THE LEGAL AND INSTITUTIONAL PRECONDITIONS FOR STRONG STOCK MARKETS: THE NONTRIVIALITY OF SECURITIES LAW

by
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Abstract

An important challenge for all economies, at which only a few have succeeded, is providing an environment in which minority shareholders have good information about the value of a company's business, and confidence that a company's managers and controlling shareholders won't cheat them out of most or all of the value of their investment. A country whose laws and related institutions foster that knowledge and confidence has the potential to develop a vibrant stock market that can provide capital to growing firms. A country whose laws and related institutions fail on either count cannot develop a strong stock market, forcing firms to rely on internal financing or bank financing - both of which have important shortcomings. This article explains why these two investor protection issues are critical, related, and hard to solve. It also discusses which of the needed laws and institutions can be borrowed from countries with strong securities markets and which must be home-grown.

I. Introduction

A strong public securities market, especially a public stock market, can facilitate economic growth by providing a way for growing companies to raise capital. Securities markets have several potential advantages over the principal alternatives - bank financing and internal financing. First, countries with strong securities markets are less dependent on bank financing. Banks are an institutional form that is prone to credit crunches and other troubles, which can reverberate through the whole economy. Second, a public stock market lets companies rely more on equity and less on debt, which gives them greater financial flexibility in an economic downturn, and may reduce the downturn's severity. Third, a stock market lets companies rely more on external capital and less on internal capital, which helps companies grow rapidly, and gives companies that focus on a single core business an advantage over diffuse conglomerates. In the United States, conglomerates are seen as a failed experiment - they are usually less efficient than more focused firms. Conglomerates remain strong in countries with weak stock markets, partly because the conglomerate form can provide the access to capital that a rapidly growing firm needs. The shortcomings of bank finance and the internal capital markets run by conglomerate groups were, in significant part, behind the recent finance-driven economic troubles in East Asia and elsewhere.

But creating strong public securities markets is hard. That securities markets exist at all is magical, in a way. Investors pay enormous amounts of money for completely intangible rights, whose value depends entirely on the quality of the information that the investors receive and on the honesty of

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