ADVOCACY, REGULATORY, AND LEGISLATIVE ISSUES

What Works in Securities Laws?

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The authors analyze how securities laws in 49 countries affect the development of stock markets. Public disclosure requirements and liability standards are positively related to stock market development. They improve market efficiency by facilitating private contracting through standardized disclosures and private dispute resolution. Public enforcement is less important.

Are laws necessary to regulate securities markets? One approach says regulation is unnecessary because reputational, legal, and contractual penalties give issuers incentive to disclose all available information. An alternative view states that private incentives are insufficient and government should require specific disclosures and mandate liability standards. A third approach holds that disclosure requirements and liability standards fail to elicit full disclosure and that public enforcement is necessary. The authors assemble a database of securities laws in 49 countries and quantitatively analyze the relationship between securities laws and stock market development in the context of the three perspectives.

In a model with perfect enforcement, market regulation is unnecessary because automatic sanctions alleviate the agency problem between promoters of an issue and investors, but if enforcement is imperfect, the market solution is not optimal. By way of example, the authors illustrate through a recent bond issue in the Netherlands that automatic penalties and clearly defined liability standards do not exist. Thus

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securities laws that provide efficient contracting and dispute resolution can encourage equity financing and stock market development.

The authors present extensive data related to securities market regulation gathered in cooperation with attorneys in the 49 countries. The variables range from prospectus requirements to the type of proof required to recover losses to the characteristics of the enforcement agency. They are organized and quantified into three indices: a disclosure requirements index, a liability standards index, and a public enforcement index. Regulatory requirements vary substantially depending on whether the legal origin of commercial laws is English common law, French civil law, German civil law, or Scandinavian law. For example, common law countries have more extensive disclosure requirements and easier recovery mechanisms for damaged investors.

These regulation indices are used to explain security market development measured by seven proxies: stock market capitalization as a percentage of GDP, domestic listed companies per capita, average equity raised by IPOs as a percentage of GDP, a measure of the value of corporate control, an index of access to equity markets, ownership concentration, and total value of stock traded as a percentage of GDP. Control variables are GDP per capita, efficiency of the judiciary, and an anti-director-rights index to measure shareholder protection.

Ordinary least-squares regressions test the impact of disclosure requirements, liability standards, and public enforcement on stock market development. Results generally show a large and significant impact of per capita GDP and efficiency of the judiciary on stock market development. The anti-director-rights index is less widely significant but is more important in the public enforcement regression. Both disclosure requirements and liability standards have a significant positive relationship to stock market development. Public enforcement does not significantly explain stock market development. Additional tests of the components of the public disclosure index on market development variables confirm a weak relationship.

In a regression including all three indices, disclosure requirements and liability standards are generally significant but public enforcement is not. Public enforcement does have some predictive power in countries

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with above-median GDP but only for IPOs. Public enforcement does not matter in the development of securities markets.

Tests for possible omitted variables show that political ideology, control for state ownership, and measures of democracy and political rights have no effect on the results. Two-stage least-squares regressions using common law as an instrument show that investor protection is significant in all the market development variables and that legal origin predicts investor protection.

The authors conclude that financial markets should not be left to market forces alone. The important aspects of securities laws that are positively related to stock market development are disclosure requirements and liability standards. They contribute to stock market development by facilitating private contracting through standardized disclosure requirements and efficient private dispute resolution. The nature of the public enforcement agency does not matter.

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