financial integrity, file reports with the regulator detailing its compliance with capital adequacy standards, and be subject to inspections by SRO or government personnel for ascertaining its adherence to specified financial and

81. *See* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 380 (2d Cir. 1973); MARC I. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES § 5.04[4] (1996).

82. *See supra* notes 78-79 and accompanying text.

83. The "shingle" theory posits that a broker-dealer, by hanging out its "shingle," impliedly represents that its behavior and the conduct of its employees will be equitable and will comply with professional norms. *See* Hanly v. SEC, 415 F.2d 589, 596-97 (2d Cir. 1969).

84. *See* JANVEY, *supra* note 72.

85. *See generally* Gregory S. Crespi, *The Reach of the Federal Registration Requirements for Broker-Dealers and Investment Advisors*, 17 SEC. REG. L.J. 339 (1990); David A. Lipton, *A Primer on Broker-Dealer Registration*, 36 CATH. U.L. REV. 899 (1987).

operational directives.[86] Because of the adverse fallout that all too realistically may occur due to a broker-dealer's insolvency or grossly abusive practices, the applicable regulator should assume an active oversight function in this setting.[87]

To induce financial intermediaries to follow specified requirements and to redress instances of misconduct, the applicable regulator must have sufficient enforcement powers. The powers provided should cover the broad range of prospective noncompliance. For technical violations causing relatively little harm, entry of a cease and desist order should be appropriate for a first-time violator. For repeat violators and for more serious offenders, such as where fraud is perpetrated on certain clients or where a broker-dealer fails to carry sufficient net capital, heftier penalties are warranted. Examples include levying a significant monetary fine and suspending for a certain period of time the subject violator from engaging in certain (or all) of its business activities. For egregious violators or where there is a systematic breakdown throughout the organization, extreme measures may be necessary. In such circumstances, the regulator may seek to bar the violator from conducting business, have a receiver appointed to preserve assets, and pursue criminal prosecution.[88]

Thus, the applicable regulator should have within its enforcement arsenal a wide array of weaponry, deploying the appropriate mechanisms to disarm its intended targets. Although granting such enforcement powers may lead to overzealousness on occasion, the dangers posed justify this risk. An efficiently run regulatory structure, containing levels of internal review by relatively detached personnel along with independent scrutiny by a judge or hearing examiner, should discourage much of the overreaching that otherwise might ensue. Moreover, in view of the tenuous situation that most emerging capital markets experience, there is widespread recognition that enforcement powers should be finely tuned and used only where clearly necessary. Otherwise, legitimate and well-heeled financial intermediaries will take their activities elsewhere, leaving the affected country without essential players in its capital market structure.[89]

Irrespective of an emerging capital market's adoption of relatively comprehensive procedures with respect to financial intermediaries situated within its borders, vigilance also needs to be directed at rogue cross-border broker-dealer practices. In today's awesomely paced technological world, there exists the continual threat of fraud by financial intermediaries and other market participants from locations

86. *See* Burke, *supra* note 22, at 587-92 (describing Estonia's requirements for licensing and regulating securities intermediaries).

87. *See* BROMBERG & LOWENFELS, *supra* note 37, § 5.7; JANVEY, *supra* note 72, ¶¶ 4.01-.02; STEINBERG & FERRARA, *supra* note 21, §§ 2:17, 13:01-:11.

88. *See, e.g.*, SEC v. Prudential Secs., [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,780 (D.D.C. 1992); SEC v. Milken, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,200 (S.D.N.Y. 1990); *In re* Rooney Pace, Inc., [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,206 (SEC 1987).

89. *See* Scott & Wellons, *supra* note 1, at 1000-04; *see also* Butler et al., *Draft Law of the Russian Federation on Securities*, 8 BUTTERWORTH'S J. INT'L BANK. & FIN. L. 133 (1993).

abroad, having adverse ramifications in the affected emerging securities market. To help guard against such cross-border abuses, understandings of cooperation should be entered into with securities authorities from other nations. Pursuant to such understandings, each regulator should agree to provide law enforcement assistance and technological support to the other when a violation of its laws is perpetrated from the other's jurisdiction. This mutuality of obligation approach, based on the concept of reciprocity, should ameliorate to some extent cross-border market abuses.[90]

VIII. Conclusion

The foregoing discussion illustrates the difficult challenge facing emerging securities markets. To attract a continual flow of outside capital, such markets ordinarily must offer the realistic lure of attractive profit, implement a sufficiently credible regulatory framework to provide foreign institutional investors with some degree of comfort, and induce the participation of sophisticated financial intermediaries while engaging in delicate yet effective oversight. Certainly, this task is difficult at best.

Even for those emerging markets that seek to attract principally domestic sources of capital, tough issues must be addressed. While seeking to facilitate the development of an active securities exchange, perceptions will exist that the market should function without impediment and that regulation should play the role of nominal bystander. In this context, however, proliferation of abusive practices impacts directly on the affected country's citizenry. Severe losses suffered by its investor-citizens may spell economic disaster in terms of diminished consumer spending power and even inability to purchase essential goods on the same level as before the debacle. Hence, sensitive benefit/loss assessments must be made. The balance struck should involve considerations that focus on promoting capital formation, facilitating the presence of a viable securities market, and providing some meaningful protection for its citizen-investors against the specter of rampant securities market fraud.

Determinations also should be made by emerging capital markets with respect to specific market abuses and corporate control transactions. For example, statutes and rules may be prescribed relating to insider trading practices[91] as well as mergers and acquisitions.[92] The specificity and detail of the approach adopted

90. *See* Michael D. Mann et al., *Developments in International Securities Law Enforcement and Regulation*, 29 INT'L LAW. 729 (1995); Harvey L. Pitt & David B. Hardison, *Games Without Frontiers: Trends in the International Response to Insider Trading*, 55 LAW & CONTEMP. PROBS., Autumn 1992, at 192.

91. *See generally* WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING (1996).

92. *See generally* H. LEIGH FFRENCH, INTERNATIONAL LAW OF TAKE-OVERS AND MERGERS (1987); NORMAN S. POSER, INTERNATIONAL SECURITIES REGULATION: LONDONS' BIG BANG AND THE EUROPEAN CAPITAL MARKETS (1991); TENDER OFFERS: DEVELOPMENTS AND COMMENTARIES (Marc I. Steinberg ed., 1985).

with respect to such practices and events will reflect policy considerations as well as perceptions of acceptable business conduct.

To help ensure periodic review of the framework then in place, institution of ''sunset'' provisions may be incorporated in statutes and regulations.[93] Such an approach may be useful for emerging capital markets that foresee incremental change. While not foreclosing in any way revision of applicable statutes and regulations at an earlier point, ''sunset'' provisions seek to compel reconsideration of the existing framework by a specified date in the future. However, the huge drawback attendant to such a timed review is the risk that the governing authorities will be concerned with more pressing priorities, or a different climate will prevail in the legislature, thereby causing insufficient attention to be focused on the issue. Indeed, if preoccupied with more urgent matters, the legislature may allow the applicable statutes to lapse, leaving no governing law in existence. This prospect should give one pause before endorsing the use of sunset provisions.

Irrespective of the contours of the system in place for an emerging securities market, a frequently important criterion impacting on ultimate success or failure is whether the various participants lend their support. Without receiving such approbation from affected constituencies, the road to success may be far too arduous. Enabling key players to provide input, engage in dialogue, and reach consensus will facilitate their acceptance of the system. By having a perceived stake in this framework, hopefully they will be more receptive to work toward its success. Thus, emerging securities markets embark on a difficult journey. Persuading affected constituencies to embrace the framework adopted represents for many emerging securities markets a critical determinant.

93. *See* 27 Sec. Reg. & L. Rep. (BNA) 853 (1995) (concept of U.S. federal agency funded through user fee).