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THE DEVELOPMENT OF AFRICAN CAPITAL MARKETS: A LEGAL AND INSTITUTIONAL APPROACH

BY

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The candidate confirms that the work submitted is his own and that appropriate credit has been given where reference has been made to the work of others.

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ABSTRACT

The role and place of capital markets in economic development have received increased attention in recent times. Consequently, establishment of capital markets has become part of the prescription offered to developing countries in order to realise economic growth. However the precise legal and institutional framework that would induce rapid and sustainable growth of the newly established capital markets in developing countries appears to continue eluding policy makers and their advisers. As a result, most capital markets currently existing in most developing countries remain undeveloped and sluggish.

This study seeks to explore optimal legal and institutional framework that can support and sustain capital market growth in developing countries. It is believed that once policy makers become aware of such a framework, they will be able to forge targeted legal and policy reforms that will help ignite emergence of vibrant capital markets in developing countries. The point of departure of this study is an observation that capital markets in most developing countries were established and continue to be operated on inappropriate legal and institutional underpinnings. This study looks at a number of theories and approaches that have formed and informed the legal and institutional framework for capital markets in developing countries, including law and economics, law and development and the Washington Consensus approaches and explains how they have contributed to weak capital markets in developing countries.

This study then proceeds to explore a possible development theory that can be used in designing and implementing legal and institutional reforms to promote development of capital markets in developing countries, in general and Southern African Development Community (SADC) region, in particular. In this regard this study uses Douglass North's framework of economic development as articulated in his work, *Understanding the Process of Economic Change* and his other prior works as a guiding light. North's framework is part of the New Institutional Economics (NIE) theory that faults neo-classic economics, which has been used as a tool of economic analysis in the previous economic theories, for its

assumption of human rationality. Instead North's framework recognises that formal rules (statutes, regulations and policy statements) will only be effective if they are compatible with existing informal rules (local practices, protocols and beliefs), which are determined by societal belief system. This study therefore argues that legal and institutional framework for capital markets in developing countries should be tailored to the unique informal rules prevalent in each country rather than being transplanted from developed countries.

The study then proceeds to look at some specific formal and informal rules that are relevant to capital market growth. As part of this exercise we look at the 'preconditions' for strong capital markets as set out by Professor Bernard Black and set them out on the formal-informal rule continuum as informed by North's framework. In order to show how informal rules affect the formal rules, a comparative study of regulatory frameworks in United Kingdom, South Africa and Malawi is undertaken.

The study concludes with some suggestions on how the legal and institutional reform for capital market development can be undertaken within the tenets of North's framework in developing countries including countries in the SADC region.

TABLE OF CONTENTS

1 CHAPTER ONE: INTRODUCTION.

1.1 STATEMENT OF THE PROBLEM

The role and place of capital markets in economic development have received increasing attention in recent times. It is believed that there is a strong correlation between the level of development of capital markets and the level of economic development of their respective country or economic region[1]. Roth[2] succinctly summarised this view as follows:

> "A well-developed capital market facilitates the capital formation that is essential to economic growth. Effective use of domestic savings allows many domestic enterprises that are unable to attract foreign capital to obtain needed capital from domestic sources. Moreover, foreign companies that find it possible to raise capital in the local market of a developing country are encouraged to establish new or expand existing operations in that country thereby making their products available without expenditures of foreign exchange."

With respect to the Southern Africa Development Community (SADC) there is an expectation that the development of capital markets in the region will make a significant contribution to the economic development of the member countries of this economic region. As it will be explained in detail in chapter 2 below, a well-functioning capital market is key to the overall economic advancement of a country. One of such roles is the efficient allocation of capital from those who have capital surplus to those who have capital deficit. Through such allocative efficiency, it is hoped that companies on the production side of the economy would be well resourced and consequently increase productivity in the economy. This would be very vital in the SADC region given that most

[1] Ajit Singh, 'Financial Liberalization, Stock Markets, and Economic Development,' [1997] 107, The Economic Journal, 771-782.
[2] A. Roth, 'Capital-Market Development in Israel and Brazil: Two Examples of the Role of Law in Development', (1967) 19 (6) Stanford Law Review, (1967) 1277-1306 at p. 1277.

of its member countries are predominantly import dependent countries due to lack of resources to support economic production that would help these countries to transition from import-based to export based economies. There is therefore a strong case for relevance of efficient capital markets in the SADC region. Further capital markets help with risk sharing for big and capital intensive projects. Investors would be reluctant to single-handedly fund a high cost project out of which they can only realised a return on capital after a relatively long period of time. Through the medium of capital markets however, investors are able to reduce their risk by only contributing to a portion of the overall cost of the project alongside other investors. Further, efficient capital markets have high liquidity levels. As such, investors are able to take out there money at any stage of the project by disposing of their equity. Thus capital markets help to assuage the fears of risk-averse investors of losing their money if they invest in big projects. Again this role of capital markets underscores the importance of capital markets in the SADC region where most countries are grappling with the problem of huge infrastructure deficit. Development of efficient capital markets is therefore vital to the infrastructure development efforts in the region. Capital markets would help both local and foreign investors to pool their investments together to fund different infrastructure projects.

Finally, properly functioning capital markets help to reduce the cost of information gathering by investors. While institutional investors may have the resources to commit towards due diligence, small investors are sometimes scared away from in some companies because they do not have the wherewithal to extract the necessary information of the relevant stock. This increases the uncertainty of the safety of their investment and they therefore end up withholding their investment. Through the mandatory disclosure obligations that capital markets place on listed stocks, capital markets ensure that market participants have equal access to the relevant information they need to make informed investment choices. This role is very important in the

SADC region where, as we shall show later in chapter 5, self-enforcing attitudes of honesty, integrity and cooperative behaviour are in short supply among market players especially issuers. Full and frank disclosure is usually rare among issuers of stock most developing countries including SADC countries. Capital markets would therefore provide the much needed assurance that because issuers are under a legal obligation to disclosure material and price sensitive information, access to such information will be available at low cost.

A number of empirical studies have found that stock markets are an important source of finance for funding the growth of large corporations in some African countries.[3] For example, it was found that in Ghana, the stock market financed about 12 percent of total asset growth of listed companies in the period from 1995-2002.[4]

Consequently, development of capital markets has become a common item on the development agenda of most developing economies including African economies. However, in Africa, an effective solution to develop its capital markets continues to elude policy makers. Despite various efforts and strategies[5] to develop the markets by African state and economic authorities, African capital markets remain underdeveloped. Professor Nicholas Biekpe[6] defined this problem in the following terms:

> "The basic question facing many policy makers in Africa is the identification of factors that constrain the development of successful and viable capital markets on the continent. Many African countries

[3] Yartey C.A. and Adjasi C.K., 'Stock Market Development in Sub-Saharan Africa: Critical Issues and Challenges', [2007] IMF Working Paper, Web: http://www.imf.org/external/pubs/ft/wp/2007/wp07209.pdf

[4] Ibid.

[5] This has mainly involved removal of trade barriers and integration of stock exchanges.

[6] In his paper entitled "African Capital Markets: Legal and Governance Framework" presented at the United Nations Economic Commission for Africa in November 2003.

> have embarked on economic reform programmes; in most cases with the support of the World Bank and the International Monetary Fund. These programmes have often included the liberalisation and restructuring of the financial sector. However, financial sector reforms have been least successful in many of these countries. The basic question, therefore, is why such reforms have not succeeded, despite the fact that they are an essential element in the development of efficient capital markets. For the further development of capital markets in Africa, useful lessons may be drawn from the experience of Asian and Latin American countries, as well as certain other African countries that have been able to promote the development of such markets successfully."

The above observation perfectly sets out the point of departure for this study which seeks to engage in a holistic diagnosis of the current malaise of capital markets in most developing countries, including Africa and provide possible alternative solutions for capital market growth in such countries.

This study seeks to explore legal and institutional constraints that may be responsible for the slow capital market growth in developing countries particularly in Africa. Policy makers in Africa need to be properly guided in order to have the right focus of their resources in their bid to develop African financial markets. This research is therefore part of the overall economic development agenda in Africa. Several development programs have been initiated in Africa aimed at implementing legal and institutional reforms as an attempt to orchestrate economic growth across the continent. Such programs have been based on different theoretical underpinnings but little progress has been registered so far, as depicted in Table 1 below which gives a picture of state of the development of stock exchanges in SADC region. It is for this reason that this research seeks to develop a theory of development that may help in the implementation of the current development agenda generally and the development of strong capital markets specifically.

TABLE 1: COMPARISON OF SOME STOCK EXCHANGES IN THE SADC REGION

COUNTRY	YEAR FOUNDED	STOCK EXCHANGE	NO OF LISTED COMPANIES *(AS AT 2009)*	MARKET CAPITALIZATION (USD-BLN) *(AS AT 2009)*
Bostwana	1989	Botswana Stock Exchange (BSE)	31	4.26
Malawi	1995	Malawi Stock Exchange (MSE)	15	1.48
Mauritius	1988	The Sock Exchange of Mauritius (SEM)	40	4.82
Mozambique	1999	Maputo Stock Exchange (MSE)	6	-
Namibia	1992	Namibia Stock Exchange (NSX)	29	0.96
South Africa	1887	Johannesburg Stock Exchange (JSE)	396	799.02
Swaziland	1990	Swaziland Stock Exchange (SSE)	5	-
Tanzania	1998	Dar es Salaam Stock Exchange (DSE)	15	3.57
Zambia	1994	Lusaka Stock Exchange (LuSE)	21	5.27
Zimbabwe	1993	Zimbabwe Stock Exchange (ZSE)	96	-

Source: Extracted from Capital Markets Authority, "A Comparative Analysis of The Performance of African Stock Markets For The Period 2008-2009 Volume II, June 2010.

1.2 AIM OF THE RESEARCH

The aim of this research is to explore an effective development theory that can be used in designing and implementing legal and institutional reforms to promote development of capital markets in developing countries, in general and SADC countries, in particular[7]. The guiding light for this research is Douglass North's framework of economic development as articulated in his work, *Understanding the Process of Economic Change*[8]. North's framework is drawn from the New Institutional Economics (NIE) theory which rejects the neo classic economics concept of rational actors with respect to economic choices but recognises that mental models, ideas and ideologies play a major role in human choices and therefore must be integrated in any economic development theory.

It will be argued that North's framework of economic change and development is likely to succeed as a development theory because it brings to light realities that previous development theories and approaches overlooked. Specifically North's model emphasises on the interplay between formal rules (statutes, regulations and policy statements) and informal rules (practices, protocols and beliefs) in any given society and posits that formal rules will only be effective if they are compatible with existing informal rules which are determined by societal belief system. This study therefore argues that legal and institutional framework for capital markets in developing countries should be tailored to the unique informal rules prevalent in each country rather than being transplanted from developed countries.

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[7] SADC is a southern African organisation whose aim is to further socio-economic cooperation and integration as well as political and security cooperation among 15 southern African states. SADC member states include, Angola, Botswana, Democratic Republic of the Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia, Zimbabwe and Madagascar.

[8] Douglas North, *Understanding the Process of Economic Change*, (Princeton University Press, Oxford 2005).

In order to show the strength of North's framework, several other theories will be analysed and compared and contrasted to North' framework. These include legal anthropology, law and economics, law and development and Washington Consensus theories, comparative law and legal transplant theories. We will then proceed to show how North's framework would be specifically applied to the development of capital markets in SADC region.

The term capital market has a wide definitional scope as it embraces the whole complex of institutions and arrangements through which capital may be raised.[9] However, this research will mainly focus on the stock markets because they currently form the most visible component of the capital markets in SADC countries.

1.3 SPECIFIC OBJECTIVES

The specific objectives of this study are as follows:

(i) Re-theorise the role of legal and institutional infrastructure in capital market development with particular reference to the SADC region.

(ii) Draw on North's framework of economic development to provide the theoretical framework for understanding the role of legal and institutional infrastructure in capital market development in the SADC region.

[9] R. Burges, *Corporate Finance Law*, (2nd edition, Sweet & Maxwell, London 1992) 5.

(iii) Use the theory to examine critically the existing legal and institutional infrastructure in SADC region, including the relationship between formal and informal institutions.

(iv) Inform/enrich the different approaches taken by law and policy reformers with regards to capital market development.

1.4 KEY RESEARCH QUESTIONS

Starting from the position that sufficient evidence of a significant nexus between capital market growth and economic development can be identified, this research seeks to answer the following research questions:

(i) Why are most new capital markets including capital markets in SADC region still underdeveloped despite different reform strategies that have been put in place?

(ii) How can North's framework of economic development help policy makers and law reformers design and implement effective capital market reform programmes?

1.5 RESEARCH DESIGN AND METHODOLOGY

As mentioned above, this research is, in the main, based on North's work on successful implementation of economic change. Part of this research is based upon doctrinal legal scholarship in the comparative law tradition. According to Zweigert and Kötz[10] this approach attempts to use a functional analysis of legal processes to describe the substantive and systemic aspects of different legal systems. There may be little or no convergence between the systems and their terminology but many legal systems attempt to protect similar interests. Only rules which perform the same function or address the same problem can profitably be compared. Zweigert and Kötz[11] state that functionality is the basic methodological principle of all comparative law.

In this study the functional analysis is based upon the regulation of capital markets in three jurisdictions and involves a description of aspects of regulatory and institutional arrangements that exist in those jurisdictions.

Mindful of the epistemological challenges that are always associated with non-empirical desk based research, part of the methodology of this work is to seek support from related empirical studies based on different philosophical underpinnings but that confirm the working hypothesis of this research. This method, which is modelled on the "two source rule" of classic journalism[12], was followed by Robert Putman in his work on Social Capital[13] who said:

> "Never report anything unless at least two independent sources confirm it. In this book I follow that same maxim. Nearly every major generalization here rests on more than one body of independent evidence, and where I have discovered divergent results from credible

[10] Zweigert, K., and Kötz, H. *Introduction to Comparative Law* (3rd edn Oxford, Clarendon Press 1998)
[11] *Ibid.*, p. 34
[12] This rule says that every rumour or tip must be double checked before it is published.
[13] Robert D Putnam, *Bowling Alone* (Simon & Schuster Paperbacks, New York 2000).

> sources, I note the disparity as well. … I have sought as diverse a range of evidence as possible on continuities and change in American social life."[14]

Also Howard Gardner used a similar methodology in his Multiple Intelligences work.[15]

In using this method, however, one needs to be mindful of the dangers of selecting from the evidence only that which supports the hypothesis and rejecting that which is obstructive to the same.[16]

In this research we will look at a number of different researches, using different philosophical underpinnings and methodologies that support North's model but will argue that the tools of analysis used by North in his work are intellectually far much superior to those adopted by other researchers and theorists.

This research adopts a multidisciplinary approach in that it draws from law, economics and social science literature. The main scholarship traditions that inform this research include, law and society, law and economics, law and finance as well as the New Institutional Economics theory. Thus the approach is not restricted to an examination of formal legal rules and includes relevant contributions from practitioners and theorists from both legal and non-legal spheres.

Finally, given the nature of this research, we adopt a high level approach to conceptualisation to avoid concept stretching. Concept stretching is defined as a form of

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[14] *Ibid*, p.26
[15]Howard Gardner, 'Beyond the IQ' in The Development and Education of the Mind (2006) pp. 48-49.
[16]K. Popper, *The Poverty of Historicism*. (Routledge, London 2002) 124

measurement error that arises when scholars inappropriately apply established concepts and theories to new contexts[17]. We have therefore, purposefully, resorted to the use of general definitions of concepts to allow cross-area comparisons among heterogeneous contexts.[18]

1.6 OUTLINE OF THE THESIS

The rest of this thesis is organized as follows; Chapter 2 discusses the role of capital markets in economic development. Specifically, this chapter looks at the legal position of stock exchanges, the functions of a stock exchange and the theoretical link between development of capital market and economic growth. This discussion is important because the hypothesis of this study is set on the premise that there is a direct correlation between the size and growth of capital markets and economic development.

Chapter 3 discusses the different theories and approaches that have in recent past informed development policy makers in designing reform agendas in developing countries. These include legal anthropology, law and economics, comparative law including legal transplant theories, law and development and Washington consensus theories. This chapter finishes with an introduction of the emerging new institutional economics theory from which, Douglass North draws his new approach to economic development reform. The purpose of this chapter is to show the shortcomings of the theoretical underpinnings on which economic agenda has, hitherto, been based and which, it is argued, explain the apparent

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[17] Henry Brady and David Collier, *Rethinking Social Inquiry*: *Diverse Tools, Shared Standards,* (Rowan & Littlefield, Publishers, Inc., 2004) p 279.
[18] Giovanni Sartori, 'Concept Misformation in Comparative Politics,' (1970) The American Political Science Review, 64(4), p1034 at p. 1044.

elusiveness of an effective approach to economic development. This discussion will also help explain why North's approach may succeed where these other theories failed.

Chapter 4 provides a detailed discussion and analysis of North's approach and explains how North's framework compares with the theories and approaches that have been hitherto deployed as set out in chapter 3.

Chapter 5 applies North's framework to capital market development theory by looking at institutions and organisations that may propel or hinder development of capital markets. In this chapter macro and micro institutions or organisations that need to be focussed on when designing a capital market development agenda are explored.

In chapter 6 the study focuses on the micro institutions and organisations necessary for capital market development as recommended by Professor Bernard Black. Black's proposed institutions and organisations are particularly crucial to this study as they are based on his practical experience with the process of establishing capital markets in developing economies. Most importantly this chapter attempts to synthesize North's framework and Black's recommendations. This is considered to be one of the central planks of this study as it brings together theory and practice for capital market development.

Chapter 7 engages in a comparative analysis of capital market regulatory regimes in three different jurisdictions, namely, United Kingdom, South Africa and Malawi. These countries have been carefully selected as they represent different levels of capital market development. Crucially, the South African capital market, which is a relatively well developed market, is located in the same economic region as the Malawi capital market, the latter being one of the least developed markets. This intriguing disparity is then explained in light of North's framework.

Chapter 8 discusses the mechanics of institutional change as espoused by North and other related theories. The aim of this chapter is to explore the practical difficulties in implementing institutional change and provide some practical ways for achieving effective institutional change.

Chapter 9 is the last chapter and discusses possible reform approaches that can be adopted in developing countries including the SADC region in order to carry out policy and legal reforms within the tenets of North's framework for institutional change. This chapter finishes with a conclusion of this study.

It should be noted that this study has deliberately avoided making firm recommendations as it is exploratory in its approach and it recognises that more research in this area is needed before a concrete road map to capital market development is drawn.

2 CHAPTER TWO: THE ROLE OF CAPITAL MARKETS

2.1 INTRODUCTION

Capital markets have since the 1990s become popular due to a number of global as well as market factors. Global factors that have generated interest in capital markets include intellectual conversion of political elites to the power of markets as instruments of economic change, privatisation of public assets and the sustained recovery in equity markets and technology revolution. Market factors include innovation in financial products and markets, the advent of institutional investors, development of derivative markets and liberalisation and internalisation of markets.[19]

The relevant question for this study is; what is the role of capital markets in the overall economic development? It is necessary to examine the role of capital markets in national economies as the need to develop capital markets in emerging markets would only be justified if markets play a significant role in economic development. Before we do that, however, we need to look at the relevant terminology which will give this study a proper perspective.

2.2 DEFINITIONAL PERSPECTIVE

The term capital market has a wider definitional scope as it embraces the whole complex of institutions and arrangements through which capital may be raised.[20] Capital markets channel the money provided by savers and depository institutions such as banks, credit unions and insurance companies to borrowers and investors through a variety of financial instruments including bonds, notes, stocks which are collectively called securities.[21] The capital market system is therefore made up of three major parts: (1) stock market, (2) bond market, and (3) money market. The Capital market is sometimes referred to as the securities market.

This work will however mainly focus on the stock markets because trading of stock is more common in developing countries than other exchange traded products like bonds, forex and

[19]B.J. Foley, *Capital Markets*, (Macmillan Education Ltd, 1991) pp 1-2.
[20] R. Burges, *Supra* note 9.
[21] See. Business Dictionary at www.**businessdictionary**.com (Last visited on 06/08/2014)

commodities. Stock markets are also called stock exchanges or equity markets. A stock exchange is defined as a market for the sale and purchase of shares, stock and other securities.[22] Stock exchanges are usually organized and regulated and securities are bought and sold at prices governed by the forces of demand and supply. Stock exchanges basically serve either as primary markets or as secondary markets of stocks. In its role as a primary market, a stock exchange allows new issues of equity or debt to be arranged in the form of an entirely new floatation or in the form of an offer to existing investors.[23] The primary market therefore enables corporations, governments, municipalities, and other incorporated bodies to raise capital by channelling savings of the investors into productive ventures.[24] On the other hand, the secondary market allows investors to sell their securities to other investors for cash, thereby reducing the risk of investment and maintaining liquidity in the system. The existence of a secondary market therefore makes the primary market operate more effectively.[25]

The history of stock exchanges can be traced back to sixteenth and seventeenth centuries when the modern business corporation and modern equity instruments were created following changes in the European financial sector and other geopolitical developments[26]. Stock exchanges were created to provide a platform for secondary trading of equity

[22] G. Cooper, and R.J Cridlan, *Law and procedure of the Stock Exchange*, (Butterworths, London 1971) 1.
[23] Foley*, Supra* note 19, P.6.
[24] G. Cooper and R.J. Cridlan, *Supra*. Note 22, p. 7.
[25] Investors will be prepared to float their shares because they know that they will be able to raise the funds they need and at the same time investors buying on a primary market are assured that they can offload their investment at any time.
[26] See: Charles Pouncy, 'Stock Markets in Sub-Saharan Africa:Western Legal Institutions as a Component of the Neo-Colonial Project', (2002) 23 (1) Journal of International Law , pp 85-117 at p.90. Pouncy notes that the stock companies were a response to the risk and reward structure of European efforts to exploit trading opportunities with non-European world. One of the geo-political imperatives was the need to finance the debt resulting from Britain and France's competition for political supremancy. *Ibid*. Also See: Jonathan Baskin and Paul Miranti Jr, *A History of Corporate Finance*, (Cambridge University Press, 1999) at pp 47-50.

instruments so that the risk-reward function that was packaged in the instruments could be readily acquired or liquidated[27].

In terms of nature and status, stock exchanges exist in different forms. In the case of *Weinberger v. Inglis*[28], Lord Buckmaster described the character and status of London Stock Exchange as follows:

> "The London Stock exchange is in Reality a building vested in certain proprietors and used for the purpose of carrying on a market for stocks and shares. It is not regulated in any way by charter or statute. The Management owes no duties to the public and the business is subject to no regulations except those which from time to time (the council) think right to impose on those whom they chose to admit. The Prestige and authority of the institution depend entirely upon the reputation it has established for honest and efficient business methods. Any group of people who so desired could start another Stock Exchange tomorrow. It is not a public market – it is a private market and access to it is only obtained through membership."[29]

Of course, technological and regulatory advances have significantly changed the nature and status of modern day stock exchanges. In Lord Buckmaster's time share dealing was face to face and socially relational. This is no longer the case as electronic trading has removed geographical and time zone boundaries that used to exist then. Also in the case of European stock exchanges like the London Stock Exchange, they now operate under the wider EU

[27] *Ibid* at p. 90.
[28] [1919] A.C. 606 H.L. 617-619
[29] *Ibid* at 618.

regulatory framework which is aimed at fostering free movement of capital within the union[30].

Apart from the formal stock exchanges, equity or debt is also traded on the Over the Counter market (OTC). This market deals mainly in securities which are not traded on an exchange, usually due to an inability to meet listing requirements. The market is operated by brokers/dealers who negotiate directly with one another over computer networks and by phone. Securities acquired in the OTC market are riskier than those quoted on the Stock Exchange for several reasons including lack of sufficient statutory protection to investors and lack of liquidity[31]. The role of OTC markets have now been significantly reduced following introduction of alternative markets where trading of most unlisted shares take place[32].

2.3 FUNCTION OF CAPITAL MARKETS.

In order to understand the role of stock markets in economic growth, it is important to look at the distinct functions of the markets themselves. Generally the functions of capital markets may be summarised as follows:

i. Capital markets maintain a free market by providing a meeting place and facilities for trading which in turn brings together a constant stream of buyers

[30] See the discussion of UK regulatory framework in chapter 7 below.
[31] Foley, *supra* note 19, p. 19
[32] Examples include AIM and NASDAQ

and sellers of stocks.[33] In this way capital markets facilitate the flow of funds generated within the economy to be made available to those who need them on terms acceptable to those supplying them.[34] In other words, capital markets provide a mechanism through which investible funds from economic agents in financial surplus are transferred to those in financial deficit.[35]

ii. Capital markets supply a continuous measure of worth, making the securities useful as a basis of credit or exchange throughout the country at a figure based roughly on the market price in the exchange.[36] Capital markets therefore act as an instrument for stock valuation which is key to determining management performance, timing further Initial Public Offerings (IPOs) and capital gain for shareholders.

iii. Perhaps the most crucial role of capital markets is that they provide liquidity for securities by providing the only substantial means by which an investor can withdraw his capital either for other capital employment or for personal expenditures. According to Berle & Means 'the market is the paying teller's window.'[37] This is made possible through the state-of-the-art technology and the business of brokering which help traders to buy and sell securities quickly and efficiently.

[33]A.A. Berle, and G.C Means, *The Corporation and Private Property*, (2002 ed, Transaction Publishers, London, 1932) 255

[34] R. Burges, *supra*, note 9.

[35] Foley, *supra*, note 19.

[36] Berle and Means, *supra* note 33.

[37] *Ibid*. P. 263

iv. Finally, capital markets protect investors by upholding rules and regulations that ensure buyers will be treated fairly and receive exactly what they pay for. This is done both via the primary market where stock market disclosure rules set a quality threshold for shares to be listed on the market and via the secondary market where, the capital market in its role as a regulator, prevents a false market through the stock exchange rules, common law and statute which are mainly concerned to prevent insider trading or market abuse.[38]

Given these functions of capital markets, there are a number of advantages that attach to a company that trades its shares on a stock exchange. According to Foley**,** selling debt or equity via an organised and recognised stock exchange yields a number of advantages including the following:[39]

i. It promotes firm growth in that access to external sources allows the firm to grow more rapidly due to its ability to raise additional capital in a considerably easier and successful manner. Such growth can be realised either through internal organic processes or acquisition of other firms.

ii. A stock exchange quotation confers on a company special status, which allows it to obtain bank credit on finer terms than would be the case for similar sized non-quoted organisation. Also the quoted status helps publicise

[38] Cooper & Cridlan, *supra* note 22.
[39] Foley, *supra* note 19, p. 10.

the company to larger clientele and may allow it to exploit international sources of capital.

iii. Further, availability of stock exchange finance gives a firm more flexible capital structure. It can be easily varied by altering the debt/equity mix to obtain finance on cheap terms. Besides conversional securities, the firm can also arrange issues in hybrid products like bonds with an option to convert into equity.

iv. Finally owners of the company can, by selling their shares, use the stock exchange to realise part of their wealth. Also as the company grows, the value of the share holding will reflect that growth and an original investment of few thousand shares may grow into an extremely valuable claim on the assets of the company.

2.4 STOCK MARKETS AND ECONOMIC GROWTH.

Having looked at the functions of the stock exchanges we are now in a position to explore the macro-economic impact of stock exchanges. It is believed that Stock markets play a crucial role in the allocation of capital resources within the economy which in turn plays a critical role in the determination of the rate of growth of the nation's output. Baumol[40] observed that:

[40] W.J. Baumol, *The Stock Market and Economic Efficiency*, (Fordham University Press, New York, 1965) 2.

> "If capital resources are not provided to those industries the demand for whose products is growing or is at least expandable, if capital is not available to sectors which are capable of increasing production and productivity and above all if there is no investment in research and development, we can be sure that the rate of expansion of the economy will suffer"

The stock market is said to be well positioned to carry out this task. The stock market has also been described as a close approximation to a perfect market because it has all the necessary characteristics required of a pure competitive market including product homogeneity (because anyone's share is identical, it does not matter which share one buys in a company) and free entry and exit i.e. anyone who owns a listed security can undertake to sell it and anyone who wishes to acquire one can purchase it.

In order to have a meaningful impact on the economy, stock markets must not only focus on the processes of finance and trade but must also facilitate growth of the production side of the economy[41]. This entails that trading of stock on the exchange markets must result in establishment of new companies or the expansion of the existing companies.

This means that a well-functioning securities market is conducive to sustained economic growth. A number of studies have established robust relationship between the development in the securities market and the economic growth. For example, Levine and

[41] C. Pouncy, *supra* note 26 at 86.

Zervos[42] found that stock market development is highly significant statistically in forecasting future growth of per capita GDP.

A number of explanatory mechanisms are put forward in support of this relationship. Firstly, securities markets augment the quantities of real savings and capital formation from any given level of national income by providing a bridge between ultimate savers and ultimate investors thereby creating the opportunity to put the savings of the cautious at the disposal of the enterprising, thus promising to raise the total level of investment and hence of growth.[43] Secondly, securities markets increase net capital inflow from abroad in that they provide a link between the national economy and the rest of the world thereby facilitating inflow of capital in the form of portfolio investment.[44] At the same time, the existence of a domestic securities market will deter capital outflow by providing attractive investment opportunities within domestic economy. Thirdly securities markets raise the productivity of investment by improving allocation of investible funds. Further, a developed securities market successfully monitors the efficiency with which the existing capital stock is deployed and thereby significantly increases the average return. Also the fluctuation of share prices causes changes in net wealth for both investors and listed companies. As share prices rise and fall individuals may change their spending plans; banks and other financial institutions may revise their lending plans as the value of their assets rises or falls.[45] Finally securities markets and its institutions help the user in many ways to reduce the cost of capital by

[42] R. Levine and S. Zervos, 'Stock Markets, Banks, and Economic Growth'. 88 American Economic Review, (1998) 537-558.
[43] G.N. Bajpai, 'Stock Markets and Economic Growth', Speech given at Global Corporate Gorvernance Meeting, Paris in November 2003. Web at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1293011165899.pdf.
[44] *Ibid*.
[45] Peter Howells & Keith Bain, *Financial Markets and Institutions*, (3rd edition Pierson Education Ltd, Essex, 2000) 171.

providing a convenient market place to which investors and issuers of securities go and thereby avoid the need to search for a suitable counterpart. Also, the market provides standardised products and thereby cuts the information costs associated with individual instruments. By specialising and operating on a large scale, the market institutions, cut costs through the use of tested procedures and routines.[46]

It is also said that securities markets provide developmental benefits by firstly providing a fast-rate breeding ground for the skills and judgement needed for entrepreneurship, risk bearing, portfolio selection and management on the part of the user. Secondly, they help integrate the informal financial systems with the institutional financial sector by directly displacing traditional assets such as gold and stocks of produce or, indirectly, by providing portfolio assets for unit trusts, pension funds and similar financial Instruments that raise savings from the traditional sector. Finally, the existence of securities market enhances the scope, and provides institutional mechanisms, for the operation of monetary and financial policy.

2.5 STOCK MARKETS AND MANAGEMENT BEHAVIOUR

Emphasis on the role of capital markets in economic development has been criticised on the ground that the issue of securities to raise capital is not the most important way in which companies finance their activities.[47] Financial statistics on sources of capital for industrial and commercial companies show that, on average, the most important source of finance derives from internally generated funds and of the externally sourced funds, bank

[46] Bajpai, *supra* note 43.
[47] Foley, *Supra* note 19, p. 6.

borrowing is the most significant source of funds with funds obtained from capital markets normally comprising less than 10% of the total funds raised at any given period of time.[48]

However, despite this relative insignificance of capital markets as a source of corporate finance, capital markets play a distinct role in corporate governance which in turn result in maximisation of shareholder value of the individual firm. In this way capital markets act as a direct supervisor of the efficiency of utilisation of the economy's capital resources.[49] It is this influence of capital markets on the corporation system that accentuates its relevance to the national economy.

In order to appreciate the economic significance of the market in terms of its influence on the corporation system, it is important to understand the relevance of the firm to the economy. The starting point in this regard would be Ronald Coase's Theory of the Firm. In his work, *The Nature of the Firm,*[50] Coase attacks classic economic theory which posits that the allocation of factors of production between different uses is determined by the price mechanism in that it does not give a complete picture of the economic system as it excludes the role of economic planning in the economic system.[51] Coase posits that organizations are factors of production such that while outside the firm, price movements direct production coordinated through a series of exchange transactions on the (open) market, within a firm

[48] *Ibid*. P. 7.
[49] Baumol, *supra* note 40. P. 78.
[50] R.H. Coase, 'The Nature of the Firm', in R.H. Coase, *The Firm, The Market and The Law*, (The University of Chicago Press, 1988) 33.
[51] Coase disagrees with Sir Arthur Salter who described the economic system as follows: "The normal economic system works itself. For its current operation, it is under no central control, it needs no central survey. Over the whole range of human activity and human need, supply is adjusted to demand, production to consumption, by a process that is automatic, elastic and responsive". J.A. Salter, *Allied Shipping Control*, (Clarendon Press, Oxford 1921) 16-17.

these market transactions are eliminated and in place of a complex market structure with exchange transactions is substituted an entrepreneur-co-ordinator, who directs production. According to Coase, therefore, a firm consists of the system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur within the limits of a contract. It is the existence of the entrepreneur coordinator in the process of coordinating production that makes any system that has capability to control the entrepreneur relevant to the economic system. As it will be shown below, capital markets have such capability.

The main reason why a firm is relevant in the economic system is that it helps avoid the cost of using price mechanism. According to Coase, there are three aspects of such costs.[52] The first is the cost of discovering what relevant prices are. Secondly, there is the cost of negotiating and concluding a separate contract for each exchange transaction which takes place on the market. The firm helps to cut these costs as the owner thereof does not have to make a series of contracts with the factors of production with whom he is co-operating within the firm, as would be necessary if this cooperation were a direct result of the working of the price mechanism. And finally there is a regulatory cost in that exchange transactions on a market and the same transactions organized within a firm are often treated differently by governments or other bodies within regulatory powers.

Finally, Coase says a firm will tend to expand until the costs of organising an extra transaction within the firm become equal to the costs of carrying out the same transaction by means of an exchange on the open market or the costs of organising in another firm.

[52] Coase, *Supra* note 50, p. 38.

According to Coase, all things being equal, a firm will tend to be larger (a) the less the costs of organising and the slower these costs rise with an increase in the transactions organised; (b) the less likely the entrepreneur is to make mistakes and the smaller the increase in mistakes with an increase in the transactions organised. (c) the greater the lowering (or the less the rise) in the supply price of factors of production to firms of larger size. Also a firm can expand through combination when transactions which were previously organised by two or more entrepreneurs become organised by one or through integration when it involves the organisation of transactions which were previously carried out among the entrepreneurs on the market.

The capital market is clearly well placed to facilitate growth of the firm in as far as it reduces transactional costs, makes corporate managers more accountable, reduces cost of capital and facilitates mergers and acquisitions.

Although, corporations take the place of an effective instrument of productivity in the modern world,[53] the potential risk of abuse of the corporation system has been lamented. The first attack on the corporation system was by W.W. Cook in his publication, '*The* Corporation Problem'[54] where he observed that the corporate device had helped some capitalists to become "the greatest benefactors of the age" and that big corporations had openly corrupted all branches of government and that for many, the polestar of existence was not what is honest but what is profitable.[55] Cook further observed that:

[53] W. Werner, 'Management, Stock Markets and Corporate Reform: Berle and Means Reconsidered', 77 Columbia Law Review, (1977) 388 at 390.
[54] W.W. Cook, ' The Corporation Problem' (1891), cited in W. Werner, *Ibid*. P. 390.
[55] *Ibid*. P. 6.

> "The spoliation of corporations and stockholders by the corporate managers have been systematised into well-known methods of proceeding and that carrying out of such plans has become a profession and an accomplishment….Corporations become insolvent and stockholders lose their investment, while individuals become millionaires. Illegitimate gains are secured and enormous fortunes are amassed by the few, at the expense of the defrauded but generally helpless stockholders."[56]

Cook recommended a restoration of an internal distribution of power that would enable shareholders, as owners of the corporation, to elect directors who would manage on their behalf and be accountable to them.

The stock market collapse of 1929 gave rise to more questions about shareholder rights and the corporation's place in the economy.[57] This led to the debate about separation of control and ownership championed by Berle & Means[58] who observed that the traditional wisdom had failed to account for the behaviour of the new public corporations and the economic and organisational systems they were creating. Their main concern was that the economic power was being concentrated in a small number of large corporations whose ownership was increasingly dispersed over a large number of shareholders. That dispersion, they argued, coupled with gradual elimination of majority and large minority shareholdings, enabled managers owning few shares or none to control these corporations and that the resulting separation of ownership and control was dissolving the atom of property.[59]

[56] *Ibid*. P. 81
[57] Werner, *supra* 53, p. 395.
[58] Berle and Means, *supra* note 33.
[59] *Ibid.* See preface. Bamoul observes that the issue of separation of ownership and control becomes less problematic when viewed from the perspective that stockholders and managements are not two well-defined polar groups with each completely homogeneous in its objectives. He observes that in practice, managements will naturally identify to a different degree with different stockholder groups and separation of ownership

Berle & Means feared that non-owner controllers might lack the owner-entrepreneur's incentive to maximise profits and that controllers motivated by desire for personal monetary gain could use their power position against the interest of ownership. They also observed that the problem had become a serious public concern since, for the first time, many of these owners were members of the "investing public"[60] who had purchased common stocks as property interests which purported to assure participation in corporate earnings and assets. According to Berle & Means, controllers held and exercised corporate powers for the benefit of all shareholders such that corporate law ought to be regarded as a branch of law of trust.[61]

Berle & Means however expressed their confidence in the public market as a device for fulfilling shareholder expectation. They argued that the shareholder had a piece of paper with an open market value and although these were merely uncertain expectations, when "aggregated, interpreted by public market and appraised in security exchange, they do have a concrete and measurable value; and it is to this value that the shareholder must and in fact does address himself. His thinking is coloured by it; and in large measure the corporate security system is based on it."[62] They therefore recommended that "the appraisal of the various expectations under the mechanism which permits the immediate turning of the

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from management, instead of amounting to a sharp cleavage, takes the form of gradual shading-off in the degree of coincidence between managerial and stockholder objectives. Baumol, *supra* note 40, P. 85

[60] *Ibid* p. 6

[61] *Ibid*. P. 242.

[62] *Iibid.* P. 252.

expectations into cash, becomes a focal point in the corporate system of today."[63] According to Berle and Means, the mechanism was the stock market.

The stock market was, therefore, thought as key to shareholder protection and in order to fulfil this role it had to be open and honest market, providing shareholders with accurate corporate information and with adequate remedies for market fraud and manipulation. This requirement is now being met by robust securities regulation of modern securities exchange.

The regulated stock market has resulted in a change in corporate goals as today management is more wary about the market evaluation of its company's prospects. As Werner observed "the old strategy of steady earnings to permit steady dividends has been replaced by a strategy of constantly increasing earnings to support constantly advancing share prices"[64] As such the management has become amenable to the invisible hand of the market. Some of the reasons why company managements are continually concerned about the market prices of their shares include the following:

i. Share price influences availability and cost of capital in that the performance of a company's shares can influence the terms on which it can obtain funds from other sources.[65] Thus share prices will affect the issuer's standing with credit rating agencies, its ability to borrow from banks, to sell commercial paper and to sell publicly or place privately long-term debt securities.

[63] *Ibid*. P. 248
[64] Werner, *supra* note 53, p. 404.
[65] Baumol, *supra* note 40, p. 81.

ii. Poor market evaluation of a company's shares will result in shareholder dissatisfaction and will expose the company to a takeover bid which, if successful, will result in change of management. Consequently corporate managers will strive for high performance of its shares to shield itself from this threat.[66]

iii. Further, market appraisal of shares directly affects the value of management's shareholdings and options to purchase company stock and this gives managers a significant personal interest as shareholders to maximise value of their shares.

iv. Finally, failure to match share price action of other companies is interpreted as a public evaluation of inferior management performance, threatening management's power position, and depreciating its value on the job market.[67] Market price is also said to be a measure of success in the contest among top managers-as among investors –to outperform each other. It is a score card in the game that managers play in a culture that equates winning with success, which in turn brings reputation and prestige.[68]

[66] Werner has noted that while wide dispersion of shareholdings before 1932 allowed management to perpetuate itself by masterly of the proxy machinery, management could be removed only after dissidents had won a proxy fight, which was difficult even where the insurgents possessed a substantial minority shareholder interest. Today management control is far less secure. It is frequently turned over, often despite incumbents' opposition, as the takeover bid in the public market has become a potent instrument of displacement. Ironically the stock market has helped to convert the share dispersion that was once management's strongest defence weapon into a powerful threat to its survival. Werner, *Supra* 53, P. 404.

[67] Manne, '*Mergers and the market for corporate control*', (1965) 73 Pol. Econ. 110

[68] Werner, *supra* note 53, p. 404.

The stock market therefore has, to some extent[69], removed fears that were initially levelled on the corporation system of plundering the property of investors by management. It is this role of the stock market, which is expressed as market for corporate control that gives it a prominent place within the economic system. Its ability to tame corporate managers enables the corporation system to roll efficiently thereby facilitating economic growth.

2.6 IMPORTANCE OF CAPITAL MARKETS IN THE SADC COUNTRIES.

In light of the above theoretical role of capital markets, there is a valid expectation that the development of capital markets in the SADC region will make a significant contribution to the economic development of the member countries of this economic region. As discussed above, a well-functioning capital market facilitates efficient allocation of capital from those who have capital surplus to those who have capital deficit. Through such allocative efficiency, it is hoped that companies on the production side of the economy would be well resourced and consequently increase productivity in the economy. This would be very vital in the SADC region given that most of its member countries are predominantly import dependent countries due to lack of resources to support economic production that would help these countries to transition from import-based to export-based economies. There is therefore a strong case for relevance of efficient capital markets in the SADC region.

Further, capital markets help with risk sharing for big and capital intensive projects. Generally, investors would be reluctant to single-handedly fund a high cost project out of which they can only realise a return on capital after a relatively long period of time. Through the medium of capital

[69] The existence of developed stock markets in developing countries has not completely eliminated corporate scandals.

markets however, investors are able to reduce their risk by only contributing a portion of the overall cost of the project alongside other investors. Given that efficient capital markets have high liquidity levels, investors are able to take out there money at any stage of the project by disposing of their equity. Thus, capital markets help to assuage the fears of risk-averse investors of losing their money if they invest in big projects. Again this role of capital markets underscores the importance of capital markets in the SADC region where most countries are grappling with the problem of huge infrastructure deficit. Development of efficient capital markets is therefore vital to the infrastructure development efforts in the region. Capital markets would help both local and foreign investors to pool their investments together to fund different infrastructure projects.

Also, properly functioning capital markets help to reduce the cost of information gathering by investors. While institutional investors may have the resources to commit towards due diligence, small investors are sometimes scared away from investing in some companies because they do not have the wherewithal to extract the necessary information of the relevant stock. This creates uncertainty of the safety of their investment and they therefore end up withholding their resources. Through the mandatory disclosure obligations that capital markets place on listed stocks, capital markets ensure that market participants have equal access to the relevant information they need to make informed investment choices. This role is very important in the SADC region where, as we shall show later in chapter 5, self-enforcing attitudes of honesty, integrity and cooperative behaviour are in short supply among market players especially issuers. Full and frank disclosure is usually rare among issuers of stock in most developing countries including SADC countries. Capital markets would therefore provide the much needed assurance that because issuers are under a legal obligation to disclosure material and price sensitive information, access to such information will be available at low cost.

Finally capital markets provide a reliable alternative source of corporate financing. Apart from the traditional bank loans, companies are able to raise more money through share issuance. A number of empirical studies have found that stock markets had been an important source of finance for funding the growth of large corporations in some SADC countries.[70] For example, it was found that in South Africa, new equity issues accounted for 18 percent of total asset growth between 1996 and 2000[71]. External debt contributed 61 percent of total financing, and retained earnings financed the remaining 21 percent[72]. Another study found that in Zimbabwe, equity finance contributed 8 percent to the funding of listed corporations between 1990 and 1999. Equity financing was the most important source of long term finance at 7.8 percent. Long term bank loans and bonds were each a very minor component of total external financing.[73] Empirical evidence was also found which confirmed that in Mauritius, the stock market financed about 9 percent of total asset growth with retained earnings and external debt contributing 30 and 61 percent respectively to the financing of total asset growth between 1992-1999.[74] The foregoing shows that the stock markets were for these companies the single most important source of long term external finance.

However, as stated in chapter 1 above, capital markets in the SADC region are not yet efficient relative to capital markets in developed countries. As such their contribution towards the overall economic growth of the respective national economies is sub-optimal. As we will discuss further in

[70] Yartey C.A. and Adjasi C.K., 'Stock Market Development in Sub-Saharan Africa: Critical Issues and Challenges', [2007] IMF Working Paper, Web: http://www.imf.org/external/pubs/ft/wp/2007/wp07209.pdf

[71] Glen, Jack and Ajit Singh, 2003, "Capital Structures, Rates of Return and Financing Corporate Growth: Comparing Developed and Emerging Markets, 1994-2000," in Litan et al (eds), *The Future of Developed Capital Markets in Developing Countries*, Washington: Brookings Institution.

[72] *Ibid.*

[73] Mutenheri E., and Christopher, J. Green, 2003, "Financial Reform and Financing Decisions of Listed Firms in Zimbabwe," *Journal of African Business*, Vol. 4 (2), pp. 155-170.

[74] Lallchand, Jawaharlal., 2001, "Capital Markets Development in Sub-Saharan Africa: A Case Study of Mauritius," *PhD Thesis*, Cambridge: University of Cambridge.

this thesis, there are a number of factors that contributes to the slow realisation of the full potential of capital markets' role with respect to economic development in developing countries including the SADC countries. One of such factors is the circumstances under which most of these capital markets were established. Capital markets in SADC countries, as is the case with most developing countries, were established as part of the World Bank and IMF economic structural adjustment reforms.[75] One of the policies that were being deployed under these reforms was privatisation of state-owned enterprises and most stock markets in SADC region with the exception of the South African Johannesburg Stock Exchange were established to act as vehicles through which issues of the privatised firms would be traded.[76]

Consequently it is observed that most of the offerings on the Sub-Saharan Africa Stock exchanges have resulted from privatisation.[77] Pouncy makes the following interesting observation:

"The Malawi stock exchange, for example, has only conducted IPOs of securities in privatized firms since its establishment in 1996; Zambia's Lusaka stock exchange has only offered the securities of privatized firms since it began operations in 1994; … Although the exchanges in Kenya and Tanzania have offered the securities of private issuers, the privatizations of the Kenya Reinsurance Company, the Housing Financing Company of Kenya, and Chemii Sugar Company will again place the Kenyan exchange in the position of refinancing formerly public entities. It is fair to say that with the exception of the stock markets in South Africa, Zimbabwe, and Namibia, the majority of all of the issues on the SSA stock exchanges have resulted from privatization."[78]

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[75] Pouncy Charles R.P. 'Stock Markets in Sub-Saharan Africa: Western Legal Institutions as A Component of The Neo-Colonial Project' (2002) *23:1 U. Pa.* ***J.*** *Int'l Econ. L., p. 111* at p.98

[76] *Ibid*. p. 104

[77] *Ibid.*

[78] *Ibid.*

It is therefore said that the capital markets in the Sub-Saharan Africa (which include SADC countries) are not playing the type of role that capital markets have played in the West and in Asia in that they are not providing financing for the development of innovative independent domestic industries. Instead, they have largely served to provide a means for multinational corporations to acquire controlling stakes in firms whose assets are exploitable natural resources and exportable agricultural commodities.[79] As a result capital markets have not made any meaningful contribution to the development of national economies in the region.

2.7 CONCLUSION

Capital markets have a distinct role in the promotion of sustained economic growth. There is a clear positive correlation between well-developed capital markets and strong national economic development. This is so mainly because capital markets create liquidity in the market, provide a channel through which financial surplus and financial deficit levels off and also provide a mechanism for checks and balances on the behaviour of corporate managers, resulting in improved economic performance. This modern relevance of capital market creates a need for each economy, more especially developing economies to develop robust capital market markets, hence the relevance of this study to economic development in developing countries. SADC countries therefore stand to benefit from well-functioning capital markets although the history of most capital markets in the region has so far limited their relevance to economic growth.

[79] Ibid.

3 CHAPTER THREE: IN SEARCH OF A CAPITAL MARKET DEVELOPMENT THEORY

3.1 INTRODUCTION

The discussion in chapter 2 shows that capital markets can effectively be developed when appropriate legal and institutional frameworks are in existence. This begs the question; how should such legal and institutional frameworks be developed in countries or economic regions where they have never existed before or where they are not robust enough to generate capital market growth.

A number of techniques have been adopted before but history has not judged most of them favourably and as a result the search for an effective development theory appears to be well and truly still ongoing. This section looks at different techniques, methods and theories that scholars and practitioners have called to aid as a tool for legal and institutional reform in developing countries.

3.2 LEGAL ANTHROPOLOGY

Legal anthropology seeks to explore the genesis and function of law and of the legal action within a society by direct observation.[80] Legal anthropologists believe that each society has its own rules that are embedded in its social order and can only be properly understood by observing the society's way of life.[81] Llewelyn *et al*[82] in their study of Cheyenne society found that the rules that are legal are those that have authority among the people and are engaged with regularity and such rules provide satisfaction among members of the society. They conclude that it is these rules that are effective in the ordering of the society because they have "legality" as opposed mere "legalism" which is "marked by unsatisfactory results".[83]

When applied to legal reform, the theory of legal anthropology posits that, in order to bring about an effective change of law, law reformers should concentrate on the society's social order and determine what rules have legality in the society. Llewelyn and Hoebel, in *The*

[80] See B. Malinowski, *Crime and Custom in Savage Society*, (Routledge & Kegan Paul, London 1926).
[81] Malinowski proposed an ethnographic approach to the study of legal issues, calling for extended fieldwork in order to study by direct observation the rules of custom as they function in actual life. *Ibid* at P. 126.
[82] K. Llewelyn, and A. Hoebel, *The Cheyenne Way*, (Norman: The University of Oklahoma Press, 1941) 284-288.
[83] *Ibid*. P. 288.

Cheyenne Way, developed a theory of investigation in which they insisted on the need to discover:

(i) The norms and rules which are felt proper for channelling and controlling behaviour. They called this the "right ways."

(ii) Practice or "what really happens".

(iii) The "trouble case" that is what was the trouble and what was done about it.

While this theory may have a role to play in legal reform its relevance would be watered down by the realities of modern world that has been turned into a global village by the invasion of modern technology. As Mc Dougal observed, " ...In this contemporary world, people are increasingly demanding common values that transcend the boundaries of nation-states; they are increasingly interdependent in fact, irrespective of nation-state boundaries, for controlling the conditions which affect the securing of their values; they are becoming ever more realistic in their consciousness of such inter-dependences and hence widening their identifications to include in their demands more and more from their fellow men."[84] As stated above however, it shall be argued that legal anthropology has a place in the process of legal reform for economic development.

3.3 LAW AND ECONOMICS

Another theory that has informed previous law reform programs is Law and Economics. The two basic premises of law and economics were that (i) people act as rational maximisers of their satisfactions in making non-market decisions and that (ii) rules of law operate to impose prices on or subsidize these nonmarket activities thereby altering the amount or

[84] M.S. McDougal, 'The Comparative Study of Law for Policy Purposes: Value Clarification as an Instrument of Democratic World Order', 1 American Journal of Comparative Law, (1952) 24.

character of the activity.[85] The proponents of Law and Economics theory therefore believed that a change in the rule of law would change human behaviour by altering the relative incentive structure, which ultimately determined human decisions. By using economic analysis, the law and economics theorists argued, it is possible to predict the change of behaviour that will result from a change of a particular law. Thus in his work, *The Economic Approach to Law,*[86] Posner advocated the adoption of economic analysis throughout the legal system including the judiciary and the legal education.

As a tool of law reform, law and economics used the efficiency approach whereby reformers first defined an efficient way of dealing with a set of particular problem and then derive rules, legal structures or institutions that are regarded most likely to achieve the efficient outcome.[87] As it will later be shown, in so far as law and economics theory mirrored neo classic economic theory and relied on the assumption of rationality of economic actors, it was therefore ill-conceived in as far as economic development reforms are concerned. Indeed there is now a realisation among Law and Economics theorists who acknowledges that the "rational actor" model of human motivation is rather too crude and most of them are drawing instead and increasingly on behavioural economics, which is a fusion of economic theory and individual/social psychology.

[85] R.A. Posner, 'Law and Economics Movement', in R.A. Posner and F. Parisi, 'Law & Economics' 1 Theoretical and Methodological Foundations, (1997) 7.
[86] R.A Posner, 'The Economic approach to Law', 53 Tex. L. Rev. 1974-1975
[87] W.M. Landes and R.A. Posner, 'Tort Law as a Regulatory Reform for Catastrophic Personal Injuries', XII Journal of Legal Studies (1984)

3.4 COMPARATIVE LAW

3.4.1 Definition

Since, as seen above, most developed countries have registered success with the rules and institutions they have adopted long time ago, comparative law stood as the first port of call for law reformers. Unfortunately, comparative law as an area of legal scholarship has been muddled with a lot of controversy and misunderstanding with respect to its academic respectability and practical functionality especially as a tool of legal reform[88].

Comparative law is defined as the study of and research in, law by the systematic comparison of one or more legal systems or of parts, branches or aspects of two or more legal systems.[89] Legal comparatists emphasise the importance of understanding that comparative law is not a distinct branch of law but rather that it signifies the systematic application of the comparative technique to the field of law.[90] Zweigert and Kotz[91] describe comparative law as an intellectual activity with law as its object and comparison as its process.[92] Adoption of a proper definition of the concept of comparative law is important as the way in which one defines "comparative" will determine its use or misuse.[93] There are

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[88] This is exemplified by the two polarised views on legal transplants taken by Allan Watson and Kahn-Freud as we will discuss below.

[89] W.J. Kamba, 'Comparative Law: A Theoretical Framework', 23 International and Comparative Law Quarterly, (1974) 485 at 486.

[90] *Ibid.* The initial view of comparative law was that it was legal science whose objective was "the discovery of the causes which underlie the origin, development and extinction of legal institutions, or in other words comparative legal history". See Gutteridge, *Comparative Law*, (2nd ed., 1949) 2.

[91] K. Zweigert and H. Kotz, *An Introduction to Comparative Law,* Supra note 10.

[92] *Ibid*. P2

[93] For example, Allan Watson, *Legal Transplants: An Approach to Comparative Law*, (Scottish Academic Press, Edinburgh, 1974) at p. 21 defines comparative law as "the study of the relationship between legal systems or between rules of more than one system...in the context of a historical relationship...a study of the nature of

two levels of comparison that comparative lawyers may engage in. *Macro-comparison* is where the spirit and style of different legal systems, the methods of thought and procedures they use are compared while under *micro-comparison* specific legal institutions or problems and rules used to solve actual problems or particular conflicts of interest are compared.[94]

Comparative law studies can take different forms and shapes including (a) comparison of foreign systems with domestic system in order to ascertain similarities and differences (b) studies that analyse objectively and systematically solutions which various systems for a given legal problem (c) studies that investigate the causal relationship between different relationships of law (d) studies that compare the several stages of various legal systems and (e) studies that attempt to discover or examine legal evolution generally according to periods and systems.[95] Categories (b) and (e) have particular relevance to this study.

3.4.2 Function

Despite the long standing controversy and mixed views on the usefulness of comparative law theory, the emergence of the global village concept has birthed new opportunities for comparative law to claim pride of place in legal research. McDougal[96] observes that "in a world shrinking at an ever-accelerating rate because of a relentlessly expanding, uniformity-imposing technology, both opportunity and need for the comparative study of law are

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law and the nature of legal development." Watson's emphasis of the historical relationship between legal systems or between rules informs his orientation on the use of legal transplants as we will explain below.

[94] Under macro-comparison research concentrates on methods of handling legal materials, procedures for resolving and deciding disputes or the roles of those engaged in the role. On the other hand, micro-comparison looks at specific questions like liability for the harm to a consumer by defective goods or rules determining the allocation of loss in the case of traffic accident. (Zweigert And Kotz)

[95] Hug, 'The History of Comparative Law' 45 Harv L Rev (1932) 1027.

[96] M.S. McDougal, *Supra*, note 84, at p 24

unprecedented."[97] The interconnectedness and interdependence of the modern world has resulted in a high demand for "common values that transcend the boundaries of nation-states."[98]

There are thus a number of closely related academic and practical aims which may be served by the systematic application of the comparative technique to legal study and research in the modern world.[99] The main functions and purposes include serving as (a) an academic discipline (b) an aid to legislation and law reform (c) a tool of construction (c) a means of understanding legal rules and a contribution to the systematic unification and harmonisation of law.[100] For purposes of this research we shall concentrate on the role of comparative law as an aid to legislation and law reform.

The role of comparative law in law reform has been well known since the coming into being of the concept of comparative law itself. Actually during infancy stage of comparative law, legislation and law reform was regarded as the principal function of comparative law. Maine who is generally regarded as the founder of comparative law stated that "the chief function of comparative jurisprudence is to facilitate legislation and the practical improvement of the law."[101]

It is, therefore, perfectly feasible to look to the experience of countries at a different stage of legal, political, social and economic evolution in order not only to modernise and modify

[97] *Ibid*.
[98] *Ibid*.
[99] Kamba, *Supra* note 89 p. 490.
[100] P. De Cruz, *Comparative Law in a Changing World,* (Routledge-Cavendish, London & New York, 2007) 18.
[101] Maine, 'Village Communities', (1871) 4 cited by Kamba, *supra* note 89 at p 495.

the laws but also to evaluate it and be highly eclectic in selecting which laws might be adopted and adapted to particular local needs and conditions.[102] Zweigert & Kotz explain this role as follows:

> " If one accepts that legal science includes not only the techniques of interpreting the texts, principles, rules and standards of a national system but also the discovery of models for preventing or resolving social conflicts, then it is clear that the method of comparative law can provide a much richer range of model solutions than a legal science devoted to a single nation, simply because the different systems of the world can offer a greater variety of solutions than could be thought up in a life time by even the most imaginative jurist who was corralled in his own system. Comparative law is an 'ecole de verite' which extends and enriches the 'supply of solutions' and offers the scholar of critical capacity the opportunity of finding the 'better solution' for his time and place."[103]

Zweigert & Kotz observe that comparative law has been proving extremely useful in the countries of central and eastern Europe where legislators face the need to reconstruct their legal systems after the collapse of the Soviet system in that the experiences of other European countries help them choose the solution which best suits their own legal traditions. They further note that even outside Europe states which used to be soviet republics are finding that foreign laws can be of assistance in framing domestic legislation, as have the republic of China and many of the developing countries in Africa.[104]

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[102] De Cruz *supra* note 100, p 24.
[103] Zweigert & Kotz, *supra* note 10, P 15.
[104] *Ibid*. P 17. De Cruz supra note 100 at p. 20 also quotes some more specific examples of how comparative law has been used in legislative process.

There are generally three areas of legal reform for which comparative law is useful[105]. Firstly, comparative law is very useful in the creation of new rules and solutions or modifying or abolishing existing ones. In this process the experience of other systems of law would be valuable not only in suggesting a foreign legal institution or solution as a model or guide, but also in showing what solution to avoid.[106] Secondly, comparative law is employed in regard to the technique of drafting or formulation of legislation. In this regard, Morrow[107] states that:

> "Any intelligent group of draftsmen charged with a task of any importance, will consider similar legislation in other states, and perhaps in England, and will not confine their efforts necessarily to a restatement of what they conceive to be 'the law' of their jurisdiction."[108]

The final area that stands to benefit from comparative law is the question of practicability of the proposed law in that the experience gained by one legal system as to the effectiveness of some legal solutions may be most valuable to another.[109]

However, while comparative law can be a powerful tool in the legislative process and law reform, it has often time been an object of misuse by law reformers as we shall see below.

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105 Kamba, *Supra* note 89 at p. 496.

106 Tallon, 'Comparative Law: Expanding Horizons' 10 J.S.P.T.L 1969. Tallon observes that: "Assuredly to resort to a foreign model is not an innovation. Its aim is not to find a foreign institution which could be easily copied, but to acquire ideas from a careful survey of similar foreign institutions and to make a reasonable transportation of those which may be retained, according to local conditions". Cited by Kamba at page 496.

107 Morrow, 'Comparative Law in Action', 3 L. Legal Ed. (1951) 403.

108 Cited by Kamba *supra* note 89 at P 497.

109 Kamba supra note 89, P 497.

3.5 LEGAL TRANSPLANTS AND LAW REFORM

One aspect of comparative law, which has been prone to misuse is legal transplants. Watson describes legal transplants as the moving of a rule from one country to another or from one people to another.[110] Legal Transplants therefore refer to the transferring of rules, systems of law, institutions, doctrines, ideas, and methods, from one country, body, organisation or jurisdiction to another. The debate on the effectiveness of legal transplants became prominent in 1974 with two polemic theories from Watson[111] and Kahn-Freud[112]. According to Watson, legal rules may be very successfully borrowed where the relevant social, economic, geographical and political circumstances of the recipient are very different from those of the donor system[113]. To Watson, what the law reformer should be after in looking at foreign systems was an idea which could be transformed into part of the law of his country. On the other hand, Kahn-Freund opined that the degree to which any rule can be transplanted depends primarily on how closely it is linked with the foreign power structure. He suggested that the use of comparative method requires knowledge not only of the foreign law but also of its social, and above all its political context.[114] According to Kahn-Freud the use of comparative law for practical purposes becomes an abuse only if it is informed by a legalistic spirit which ignores this context of law.[115] The battle lines on this debate therefore were drawn between the

[110] Allan Watson, *Legal Transplants: An Approach to Comparative Law*, (Scottish Academic Press, Edinburgh, 1974) 21.

[111] *Ibid.*

[112] O. Kahn-Freund, 'On Uses and Misuses of Comparative Law', 37 Morden Law Review (1974) 1.

[113] A. Watson 'Legal Transplants and Law Reform', Law Quarterly Review (1976) 79 at 80.

[114] O. Kahn-Freund, *Supra* note 112, P. 27.

[115] Kahn-Freund's thesis is premised on Montesquieu's opinion that it was only in most exceptional cases that the institutions of one country could serve those of another because law was very closely linked with its environment due to factors like climate, fertility of the soil, size and geographical position of the country, the kind of life led by the people, their wealth density trade and so on. Kahn-Freud contends that environmental factors are now less important as barriers to transplantation but that political factors have equally gained in importance.

transferists and culturalists.[116] Kahn-Freund has been supported by other culturalists including Legrand[117] and the Siedmans [118]who believe that law is a culturally determined artefact, which cannot be transplanted. Legrand reasoned that given that the meaning of a rule is specific to a particular culture, the meaning stays behind if the culture itself cannot be transplanted as well and if the meaning stays behind, the transplant never happened and all that was displaced from one jurisdiction to the other was 'a meaningless form of words'.[119]

Comparatists now are seeking to find a middle ground between the above extreme theory positions. One of such intermediate views has come from Du Plessis[120] who has put forward what he calls Mixed Legal System concept. He describes mixed legal system as a result of some process on introduction of foreign law into a jurisdiction and that lawyers in these jurisdictions are able to identify the foreign origin of their laws and do not deny that the law derived from a foreign law acquires a new meaning in its new environment.[121] He further reasons that since culture is not genetic and can be learnt, then not only rules but legal culture itself can be transplanted. According to Du Plessis, the experiences of mixed legal systems are powerful evidences of the potential for successful borrowing or transplantation

[116] N. Foster 'Transmigration and Transferability of Commercial Law in a Globalized World', in Harding, Andrew and Orucu Esin (eds) 'Comparative Law in the 21st Century', (Kluwer Law International, The Hague, The Netherlands, 2002) 59.
[117] P. Legrand, 'The Impossibility of 'Legal Transplants'', 4 Maastritch Journal of European and Comparative Law (1997) 111.
[118] A. Siedman and R.B. Siedman, 'State and Law in the Development Process: Problem Solving and Institutional Change' in *The Third World* (MacMillan, Basingstoke, 1994) 44-46.
[119] Legrand, *Supra* note 117.
[120] J. Du Plessis, 'Comparative Law and the Study of the Mixed Legal System' in Reimann and Zimmermann, *The Oxford Handbook of Comparative Law,* (Oxford University Press, Oxford 2006) 478 - 510.
[121] *Ibid,* p 488. Du Plessis suggests that "if a change in meaning implies that the term "legal transplant should not be used, because that which is transplanted by definition may not change in the process of transplanting, then another term should be used such as 'legal borrowing'."

of laws according to function synthesis rather than failure.[122] Another different view has been expressed by Teubner[123] who prefers to describe a foreign legal element as an 'irritant' rather than a transplant. According to Teubner, the transfer of a legal concept from one system to another will have unpredictable affects, because structural coupling will change. He explains that:

> "When a foreign rule is imposed on a domestic culture…it is not transplanted into another organism, rather it works as a fundamental irritation which triggers a whole series of new and unexpected events… 'Legal irritations' cannot be domesticated; they are not transformed from something alien into something familiar, not adapted to a new cultural context, rather they will unleash an evolutionary dynamic in which the external rule's meaning will be reconstructed and the internal context will undergo fundamental change."

3.6 LAW AND DEVELOPMENT AND THE 'WASHINGTON CONSENSUS" THEORIES

The law and development concept provides a perfect example of how scholars and practitioners have sought to use comparative legal theory as a tool for legal reform. Close examination of the law and development philosophy shows that the concept was premised on Watson's thesis of legal transplants. The rise and fall of the law and development movement is axiomatic of the disastrous shortfalls of the transferist view of legal transplants.

Law and Development theory was launched by American scholars in the 1960s apparently as part of the general response of Universities to pressures from development agencies who

[122] *Ibid.* P 489.
[123] G. Teubner, 'Legal Irritants: Good Faith in British Law or How Unifying Law Ends Up in New Divergences', 61 *Morden Law Review* (1998) 12.

were at the time in the process of expanding their development assistance activities in third world countries after the end of World War II. The idea of law and development movement, as it was later known, was part of the then prevailing modernisation school of thought. Modernisation theory posited that a society's underdevelopment was both caused by and reflected in its traditional (as opposed to modern) economic, political, social and cultural characteristics or structures and that in order to advance, underdeveloped societies would have to undergo the same process of evolution from traditionalism to modernity previously experienced by more developed societies.[124] It was therefore thought that the modernisation of the Third World would be accomplished by the diffusion of capital, institutions and values of the First World.[125] Drawing on the modernisation theory and a conception of law as an instrument of development[126] , proponents of law and development thesis sought to diffuse, Western law, which was believed to be the functional prerequisite of an industrial economy[127] to the Third World.

In order to implement their model, law and development theorists adopted a top-down approach by emphasising the reform of legal education and the legal profession and the reform of formal legal rules although this was to a lesser extent.[128] It was believed that the reform of legal education and the legal profession would orchestrate other forms of

[124] K.E. Davies and M.J. Trebilcock, 'The Relationship between Law and Development: Optimists Versus Skeptics', Law and Economics Research Paper Series, Working Paper No. 08-24 (2008) 9, Web:http://ssrn.com/abstract=1124045

[125] B. Tamanaha, 'The Lessons of Law and Development Studies', 89 AM.J.INT'L L.470. This process would involve the emergence of a free market system, the rule of law, multi-party politics, the rationalisation of the authority and growth of the bureaucracy, and protection of human rights and basic freedoms. See Davies and Trebilcock, Ibid at p 9.

[126] M. Burge Elliot, 'Law and Development: A Review of the Literature and a Critique of 'Scholars in Self-Estrangement,' 25 AM. J. COMP. L. (1977) 492, Burge said this concept "sees law as a force which can be moulded and manipulated to alter human behaviour and achieve development." pp 505-6.

[127] See D.M. Trubek, 'Towards A Social Theory of Law: An Essay on the Study of Law and Development', 82 YALE L.J. (1972) 44.

[128] K.E. Davies and M.J. Trebilcock, (2008) *Supra* note 124.

modernisation, including the emergence of other institutions integral to an effective modern legal system such as those responsible for administering and enforcing legal rules. Ohnesorge[129] observed that “reforming legal education became an important fulcrum for gaining leverage to reorient entire legal cultures...the goal was Americanisation”. [130] It was further thought that properly educated lawyers and Judges would help close the gap between the law on the books and the law in action in developing countries.[131]

The first era of Law and Development was however short-lived as by 1974, Trubek and Galanter[132] declared it history. Several factors were identified as having caused the movement to fail. Firstly it is contended that the movement lacked any theory of the impact of law on development, and practitioners thus had no way to prioritize reforms or predict the effects of various measures. As Lowenstein observed, the idea was supported by nothing more than "hopeful speculation" that education could overcome values instilled by family, class, religion, and other social forces.[133] Secondly, it is said that there was too little participation by the lawyers and others in the target country who would either have to carry out the reforms or who would be affected by them; instead foreign legal consultants, through a combination of expertise and access to funding, were often able to dictate the content and pace of reform[134]. Another problem was that the movement focused on the

[129] J.K.M. Ohnesorge, ‘Developing Development Theory: Law and Development Orthodoxies and Northeast Asian Experience’, Legal Studies Research Paper Series, Paper No. 1024, July 2006 http://ssrn.com/abstract=9176781
[130] *Ibid.* at p 21.
[131] M. Burge, (1977), *Supra*, note 115.
[132] Trubek, M. David and M. Galanter, ‘Scholars in Self-Estrangement: Some Reflections on the Crisis in Law and Development.’ Wisconsin Law Review *(*1974): 1062–1101
[133] Steven Lowenstein, *Lawyers, Legal Education, and Development: An Examination of the Process of Reform in Chile. (* International Legal Center, New York 1970).
[134] Brian Tamanaha, ‘The Lessons of Law-and-Development Studies’ 89 American Journal of International Law *(1995) 4*70-486.

formal legal system to the exclusion of customary law and the other informal ways in which many in developing nations order their lives.[135]

However the most significant reason for the failure of the law and development movement is said to be the naive belief that the American legal system (and American legal culture generally), could be easily transplanted to developing countries[136]. Berkwitz, Pistor and Richard[137] note that "the strong quest at the time for extensive research and better theories on the role of law and legal institutions in economic development did not materialise, mostly because the erstwhile proponents of the law and development movement turned inwards to the American legal system."[138] Trubek and Galanter explain that the theory of law and development was based on a tacit set of assumptions which they call "liberal legalism," in the form of a series of propositions about the role of law in society and the relationship between legal systems and development.[139] Legal liberalism views a legal system as an integrated purposive system, which draws on the power of the state but disciplines that power by its own autonomous and internally derived norms and through which the behaviour of social actors is aligned with and guided by legal rules.[140] The problem with the legal liberalist model is that it was ethnocentric and could not fit into the jurisdictions which the reforms targeted. For instance, Trubek and Galanter note that the model assumed social and political pluralism when at the time, in most of the Third World

[135] Trubek and Galanter 1974, *Supra* note 132.
[136] John H. Merryman, 'Comparative Law and Social Change: On the Origins, Style, Decline & Revival of the Law and Development Movement' 25 The American Journal of Comparative Law *(*1977) 457–83.
[137] D. Berkwitz, K. Pistor and J. Richard, 'The Transplant Effect', 51 American Journal of Comparative Law (2003) 163.
[138] Ibid, p. 2.
[139] Trubek and Galanter 1974, *Supra* note 132.
[140] Ibid. p. 1072.

countries social stratification and class cleavage juxtaposed with authoritarian or totalitarian political systems were the order of the day.[141]

Further, the model assumes that state institutions are the primary locus of social control, while in much of the Third World the grip of tribe, clan and local community is far stronger than that of the nation state.[142] Also the model assumes that rules both reflect the interests of the vast majority of citizens and are normally internalised by them, while in many developing countries rules are imposed on the many by the few and are frequently honoured more in the breach than in the observance. The final assumption made by this model is that courts are central actors in social control, and that they are relatively autonomous from political, tribal, religious, or class interests. However, in many countries courts are neither very independent nor very important.[143] Thus while in the United States, judges play a significant role in policymaking, and as a result, lawyers are often able to engineer significant changes in policy through litigation, this is not true in civil law systems or indeed even in the United Kingdom and other nations that share the same common law background as the United States.[144]

The second era of Law and Development theory emerged in the 1990s following the collapse of the Soviet System. The new law and development was born out of disenchantment with socialist ideas and central planning, which had created a need for an

[141] *Ibid*. p. 1080
[142] *Ibid.*
[143] *Ibid.* at p. 1081
[144] Merryman, *Supra* note 136.

alternative set of ideas on how to organise economic and political life.[145] As Ohnesoge observes "the fall of the Berlin Wall and the collapse of the socialist world presented the development world with the problem of how to nurture market economies in Eastern and Central Europe, the Baltics and Central Asia, where legal systems were geared to socialist rather than capitalist economics and at the same time it left developing countries with nowhere to turn except the U.S.-dominated West, in which views on economics and the role of the state in society had taken a strong turn towards the market."[146]

The term "Washington Consensus" was coined by John Williamson,[147] who attempted to summarize, with particular reference to policy reform in Latin America, "the conventional wisdom of the day among the economically influential bits of Washington, meaning US government and the international financial institutions"[148] Williamson codified the approach as a set of 10 axiomatic generalizations[149] which, given certain values, are generally shared by scholars and practitioners concerned with economic growth in developing countries.[150] In broad terms, the "Washington Consensus" approach recommended that governments should reform their policies and, in particular: (a) pursue macroeconomic stability by controlling inflation and reducing fiscal deficits; (b) open their

[145] Moses Naim, 'Washington Consensus or Washington Confusion'. Paper presented at the IMF Conference on Second Generation Reform*s* (Washington November 8-9, 1999)
[146] J.K.M Ohnesorge, *Supra* note 129 .
[147] Williamson work include, 'Democracy and the `Washington Consensus', 1993, World Development, 21 (8), 1329-1336 and 'The Washington Consensus revisited'. In L. Emmerij, *Economic and social development into the XXI century* (pp. 48-61). Washington DC: Inter-American Development Bank (distributed by John Hopkins University Press, Baltimore).
[148] J. Williamson, 'Democracy and the `Washington Consensus'. 21 (8*)* World Development, (1993) 1329-1336.
[149] These included Fiscal Discipline, Interest Rate, Public Expenditure Priorities, Tax Reform, Exchange Rate, Trade Liberalisation, Foreign Direct Investments, Property Rights, Deregulation.
[150] C. Gore, 'The Rise and Fall of the Washington Consensus as a Paradigm for Developing Countries*', 28 (5) World* Development (2000) 789-804.

economies to the rest of the world through trade and capital account liberalization; and (c) liberalize domestic product and factor markets through privatization and deregulation.[151]

The Washington Consensus or neoliberal Rule of Law, as the approach was also known, sought to provide bottom to top approach to legal reform. Its reform agenda was well articulated by Gray,[152] principal economist in the World Bank's Policy Research Department, who stated that:

> "Formerly socialist economies must] establish the institutions of a private market economy. Socialism either crippled or reoriented these institutions to reflect the goals of central planners. Legal frameworks defining property rights, private contract regimes, fiduciary liability, dispute resolution mechanisms, and rules of entry and exit for private firms atrophied. Courts lost much, if not all, of their independence as well as their role as adjudicators of commercial disputes and enforcers of commercial laws. Banks lost their independent monitoring role over firms and became instead passive funnels for channelling state funds. "Watchdog" institutions that provide critical information for markets to function, such as credit-rating and consumer protection services, accounting and legal professions, and independent journalism, had neither reason nor permission to exist. Finally, socialism inhibited (indeed, often classified as illegal) the development of basic norms and ethics of market conduct and fiduciary responsibility on which so much

[151] *Ibid*. P. 789. It is said that the "Washington Consensus" philosophy has its roots in the work of Nobel Laureate Robert Solow whose model of economic growth predicted that any given rate of savings and investment would generate a constant level of per capita income which would rise with the level of exogenous technological change. Robert Solow, 'A contribution to the Theory of Economic Growth,' (1965) 70 Q.J. Econ. 65, quoted by C. Pouncy (2002) *Supra* note 26 at p. 94. Based on Solow model therefore, the neoliberal economic agenda advocating free markets, unrestrained currency mobility, low government spending and a general policy of fiscal austerity would stimulate national savings and investment and ultimately promote economic growth. C. Pouncy (2002) *supra* note 26 at p. 94.

[152] Cheryl W. Gray, 'In Search of Owners: Privatization and Corporate Governance in Developing Economies', 11 (2) World Bank Research Observer (1996) 179-197.

> behaviour in advanced market economies implicitly rests. These laws, organizations, professions, and commercial norms must now be rebuilt, sometimes from scratch."[153]

The goal of the neoliberal rule of law was, therefore, to achieve a well-functioning legal system in a market economy, which required a supply of market-friendly laws, adequate institutions to implement and enforce them, and a demand for those laws from market participants.[154]

The new law and development model was propagated by the World Bank and IMF through its Structural Adjustment Programs (SAPS) which were imposed on developing countries to ensure debt repayment and economic restructuring[155]. Adopting a one-size-fits-all approach and applying the conventional text-book economics, the World Bank sought to implement its structural adjustment programmes by providing similar comprehensive policy packages for all its third world borrowers. Firstly, it offered aid only to governments which reduced their intervention in domestic and foreign markets upon the neoclassical assumptions that excessive governmental intervention is the reason for inefficiency and poverty; then it insisted on privatisation to encourage the growth of the private sector competition; thirdly, it insisted on the opening up of the economy to international competition by relaxing import/export licensing and tariffs laws in the aid of promoting efficiency among local producers; fourthly it requested the devaluation of currency to render exports more competitive by lowering export prices; and fifthly it insisted that governments cut public expenditure to reduce budget deficits; finally, it demanded that the governments create a hospitable climate for international investors.[156]

[153] *Ibid.* p 181.
[154] J.K.M Ohnesorge, *Supra* note 129. He notes that this model claimed that a strong framework for private property and contract enforcement as well as other areas of law like intellectual property rights, competition law, corporate and insolvency laws was crucial for economic development. See p. 34.
[155] C. Pouncy, *supra* note 26 at p. 97.
[156] The World Bank, *Adjustment in Africa: Reforms, Results and The Road Ahead*, (New York: University of Oxford Press, 1994) 284.

The structural adjustment program, however, brought about contrary outcomes. For instance, decreased government spending led to cutbacks in essential services such as education, health, and welfare programs.[157] Also currency devaluation made foreign equipment and spare parts expensive while high interest rates promoted speculation rather than savings and trade liberalisation encouraged dumping of foreign products in developing countries' markets.[158] In a bid to correct a rather discouraging development trajectory, the multilateral institutions added the development of stock markets as an additional reform that would promote economic prosperity in developing countries.[159]

However despite all these efforts, the new law and development theory, as its precedesor, still failed to achieve its intended results. One main criticism of neoliberal rule of law is that it paid more attention to the prescription of the laws on paper than to enforcement of the same. Berkwitz, Pistor and Richard explained the demise of this model in this way:

> "While nobody has yet stood up and declared the death of the second law and development movement, there is a broad consensus that the impact of legal reform efforts has been at best limited. The most common complaint is that while the transplanted law is now on the books, the enforcement of these new laws is quite ineffective. In fact, empirical analysis suggests that there is little correlation between the level of legal protection afforded by statutes on the one hand, and the measures for the effectiveness of legal institutions on the other. While Russia today can boast with the most refined corporate law in the region thanks to American advisors, shareholder rights are systematically trampled

[157] *Ibid.*
[158] C. Pouncy, (2002), *supra* note 26 at p. 98.
[159] *Ibid.*

and Russia performs poorly on performance measures for the effectiveness of the judiciary and the trustworthiness of legal and administrative institutions."[160]

3.7 THEORIES OF LEGAL CHANGE

The general theories discussed above have been crystallised into a stream of theories used in legal reform circles collectively known as theories of legal change. These are theories that have, over the years, been advocated by different scholars, on how law changes in society. The first of these legal theories is the *Evolutionist approach.*[161] Early evolutionary theorists believed that legal development occurs automatically as a society passes from one stage of economic development to another.[162] Others thought that cultural or other factors than economic differences determined stages of legal development.[163] Through Henry Maine's *Ancient Law,*[164] the evolutionary approach was systemised and it was believed that societies transition from "archaic" to "tribal" to "territorial"[165] and that law, in the sense of abstract principles, would only effectively exist in territorial societies.[166] The general feature of the evolutionist approach is that human intervention is removed from the process of legal development. As such legislation is either relegated to a distinctly subordinate place[167] or in some instances considered altogether useless especially if it involves borrowing ideas across

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[160] D. Berkwitz, K. Pistor and J. Richard, 'The Transplant Effect', *Supra* note 137 at pp. 64-65.
[161] See Donald Horowtz, 'The Quran and Common Law: Islamic Reform and the Theory of Legal Change', 42 American Journal of Comparative Law (1994) 244.
[162] Peter Stein, *Legal Evolution: The Story of an Idea*, (Cambridge: Cambridge University Press, 1980). Stein observes that evolutionists believed that genuine concepts of contract and property could only develop with the consolidation of agriculture. See pp 23-50.
[163] See, Charles Secondant and Baron De Montesquieu, *The Spirit of the Laws 6-7* (Thomas Nugent Trans., 1949)
[164] Henry Summer Maine, *Ancient Law*, (London, John Murray, 1861).
[165] Leopold Pospisil, *Anthropology of Law: A Comparative Theory*, (HRAF Press, 1974) 128-43
[166] Territorial societies were further divided into stationary (those ordered along family lines) and progressive (where family obligations were displaced by individual obligations and it was believed that legal development was slow in the former while in the later the legal order moved from status to contract. See Henry Maine, *Ancient Law*, *Supra,* note 164.
[167] Henry Maine, *Ancient Law*, *supra* note 164.

systems that are at different stages of cultural or economic development.[168] For evolutionists therefore nothing proceeds from individual will and everything comes from the situation of particular countries.[169]

The second theory of legal change is the *Utilitarian Approach.*[170] Unlike evolutionists, utilitarian theorists do not find the sources of legal development in cultural or economic development of societies but believe that legal innovations emanate from demonstrations of social need[171]. The focus of the utilitarian approach is on the efficiency of legal rules and regards the increases in efficiency as the end-product of change.[172] According to Robert Clark,[173] legal change based on cost reduction follows a four-step sequence involving changes in the economy and society that create opportunities to reduce costs, followed by the emergence of a legal principle that does in fact reduce costs, which is followed by new costs and then by new rules to reduce them as well as to regulate the struggle over the distribution of cost savings.[174] Clark observes that the great increase in the past two hundred years in the size of business firms, in the number of investors or capitalists, and in the amount of wealth in the economy have given rise to new forms of organisation, new roles and the laws governing them, new legal doctrines and new kinds of legal proceedings.[175] It is argued that this kind of change will obviously require some legal

[168] Friedrich Carl von Savigny, *On the Vocation of Our Age for Legislation and Jurisprudence* 24-30 (Abraham Hayward trans. 1831) discussed in Stein, *Supra*, note 162 at pp. 58-65.
[169] John Millar, 'The Origin of the Distinction of Ranks' (1806), quoted in Stein, *supra* note 162 at 47.
[170] *Ibid,* p. 247.
[171] *Ibid.*
[172] One of the examples offered under this approach is the common law litigation process whereby litigants contest inefficient legal rules in attempt to realise cost savings by persuading judges to change the rules. See Priest, 'The Common Law Process and Selection of Efficient Rules', (1977) 6 Journal of Legal Studies 65 Quoted in Horowtz, *Supra*, note 161 at p. 247.
[173] Robert Clark, 'The Interdisciplinary Study of Legal Evolution' (1981) 90 Yale Law Journal 1238
[174] *Ibid,* p 1241.
[175] *Ibid,* p 1242.

invention and therefore changes will not occur automatically[176] as the evolutionists seem to suggest. This approach is however criticised on the grounds that it is unrealistic to take out ideology and other interests from the process of legal change.[177]

Another documented approach to legal change is the *social change approach*[178]. This approach views law as a reflection of social structures and opinions prevalent in a society and that as these change law changes accordingly[179]. Another view of the social change theorists holds that changes in the social structure of society result in changes in people's altitude and these changes produce a gap between what the law on the books could offer and the desired outcome. This forces lawyers and judges to move in to narrow the gap through legal fiction and judicial interpretation and later legislators jump in to close the gap through legislation[180].

Finally, other theorists of legal change have advocated an *intentionalist approach*. Proponents of this approach believe that law cannot change without an agent as the other theorists seem to imply. They believe that legal innovation requires legal innovators[181]. This theory traces its origin from the "transferist" school of thought with regard to the use of comparative law for legal reform. As discussed above one of the proponents of the intentionalist approach is Allan Watson who argues that the legal elite and its culture

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[176] See Horowtz, *Supra* note 161 at p. 248.
[177] Epstein, 'A Static Conception of the Common Law' (1980) 9 Journal of Legal Studies 253 269-75. Quoted in Horowtz, supra note 161 at p. 248.
[178] *Ibid* p. 249.
[179] *Ibid.*
[180] *Ibid.* The author quotes Lawrence Stone, 'Road to Divorce: England 1530-1987', (1990) who illustrated this approach through the changes in divorce law in England. Stone observed that changes in people's altitudes produced a gap between what parties to failing marriage wanted and what the law could give them resulting in the parties resorting to connivance, collusion, and even perjury to force desired outcomes.
[181] Horowtz, *supra* note 161 at p. 251.

determine the timing, extent, and nature of legal change[182]. Watson further argues that the adoption of legal innovations depends on, *inter alia*, the range of potential innovations that are known to lawyers and seem natural or fitting to them whether or not the innovations are well adapted to the society at large[183]. It is emphasised that the most important method of change is borrowing and that lawyers will always borrow from systems they understand[184] and that they tend to be fixed on a single donor system that is more prestigious than their own, more culturally akin to their own, or unusually accessible.[185] The determinants of the shape of change therefore will be the knowledge, the traditions and the interests of the lawyers.[186]

Another intentionalist view holds that legal innovations are the product of the interplay of the agents of state authority with the legal profession.[187] It is believed that political leaders always attempt to align the legal system with their own ideas and interests. However, in order to do this they will have to secure the cooperation of the lawyers and use different devices in the stock of ideas held by those lawyers.[188] As such the shape of the legal change that will eventually emerge will be an "amalgam of political preference and professional interest."[189]

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[182] Allan Watson, 'Legal Change: Sources of Law and Legal Culture', (1983) 131 U. Pa. Law Review 1121 at 1153 quoted by Horowtz, *supra* note 161 at 251.
[183] Alan Watson, *The Evolution of Law*, 1985, (Johns Hopkins University Press; Expanded edition (October 25, 2000).
[184] *Ibid*, pp 74-76.
[185] Allan Watson, 'Legal Change', *supra* note 182 at pp 1146-47.
[186] Horowtz, *supra* note 161 at p. 251.
[187] Terence C. Halliday & Bruce G. Carruthers, 'The State, Professions, and Legal Change: Reform of the English Insolvency Act, 1977-1986' (American Foundation Working Paper No. 9019, 1990). Quoted in Horowtz *supra* note 161 p. 251
[188] *Ibid* at p 252
[189] *Ibid.*

3.8 NEW INSTITUTIONAL ECONOMICS

The new institutional economics (NIE) has been described as 'an interdisciplinary enterprise combining economics, law, organization theory, political science, sociology and anthropology to understand the institutions of social, political and commercial life.'[190] According to Coase, NIE refers to the branch of economics that concerns itself with the ways that economic behaviour, whether by individuals or firms, is affected by the institutional setting in which actors find themselves.[191] The term 'new institutional economics' was originated by Oliver Williamson[192] and draws its logic from Coase's analysis of the nature of the firm.[193]

In essence NIE seeks to incorporate a theory of institutions into economics. NIE accepts neo-classical economics' fundamental assumption of scarcity of resources but denies its rationality postulate in respect of individual economic actors.[194] According to North,

> "the new institutional economics builds on, modifies, and extends neoclassical theory to permit it to come to grips and deal with an entire range of issues heretofore beyond its ken. What it retains and builds on is the fundamental assumption of scarcity and hence competition--the basis of the choice theoretic approach that underlies micro-

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[190] Peter G. Klein, New Institutional Economics, (Department of Economics, University of Georgia) in the *Encyclopedia of Law & Economics* edited by Boudewijn Bouckaert (Univ. Ghent and Univ. Utrecht), Edward Elgar and the University of Ghent, 1999.

[191] Ronald Coarse, 'The New Institutional Economics', 88(2) American Economic Review: Papers and Proceedings of the Hundred and Tenth Annual Meeting of the American Economic association (1998) 72.

[192] Oliver E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications*, (New York, NY, Free Press, 1975).

[193] Ronald H. Coarse, 'The Nature of the Firm', *Supra* note 49. Coarse's work introduced the concept of transaction costs in economic analysis.

[194] Douglass North, 'The New Institutional Economics and Development' in Harriss J., Hunter J., and Lewis C.M., *The New Institutional Economics and Third World Development*, (Routledge, 1995) 17-26.

> economics. What it abandons is instrumental rationality--the assumption of neoclassical economics that has made it an institution-free theory."[195]

According to NIE theorists, the concept of rational actors presupposes a world where individuals act on complete information with full mental capacities. In reality however, information is incomplete and there is limited mental capacity by which to process information and this determines the cost of transacting which underlies the formation of institutions.[196] NIE uses cognitive science to explain its objection to the assumption of instrumental rationality. It is believed that individuals possess mental models to interpret the world around them, which are culturally derived through intergenerational transfer of knowledge, values and norms which vary radically among different ethnic groups and societies and as a result there is immense variation in mental models, hence different perceptions of the world and how it works.[197] It is further believed that societies impose constraints on human interaction in order to structure exchange. However, since such constraints or institutions are based on incomplete information and imperfect subjective mental models, there will be transaction costs that will result in imperfect markets.[198] Further, since individuals make choices on the basis of their mental models, ideas and ideologies will play a major role in human choices.

NIE therefore extends economic theory by incorporating ideas and ideologies into the analysis and models of the political process as a critical factor in the performance of

[195] *Ibid*, p. 17.
[196] *Ibid* p.18.
[197] *Ibid*.
[198] Douglass North, 'The New Institutional Economics and Development' *Supra* note 194.

economies, as the source of the diverse performance of economies, and as the explanation for "inefficient" markets.[199]

NIE distinguishes institutions from organisations. Institutions are defined as the rules of the game in a society, that is, the humanly devised constraints that shape human interaction. For institutional economists, an institution is not a material or physical phenomenon but a socially constructed belief system about the way things are and the way things should be. In other words, institutions are prevalent patterns of thought that impact the structure, operation and consequences of all processes in societies, including its economic and financial processes.[200] Institutions are composed of formal rules (statute law, common law, regulations), informal constraints (conventions, norms of behaviour, and self imposed codes of conduct), and the enforcement characteristics of both.

On the other hand, organisations are players in the game in the form of groups of individuals bound by a common purpose to achieve common objectives. They include political bodies (political parties, the senate, a city council, a regulatory agency); economic bodies (firms, trade unions, family farms, cooperatives); social bodies (churches, clubs, athletic associations); and educational bodies (schools, colleges, vocational training centres).[201]

[199] *Ibid.*
[200] Charles R.P. Pouncy, 'The Rational Rogue: Neoclassical Economic Ideology in the Regulation of the Financial Professional', 26 VT. L. REV. (2000) 263
[201] *Ibid,* at P. 23.

The major role of institutions in a society is to reduce uncertainty by establishing a stable, although not necessarily efficient, structure to human interaction.[202] Institutions affect the performance of the economy through their effects on the costs of exchange and production. According to Coarse,[203] the cost of transacting arises because information is costly and asymmetrically held by the parties to the exchange. Transactional costs include the cost of measuring the multiple variable dimensions of the goods or services exchanged or of the performance of the agents and the costs of enforcing agreements. According to NIE, therefore what is important in order to improve economic performance of an economy is the creation of institutions that will facilitate low transaction costs. In this way NIE provides a middle ground between hitherto polemic view of economic analysis about the state as the major catalyst of economic growth on the one hand and the neo-classic economics' emphasis on the all-importance of the market on the other. As stated by Toye:[204]

> "The recognition of transaction costs, and the consequent retreat from the Walras-Pareto view of markets, disposes of the automatic preference for provision of goods and services through the market. Equally their presence undermines an ideal view of governments as benevolent and omnicompetent. Market failure is clearly with us, to a greater or lesser extent. But so is government failure. So the questions of public policy become more complicated. Should imperfect governments be used to correct imperfect markets, or contrariwise should imperfect markets be brought into play to improve the resource misallocations of imperfect governments? What NIE tells us is that neither answer is invariably correct. Rather, the task is to estimate the respective net changes in transaction costs in comparison with the anticipated

[202] Douglas North, *Institutions, Institutional Change and Economic Performance*, (Cambridge University Press, 1990) 8.

[203] Ronald Coarse, 'The New Institutional Economics', *Supra* Note 191.

[204] J. Toye, 'The New Institutional Economics and its Implications for Development Theory', in J.Harriss, J. Hunter and C.M Lewis, *The New Institutional Economics and Third World Development*, (Routledge, 1995) 49-68.

> allocative improvement, to find out whether policy should be favouring additional government intervention or further privatisation."[205]

So how does NIE fit into the development and economic performance discourse? As stated above, NIE calls for the modification of the neo-classical theory that market forces will bring about economic change on their own. According to neo-classical theorists, market forces not only generate the most Pareto-efficient[206] outcome possible in a static framework, but they also do so in a long run dynamic framework in that institutional adaptations which favour Pareto-efficiency are favoured over the long term, while those which do not are abandoned.[207] This 'natural selection' view of institutional development is denied by NIE for being based on a mechanism that has no place for conscious motivation, decision-making or choice and can therefore not be applied to social practices which reflect human aspirations and endeavours.[208] NIE posits that the existence of norms, customs and organisations require that people have to choose how conventional to be and whether they want to join certain institutions or to try to subvert them.[209] This clearly shows that implementing foreign policies or rules without proper consultation within the borrowing country is an inappropriate reform strategy.

Further, the understanding of the interplay between institutions and organisations advocated by NIE provides a new vein of thinking about the design of institutions and organisations for development. Distinct institutional arrangements can shape organisational

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[205] *Ibid at* p. 58.
[206] Pareto efficiency exists when resources are allocated in the most efficient manner. See: http://www.investopedia.com/terms/p/pareto-efficiency.asp
[207] *Ibid.,* p. 61. Toye notes that this neo-classical view involves an implicit appeal to the biological analogy of natural selection, in which institutions which are ill-adapted to their conditions become gradually extinct.
[208] *Ibid.*
[209] *Ibid.*

behaviour and alternative sets of organisations may impact on institutions.[210] The impact of the NIE theory on to the development agenda is summarised by Toye who stated that:

> "The NIE suggests that development should be redefined as economic growth plus appropriate institutional change, meaning institutional changes which facilitate further economic growth. Appropriate institutional change has been elevated by the NIE to a central place in the theory of development, by contrast with neo-classical growth theory's central focus on saving and population growth."[211]

The question then is how institutional change can be effectively implemented. The answer to this question continues to elude policy makers and it is this answer that North has attempted to provide in his work, *Understanding the Process of Economic Change*[212]*.* North notes that institutions are path determined and that the reason why reversal of such institutional paths is usually difficult is because 'we still know too little about the dynamics of institutional change and particularly the interplay between economic and political markets."[213] In this work, North sets out a dynamic model of economic change. It is to this model that we now turn in the next chapter.

3.9 CONCLUSION

The above discussion has shown how policy makers and legal as well as institutional reformers have grappled with the process of development reforms using different theoretical foundations. Most of these theories and concepts have proved ineffective over

[210] J.Harriss, J. Hunter and C.M Lewis, *The New Institutional Economics and Third World Development*, *Supra* note 194 at p.6.
[211] Toye, *Supra* note 204 at p. 61.
[212] D. North, *Understanding the Process of Economic Change*, *supra* note 8.
[213] D. North, *Institutions, Institutional Change and Economic Performance, Supra* note 202 at p. 20.

time. As explained above some of the theories were misconceived with respect to the process of economic change in that they were premised on neo-classic economic theory's presumptions of a rational decision maker with access to all the information needed to make efficient decisions. New Institutional Economics (NIE) on the other hand has brought a significant paradigm shift in economic development thinking by calling for the modification of the neo-classical theory that market forces will bring about economic change on their own and through its emphasis on the role of institutions and organisations in economic development. This is why the North's framework for economic change is considered in this study as the best theory to form and inform modern development agenda.

This study is however not advocating an outright abandonment of the theories in question but rather that the said theories should be used in the light of North's framework so that the impact of prevailing belief system as well as the path dependent nature of the development trajectory is fully taken into account when formulating the reform agenda. For instance, the comparative law method is still a useful tool of legal and institutional reform. However, according to this study, it is the culturist view of comparative law and not the transferist view that should inform policy makers for purposes of legal and institutional reform. A detailed comparison of the rest of the theories and North's theory is provided in section 4.10 below.

4 CHAPTER FOUR: NORTH'S FRAMEWORK OF ECONOMIC CHANGE

4.1 INTRODUCTON

The underlying premise of North's framework is the centrality of human mental models to the process of economic change. North observes that economics is a theory of choice and that people choose among alternatives that are themselves constructions of human mind and that therefore how the human mind works should form the foundation of any inquiry on economic development.[214] According to North therefore, economic change is the result of changes in, the quantity and quality of human beings, stock of human knowledge particularly as applied to the human command over nature and institutional framework that defines the deliberate incentive structure of a society and that therefore there is need of a

[214] North, *Understanding the Process of Economic Change , Supra* note 8, p. 11.

complete theory to integrate theories of demographic, stock of knowledge and institutional change.[215]

In a classic intellectual journey North has over a period of time developed a framework for economic change that is capable of plugging most of the gaps in economic theory that were unattended to by classic economic theorists. Aided by his economic history pedigree, North firstly sought to understand the development of legal institutions that orchestrated the rise of the Western powers to economic dominance.[216] With this understanding, he later developed an institutional framework describing how the West achieved its economic success at a structural level.[217] He then reinforced this framework by explaining the dynamics and the processes that are involved in the process of economic change by incorporating work from other human sciences other than economics, and economic history.[218] This is why North's framework is so unique as it goes beyond the usual tenets of economic theorising.

The starting point of North's framework is the analytical distinction between "institutions" and "organisations". Institutions are "the rules of the game in a society"[219] or the humanly-devised constraints that structure human interaction and may either be formal or informal. Both types of institutions are important to how an economy functions. Examples of formal rules include statute law, common law and regulations while informal rules manifests in the

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[215] *Ibid.* P. 1.
[216] D.C. North and R.P. Thomas, *The Rise of the Western World: A New Economic History* (Cambridge: Cambridge University Press, 1973).
[217] D. North, *Institutions, Institutional Change and Economic Performance*, *Supra* note 204.
[218] D. North, *Understanding the Process of Economic Change* , Supra note 8. His recent collaborative work D.C. North and J. J. Wallis and B. R. Weingast *Violence and Social Orders* (Cambridge: Cambridge University Press, 2009) is not considered here, and it is not necessary to endorse this work, which raises fundamental issues on the interpretation of modern history, in order to make use of the earlier work.
[219]D. North (1990) *supra* note 202 at p 4

form of conventions, norms of behaviour, and self-imposed codes of conduct. The distinction between formal and informal rules is very vital in order to understand the process of economic change. Thus while laws are formal institutions, how people understand laws, and whether they respect them, are elements of society's informal institutions. On the other hand, organisations are the players of the social game. Organisations are basically groups of individuals bound by a common purpose to achieve objectives.

It has been noted that the terms "institution" and "organisation" are analytical terms, not expressive of any essential nature.[220] This entails that a single feature of the world, such as a court, may be viewed as either institutional; when seen as a part of the context in which an organisation is situated; or, organisational when viewed as a group of people that act in concert to protect or extend their power and influence. The significance of the institutional structure and the organisations that develop within that institutional structure is that they determine the incentives of the society which in turn determine how a society operates. These incentives may determine whether a society will have either higher or lower transaction costs, cooperation or predation behaviours, will encourage effective investment and productivity growth or focus on rent seeking behaviour.[221]

North identifies three major challenges to economic change, namely, uncertainty, the evolving human environment (he calls this non-ergodicity) and institutional path

[220] Graham Ferris, 'The path dependant problem of exporting the rule of law', 101 The Round Table (2012).
[221] The key concepts and the sporting metaphor are all introduced in the first chapter of D. North (1990) *supra,* note 202.

dependence. According to North any development agenda should take into account these potential problems and be able to devise ways of getting around them.

4.2 UNCERTAINTY

North posits that uncertainty is the key challenge for economic development. He observes that we live in an uncertain world and market economies operate within the context of uncertainty. According to North, the key to understanding the process of change is the intentionality of the players enacting institutional change and their comprehension of the issues and the source of human intentionality is the constant human effort to reduce uncertainties.

With regards to economic development, certainty is a relevant factor in that investors will at the very least look for some degree of certainty that they will have a return on their investment before committing their resources to a particular country or economic region. One of the things that investors will be looking for in order to be certain of a return on investment is the institutional structures available that will protect their property rights. Any semblance of uncertainty as to the safety of their investment will cause investors to shy away.

According to North there are different degrees of uncertainty and he counsels that it is important to understand the ability of any given society to deal with the different levels of uncertainty before devising strategies for institutional change. These include:

(i) Uncertainty that can be reduced by acquiring more information and using it within existing theories of explanation. Here predictability can be brought about by collecting and collating more information about the characteristics of a particular human activity.[222] This type of uncertainty, therefore, can be reduced to risk, through the collection of enough data.[223]

(ii) Uncertainty that can be reduced by increasing the stock of knowledge within the existing institutional framework. This type of uncertainty cannot be resolved without the development of some new explanatory theory either through coining of new and more powerful explanations with reference to pre-existing subjects of inquiry or development of new subjects of inquiry.[224] Thus, where this type of uncertainty exists there will be need for societal reorganisation and redirection of resources and acquisition of new knowledge albeit without necessarily changing the institutional structures.

(iii) Uncertainty that can be reduced only by altering the institutional framework. This kind of uncertainty requires changing the incentive structure of the players or social actors. Such incentives will either encourage or discourage social actors to act or from acting in a particular direction. Examples include institutional changes altering the pay-off to cooperative activity like legal enforcement of contracts, increasing the incentive to invent and innovate like patent laws and lowering

[222] D. North (1990) *supra,* note 202 at p. 17. North gives an example of the development of marine insurance which evolved development of information on ships cargoes, destinations, time en route, wrecks and damage in order to convert uncertainty into risk.
[223] See, Graham Ferris, (2012) *Supra* note 220 at pp. 363-374
[224] *ibid*.

transaction costs in markets like the creation of a judicial system that lowers the costs of contract enforcement.[225] This uncertainty can therefore be best tackled by governments and legal systems.

(iv) Uncertainty in the face of novel situations that entails restructuring beliefs. North says the response of humans to novel situations depends on how novel they are and on the cultural heritage of the actors. He says to the extent that their cultural heritage has equipped them to deal with such problems, they may make responses that make the environment more predictable but if they have not been so equipped they may make inappropriate responses.[226] This type of uncertainty differs from the second and the third types of uncertainty in that it emanates from the "beliefs" and the "culture" of a particular society. It therefore differs from the second type of uncertainty because "beliefs involve normative aspects that are not present in the idea of knowledge and explanatory frameworks"[227] and from the third category of uncertainty because culture is not the same as institutional framework as it offers a broader conception that includes but is not exhausted by the institutions of a society.

This is, therefore, the most crucial type of uncertainty in as far as the process of economic change is concerned and it accounts for most of the differences in economic performance of national economies with similar institutional

[225] North (2005) *supra* note 8 at p. 18
[226] *Ibid.*
[227] Graham Ferris, (2012) *supra* 220

structures and it explains why institutional framework borrowed from a different society may not work the same trick in the borrowing society.

(v) Residual uncertainty that provides the foundation for "non-rational" beliefs. This is uncertainty that remains after every effort has been done to establish predictability through the above means. North says such residual uncertainty leads to non-rational beliefs which play a critical role in decision making. These include religious belief systems such as Islamic Fundamentalism and secular ideologies and belief systems such as communism.[228] This category of uncertainty is that which at any time and place cannot be reduced by rational means and therefore gives rise to irrational modes of explanation and resolution. Every reform agenda therefore needs to make allowance for such non rational beliefs that are bound to make implementation of reforms less perfect. The best policy is to take into account as much of such beliefs as possible.

What can be deduced from the foregoing is that in order for any economic model to be effective, there must be a proper understanding of the type of uncertainty being dealt with and relevant strategies must be devised to help reduce the uncertainty in question.

4.3 NON-ERGODICTY

North says that the efforts of economic players to reduce uncertainty, is frustrated by the non-ergodic world that they operate in. He notes that we live in a world of

[228] North (2005) *supra* note 8 at P. 19

continuous novel change and that comprehending such a world that is constantly evolving entails new theory, or modification of the existing institutional framework. Usually the alteration of institutions that has led to the reduction in the uncertainties of the physical world has created the complex social world which has produced a whole new set of uncertainties. The key problem for agents, therefore, is one of uncertainty over time. Importantly it is not risk over time and the most relevant category of uncertainty is uncertainty caused by novel problems because repetitive problems can be reduced to risk[229] The challenge therefore is that as the social world itself generates novel uncertainties, then even if human beliefs were perfectly aligned with reality, and sufficiently worked out to allow agents to act with confidence, the world would change and undermine this perfect correspondence between model and reality[230].

Thus, while the law of merchants, patent laws, the institutional integration of distributed knowledge and the creation of a judicial system are important parts of efforts to make markets more efficient in developed countries, when such institutional changes are applied to third world economies, they frequently alter income distribution and produce political instability leading to consequences that are the very reverse of the intended objection[231]. It is therefore important that any development model should include strategies of dealing with the likely new uncertainties that would follow the institutional change undertaken. The starting point would be inbuilt institutional review mechanisms.

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[229] See, Graham Ferris (2012) *supra* note 220. The difference between Risk and Uncertainty is explained below.
[230] *Ibid.*
[231]North (2005) *supra* note 8 at P. 21

4.4 RISK, UNCERTAINTY AND NON-ERGODICITY.

The concept of non-ergodicity as described above may be confused with the concept of uncertainty and risk. However these three concepts are different. It is therefore important to look at their distinct meanings before proceeding with the rest of North's proposition of development theory.

Risk and uncertainty has sometimes been used interchangeably but they are completely different concepts. In its simplistic form, uncertainty denotes lack of complete certainty, that is, the existence of more than one possibility.[232] The possibilities may be either positive or negative. On the other hand risk refers to a state of uncertainty where some of the possibilities involve a loss, catastrophe, or other undesirable outcome.[233] The distinctions between these two concepts was ably analysed by Knight in his groundbreaking work *Risk, Uncertainty, and Profit*[234], (1921) where he stated that:

> "... Uncertainty must be taken in a sense radically distinct from the familiar notion of Risk, from which it has never been properly separated. The term 'risk,' as loosely used in everyday speech and in economic discussion, really covers two things which, functionally at least, in their causal relations to the phenomena of economic organization, are categorically different. ... The essential fact is that 'risk' means in some cases a quantity susceptible of measurement, while at other times it is something distinctly not of this character; and there are far-reaching and crucial differences in the bearings of the phenomenon depending on which of the two is really present and operating. ... It will appear that a measurable uncertainty, or 'risk' proper, as we

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[232] Douglas W. Hubbard, *The Failure of Risk Management: Why It's Broken and How to Fix It*, (John Wiley & Sons, 2009)
[233] *Ibid.*
[234] Frank H. Knight, *Risk, Uncertainty, And Profit* (1921), (Signalman Publishing, 2009).

shall use the term, is so far different from an unmeasurable one that it is not in effect an uncertainty at all. We ... accordingly restrict the term "uncertainty" to cases of the non-quantitative type."[235]

Thus risk can be defined as uncertainty based on a well-grounded (quantitative) probability and can be measured as a product of the probability that some event will occur and its consequences if it does occur. Uncertainty, however, cannot be assigned such a well-grounded or measurable probability.[236] Risk, therefore, is a condition in which it is possible to derive a probability distribution of outcomes and can therefore be insured against; while uncertainty is a condition in which no probability distribution exists and it cannot be insured against[237]. It is generally impossible to theorise under the condition of uncertainty[238]. Risk can be easily managed by gathering relevant information about the phenomena in question and their causes while uncertainty cannot be often reduced in this way.

As stated above, non-ergodicity, as coined by North, is a distinct concept from both risk and uncertainty. Non-ergodicity refers to new uncertainties and risks that usually come about following human efforts to manage current uncertainties and risks. Non-ergodicity results from the constantly changing nature of the human environment and as such there is little that can be done to avoid it other than adapting human strategies to new challenges.

[235] *Ibid.* P. 19.
[236] Tom Ritchey, Anna-Lena Lövkvist-Andersen, Richard Olsson and Maria Stenström, 'Modelling Society's Capacity to Manage Extraordinary Events', (2004), Web: http://www.swemorph.com/pdf/sra.pdf. Last accessed on 01/02/2014.
[237] North (2005) *supra* note 8 at p. 13.
[238] See, Kenneth Arrow, 'Alternative Approaches to the Theory of Choice in Risk Taking Situations' 19 (4) Econometrica (1951) 404-437.

4.5 PATH DEPENDENCY

According to North, economic change is path dependent in that the way by which institutions and beliefs were derived in the past, influence present and future choices of a society. The explanation for this is that institutions, together with standard constraints of economic theory, determine the opportunities in a society. Organisations are created to take advantage of those opportunities, and, as the organisations evolve they alter the institutions. The resultant path of institutional change will therefore be shaped by the lock-in that comes from the symbiotic relationship between institutions and the organisations that have evolved as a consequence of the incentive structure provided by those institutions and the feedback process by which human beings perceive and react to changes in the opportunity set.[239] Thus Institutional path dependence will exist because of (i) network externalities-where more people are buying into a particular institution thereby increasing its value or usefulness, (ii) economies of scope – the demand for more and related institutions in order to reduce transactional costs and (iii) complementarities – the synergies derived from existing institutions that make them more useful, that exist with a given institutional matrix.[240] Also, relatively small differences in starting conditions can have unpredictable and large effects on eventual outcomes, because of the reflexive nature of society working through feedback loops, and other mechanisms. Feedback loops can be positive or negative in effect.[241] The

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[239] North (2005) *supra* note 8 at p. 7.

[240] North (1990) *Supra* note 202 at p. 20

[241] M.A. Pollack, When *Cooperation Fails: The International Law and Politics of Genetically Modified Foods* (Oxford, Oxford University Press, 2009) gives an example of feedback loops generating a negative effect.

potential power of such feedback loops can make initially small differences in starting conditions potentially determinative over time.[242]

A good example of the effect of path dependence would be where the political elites are reaping benefits from an existing institutional framework and they therefore oppose any institutional change that would take away those benefits regardless of the economic efficiencies the proposed framework would bring. This is why, says North, once an economy is on an 'inefficient' path that produces stagnation it can persist because of the nature of path dependence[243]. According to North, "understanding the process of change entails confronting directly the nature of the limits to change that path dependence imposes in various settings".[244]

The concept of path dependency, therefore, provides a general theoretical explanation for the relative unpredictability of legal transplantation because in most cases the recipient will respond to the transplanted law in novel ways peculiar to the new social environment. It is therefore important to note, when considering a reform proposal, that the merit of the proposal will be contingent upon the nature of the recipient society. Transplanting will only work in a straightforward manner if the recipient society shares very similar belief and institutional structures with the donor society. [245] It is further noted that "even in the most propitious circumstances the match of beliefs and

[242] Graham Ferris (2012) *supra* note 220.
[243] North (1990*), supra* note 202 at p. 20
[244] North (2005), *supra* note 8 at p. 52.
[245] For an attempt to test this empirically see: D. Berkowitz, K. Pistor and J.-F. Richard 'Economic Development, Legality, and the Transplant Effect' 47 European Economic Review (2003) 165.

institutions will not be identical, as we are dealing with complex systems that are path dependant".[246]

Thus, local conditions are always as important as the contents of any reform attempt. What is needed is the establishment of effective adaptive institutions within a society. The starting point in this regard is an understanding of the interplay between beliefs and institutional systems of a given society as discussed below.

4.6 BELIEF SYSTEM AND INSTITUTIONAL CHANGE

The central plank as well as the point of departure of North's framework for institutional change is the role of human mental constructs or belief system in making human choices. North posits that the structure that humans create to order their political and economic environment in the form of formal rules, informal norms and the enforcement characteristics of both is derived from their belief systems and is the basic determinant of the performance of an economy in that it provides the incentives which shape the choices that humans make.[247] North says there is an intimate relationship between belief system and institutional framework as the belief system may be seen as the internal representation of the human landscape and institutional structure the external manifestation of that representation.[248]

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[246] Graham Ferris (2012) *supra* note 220.

[247] North (2005), *supra* note 8 at p. 48.

[248] *Ibid*. P. 49. The said institutional framework is said to consist of the political structure that specify the way we develop and aggregate political choices, the property rights structure that defines the formal economic incentives, and the social structure in the form of, norms and conventions, that defines the informal incentives in the economy.

The emphasis on the relevance of the system of belief distinguishes North's framework from classic economic theory, which ignores the beliefs of agents, taking little interest in their origins or effects[249]. Classic economics is predicated on the rationality assumption, that is, every human being is capable of making rational decisions. North expresses his misgivings with the rationality assumption as follows:

> "The substantive rationality assumption of the economist works well in competitive posted-price markets. The competitive environment so structures the situation that price can effectively be viewed as a parameter and only the quantity to buy or sell need be chosen. If all choices were simple, were made frequently, had substantial motivation, then substantive rationality would suffice for all purposes...But as soon as we move away from this simple competitive model and the price depends on the behaviour of other buyers and sellers the complexity of the decision increases and we need to delve much more deeply into the cognitive process."[250]

Belief system causes individuals either to believe or not to believe in a particular institution and where there is no belief in an institution; the same will not operate in practice. For instance, rule of law will only operate and facilitate people's plans if the rule of law is believed in by the people.[251]

Thus the institutional structure of a society will reflect the accumulated beliefs over time and change in the institutional framework is usually an incremental process

[249] The assumption being that if beliefs are wrong then negative feedback from the world will lead to the beliefs being corrected, or to the holders' of the beliefs swiftly becoming marginalised and unimportant for analysis. See, Graham Ferris (2012) *supra* note 220.
[250] North (2005), *supra* note 8 at p. 23.
[251] Graham Ferris (2012) *supra* note 220.

reflecting the constraints that the past imposes on the present and the future.[252] This explains why, while the formal rules can be changed overnight, the informal norms will only change gradually. In this regard, North observes that since it is the norms that provide the essential legitimacy to any set of formal rules, revolutionary change is never revolutionary as its supporter's desire and performance will be different.[253] Consequently, societies that adopt the formal rules of another society are likely to have very different performance characteristics than the original country because both the informal norms and the enforcement characteristics will be different. It is for this reason that transferring the formal political and economic rules of successful Western market economies to Third World and Eastern European economies is not a sufficient condition for good economic performance.[254]

4.7 ESSENTIAL CHARACTERISTICS OF INSTITUTIONAL CHANGE.

Based on the above analysis, North has developed five propositions that define the essential characteristics of institutional change as follows:

1. Competition is the key to institutional change in that it bleeds continuous interaction of institutions and organizations in the economic setting of scarcity. North says the opportunities provided by the institutional matrix determine the kinds of organisations that will come into existence and the entrepreneurs of organisations induce institutional change as they face

[252] North (2005), *supra* note 8 at p.49.
[253] North (1990), *supra* note 202 at p. 25
[254] *Ibid*.

competition derived from an economic world of scarcity by altering the rules either directly by political bodies or indirectly by economic or social organisation pressuring political organisations or by deliberately altering the kinds and effectiveness of enforcement of rules or the effectiveness of sanctions and other means of informal constraint enforcement.[255]

2. Competition forces organizations to continually invest in skills and knowledge to survive. The kinds of skills and knowledge individuals and their organizations acquire will shape evolving perceptions about opportunities and hence choices that will incrementally alter institutions. The ubiquity of competition in the overall economic setting of scarcity induces entrepreneurs and the members of their organisation to invest in skills and knowledge with the aim of improving the efficiency of the organisation relative to that of rivals.[256]

3. The institutional framework dictates the kinds of skills and knowledge perceived to have the maximum pay-off. The institutional matrix defines the opportunity set which may either be those that make the highest pay-offs in an economy income redistribution or those that provide the highest pay-offs to productive activity. The organisations that will come into existence will reflect the pay off structures and the direction of their investment in skills and knowledge will equally reflect the underlying incentive structure.[257]

[255] North (2005) *supra* note 8 at p. 60.
[256] *Ibid*, p. 60.
[257] *Ibid*, p. 61.

4. Perceptions are derived from the mental constructs of the players. The mental constructs individuals form to explain and interpret the world around them are partly a result of their cultural heritage, partly a result of the 'local' everyday problems they confront and must solve, and partly a result of non-local learning. As a result, individuals from different backgrounds will interpret the same evidence differently and in consequence make different choices.[258]

5. The economies of scope, complementarities, and network externalities of an institutional matrix make institutional change overwhelmingly incremental and path dependent. Institutional change will be incremental because large scale change creates too many opponents among the existing organisations that will be harmed and therefore oppose such change and path dependence will occur because the direction of the incremental institutional change will broadly be consistent with the existing institutional matrix and will be governed by the kinds of knowledge and skills that the entrepreneurs and members of organisations have invested in.[259]

4.8 INSTITUTIONS AND INCENTIVE STRUCTURES

The above propositions are very crucial tools for understanding the role of institutions in providing incentive structures in an economy. According to North,

[258] *Ibid*. P. 62.
[259] *Ibid*. P. 62.

individuals will be incentivised to invest in skills and knowledge perceived to have the maximum pay-off. Their perceptions will be derived from the opportunity set that is defined by existing institutions in the economy. Thus in an economy where the highest rate of return comes from piracy, it will be expected that the organisations will invest in skills and knowledge that will make them better pirates whereas if there are high returns to productive activities, organisations will devote resources to investing in skill and knowledge that will increase productivity. [260] Therefore, the extent to which societies will invest in formal education, schooling, the dissemination of knowledge and both applied and pure research will mirror the perceptions of the entrepreneurs of political and economic organisations. However, the root source of these perceptions is the mental constructs that individuals form to interpret the world around them. Consequently, the different ways in which societies interpret the evidence surrounding them and the subsequent choices they make, set them on different developmental paths.

4.9 DESIGNING AN INSTITUTIONAL FRAMEWORK FOR ECONOMIC CHANGE.

North concludes his framework by providing specific guidelines on how an institutional framework for economic change can be designed. North says that when humans understand their environment as reflected in their beliefs and construct an institutional framework that enables them to implement their desired objectives, there is consistency between those players in a position to shape their destiny and the desired outcome. North observes that efforts to achieve economic change have

[260] *Ibid.* P.61

been “a trial and error process with lots of errors, endless losers and no guarantee of getting it right in spite of the enormous accretion of knowledge over several past centuries”.[261] According to North, achieving a sustainable economic change requires perceiving correctly changes in the human environment, incorporating those perceptions in the belief system and altering the institutions accordingly. This process would result in the following:

1. “The implications of the novel changes would be understood with respect to the effects on the three fundamental sources of change i.e. demography, the stock of knowledge, and institutions and the resultant new interaction among them.

2. This new knowledge would be incorporated in the belief systems of those in a position to modify the institutional matrix.

3. The formal rules, the informal constraints and the enforcement characteristics would be altered accordingly and would produce the desired change.”[262]

North has set out the following recommendations on what needs to be considered when designing an institutional framework for economic change:

1. The world and any new events or interventions will be apprehended by agents through systems of belief and in the contexts created by social and

[261] *Ibid.* P 116
[262] North (2005), *supra* note 8 at p. 117

economic institutions. How a problem is perceived and what strategies are readily available to deal with it are determined by the previous experience of a society as embodied in its institutional structure. It is, therefore, essential to change both the institutions and the belief systems for successful reform since it is the mental models of the actors that will shape choices.[263]

2. Any institutional framework for development must promote a common cultural heritage, which provides a means of reducing the divergent mental models that people in a society possess and constitutes the means for the intergenerational transfer of unifying perceptions. North gives an example of modern western societies like the US that embody a rich cultural heritage which has led to the immensely complex artifactual structure that not only gives them command over nature in an unparalleled fashion but equally extends their range of easy decision making over space and time in ways that would be beyond the comprehension of their ancestors.[264]

3. The institutional framework must also promote competition among economic players. Continuous interaction between organisations and institutions in the economic setting of scarcity is key to institutional knowledge hence the need for competition. Competition forces organisations to continually invest in skills and knowledge. Therefore, all well-functioning

[263] North (1990), *supra* note 202 at p. 25
[264] *Ibid, p*. 36

factor and product markets must be structured to provide incentives for the players to compete at the margins that induce growing productivity.[265]

4. Order is a necessary condition for long-run growth and establishment and maintenance of a variety of conditions underlying freedom of person and property. Disorder, says North, increases uncertainty because rights and privileges of individuals and organisations are up for grabs resulting in disruption of existing exchange relationships in both political and economic markets and disappearance of conformity as a result of disintegration of norms and/or change in enforcement.[266] Solving the development puzzle therefore requires the crafting of political institutions that provide the necessary underpinnings of public goods essential for a well-functioning economy and at the same time limit the discretion and authority of government and of individual actors within government.[267] North identifies four characteristics of the ideal political model as follows:

    i. "An institutional matrix that produces a set of organisations and establishes a set of rights and privileges.

    ii. A stable structure of exchange relationships in both political and economic markets

[265] North (2005), *supra* note 8 at p. 85.
[266] *Ibid*, p. 106
[267] *Ibi,*. p. 85

iii. An underlying structure that commits the state to a set of political rules and enforcement that protects organisations and exchange relationships;

iv. Conformity as a result of some mixture of norm internalisation and coercive enforcement".[268]

5. Further the existence of a non-ergodic world entails that the environment is continually being altered in new ways and the challenge is to understand correctly the changes in the environment, develop appropriate institutions and implement policies to solve the new problems we will face. This calls for a flexible system of institutions that will respond to the constantly changing world. This is where the ability to deal with novel situations comes handy. North notes that institutions adopted at a particular time, even if optimal at the time, may be far from optimal as the human environment changes over time.[269]

6. The institutional framework must promote impersonal exchange. Impersonal exchange requires the development of economic and political institutions that alter the pay-offs in exchange to reward cooperative behaviour. The creation of the necessary institutions requires a fundamental alteration in the structure of the economy and the polity which frequently is not in the feasible set given the historically derived beliefs about institution of the

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[268] *Ibid,* p 105.
[269] *Ibid*. p. 22.

players. The move from personal exchange[270] to impersonal exchange is critical to achieving economic growth but at the same time it is not easy. The difficulty arises from what North calls "the genetic architecture" from man's 3 million years as a hunter/gatherer which predisposed humans to engage in small-scale cooperative behaviour manifesting as clan, tribe and other small group interactions necessary for survival in a hostile physical environment.[271] Impersonal exchange requires economic institutions and organisations like bills of exchange, banks, corporate structures, firms and various economic institutions engaged in long distance trade. Such institutions and organisation needs to be bolstered by impersonal enforcement mechanisms to provide effective enforcement of agreements in impersonal exchange.[272]

7. The institutional framework must promote specialised knowledge. North says specialisation of knowledge is a necessary condition to realising Adam Smith's Wealth of Nations.[273] Specialisation and division of labour in a society leads to dispersed knowledge which must be integrated. In order for developing countries to survive and grow in the context of the competition from already developed world, they must construct an effective price system and supplement it by creating the institutions and organisations to integrate that knowledge at low costs of transacting.[274] However, integrating dispersed knowledge at low transactional costs requires novel institutional and

[270] Personal exchange relies on reciprocity, repeat dealings and some informal norms that tend to evolve from strong reciprocity relationships. Ibid at p. 117.
[271]North (2005), *supra* note 8 p. 119.
[272] *Ibid.*
[273] *Ibid*. P. 84
[274] *Ibid.* P. 120

organisational connections to overcome the public goods attributes, externalities and informational asymmetries that prevent the price system from fully integrating distributed knowledge.[275] A well-functioning market must provide an institutional framework that will allow goods or service to be designed in such a way that the new user does not have to have the detailed knowledge of the specialist.[276] Examples of such institutions would include warranties, guarantees and trademarks.

8. Further, the institutional framework must reduce transaction costs. Transaction costs arise from the cost of measuring the multiple valuable dimensions of a good or service, protection of individual property rights, integration of dispersed knowledge of a society and enforcement of agreement. Production and transaction costs can be lowered by (i) the development of a uniform system of weights and measures, technological research for better measurement, and improved specification of property rights, (ii) the creation of an effective judicial system to reduce the costs of contract enforcement, and (iii) the development of institutions to integrate the dispersed knowledge in a society as well as to monitor and meter agreements and adjudicate disputes. In this regard North counsels that the institutions and that have emerged in the Western world, such as property rights and judicial systems, do not have to be faithfully copied in developing

[275] *Ibid*. P. 85
[276] *Ibid.* P. 121.

countries as the key is the incentive structure that is created for individuals and organisations to engage in productive activity.[277]

9. Finally, North says it is adaptive rather than allocative efficiency which should be the guide to policy formulation as allocative efficiency is a static concept with a given set of institutions while the key to continuing good economic performance is a flexible institutional matrix that will adjust in the context of evolving technological and demographic changes as well as shocks to the system.[278] He says the foundations of such flexible institutions reside in widely held beliefs embodied in the informal constraints of society.[279]

4.10 NORTH'S THEORY COMPARED WITH OTHER THEORIES.

What North's framework for economic development has achieved is the provision of a hither to elusive explanation as to why certain approaches to legal and institutional reform adopted under comparative law methodology and legal transplant theories proved ineffective and why other theorists within these schools of thought could be right.

As stated above, legal anthropology theory is relevant in so far as it recognises the importance of informal rules. However, the theory lucks any explanation why they are relevant other than that ethnographic observation shows the rules as having authority and being used regularly by the members of the community. North's framework however

[277] *Ibid*. pp 158-159. Here North observes that through the Household Responsibility System, the Chinese developed an incentive structure which managed to produce rapid economic development without any of the recipes of the West.
[278] North (1990), *Supra* note 202 at p 26
[279] North (2005) *Supra* note 8 at p 78.

properly explains why informal rules are relevant to behaviour ordering. North goes further to acknowledge the role of formal rules as long as the society has developed the necessary sophistication through learning to use them.

However, the law and economics theory is out rightly rejected by North in that it is based on the wrong assumption of rationality of economic actors. The flaws of this theory are manifest in the failure of the Washington Consensus development model which was market-oriented. As stated above these flaws have been acknowledged within the law and economics circles which has resulted in shift towards behaviour economics, which has traces of North's framework with regards to the role of human mind and belief system in economic choices.

It is also clear that most legal reforms that have been undertaken using comparative law methods have not worked because they only involved transfer of formal rules without any consideration of the informal institutions in the transferee countries. Examples in this regard are the reforms that were sought to be done under the first law and development movement. As explained above, the concept of legal reform under the first law and development studies was modelled on Watson's approach that legal rules may be very successfully borrowed where the relevant social, economic, geographical and political circumstances of the recipient are very different from those of the donor system.[280] However, Kahn-Freud's and Legrand's approach to legal transplants ties in with North's model as they believed that the use of comparative method requires a knowledge not only of the foreign

[280]See: Kamba, *Supra* note 89 at p. 496.

law but also of its social, and above all its political, context.[281] Further, Kamba, has advocated a three-stage technique of comparative law. He suggests that the process of comparison should involve (i) the description phase which may take the form of a description of the norms, concepts and institutions of the systems concerned, (ii) the identification phase identifying differences and similarities of systems compared and (iii) the explanatory phase, which should give an account of the resemblances and dissimilarities between systems, concepts or institutions. This methodical approach clearly seeks to take into consideration the unique local conditions of the transferee community. However, it does not go far in its explanation as to why this is necessary. This lacuna is filled by North's framework.

A number of empirical studies that have been carried out recently confirm the premise of North's framework. One of such studies was carried out by Berkowtz, Pistor and Richards.[282] The aim of the study was to assess the impact of the way in which a country received its formal laws on the effectiveness of the law (the authors call this legality). This study concluded that the process of law making rather than the contents of legal rules determines the effectiveness of legal institutions. They found that where law develops internally through a process of trial and error, innovation and correction and with the participation or involvement of users of the law, legal professionals and other interested parties, legal institutions tend to be highly effective. By contrast where foreign law is imposed and legal

[281] See: Morrow, 'Comparative Law in Action', *Supra* note 107 at p. 403.
[282] D. Berkowitz, K. Pistor and J.Richard, 'The Transplant Effect', *supra* note 137 at pp 64-65.

evolution is external rather than internal, legal institutions tend to be weak. Berkowtz et al argued that:

> "...for law to be effective, a demand for law must exist so that the law on the books will actually be used in practice and legal intermediaries responsible for developing the law are responsive to this demand. If the transplant adapted the law to local conditions, or had a population that was already familiar with basic legal principles of transplanted law, then we would expect that the law would be used. Because the law would be used a strong public demand for institutions to enforce this law would follow. And, legal intermediaries that are responsible for developing and enforcing this imported law would be able to develop the law so as to match demand, because the strong demand for law would provide resources for legal change. Where these conditions are present we would expect the legal order to function just as effectively as in an origin country where the law was developed internally. However, if the law was not adapted to local conditions, or if it was imposed via colonization and the population within the transplant was not familiar with the law, then we would expect that initial demand for using these laws to be weak. Legal intermediaries would have a more difficult time developing the law to match the demand. Countries that receive the law in this fashion are thus subject to the "transplant effect": their legal order would function less effectively than origins or transplants that either adapted the law to local conditions and/or had a population that was familiar with the transplanted law."[283]

The above reasoning and findings chime with North's framework as it emphasises on adapting the law to local conditions and also the internal generation of legal rules as opposed to imposition of external rules. However North has given a better explanation why this is necessary.

[283] *Ibid* at p. 167-168.

Similarly the various theories of legal change make very interesting comparisons when juxtaposed to North's framework. In so far as the evolutionist approach associates legal development with particular cultural or economic attributes of a society and disagrees with borrowing of legal ideas from dissimilar societies, it compares with North's framework. However, the fact that it undervalues "the role of cognition, of ideas, of goals, and often of individual legal innovation"[284] it removes itself from the ambit of North's framework, which recognises the role of formal rules as long as they are properly aligned to the existing informal rules.

The Utilitarian theory of legal change conforms to North's framework in its recognition that legal change is orchestrated by the human desire to increase efficiency and reduce transactional costs, which is one of the main planks of North's framework. Douglas North, for instance, has given examples of laws pertaining to trademarks and patents as well as limited corporate liability as some of the innovations, which came about in an attempt to increase the private rate of return[285]. However, the emphasis of this approach on efficiency considerations only as the sources of legal change makes it incomplete compared to North's framework. As observed by Horowitz, "the outcomes of legal change are too various to be subsumed under the rubric of any self-regulating functionalism"[286].

However, of all the theories of legal change, the social change theory comes closest to North's framework in that it depicts the importance of informal rules and the process in which informal rules can influence the introduction of formal rules. This approach espouses

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[284] Horowtz, *Supra* note 161 at p. 246.
[285] North and Thomas, 'An Economic Theory of the Growth of the Western World', 23 Economic History Review (1970) 1.
[286] Horowitz, *Supra* note 161 at p. 248.

the bottom up approach to legal change which is advocated by North's framework. It also recognises the relevance of people's attitudes or belief systems to the process of legal development. However, while the premise of this approach is sound, it is not the case that changing social structure is the only source of legal change. So this approach is rather too narrow for a general theory of legal change.

With regard to the intentionalist approach, despite the weaknesses, in so far as it advocates wanton borrowing of legal rules, for purposes of developing a practical theory of legal change, the "intentionalist" view is still useful in that it recognises the need and the role of a "visible hand" in the process of legal reform. This is also a central theme under North's framework, which emphasises that the agent of change is an entrepreneur (social, economic and political) and that the nature and direction of change is determined by the belief system of the entrepreneur.[287]

The forgoing shows that all the different theories of legal change that have been posited by different legal theorists, over time, find their expression in North's framework as such they are all correct to some extent. North's framework recognises the evolutionary element of institutional change overtime, recognises that institutional change is need-based in that the ultimate purpose of change is reduction of transaction costs. Further, North's framework emphasises on the role that changing social structure through changes in the belief system of the society, play in inducing institutional change. Finally North's framework recognises the role of an agent including the polity in the process of change. This means that all the four different strands of theories of legal change are embodied in North's framework. This

[287] North (1990) *supra* note 202 at 73

lends huge credibility to North's framework and justifies our choice in using the framework as a tool of analysis for purposes of designing the necessary legal reform for capital market development.

In the next chapters we will seek to show how North's framework of economic change can be applied to the development of capital markets in developing countries.

5 CHAPTER FIVE: NORTH'S FRAMEWORK AND CAPITAL MARKET DEVELOPMENT THEORY

5.1 INTRODUCTION

The institutional foundations for capital markets are clearly alien to most developing economies. The roots of capital markets or capitalism are traced to the West[288]. Capitalism as a system requires certain conditions to exist in order for it to take hold. It has been said that the notion of "capitalism is identified with a system of unfettered individual enterprise: a system where economic and social relations are ruled by contract, where men are free

[288] See, S. Perjovich, *Law, Informal Rules and Economic Performance: The Case for Common Law*, (Edward Elgar, Cheltenham p, 2008) 115. It is said that European stock markets first ermeged in the sixteenth and seventeenth centuries following the creation of modern business corporations modern equity instruments which prompted changes in the European financial markets. See. Charles Pouncy, 'Contemporary Financial Innovation: Orthordox and Alternatives' (1998) 51 SMU L. REV. 505 at pp. 521-24.

agents in seeking their livelihood, and legal compulsions and restrictions are absent."[289] According to Pejovich, the two cornerstones of capitalism are classical liberalism and methodological individualism.[290] We proceed on the assumption that these qualities or characteristics are usually in short supply in most developing economies. Consequently, introduction of capital markets in these economies would bring about a certain level of uncertainty on the part of economic agents whose mental models are not yet prepared to operate within such a system. Further, such actors will lack the requisite skill and knowledge for such a system to work efficiently.

There is therefore a case for capital market institutional reform in developing economies in order to realise sustained capital market development. However, as discussed above, designing and implementing such reforms will require a clear understanding of the intricacy of the process of institutional change.

First and foremost, it is necessary to understand the interaction between institutions (rules of the game) and organisation (players of the game) in the process of institutional change. According to North, organisations and their entrepreneurs engage in purposive activities aimed at maximising wealth, income or pursue other objectives defined by the opportunities afforded by the institutional structure of the society.[291] The wealth maximising activities by the organisation result from learning by doing and investing in the kinds of skills and knowledge that will pay off.[292] It is this maximising behaviour of economic organisations that will shape institutional change by (a) the resultant demand for

289 D. Maurice, *Studies in the Development of Capitalism*, (Routledge & Kegan Paul, London, 1963) 3.
290 S.Perjovich, *supra*, note 288 above, p.26. These terms are discussed in detail at section 5.3 (vi) below.
291 North (1990) *supra* note 202 at P.73.
292 *Ibid.* P.79

investment in knowledge of all kinds; (b) the ongoing interaction between organised economic activity, the stock of knowledge, and the institutional framework; and (c) incremental alteration of the informal constraints as a by-product of maximising activities of organisations.[293]

The above realities and dilemmas ought to be considered when developing an institutional framework for capital markets. According to North's framework, the first step of the task should be a comprehensive analysis of both formal and informal rules that exist in a given society or in this case in a given economy. Such analysis will help to identify aspects of both formal and informal rules as well as organisations that work and those that do not work for purposes of capital market development. Once the analysis is done, the findings thereof will form and inform a framework for institutional reform.

5.2 FORMAL INSTITUTIONS OF CAPITAL MARKETS

So what are the formal institutions that economic actors put or ought to put in place in order to achieve sustainable capital market growth? Pejovich[294] described formal rules[295]. as follows:

> "Formal rules are constitutions, statutes, common laws and other governmental regulations. They usually take a written form and are externally enforced. They define the political system (the hierarchical structure, decision making powers, the

[293] *Ibid*.P. 78.
[294] S. Perjovich, *Supra*, note 288.
[295] As discussed above, formal rules include political and judicial rules, economic rules and individual contracts. See North (1990) *supra* note 202 at p. 47.

individual's rights); the economic system (property rights, freedom of contract, open entry into all markets); the protection system (judiciary, police, military)."[296]

Given that they are politically orchestrated, formal rules are easy to change compared with informal rules but they are attached with a high risk of non-observance if they conflict with the informal rules of the society.[297]

Different studies in economic development show that there are many institutional pre-requisites for capital market development and that unless such preconditions are achieved by those seeking to implement it, their efforts to establish thriving capital markets will not be properly rewarded. Pardy[298] contends that there are two basic building blocks necessary for a thriving securities market: (1) a *macroeconomic* and *fiscal* environment conducive to the supply of good quality securities and sufficient demand for them; and (2) a *market infrastructure* capable of supporting efficient operation of the securities market. In this study we shall call these two categories of formal institutions, *"macro infrastructures"* and *"micro infrastructures"* of capital market growth respectively.

The macro infrastructures are the broad and high level institutions and organisations that help create a conducive environment to facilitate and sustain capital market growth. It is recognised that the demand for and supply of securities is crucially linked to the state of the macro economy.[299] If the macro economy is conducive to profitable business operation, a sufficient number of sound businesses can develop to a stage where access to securities

[296] Perjovich, *supra* note 288 at p. 141.
[297] *Ibid.*
[298] R. Pardy, 'Institutional Reform in Emerging Securities Markets' (1992) Policy Research Working Papers (Financial Policy and Systems). The Wold Bank, WPS, 907.
[299] *Ibid* at p. 2.

markets is useful for their continued growth. It is therefore argued that the starting point for capital market development policies on the part of government is to tend to macroeconomic fundamentals which will foster business profitability, savings growth, and investment confidence.[300] Examples of these institutions include the rule of law and the judicial system, political environment, anti-corruption regime, secure property rights, entry requirements for new and foreign companies, taxation and corporate insolvency rules.

On the other hand, micro infrastructures are those which attempt to directly enable the securities market operate in an efficient, fair and stable manner. These are the legal, regulatory and institutional infrastructure upon which the market's operation is based[301]. Examples may include investor/shareholder rights, accounting and audit rules, listing requirements, regulation of intermediaries, capital market structure, etc. The purpose of the micro infrastructure is to promote market transparency and prevent market manipulation and abuse.

5.2.1 Macro Infrastructures

i. The Rule of Law

Rule of law is a concept that lends itself to so many descriptions and expressions. In essence however rule of law is used as an appeal for "the imposing of effective inhibitions upon

[300] *Ibid* at p. 3.
[301] *Ibid*. p. 4.

[state] power and the defence of the citizen from the state power's all-intrusive claims"[302]. The World Bank has had different working definitions of 'rule of law' at different times of its use of the concept during the implementation of a development agenda in emerging economies[303]. During the era of Ibrahim Shihata,[304] as General Counsel, the Bank proceeded on the basis that rule of law requires that:

> "(a) there is a set of rules that are known in advance (b) such rules are actually in force (c) mechanisms exist to ensure the proper application of the rules and to allow departure from them as needed according to established procedure (d) conflicts in the application of the rules can be resolved through binding decisions of an independent judicial or arbitral body, and e) there are known procedures for amending the rules when they no longer serve their purpose."[305]

When Ko-Yung Tung was General Counsel however, the Bank adopted a slightly different understanding of the rule of law by stating that rule of law prevails where "a) the government itself is bound by the law, b) every person in society is treated equally under the law, c) the human dignity of each individual is recognised and protected by the law, d) justice is accessible to all."[306] It was emphasized that rule of law requires transparent legislation, fair laws, predictable enforcement and accountable governments to maintain order, promote private sector growth, fight poverty and have legitimacy.[307]

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[302] E.P. Thompson, 'Whigs & Hunters' (1975) cited in, Bob Fine, Richard Kinsey, John Lea, Sol Picciotto and Jock Young, *Capitalism and the Rule of Law: From Deviancy theory to Marxism* (Hutchinson & Co publishers, 1979).
[303] The different definitions are said to have depended on the definition adopted by the reining General Counsel for the Bank. See: Gordon Baron, 'The World Bank and the Rule of Law Reform' (2005), World Bank Working Paper Series, ISSN 1470-2320.
[304] Shihata was World Bank's General Counsel from 1983 to 1998.
[305] Gordon Baron, 'The World Bank and the Rule of Law Reform' (2005), World Bank Working Paper Series, ISSN 1470-2320, p. 13.
[306] *Ibid p.14.*
[307] *Ibid.*

In modern day political economy, rule of law is a term used to describe the presence or absence of specific, observable criteria of the law or the legal system including a formally independent and impartial judiciary; laws that are public; the absence of laws that apply only to particular individuals or classes; the absence of retroactive laws; and provisions for judicial review of government action.[308]

The relationship of the rule of law and economic development is better understood by looking at the role of law in facilitating economic markets. Sunstein[309] has posited that the concept of free markets depend, for their existence, on law. He stated that:

> "We cannot have a system of private property without legal rules, telling people who owns what, imposing penalties for trespass, and saying who can do what for whom. Without the law of contract, freedom of contract, as we know and live it, would be impossible."[310]

Further, the law is used to assign the roles of different economic actors and prescribe the rights and obligations of the holders of those roles. This brings order, consistency and some level of predictability of the outcomes of different economic actions. Thus in terms of North's framework of economic change, law (both in its formal and informal nature) can be a powerful tool for changing norms and beliefs and bringing about certainty.

[308] Matthew Stephenson of the Harvard University Department of Government and Law School. See his brief on http://go.worldbank.org/DZETJ85MD0.
[309] C.R. Sunstein, *Free Markets and Social Justice*, (Oxford: Oxford University Press, 1997).
[310] *Ibid,* p.5.

The rule of law is said to be the container that holds the rest of the formal rules[311]. It has therefore been argued that "if private property rights, the law of contract, an independent judiciary and a constitution are major institutions in the container of the rule of law, their economic implications must be largely responsible for the observed performance of the free-market and private property economy. And differences in the credibility and stability of those four institutions, on a country-by-country basis, should explain differences in economic performance."[312] Thus the rule of law is said to have been a major vehicle for the institutionalisation of classical liberalism into capitalism.[313]

In their empirical study, La Porta et al[314] found that in countries where there is less efficient judicial system and observance of the rule of law, there are weak and shallow capital markets. This therefore confirms that poor institutions and low observance of the rule of law would mean that contract/property rights are weakly enforced or subject to arbitrary governmental override.

ii. Judicial System

The judiciary is one of the important formal institutions that promote economic change. Judges interpret new formal rules thereby shaping the actual application of the rules in practice. In this way judges are the agents of change - hence the need for an efficient and effective judicial system.

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311 S. Perjovich (2008) *supra* note 288 at p. 41
312 *Ibid*, p. 41
313 *Ibid.* p. 39.
314 Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer and Robert W. Vishny, 'Law and Finance', (1998) 106 Journal of Political Economy, (1998) 1113-1155.

Where the judiciary is inefficient and ineffective, corruption, risk of expropriation and contract repudiation will be unchecked and this will result in less developed capital markets.[315]

iii. *The Political Order*

Political order subsisting in a given economy is said to have a significant bearing on the development trajectory of the economy. As discussed above, the political order-economic development nexus is one of the centre pieces of North's thesis. According to North, achieving economic growth requires the crafting of political institutions that provide the necessary underpinnings of public goods essential for a well-functioning economy, and at the same time limit the discretion and authority of government and of individual actors within government.[316]

The intrinsic differences in political and social governance structures between developed and developing countries, has been further explored recently by North *et al*, in their work, *In the Shadow of Violence: Politics, Economics, and the Problems of Development.*[317] North et al draw a distinction between what they call "Open Access Orders" (OAO) and "Limited Access Orders" (LAO). According to North et al, a typical LAO structure involves two

[315] *Ibid*.
[316] D. North (2005) *supra* note 8 at p. 50
[317] Douglas North, John John Joseph Wallis, Steven B. Webb, and Barry R. Weingast , *In the Shadow of Violence: Politics, Economics, and the Problems of Development*, (New York, Cambridge University Press, 2013). The articles in this collection were based on the editors earlier work, Douglas C North, Joseph Wallis, and Barry R. Weingast, *Violence and Social Orders: A Conceptual Framework for Interpreting Human History* (New York: Cambridge University Press, 2009).

powerful groups who have capacity to instigate violence against the other. Each group is controlled by an elite subgroup,[318] which is in charge of its subjects or client organisations and have privileged or exclusive access to the resources within the group through special arrangements that are put in place enabling them to extract "rent" from the subject in exchange of protection and other services received from their elite group. Each of the elite groups of the two groups stands to suffer reduced rent if violence erupts between the two groups. Consequently, the two groups are incentivised to keep peace with each other by entering into a "dominant coalition" to avoid violence.[319]

North et al therefore portray the rule of law as generated by mature and normalised power relations between elites. Rather than resort to violence, powerful organisations resolve disputes through legal forms. Consequently, the dispute resolution mechanism adopted by the ruling elites are applied to non-elite groups. In this sense, rule of law is the institutional manifestation of an approach to power by the elite groups who are enjoying the gains of cooperation.

LAOs constrain economic development in that "limited access to organisations and economic rights limits competition and economic productivity."[320] Also, LAOs breed local monopolies and restrictions on economic entry, thereby hindering competitive markets and long-term economic growth.[321]

[318] These may include economic, political, religious or educational leaders in society.
[319] North *et al*, (2013) *supra* note 317 at p.5.
[320] North *et al*, (2013) *supra* note 317 at p.8.
[321] *Ibid* p.9

OAOs on the other hand are characterised by institutions that support open access and political as well as economic competition. Unlike LAOs where there are two or more powerful groups capable of instigating violence, in OAOs government has a monopoly on violence through the military and police forces. Consequently, in OAOs "entry into economic, political, religious, and educational activities is open to all citizens as long as they meet standard (impersonal) requirements."[322] OAOs thrive within the milieu of functional rule of law. In order for a LAO to transition to an OAO there is a need to put in place institutional arrangements that support impersonal exchange,[323] and members of the dominant coalition must find it in their interest to expand impersonal exchange. The result will be a transformation from a system of "limited access rent creation to open access entry."[324]

The relevance of political order to economic development is as old as classic economics itself, it being at the very centre of Adam Smith's ground-breaking *Wealth of the Nations*[325] treatise. According to Smith, economic development hinges on two important factors, namely (1) the secure existence and efficient operation of the basic institutions of production, exchange and accumulation: property, contractual relationships, markets, currencies and credit systems; and (2) the strength of social attitudes conducive to economic endeavour, especially the motivations of the people to better their condition through labour, savings and productive investment.[326] These conditions can only exist

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[322] *Ibid*. P. 16.
[323] *Ibid* p 17.
[324] *Ibid.*
[325] Edwin Cannan (ed), *Adam Smith's An Inquiry Into the Nature and Causes of the Wealth of the Nations*, (New York, 1937).
[326] See L. Bellet, 'Political Order and Economic development: Reflections on Adam Smith's Wealth of Nations', 23 Political Studies (1975) 430- 441 at p.432.

where there are sufficient checks and balances to political power as arbitrary authority and insecurity will effectively restrict economic creativity and the growth of economic exchange.[327] Smith also noted that in countries where there are weak governments and political disorder, the rich often fail to employ their wealth at all, preferring to hoard or hide a considerable part of it. He observed that:

> "In those unfortunate countries, indeed, where men are continually afraid of the violence of their superiors, they frequently bury and conceal a great part of their stock, in order to have it always at hand to carry with them to some place of safety, in case of their being threatened with any of those disasters to which they consider themselves at all times exposed."[328]

While patriotism may urge domestic investment, when this necessitates a high risk of being plundered by arbitrary power, or through expectations of political disorder and violence, those who are more prudent than patriotic will seek a shelter for their wealth in the more developed countries.[329]

Finally, political instability is antithetic to economic development. Generally, "no investor wants to pour money into a country where a new government can shoot its way to power, kill the old government, and steal its money."[330]

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[327] *Ibid.* p. 433.
[328] Edwin Cannan (ed), *Adam Smith's An Inquiry Into the Nature and Causes of the Wealth of the Nations*, (New York, 1937) 268.
[329] L. Bellet, (1975), *supra* note 326.
[330] Jason Gottlieb, 'Launching the Phnom Penh Stock Exchange: Towards a Legal Framework for Launching a Stock Exchange in an Underdeveloped Country' 14 Colum. J. Asian L (2000-2001) 235 at p. 253. See also Paul Collier, *Wars, Guns and Votes: Democracy in Dangerous Places*, (Vintage Books, London 2010)

iv. Anti -Corruption Rules

Corruption has long been recognised as being anathema to economic growth and as such would have an adverse effect on capital market development. The effect of corruption on economic development is explained in a number of ways.

Firstly, corruption affects economic efficiency in that it discourages innovation. Murphy et al (1993)[331] argue that since innovators will need several government permits and licences in order to start a new enterprise, and given that most new entrants on the market are cash- and credit-constrained, requiring them to pay hefty sums to bribe government officials would turn innovators away from the market thereby reducing the number of potential players in the market.[332] Further, in his study of the relationship between corruption and investment, Maori[333] found that corruption reduces private investment. He observed that corruption acts as a tax on the returns to private investment thereby reducing the *quantity* of investment, and also that corruption redirects scarce investment capital to less productive uses, thereby impairing the *quality* of investment.

On a practical level, in an economy where corrupt practices are prevalent, companies will bribe their way to the official exchange list even if they do not strictly meet all the listing requirements. This would be detrimental to investors who blindly believe that any company

[331] K.M, Murphy, A. Shleifer, and R.W. Vishny, 'Why is Rent-seeking So Costly to Growth?' 83 (2) American Economic Review (1993) 409-14.
[332] This is a classic problem of a Limited Access Order (LAO), which result in economic stagnation. See North et al, (2013) Supra note 286.
[333] P. Maori 'Corruption and Growth.' 110 3 (442) *Quarterly Journal of Economics,* (1995) 681-712.

listed on a stock exchange is worth investing in.[334] Similarly, it would also be possible for regulators to gloss over the monitoring of compliance of listed companies' continuous disclosure obligations as well as the enforcement of market rules where there is a breach, because corporate officials would be in a position to bribe regulators away from their companies' operations.

The negative correlation between corruption and capital market growth has also been empirically confirmed by La Porta *et al*,[335] who observed that most common law countries have less incidence of corruption due to strict enforcement of investor rights and that in consequence they have strong and deep capital markets in comparison to countries with Franco - German legal systems, where there is high incidence of corruption.[336]

Therefore, the existence of effective anti-corruption rules and an efficient anti-corruption agency would help curb corrupt practices in an economy, and thereby improve corporate productivity and efficiency which would in turn encourage growth of capital markets. Anti-corruption rules would provide the necessary incentive structure for market players not to engage in corrupt practices. It should of course be noted that corruption is not a simple phenomenon because in LAO society, corruption may be used by the political elites to extract rent and therefore to sustain the polity non-violently and allow progress towards

[334] An example of how less deserving companies can "corrupt their way" to exchange listing is the listing of a company called Eurasian Natural Resources Corporation (ENRC), which was investigated by the Serious Fraud Office on allegations of corruption. See the *Guardian*, 26 April 2013, The City is in Denial as Oligarchs from Wild East Shred its Reputation, by Nils Pratley. Available on http://www.theguardian.com/business/nils-pratley-on-finance/2013/apr/26/city-denial-oligarchs-wild-east-reputation. Last accessed on 28 June 2014.
[335] La Porta et al (1998) *supra* note 314.
[336] The legal origin theory espoused by La *Porta et al* in this research has been a subject of much scholarly debate. See: Ruth V. Aguilera and Cynthia A. Williams, 'Law and Finance': Inaccurate, Incomplete, and Important (December 15, 2009) Brigham Young University Law Review, Illinois Public Law Research Paper No. 09-20. Available at SSRN: http://ssrn.com/abstract=1523895. However our interest in their finding is the empirical negative correlation and capital market growth.

doorstep conditions and OAO. Therefore dealing with corruption will require a nuanced approach that is sensitive to the existing social and economic structures (organisations).

v. Secure Property Rights

The term property has an elusive meaning.[337] Property may mean the thing that is owned or the relationship between the owner and the thing.[338] Property rights have been defined as the rules that govern the use of scarce resources.[339] Property may be personal or real property. For purposes of this work therefore property shall refer to both real and personal property as they both are relevant to capital market development.

Of particular relevance to capital market development is the concept of a company share as an incident of property. A share has been described as the "interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders *inter se*..."[340] The legal nature of share ownership has generated interesting debate and it has been argued that a share does not exhibit some of the key characteristics of property and as such describing shareholders as owners of the shares they hold smacks of a "legal fabrication."[341] Be that as it may, it is acknowledged that "the legal protection of the share asset as private property is key to stimulating economic activity in relation to the investment market, arguably towards maximum efficiency."[342]

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[337] Daniel H. Cole and Peter Z. Grossman, 'The Meaning of Property "Rights:" Law vs. Economics?' Land Economics, Vol. 78, No.3 (Aug, 2002), pp. 317-330.
[338] *Ibid.*
[339] See: http://www.investopedia.com/terms/p/property_rights.asp, last accessed on 28 June 2014.
[340] *Borland's Trustee v. Steel Bros. & Co*. [1901] 1 Ch. 279.
[341] See: Iris Chu, 'The Meaning of Share Ownership and the Governance Role of Shareholder Activism in The United Kingdom, ((2008-2009) 8 Rich. J. Global L & Bus. 117
[342] *Ibid* at p. 121.

Security of private property rights is said to be directly correlated to investment in different ways. The ground breaking work on the role of property rights in economic development was carried out by Professor Hernado De Soto.[343] De Soto asserts that capital markets fail in emerging economies because of lack of formally titled property. He says that while the majority of residents in developing countries do own property, ownership of the property is secured informally, through neighbourhood associations or mafias, for example, rather than through formal titles and a property registration system. According to De Soto, this lack of formal titling prevents the use of property as collateral, and hence prevents the capital embedded in these assets from being "unlocked." Thus while entrepreneurs in developed market economies are able to turn their houses into capital to start businesses; many potential entrepreneurs in the developing world are not able to obtain loans due to lack of collateral.

Another study carried out by Besley'[344] also shows the role of property rights for investment. Besley developed three theoretical models that imply the link between property rights and investment incentives. Firstly, property rights ensure freedom from expropriation. This will affect the level of investment because individuals do not invest if their fruits of investments are seized by others. Secondly, property rights are linked to the credit market in that if better property rights make it easier to use land as collateral, then constraints on funding investments are diminished. Finally, better property rights in the form of superior transfer rights lead to expanded trading

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343 Hernando De Soto. 2000. *The Mystery* of *Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else. (*New York: Basic Books., 2000) 276.

344 Timothy Besley, 'Property rights and investment incentives: Theory and evidence from Ghana', 103 *Journal of Political Economy (1995)* 903-937.

opportunities and the ability to exploit gains from trade which eventually enhance investment incentives.[345]

Johnson *et al*,[346] also found an empirical link between property rights and reinvestment of earnings by firms. Johnson et al found that weak property rights discourage firms from reinvesting their profits, even when bank loans are available. Where property rights are relatively strong, firms reinvest their profits; where they are relatively weak, entrepreneurs do not want to invest from retained earnings. In the same vein, Claessens and Laeven[347] have argued that the existence of an environment with poorly developed financial systems and weak property rights have two effects on firms: first, it reduces the access of firms to external financing; and second, it leads to firms allocating resources in a suboptimal way.

The foregoing shows that countries with strong and secure property rights may be able to develop deep capital markets because investors will be attracted to put their wealth in the market. It should be noted here that these pre-conditions are cumulative and interrelated as strong and secure property rights depend on strong and predictable enforcement, which in turn depends on rule of law as well as independent and non-corrupt judges. According to North, it is all about the incentive structure such that if violence is believed to be more effective or efficient as a means to secure control of valuable resources then organisations will invest in violence. However if property law is seen as more effective or efficient then organisations will invest in property rights and support the legal system that they rely on.

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[345] See *Ibid*, p 907.

[346] Simon Johnson, John McMillan and Christopher Woodruff, 'Property Rights and Finance', 92 (2) The American Economic Review, (2002) 1335-1356.

[347] Stijn Claessens, and Luc Lavean, 'Financial Development, Property Rights, and Growth', 58(6) The Journal of Finance, (2003).

vi. Market Access Rules

The development of capital markets[348] depends on the number of companies participating in the market. The number of corporate participants is determined by the level of access to the market granted to business entities within or outside a particular economy. Barriers to entry are therefore likely to affect the number of market players. According to North *et al's* Limited Access Order (LAO) and Open Access Order (AOA) analysis, AOA's are characterised by open access to economic activities to all and this allows for economic competition and the existence of perpetually lived public and private organisations, which are "door step" condition for transformation from LAO to OAO.[349]

There are different levels of access to entry that needs to be properly regulated to allow more companies a chance of participating in the market. The first level is access to entry into the formal corporate world. This concerns the nature of the process and associated costs that apply in order for new businesses to register as companies or firms. These include legal requirements that need to be met before a business can officially open its doors, the official cost of meeting these requirements, and the minimum time it takes to meet them if the government does not delay the process. In their study, *Regulation of Entry,*[350] Djankov et al, found that countries with cumbersome, time-consuming, and expensive entry requirements are associated with sharply higher levels of corruption, and a greater relative

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[348] Capital Market development is usually determined by market capitalisation, as measured by the valuation of firms, the number of listed firms (market breadth), and the rate at which firms go public (IPO activity).
[349] North *et al*, (2013) *Supra* note 317.
[350] Djankov, S., R. L. Porta, F. L. de Silanes, and A. Shleifer, 'The Regulation of Entry'. 117 (1) Quarterly Journal of Economics *(2002)*.

size of the unofficial economy. This is so because new businesses who cannot meet the entry requirements will either resort to bribe government officials to register them as companies or will decide to operate informally and therefore outside government control.

The second level is access to entry into the capital market. This concerns the requirements that companies have to meet before being listed on the stock market. These may include legal requirements for a private company to become a public company, capitalisation requirements as well as corporate governance obligations. Stricter regulation of entry into the market is likely to result in fewer companies being listed on the official stock market. One way of easing access to the market is the establishment of Alternative Capital Markets to allow smaller companies to float shares with a more flexible regulatory regime than is applicable to the main market.[351] However as noted above, there is a reputational risk if corrupt companies manage to secure the reputational gains of listing on a stock market. Access in a system characterised by corruption needs corruption, although it is important to bear in mind that extreme restriction may create a new breeding ground for corrupt practices.[352] It is therefore important to take a balanced approach.

The final level of barriers to entry is regulation of foreign companies seeking to invest in the economy. Different countries have different restrictions for foreign companies to operate in their jurisdictions. This may be through company law rules or government policy. Another level of access for foreign companies would be access for foreign companies to trade their securities on the local stock exchange. The more foreign securities are allowed to trade on the local market, the more liquid the market will become.

[351] A good example is the UK's AIM and South Africa's Alt-X markets.
[352] This is an example of North's "non-ergodicity" problem.

vii. Share Ownership Structure

In order to have an active secondary market, there is need for more shares to change hands in the market. However, in a market that is dominated by companies with concentrated ownership or family-controlled companies, shares may not change hands often. Family controlled companies will always be wary of diluting their control and therefore not willing to float more shares on the market. It has been observed that well-developed equity markets, such as those in the US and Britain, are dominated by listed companies with diffused ownership - majority ownership is rare and very few large companies are family-controlled.[353] Possible ways of restructuring share ownership rules are discussed in detail in chapter 9 below.

viii. Taxation Rules

Favourable taxation rules towards listed companies may attract more private companies to trade their securities on the market. In most developing economies, many companies fear that once they float their shares on the market, they will be put on the spot and be required to pay more tax.[354] Consequently companies shun the market. Further, tax incentives to investors who buy and sell shares on the market will attract more investors to the market, thereby increasing market liquidity whereas excessive taxation of capital gains from the sale of shares, for instance, will encourage investors to retain their shares and take out their

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[353]See, Erica Gorga, 'Changing the Paradigm of Stock Ownership: From Concentrated Towards Dispersed Ownership? Evidence from Brazil and Consequences for Emerging Countries', (2008), *3rd Annual Conference on Empirical Legal Studies Papers*, *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1121037)*

[354] See, Interview by Dr. Fratern M. Mboya, Chief Executive Officer of the Tanzania Capital Markets and Securities Authority (CMSA), 24 APRIL 2006, WEB: http://www.tanzaniainvest.com/tanzania-banking-and-finance/interviews/37-interviews/52-capital-markets-and-securities-authority-interview

profits in dividends.[355] It has been noted that in countries with relatively developed financial markets, and in all countries that have high inflation rates, the supply of financial assets is highly responsive to tax changes.[356] Chamley[357] showed that the removal of onerous levels of taxation stimulates financial intermediation when such a measure is conceived to be a permanent policy change. The correlation between taxation and the supply of financial instruments has resulted in tax policies featuring prominently among policy instruments used to develop securities markets in some countries. In Korea, for example, tax policies have been used not only as incentives for the supply of, and the demand for, securities, but also as penalties for companies that were reluctant to go public.[358] Similar measures used in Brazil include dividend tax exemptions or reductions, stock acquisition tax incentives, and provision of tax fund shares, among others.[359]

Further, the tax environment plays a major role in determining the volume of inflow of foreign portfolio investment to emerging economies, such that the inflow of portfolio investments into any emerging capital market will largely be affected by the tax regime that affects the rates of return on financial assets.[360]

ix. Corporate Insolvency Rules

[355] See, E.L. Inanga, and C. Emenuga, 'Taxation of financial assets and capital market development in Nigeria' (1996), Research paper / African Economic Research Consortium; 47

[356] J. Khalilzadeh-Shirazi, and A. Shah. 'Introduction: Tax policy issues for the 1990s'. 5 (3) The World Bank Economic Review (1991) 459-471.

[357] C. Chamley, 'Taxation of financial assets in developing countries' 5(3) The World Bank Economic Review (1991) 513 - 533.

[358] H. Horch, and P.A. Popiel. 'Securities market development in Korea' (1989a) EDI Working Papers, The World Bank.

[359] H. Horch, and P.A. Popiel. 'Development of securities markets in Brazil' (1989b), EDI Working Papers. The World Bank.

[360] See, A. Shah and J. Slemrod. 'Do taxes matter for foreign direct investment?' 5(3) The World Bank Economic Review (1991) 473-49 1 and M. Dailami, and M. Atkin. 'Stock markets in developing countries: Key issues and research agenda' (1990). Pre-Working Paper Series. WPS 515, The World Bank.

Corporate insolvency rules may determine the attractiveness of a particular market to foreign companies. For instance multinational companies will be attracted to a pro-debtor insolvency regime and they will be wary to set up shop in a country where there are no terms for bargaining over creditor exit or refinancing of the distressed enterprise. There is therefore need for a balanced insolvency regime.

x. Competition Rules

According to North, the institutional framework that will give rise to economic change must promote competition among economic players because competition forces organisations to continually invest in skills and knowledge, hence the need for all well-functioning factor and product markets to provide incentives for the players to compete at the margins that induce growing productivity.[361] Competition rules that govern market competition, open trade, and free entry and exit of market players promote impersonal exchange because they increase the opportunity costs of sticking to relational networks.[362] The politics of open competition are particularly dangerous in Limited Access Orders, as competition that is open may threaten the economic basis of social and political stability.[363] Therefore this is an aspect of macro-infrastructure that needs careful implementation.

[361] *Ibid*. P. 85.
[362] Burt, R. S., Guilarte, M., Raider, H. J., & Yasuda, Y. (2002) 'Competition, contingency, and the external structure of markets' in New Institutionalism in Strategic Management. Advances in Strategic Management: A Research Annual, 19: 167-217.
[363] North *et al*, (2013) *supra* note 317.

xi. Enforcement Mechanisms

A rule will only have value if it can be enforced. Mechanisms ought to be put in place to enable parties to an exchange to enforce compliance at a transaction cost that will make them that the exchange is worthwhile to them.[364] It is observed that where there are high costs of measuring contract performance and no form of enforcement is possible, the gains from cheating and reneging exceed the gains from cooperative behaviour[365]. The process of perfect third-party enforcement involves a neutral party with the ability, at no or low cost, to be able to measure the attributes of a contract and, to enforce agreements, at low or no cost, such that the offending party always compensates the injured party so that violation of contract becomes costly.[366] According to North, the inability of societies to develop effective, low cost systems for the enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third Word.[367]

5.2.2 Micro Infrastructures

As stated above, the role of micro institutions is to ensure market transparency and investor protection.[368] According to Pardy[369], these institutions aim to provide four things:

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[364] D.North, (1990) *supra* note 202 P. 54.
[365] *Ibid*. 55
[366] *Ibid.* 58
[367] *Ibid.* 54
[368] Investors need assurance that what they are investing in is worthy their money and also that their investment will be safe.
[369] R. Pardy, 'Institutional Reform in Emerging Securities Markets' (1992) - Policy Research Working Papers (Financial Policy and Systems). The Wold Bank, WPS, 907 at p 4.

- Certainty as to property rights and contract. It is noted that clear rights to property and enforceable rights and obligations under contracts are crucial to the ability to trade and transfer title to securities, and enter into options and other agreements concerning securities.

- Transparency of trading and other procedures, and public disclosure by companies of all information relevant to the value of their securities. These are necessary for efficient price setting, and for confidence in the fairness of the market.

- Protection against unfair practices by intermediaries and insiders. This relies upon supervision by a supervisory authority and the imposition by it of penalties for wrong-doing rather than on scrutiny of transactions by investors themselves to protect their own interests.

- Protection against the financial failure of intermediaries and market institutions such as clearing houses. This will give investors confidence that they will not suffer financial loss from the failure of an intermediary and also provides a degree of financial stability to the market as a whole by helping to reduce bankruptcies or delays in the performance of contracts by intermediaries both of which have detrimental flow-on effects which may be system-wide.

Micro institutions are the detailed rules that govern the efficient operation of the capital market. In this work we will use the recommendations of Black[370] who provided a long list of what he called "the preconditions for capital market development" as a reference point to capital market micro institutions. We shall seek to show that Black correctly identifies the necessary institutions at micro level but that these institutions will only work effectively within a 'Northian' framework. These shall be discussed in detail in the next chapter.

5.3 INFORMAL INSTITUTIONS OF CAPITAL MARKETS

As stated above, informal institutions are traditions, customs, conventions, routine, codes of practice, moral values, religious beliefs, and all the other norms of behaviour that have spontaneously, survived the test of time and served to bind the generations.[371] Informal institutions are enforced by means of sanctions that include loss of reputation, ostracism by friends and neighbours, expulsion from community and sometimes more severe forms of punishment.[372] Informal institutions are often self-enforcing because actors find it beneficial to adhere to them as long as others are adhering them as well.[373] Adam Smith observed that economic development hinges on two important factors, namely (1) the secure existence and efficient operation of the basic institutions of production, exchange and accumulation: property, contractual relationships, markets, currencies and credit systems; and (2) the strength of social altitudes conducive to economic endeavour, especially the motivations of

[370] Bernard. S Black, 'The Legal and Institutional Preconditions For Strong Securities Markets' (2000-2001) 48 *UCLA Law Review* 78.
[371] S. Perjovich, (2008) *supra* note 277.
[372] *Ibid.*
[373] G.E. Skoog, "Supporting the Development of Institutions – Formal and Informal Rules: An Evaluation Theme Basic Concept", 2005, SIDA, UTV Working Paper 3 P. 21

the people to better their condition through labour, savings and productive investment[374]. The second factor is a proxy for informal institutions for economic development.

Informal rules are usually the silent determinants of choices of economic entrepreneurs as they normally affect their mental processes in decision making. Skoog[375] has succinctly put it as follows:

> "When confronted with a new problem and facing uncertainty about how to handle it, an actor is likely to rely on past experience and 'thinking' (subjective perceptions – ideas as well as values) to interpret the situation and experiment with behaviour to deal with the problem. The way she goes about this will thus be influenced by the legacy of her past and the present institutional and ideological context in which she finds herself. By making trials, eliminating errors and repeating successful behaviour as the problem recurs, the actor will gradually learn how to handle it. Over time she will develop a behavioural rule that offers a solution to the recurrent problem. When her behaviour has been repeated sufficiently often to display regularity, it becomes exactly what others will expect from her in similar situations. This is now a social rule for interaction – an institution".

The foregoing explains why informal institutions are crucial to the process of economic change. It is thus said that since informal rules differ from one country to another, people's reactions to the same set of formal institutions and policies lead to different and

[374] See L. Bellet (1975), *supra* note 326 at p.432.
[375] *Ibid.* p. 28.

unintended results.[376] The following are some of the informal institutions, in the form of behavioural traits that are relevant to capital market development:

i. *Honesty, integrity and living up to a reputation pay off in strictly wealth maximising terms.*

The above behavioural traits are very crucial to market exchange. Corporate managers will need to have sufficient level of honesty and integrity and fear for their reputation in order to release true company information to investors and refrain from market abuse practices such as falsification of company records and other pieces of vital information as well as insider trading. Similarly, market regulators will need to personally internalise and encourage the internalisation a culture of honesty and integrity through codes of ethics in order to effectively root out market malpractices and other abuses. North observes that the success story of the evolution of constitutional forms in England in the seventeenth century was a product of both respect for the law and the honesty and integrity of the judges.[377]

ii. *Norms of cooperative behaviour*

Corporative behaviour of economic agents facilitates complex exchanges and reduces cost of measurement and enforcement of exchange. It is observed that in the absence of such behaviour, asymmetric information and the consequent distribution of the gains will lead to devoting excessive resources to measurements or may lead to exchange not taking place at

[376] S. Perjovich, (2008) *supra* note 288 at p. 167.
[377] D. North, (1990) *supra* note 202 at p. 60.

all because the exchange is unenforceable.[378] According to North, the growth of more complex forms of exchange in later medieval and early modern Europe was made possible by a variety of organisations and instruments that make norms of cooperative behaviour effective such as the early law of merchant's published codes of merchant conduct.[379] Thus self-enforcing codes of conduct for market players like accountants, auditors, lawyers and brokers may facilitate corporation as well act as a means to generate and enforce standards of honesty and service.

iii. Democratic culture

It is said that the level of decentralisation in rule making and the extent to which voluntary groups bargain with the powers that be will determine the effectiveness of formal rules.[380] The greater the level of decentralisation, the greater the probability that the formal rules that are aimed at improving the incentive structure to create wealth will encounter less friction in their interaction with informal rules.[381] Further, where potentially affected parties are able to interact with the decision makers and wield some power to wring concessions, the probability that formal rules will last and realise their wealth creating potential will be greatly strengthened.[382] This means that in economies where there is generally a culture of imposed or autocratic rule making, formal rules will not be as effective as they would be in

[378] *Ibid*, p. 41.
[379] *Ibid.* p. 41.
[380] J. Winiecki, 'Formal Rules, Informal Rules and Economic Performance: An Organising Framework', 51 (2) Acta Oeconomica, (2000/2001) 147-172 at p. 158.
[381] *Ibid*. p. 158
[382] *Ibid*. Winiecki gives the example of Imperial China where wealth creation enhancing measures introduced by *fiat* of an emperor failed to generate desired lasting economic effects.

decentralised or democratic regimes. This entails that a "bottom-up" approach is more likely to succeed than a "top-bottom" approach when it comes to changing people's behaviour.

iv. Corruption level

Corruption is an institutional phenomenon, informal in character and may be influenced by incentives shaped by other formal and informal political, economic and socio-cultural rules, as well as by such factors as resource availability[383]. Corruption is sometimes said to be informal rules' response to the perceived unfairness and/or ineffectiveness of formal rules and that 'once it takes deeper roots, new formal rules tend to get weakened or distorted as transaction costs tend to increase or decrease by much less than expected from the original restructuring of the property rights enhancing the creation of wealth.'[384]

As noted above, it is important to address the problem of corruption at the macro-institutional level through effective anti-corruption rules. However, it is also important to deal with corruption, in its informal nature as a behavioural trait, at micro-institutional level. It is at the level of individual and group beliefs and values that corruption infests social and economic systems. It is therefore at the micro-institutional level that anti-corruption efforts should be effective. Thus addressing corruption as a belief system, that is, an informal institution is key to economic development.

v. Belief system of the society

[383] G.E. Skoog, *Supra,* note 373 at p. 14
[384] J. Winiecki, *Supra* note 380.

According to North,[385] religious beliefs that people hold may be of the kind that gives preferences to solutions characterised by low adaptive efficiency, piling up one error upon another. It is also said that there are systematic differences between ethnic and other groups, in their ability and willingness to better their living conditions, and that these differences stem largely from divergent philosophies, world views, religious or ideological beliefs etc.[386] The effect of belief system on economic development depends on where it can be placed on the Individualistic/collectivist continuum[387]. This will be explained as we look at the next proxy of informal institutions.

vi. Culture of Individualism and Classical Liberalism

It is said that the two cornerstones of capitalism are classical liberalism and methodological individualism.[388] According to Perjovich, individualism means that human action is the result of emotions, desires, preferences and evaluations that only the individual can develop and appreciate.[389] Perjovich goes on to posit that:

> "The culture of individualism rewards competitive performance, promotes risk taking and views income inequalities as desirable results of entrepreneurship and free trade. It sees

[385] North (1990), *supra* note 202.
[386] T. Sowell, *Race and Culture: A World View*. (New York: Basic Books, 1996) cited by Winiecki, *supra*, note 369 at p.163.
[387] J. Winiecki, *Supra* note 380 at p. 163.
[388] S. Perjovich (2008) *supra* note 277 at 26. Perjovich refers to these two concepts collectively as "the culture of capitalism".
[389] *Ibid* p.26 .

the community as a voluntary association of individuals who, in the pursuit of their private ends join and leave the community by free choice."

Classical liberalism on the other hand is about individual liberty, openness to new ideas, tolerance of all views, private property rights, rule of law and the freedom of contracts. Classical liberalism is said to create an environment in which individuals are free to pursue their private ends and a society where individuals are expected to tolerate one another's preferences and not attempt to impose their own preferences upon others, while the state is expected to protect those preferences from any external interference including from the state itself.[390]

vii. Informal political institutions and power relationships

These present another set of informal institutions that affect the economic development trajectory in an economy. While many countries, especially in developing economies, have adopted the concept of democratic governance, the affairs of such countries are predominantly governed by different unwritten rules and power relationships that are not codified in their democratic constitutions. Thus most developing countries have a Limited Access Order governance structure[391].

[390] *Ibid*, p. 27.
[391] North *et al* (2013) *supra* note 317.

There are two interrelated ideologies upon which these informal political rules are founded and shaped. The first one is neo-patrimonialism, which refers to the vertical distribution of resources that gave rise to patron-client networks based around a powerful individual or party[392]. In a neo patrimonial state, "real power and real decision-making lie outside formal institutions. Instead, decisions about resources are made by 'big men' and their cronies, who are linked by 'informal' (private and personal, patronage and clientelist) networks that exist outside the state structure, and who follow a logic of personal and particularist interest rather than national betterment"[393].

The second ideology is clientlism, which refers to the "forms of protective relationship of mutual benefit between a person or persons occupying a higher place in a social hierarchy (patron) and a following concerned with protection and the acquisition of certain advantages (clients)."[394]

The informal networks that will result from the above may resist institutional changes that undermine their investment in the existing institutional arrangements. The challenge is therefore to incentivise such organisations and the elite interests they represent to allow or support changes from the inherently personal markets they control to impersonal markets.

[392] Ana Huertas Francisco, 'Neopatrimonialism in Contemporary African Politics' (2010) E-International Relations Students found at http://www.e-ir.info/2010/01/24/to-what-extent-can-neopatrimonialism-be-considered-significant-in-contemporary-african-politics/. Last checked on 08/07/2014.
[393] Diana Cammack, 'The Logic of African Neo Patrimonialism: What Role for Donors?',(2007) 25 (5) Development Policy Review 599-614 at p. 600.
[394] Manfred G. Schmidt 'The Parties-Do-Matter Hypothesis and the Case of the Federal Republic of Germany' (1995) 4(3) German Politics.

viii. Impersonal exchange

According to Adam Smith, two key components in the wealth creation process of human societies are, exchange and specialisation.[395] There are however different forms of exchange that manifest in different societies depending on the level of development of a particular society. The first kind of exchange that has characterised most of economic history has been personalised exchange involving small-scale production and local trade.[396] Personal exchange is characterised by repeat dealing, cultural homogeneity (common set of values) and a lack of third party enforcement. It is a form of corporation that depends on explicit trust[397] and the kind of informal norms that tend to evolve from strong reciprocity relationship.[398] In societies that rely on personal exchange, transaction costs are low but because there is little, if any, specialisation and division of labour, transformational costs are high.[399]

The second pattern of exchange that has evolved due to the need for more complex transactions is the impersonal exchange. The shift from the known (personal) to the unknown (impersonal) generated difficult problems of trust. Historically, these trust problems were resolved by using available social resources "in which parties are constrained by kinship ties, bonding, exchanging hostages, or merchant codes of

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[395] E. Kimbrough, V. L. Smith and B.J. Wilson, 'Building a Market: From Personal to Impersonal Exchange' in Paul J. Zak, (ed), *Moral Markets: The Critical Role Of Values In The Economy* (Princeton University Press, 2007). Also found at. *http://econfaculty.gmu.edu/pboettke/workshop/archives/spring07/KimbroughSmithWilson2006-2006.pdf*. Last accessed on 08/07/2014.
[396] D. North, (1990), *Supra* note 191 at p.34.
[397] E. Kimbrough et al., *Supra* note 395 at p. 1
[398] D. North (2005), *supra* note 8 at p117.
[399] *Ibid.*

conduct."[400] The establishment of impersonal exchange permits a widening of the market and the realisation of the gains from more complex production and exchange, extending beyond the bounds of a small geographic entity.[401]

However, the most ideal form of exchange is impersonal exchange with third party enforcement. This is the form of exchange where cooperation by individuals does not depend on repeat dealings or past knowledge of the other part to the transaction. The cooperation and trust among individuals that initiates and sustains impersonal market exchange is implicit and not readily observable.[402] Impersonal market exchange requires the development of economic and political institutions that alter the pay-offs in exchange to reward cooperative behaviour.[403] Impersonal market exchange is said to be the critical underpinning of successful modern economies involved in the complex contracting necessary for modern economic growth.[404]

5.4 FORMAL AND INFORMAL CONSTRAINTS LIKELY TO AFFECT CAPITAL MARKET DEVELOPMENT IN SADC COUNTRIES.

[400] *Ibid*. p. 35 According to North, the early development of long-distance and cross-cultural trade and the fairs of medieval Europe were built on such institutional constructs.
[401] *Ibid*.
[402] E. Kimbrough *et al., Supra* note 395 at p. 1
[403] D. North, (2005) *Supra* note 8 p. 118.

[404] D. North (1990), *Supra* note 202 at p. 35. For instance it is said that the introduction of modern stock companies in Europe was a response to the risk and reward structure of European efforts to exploit trading opportunities with non-European world. Pouncy (2002) *supra* note 26.

SADC countries seeking to establish and develop capital markets face a multiplicity of formal and informal constraints that make such a task daunting, and are likely to set the process of developing capital markets in these economies in a path dependent trajectory. These include the following.

i. Political Instability

Many SADC countries that are in the process of establishing capital markets share a history of civil wars and dictatorships. Further as discussed above, the governance of these countries is founded on informal political rules and power relationships that are usually contrary to democratic values and principles. It has been observed that a number of sub-Saharan African countries display the outward signs of modern, democratic states and are often treated as though power and decision-making reside within government institutions and that they function as designed when this is not usually the case.[405]

Political stability is a crucial part of the process of economic development because investors will be less attracted to invest in a country where the state where governments change by the bullet and not by the ballot."[406] Political instability may result either in lack of clear state control or too much state control.[407] In countries where there is no clear state control, markets will be unregulated and corruption is unchecked. On the other hand, in a country where the government exerts too much control of the market, inefficiency may result. It is

[405] D. Cammack, (2007) *supra* note 382 at p. 351
[406] J. Gottlieb, 'Launching the Phnom Penh Stock Exchange: Toward A Legal framework for Launching Stock Exchange in an Underdeveloped Country', *supra* note 319.
[407] *Ibid*. pp 253 and 254.

said that state attempts to control the direction of the market are counterproductive, since they distort information even further, creating artificial bubbles that will inevitably burst.[408]

The problem is that most, if not all, SADC countries are Limited Access Orders (LAOs) and they have not yet made the transition to Open Access Orders (OAOs)[409]. The challenge is to develop institutions and organisations that can facilitate the transition, rather than facilitate regression to a more violence prone type of LAO.

ii. Lack of Initial Capital

By definition a developing country has low GDP and as such the bulk of its population will not have the financial wherewithal to participate in the capital market. Most SADC countries are characterised by deep rural poverty and very limited sources of capital. As observed by De Soto[410], most of the capital in developing countries is locked up in informal property that cannot be turned into capital or used as collateral to secure a loan from Banks. This scarcity of capital has significant implications to the development of capital markets as it would be extremely difficult to sustain a capitalist market where capital itself is not available or is

[408] *Ibid* p. 254. However, state control by way of protectionism is sometimes necessary and beneficial especially during the early stages of an economy.
[409] Brian Levy, 'Seeking the Elusive Developmental Knife Edge: Zambia and Mozambique-A Tale of Two Countries' in North et al (2013) *supra* note 306 at 112-148.
[410] De Soto, *supra* note 332.

extremely in short supply[411]. Broadening market participation by economically empowering the population, therefore, should become a policy priority for authorities in SADC countries.[412]

iii. Lack of Investment Opportunities

Coupled with lack of initial capital is lack of opportunities for the population to invest. Many developing economies are characterised by narrow corporate base. The majority of businesses in developing countries are not formally registered and therefore have no potential of being listed on a stock exchange. With the exception of countries with natural resources, many developing countries have very few industries that would seek high volumes of capital injection. Consequently many developing capital markets have relied on privatised national companies[413] as their initial candidates and many markets have been unable to attract privately-owned companies. The limited availability of companies to list on the capital market[414] result in thin market capitalisation, which is an important metric of capital market growth.

iv. Socio-Cultural Barriers

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[411] J. Gottlieb, *Supra*, note 319 at p. 258.

[412] An example of such policies is the lottery scheme adopted by the Shanghai Exchange where initial shares and options were given out by lottery. See, E. Hertz, *The Trading Crowd: An Ethnography of Shanghai Stock Market* (Cambridge University Press, 1988) 51-52.

[413] See: Kenneth Kaoma Mwenda, *Zambia's Stock Exchange and Privatisation Programme: Corporate Finance Law in Emerging Markets*. Studies in African Economic and Social Development. Lewiston, NY: Edwin Mellen Press, 2001.

[414] For example both the Malawi Stock exchange and Tanzania Stock Exchange had to wait for more than a year after being established before the first company was listed for trading. See, Malawi Stock Exchange website at http://www.mse.co.mw and , Interview by Dr. Fratern M. Mboya, Chief Executive Officer of the Tanzania Capital Markets and Securities Authority (CMSA), 24 APRIL 2006, http://www.tanzaniainvest.com/tanzania-banking-and-finance/interviews/37-interviews/52-capital-markets-and-securities-authority-interview, respectively.

Another challenge facing policy makers in developing countries is culture-oriented altitudes of both entrepreneurs and investors towards the capitalist concept of stock markets. In most developing countries the idea of capitalism is alien and sometimes runs counter to the cultural values of society.[415] One of the effects of strong cultural ties is lack of impersonal exchange as discussed above. According to North, the move from personal exchange[416] to impersonal exchange is critical to achieving economic growth.

Further, many traditional societies believe in family wealth and as such entrepreneurs are sceptical about the idea of giving away their stake in their family enterprises to the public through capital markets. Even those who are convinced of the positives of capital market trading will still be wary of giving away their majority stake to the market. Consequently, the few companies that will be prepared to trade their shares on the market will not have dispersed ownership thereby adversely affecting the liquidity of the market.

Another facet of cultural barriers to capital market development in developing countries is the anti-colonialist sentiment that still manifests itself whenever a foreign concept is being introduced. This problem would be exacerbated with respect to capital markets given that, as discussed above, a large sector of society is usually shut out of the market, which leads to the perception that the capital market idea is a neo-colonial gimmick aimed at exploiting the national resources by foreigners.[417]

[415] These may include some religious beliefs that put social development above material production.
[416] Personal exchange relies on reciprocity, repeat dealings and some informal norms that tend to evolve from strong reciprocity relationships. D. North (2005) *supra* note 8 at p. 117.
[417] See, J. Gottlieb, *Supra* note 330 p. 258.

v. Lack of Specialised knowledge

Given the exotic nature of the idea of capital markets in developing countries, the process of installing the markets is likely to be affected by lack of specialised knowledge to operate the markets effectively and efficiently. Apart from understanding the role of capital markets to economic growth, operators of the markets need more education not only in stock exchange trading but also market based pricing[418]. Unfortunately, in most developing countries the capital markets have been installed without properly trained and skilled market practitioners. Gottlieb observes that:

> "Capitalism, and its attendant features that most investors in developed nations take for granted, is not a natural state of being - it seems entirely artificial that two friends cannot discuss business simply because one is a regulator and one is a businessman."[419]

Without specialised knowledge of the operation of the market, the pace of development of these markets will remain slow and the expected benefits of capital markets will not be realised. Effective and efficient operation of capital markets requires specifically trained practitioners including regulators, brokers, lawyers, judges, accountants as well

[418] See, M. Ashwin, 'Capitalism in Transition: The Role of International Law' (1995) 89 AM. SOC'Y INT'L. PROC. 103, 112. Ashwin tells a story is told of a group of Russians who visited the New York Stock Exchange in order to learn how they could develop a stock exchange in Russia. After visiting the trading floor and being given trading floor activities, one of the members of the group asked a question; In the morning when the opening bell rings, how do you decide what price you are going to start the stocks out at?.
[419] J. Gottlieb, *supra* note 330 at p. 256.

as auditors. However, such skilled professionals are still in short supply in developing countries[420].

vi. Poor Financial Reporting and Limited Access to Information

It was observed by Barry Lockwood that:

"In many developing nations, security markets are either lacking entirely or are poorly developed. Further, financial reporting may be unreliable and access to information highly limited."[421]

Poor financial reporting may stem from absence of cultural traits associated with honesty and integrity. Ledeneva[422] cites false reporting and document falsification as examples of practices that emanate from Russian unwritten rules that are practically observed within Russian economy.[423]

As discussed above, symmetric information flow is one of the key preconditions for strong capital markets. In developing countries, the problem of information asymmetry is more acute and accentuated. There are a number of factors that contribute to this problem. Firstly, most developing countries lag significantly behind in terms of technological advances that are in use in developed countries. As such developing countries have no means or skill

[420] See: Stuart R. Cohn, 'Teaching in a Developing Country: Mistakes Made and Lessons Learned in Uganda, 48 J. Legal Educ. (1998) 101 at p.104.
[421] C.B. Barry and L.J. Lockwood, *New Directions in Research on Emerging Capital Markets, Financial Markets, Institutions and Instruments*, Vol. 4, No. 5, (Oxford: Blackwell Publishers, 1995), p.17.
[422] A. Ledeneva, *Unwritten Rules: How Russia Really Works*, (Centre for European Reform, 2001).
[423] *Ibid.,* p.17.

to disseminate information to the members of the public most of whom are based in rural areas.

Secondly, in some countries government controls information to be released by the market to investors such that the information disseminated will at best be selective and at worst doctored in order to mask the real state of the market.[424] Thirdly, most companies in developing countries, especially those previously owned by the state, are still controlled by powerful political elites and often flout disclosure requirements with impunity. Finally, lack of information may be due to inadequate regulation of market participants.

vii. Lack of Infrastructure

As stated above, most developing countries lack appropriate systems to effectively operate the capital market. Gottlieb explain this problem as follows:

> "Many developing countries suffer from a basic lack of infrastructure that makes more advanced trading options moot. This problem goes beyond simple poverty as an obstacle to investment. If a stock exchange has no way to communicate its prices, trading is rather difficult anywhere beyond the floor of the exchange. This situation disadvantages both foreigners and those living away from the market usually the poor rural population."[425]

[424] A good example is Zimbabwe where, at the peak of the country's economic woes, state authorities controlled and manipulated economic data to create a semblance of economic sanity.
[425] J. Gottlieb, *supra* note 330 at p. 262.

There is a whole range of basic infrastructure, lack of which may contribute to inefficient market operation including facilities for telecommunications, roads, sewage, water, and electricity.

viii. Corruption

Corruption is rampant in many developing countries[426]. As already discussed above, corruption adversely affects the development of capital markets because it scares off potential investors. Basically, corruption blurs transparency, hides information, and affects the dispute resolution process in a way that undermines investors' trust.[427] In other words corruption corrodes any system put in place to promote development of capital markets.

ix. High rate of illiteracy

The majority of the population in developing countries is illiterate or semi-illiterate. However, learning basic skills to trade on the capital market will require a certain level of literacy and as such it is likely that the majority of the population will be automatically excluded from market activities. This will reduce the number of potential investors and in turn reduce liquidity of the market.

x. Insufficient Enforcement of Rules

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[426] See: Dambisa Moyo, Dead Aid*: Why Aid is not Working and How There is a Better Way for Africa*, (New York: Farar, Straus, and Giroux, 2009) at pp. 56-57.
[427] Ashwin, *Supra*, note 418 at p. 110.

Developing economies usually lack credible mechanisms to enforce compliance of the rules with the consequence that most formal rules only exist on paper but not in practice. North describes the problem as follows:

> "In developed countries, effective judicial systems include well-specified bodies of law and agents such as lawyers, arbitrators, and mediators, and one has some confidence that the merits of a case rather than private payoffs will influence outcome. In contrast, enforcement in Third World economies is uncertain not only because of ambiguity of legal doctrine, but because of uncertainty with respect to behaviour of the agents[428]."

5.5 CONCLUSION

The discussion in this chapter shows that there are specific formal and informal institutions that need to be in place in order to establish efficient and effective capital markets. However, authorities and policy makers in developing economies face a challenge in their attempt to achieve rapid and sustained capital market growth due to a number of formal and informal institutions that are in conflict with existence of developed capital markets.

The implication of the above is that simply adopting the formal rules for regulating capital markets in developed countries will not provide the required solutions. The specific challenges outlined above will need to be tackled in parallel with the process of reforming the regulatory framework for emerging capital markets.

[428] D. North, (1990) *supra* note 202 at P. 59.

6. CHAPTER SIX: NORTH'S MODEL AND BLACK'S PRECONDITIONS FOR STRONG CAPITAL MARKETS

6.1 BUILDING CAPITAL MARKETS: A PRACTICAL PERSPECTIVE

Using his practical experience in company and securities law reform in a number of developing economies, Professor Bernard Black[429] provides a comprehensive analysis of legal and institutional preconditions for establishing strong capital markets. Black has posited that in order for a country to have strong public securities markets, its laws and related institutions must give minority shareholders good information about the value of a company's business and confidence that the companies' insiders[430] will not "cheat investors out of most or all of the value of their investment through self-dealing transactions or even outright theft."[431] This calls for a complex web of market-supporting laws and institutions to deal with market information asymmetry, insider dealing and other forms of market abuse. It is important to mention at the outset that Black's analysis is based on the neo-classical economic model of "rational choice".

Black is useful because his work is focussed on capital markets as a subject matter and at the establishment of capital markets at a National level. Thus, he is more particular than North in two distinct dimensions. He is interested in a single aspect of development rather than development overall. He is interested in specific jurisdictions rather than in factors common across all jurisdictions.

In the context of the methodology of this research, Black provides a practical confirmation of North's Propositions. His recommended institutional structures for capital market

[429] Bernard S. Black, 'The Legal and Institutional Preconditions For Strong Securities Markets' (2000-2001) *supra* note 370. Black has been involved in legal reform work in Armenia, Indonesia, Mongolia, Russia, South Korea, Ukraine and Vietnam.
[430] These include company managers and controlling shareholders.
[431] B.S Black, *Supra* note 370 at p. 783.

development, by and large, do align, as we will show in this chapter, with North's framework for development. In other words, Black reduces North's high level and mostly abstract thesis into some palatable and practical framework which can be adopted by policy makers in designing and implementing capital market reforms within North's framework.

It is for this reason we set out in this chapter to explore the theoretical complementarities between Black's pre-conditions for strong capital markets and North's framework for economic development.

6.2 THE STRUCTURAL CHALLENGE TO SUCCESSFUL CAPITAL MARKETS

According to Black, the connection between strong investor protection along these two dimensions and strong securities markets creates the potential for two separating equilibria to exist, namely, the "lemons" equilibrium and the "strong markets" equilibrium.[432] Under the "lemons" [433] equilibrium, that is, a market where some companies do not disclose full information and are involved in self-dealing, investors will discount the prices they offer for shares of all companies. This will adversely affect those issuers who are honest and are making full and frank disclosures as they do not receive fair value for their shares.[434] Discounted share prices will eventually result in companies resorting to other means of corporate finance or issuing shares in foreign capital markets.[435] On the other hand, in "strong market" equilibrium, investor protection produces prices that make it attractive for

[432] *Ibid*. page 784.
[433] This example originated from G. Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism,' (1970) 84 Quarterly Journal of Economics 488-499. Akerlof used an example of a market for used cars.
[434] This Phenomenon is referred to as "Adverse Selection". See Akerlof, *Ibid*.
[435] B.S Black, (2001) *supra* note 370 page 784

honest companies to issue shares, which increases the average quality of the shares that are issued, which further increases share prices and encourages more honest issuers.[436] The aim of policy makers who wish to facilitate capital market growth therefore should be to achieve the "strong markets" equilibrium.

The concept of information asymmetry in capital markets can be related to North's concept of uncertainty, which he says is one of the key vices that societies aim to fight through learning and repetitive transacting. According to North, the level of uncertainty that exist in a particular society determines the level of that society's development. The more economic actors invest in learning and engage in repetitive transaction, the less uncertainty exists and the more developed the society become.

Thus the structure of the problems caused by asymmetries of information is understood by both neo-classic theorists like Black and NIE theorists like North in the same way. However, NIE theory tends to draw attention to the mediation of feedback through institutional or organisational or individual belief systems. If the market has "lemon" in it this may or may not be realised by participants. Once realised it may cause participants to form several beliefs, including that such markets are by their nature crooked. If reforms take place that limit or remove "lemons" then the effectiveness of the reforms will be determined both by whether the reforms do actually remove the lemons and by how the participants understand the effects of the reforms. For neo-classical theory the removal of lemons will be effective to alter market behaviour and learning effects can be ignored.[437]

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[436] *Ibid.*
[437] J Knight and DC North, 'Explaining economic change: the interplay between cognition and institutions' (1997) 3 Legal Theory 211

Also while neo-classic theorists proceed on zero-transaction costs assumption, NIE theorists account for effects of transaction costs. As such for Black, the existence of his suggested preconditions should suffice to bring about strong capital markets. On the other hand, NIE theorists believe that mere existence of this precondition is not enough as in some instances high transaction cost may prevent some actors from, for instance, accessing the information.

It is within this 'NIE nuance' that we intend to analyse Black's preconditions for strong capital market.

Black describes the information asymmetry problem as follows:

> "A critical barrier that stands between issuers of common shares and public investors is asymmetric information. The value of a company's shares depends on the company's future prospects. The company's past performance is important as a (partial) guide to future prospects. The company's insiders know about both past performance and future prospects, but investors don't know this information and can't easily find out. They need to deliver this information to investors so that investors can value the company's shares".[438]

Black observes that it is not easy for issuers to deliver credible information as insiders have an incentive to exaggerate the issuer's past performance and future prospects and investors

[438] B.S Black, (2001) *supra* note 370, p. 786.

can't directly verify the information that the issuer provides.[439] Consequently, as investors are unable to know which companies are truthful and which aren't, they discount the prices they will offer for the shares of all companies in order to receive a fair price, on average.[440] As discussed above however, discounted prices will discourage an honest issuer as they will not receive a fair price.

With respect to self-dealing, Black singles out two categories of self-dealing as major obstacles to strong capital markets.[441] These are:

(i) "direct self-dealing, where a company engages in transactions, not on arms-length terms, that enrich the insiders themselves, their relatives or friends, or a second company that they own a larger percentage of; and

(ii) indirect self-dealing or insider trading, where insiders use information about the company with less-informed investors."[442]

The prevalence of insider self-dealing, direct or indirect, like the problem of information asymmetry, gives rise to a "lemons market" in that investors don't know which insiders are honest, and 'which will appropriate most of the company's value, so they discount the prices they will offer for the shares of all companies'.[443]

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[439] *Ibid*
[440] *Ibid*
[441] *Ibid*, p. 804.
[442] *Ibid.*
[443] *ibid*

Black has observed that the problem of insider self-dealing is harder to solve than the problem of information asymmetry. First, honest disclosure of information during a public offering of shares can't be undone once the offering is completed. In contrast, once a company has sold shares, the company's insiders can always renege on a promise not to self-deal.[444] Second, false or misleading disclosure in a public offering often occurs in a formal disclosure document, and thus leaves a paper trail. If subsequent events reveal the business problems that the company tried to conceal, the deficiencies in the original disclosure will often be obvious enough to make it straightforward for regulators or investors to seek sanctions or damages against the offending insiders and, if appropriate, their accountants, bankers, and lawyers. In contrast, insider self-dealing is often hidden. It must be uncovered before it can be policed.[445] Third, a securities offering is a discrete event that lets investors insist on participation by reputational intermediaries[446] while self-dealing lack a similar triggering event.[447]

Fourth, once a company has issued shares at a discounted price, in a market characterized by information asymmetry, insider self-dealing, and resulting in a lemons problem, the insiders may feel *entitled* to appropriate most of the company's value for themselves and they will fiercely resist any change in legal rules that limits this opportunity. They will therefore fight against any legal and institutional reforms that might prevent them from

[444] *Ibid*, 805
[445] *Ibid*, 805
[446] Reputational intermediaries are discussed in detail at 3.3 below.
[447] Black notes that while accountants' annual audit is an important check on self –dealing, and securities lawyers can play a role if they prepare the company's public disclosure filings, investment bankers recede into the background. See, *Ibid* p 806

taking what they see as their fair share of the company's value.[448] This possibility is of particular concern if the enforcement of the securities regulation might threaten the rents of elites that are vital for the stability of LAO. It is desirable to encourage elites into formal organisation and exploitation of their economic assets, but care must be taken in how protection of "minority" shareholder rights is extended. The value of their investment to the relevant elites must be seen *by those elites* to outweigh the restrictions on freedom of action by those elites.

In his analysis, Professor Black has listed a number of core institutions that would counter information asymmetry and minimise insider self-dealing. These core institutions are classified into five broad themes as follows:

i. Local Enforcement (Effective Regulators, prosecutors and Courts)
ii. Disclosure of Information
iii. Reputational Intermediaries
iv. Insider Trading liability
v. Market Transparency

The aim of this section is to examine Black's recommended institutional preconditions for strong capital markets in light of North's model for economic development. As stated in Chapter 4 above, North distinguishes institutions from organisations, institutions being considered as rules of the game and organisations regarded as players in the game manifesting in the form of groups of individuals bound by a common purpose to achieve objectives. Institutions may be formal or informal rules that a particular society comply with

[448] *Ibid*, 806

in the running of its affairs. While formal rules can be changed by fiat and therefore at any time, informal rules can only change overtime.

In the context of North's framework therefore, Blacks preconditions for strong capital markets will fall into formal or informal institutions and organisations that are vital for the establishment of a strong capital market. It should be noted that it is possible for a single institution to have formal and informal institutional aspects as well as organisational aspects. For instance, a single organisation, say a Central Bank, will have both formal and informal aspects with regards to its governing rules and the prevailing custom and/or belief system of the individuals who operate the bank. At the same time, the Central Bank is an organisation being a group of individuals bound by a common purpose to achieve its objectives. Specific identification of organisation is important as organisations, according to North, are key agents of change through competition and investment in knowledge and skills of its staff, which result in changes of both formal and informal rules[449].

Also the distinction between formal and informal institutions is vital to our understanding of Black's preconditions of strong capital markets and such analysis would help to inform policy makers on which institutions on Black's list can be achieved in the short term through statutory intervention and those institutions that can only be achieved over a long period of time and can therefore not be transplanted from outside.

In light of the above, we will analyse Black's preconditions for strong capital markets by identifying the formal and informal elements as well as organisational aspects of the

[449] North (2005) *supra* note 8 at pp. 60-61

preconditions. The purpose for such classification is to identify those core institutions that can be easily changed by way of formal rules and those that are informal in nature and may only change over time.

6.3 LOCAL ENFORCEMENT (EFFECTIVE REGULATORS, PROSECUTORS AND COURTS)

The effectiveness of any rule is dependent on the strength of the existing enforcement mechanism. As such the first set of preconditions for strong capital markets are institutions and organisations that provide an enforcement mechanism for the rules. These include effective regulators, prosecutors and the judicial system. Examination of this set of preconditions through the lens of North's framework reveals that these preconditions exhibit both formal and informal institutions as well as organisations.

6.3.1 A Securities Regulator or Prosecutor

The first enforcement agency is a securities regulator or prosecutor. A securities regulator is one of those preconditions that exist as an organisation and also has formal and informal institutional elements. It is an organisation in that most securities regulators will exist as government agencies established through statute and most market prosecutors are part of a Justice Department or equivalent and therefore part of the government establishment. The purpose of a securities regulator or prosecutor is to detect and deter breaches of market rules. The regulator is responsible for setting up standard practices for market players and this may include licensing market participants and enforcing compliance with market rules or practices. Prosecutors deal with cases involving criminal liability.

However, merely legislating a securities regulator or prosecutor into existence is not sufficient. According to Black, the securities regulator or prosecutor must be honest and must have the staff, the skill and budget to pursue complex securities cases involving false or misleading disclosure and to untangle complex self-dealing transactions.[450] This is an informal element of this precondition. The effectiveness of a regulator or prosecutor will therefore depend on the formal rules that govern its operations as well as informal rules that impact on its institutional practice. The powers of investigation, negotiation discretion, prosecutorial discretion, and where relevant, discretion over sanctions, are both formal and informal in practice. The independence of the regulator or prosecutor is formal notionally, but will only be real if the political culture respects it. The effective working professional code is primarily informal, but can be supported through such formal devices as codes of practice.

Further, an honest, well-staffed, skilled and decently funded regulator cannot be brought about through legislation. These virtues are a product of the deep seated belief systems of government officials and individual staff that work for the regulator and the prosecutor. They are therefore informal in nature. Further, corrupt government officials may also deliberately underfund the regulator so that their staffs is amenable to fraud and to frustrate skilled and honest staff away.[451] This will create more incentives for officials to remain more corrupt as it will create a payoff of sorts.

[450] *Ibid*. pp. 790 & 807.
[451] *Ibid*. p.790.

Lack of skilled and motivated staff is one of the major problems for regulators and prosecutors in developing economies. For example, it is noted that "insiders often use transactional complexity and multiple intermediaries to hide their interest in a transaction, and anonymous offshore accounts to hide insider trading".[452] Therefore proving a self-dealing case will require developing a chain of circumstantial evidence and digging through the company's records to show how insiders have twisted the truth. This task will always befuddle ordinary prosecutors, or at least lead them to seek out easier cases.[453] This also shows that lack of sufficient skill will create an incentive structure for prosecutors to pick and choose market abuse cases they would tackle. Building an honest and skilful team of regulators or prosecutors therefore cannot be done overnight. However with a robust and clear set of governance rules this can be achieved after a reasonable period of time.

6.3.2 Judicial system

The Judiciary, like the securities regulator, is an organisation in so far as it is part of the government establishment and a product of legislation but has also formal and informal rules which determine its institutional practice. Courts are crucial to resolving securities cases involving both civil and criminal liability. The judicial system of developing countries has often been the focus of "rule of law" reforms, and has proven no more tractable than other aspects of state institutions.[454] According to Black, in order to build a strong securities

[452] *Ibid*. P. 807
[453] *Ibid*. p. 790
[454] DM Trubek and M Galanter, 'Scholars in self-estrangement: some reflections on the crisis in law and developmental studies in the United Sates' (1974) *Wisconsin Law Review* 1062; TA Kelly, 'Exporting western law to the developing world: the troubling case of Niger' (2007) 39 George *Washington International Law Review* 321; one problem faced by the post-genocide regime in Rwanda was the mass complicity of the judiciary in the genocide, see: Jean Hatzfeld, The Strategy of Antelopes: Rwanda after the genocide (London, Serpents Tail, 2009)

market, there is need for "a judicial system that is (a) honest; (b) sophisticated enough to handle complex securities cases and self-dealing transactions involving multiple intermediaries; (c) can intervene quickly when needed to prevent asset stripping; and (d) can produce decisions without intolerable time frame (and with appropriate adjustments for the time value of money)".[455]

Like securities regulators or prosecutors, the judicial system fits both sides of the formal/informal coin. While the rules that govern the operations of the judiciary are formal in nature, the existence of an honest, sophisticated and efficient judiciary will require a cultural transformation of the society in question. Every modern society has a judicial system of sorts but very few have honest and efficient judicial systems. Ineffective judicial systems come about due to a number of factors including corruption, political pressure, lack of funding and lack of skilled and/or trained personnel.[456] As stated in Chapter 5 above, rule of law is one of the macro institutions that will sustain a strong capital market and the Judiciary is the custodian of the rule of law.

Further, Black states that besides an effective and efficient judicial system, there must be "procedural rules that provide reasonably broad civil discovery and permit class actions or another means to combine small claims of many investors".[457] This is a formal aspect of the judicial system. It is observed that meaningful liability risk will require not only formal liability rules, but also procedural rules that provide reasonably broad civil discovery as well as rules that allow for class action to enable investors combine their individual small claims

[455] *Ibid*, pp. 790 & 807
[456] *Ibid* at p. 791
[457] *Ibid* p. 791

into one big claim.[458] These rules may also include contingency fee procedure.[459] Black specifically notes that the need for broad discovery is more crucial for self-dealing than information asymmetry as misdisclosure in a public offering will always leave a paper trail which is normally not the case with instances of self-dealing.[460] As such the judicial system will need to infer wrongdoing from circumstantial evidence.[461]

6.3.3 Stock Exchange

The formal institutions described above: regulators, court, procedural law and rules of court; are public sector formal institutions. A stock exchange can be publicly provided, but does not need to be, and usually is not. Therefore it is a private or civil society regulatory agency. Although Self Governing Organisations are dealt with below, we feel that a stock exchange is so integral to the structure of capital markets that it is noted here under the major public institutions of regulatory support and control of capital markets.

According to Black strong capital markets will require "a stock exchange with meaningful listing standards, the willingness to enforce them by fining or delisting companies that violate the rules governing self-dealing transactions, and the financial resources and skill to run a surveillance operation that can catch at least some insider trading"[462]. Establishing a stock exchange with these qualities will require a shift in belief system of society. The nature of the listing standards and the level of their enforcement will depend on the ethical values

[458] *Ibid.* The SEC model or regulation provide such rules.
[459] *Ibid*
[460] *Ibid* p. 807
[461] *Ibid* p. 807
[462] *Ibid at* p. 796

of stock exchange operators. Further if the stock exchange is largely funded by government, the levels of funding and therefore the extent of its advancement will depend on the incentives available to government officials to adequately fund the operation of the exchange.

6.4 REPUTATIONAL INTERMEDIARIES

As stated above, in a situation where a 'lemons market' exists, investors will tend to discount the share prices they will offer to companies and discounted share prices will discourage honest issuers and cause them to turn to other forms of financing.[463] Discounted share prices however will incentivise dishonest issuers to issue shares which are even more worthless. Consequently, while high-quality issuers will be forced to leave the market, low-quality issuers will remain and cause more damage to the market.

Black suggests that one solution to the above conundrum would be the existence of laws and private as well as public institutions that will give investors reasonable assurance that the issuer is being truthful.[464] One of such set of institutions is reputational intermediaries, which include, accounting firms, investment banking firms, law firms, credit rating agencies and stock exchanges. Reputational intermediaries are important because they can credibly vouch for the quality of information on the basis that they are 'repeat players' who will suffer reputational loss if they permit a company to exaggerate its prospects or gloss over any self-dealing transactions, which exceeds the intermediary's one-time gains from

[463] *Ibid* at p. 787
[464] *Ibid*.

permitting the exaggeration.[465] This role of reputational intermediaries can be reinforced by civil liability to investors if they endorse faulty disclosure or self-dealing transactions coupled with possible criminal prosecution if they intentionally do so.

Having one set of reputational intermediaries however, may not be enough as there is a danger that new entrants may seek to free ride on other intermediaries' reputation and not bother to guard their own reputation. Consequently second tier reputational intermediaries are recommended.[466] This may be in the form of self-regulatory organisations (SROs), which may be voluntary or mandatory. One example cited by Black is the requirement in United States for all investment bankers to belong to either the New York Stock Exchange or the National Association of Securities Dealers.[467] With such arrangement in place, a member evicted by one organization is unlikely to be accepted by the other such that the organization's power to evict a member becomes the power to put the member out of business and not merely deprive it of the reputational enhancement that voluntary membership could bring.

It is further realised that SROs themselves will need to be policed to avoid a situation where low-quality intermediaries form a lax SRO to vouch for their quality such that investors will have to figure out whether the SRO itself is bogus.[468] The suggested solution to deal with this problem is to reinforce liability of the intermediaries and set up minimum quality standards for intermediaries. According to Black, a system in which different "multiple

[465] Ronald Gilson & Reinier Kraakman, 'The Mechanisms of Market Efficiency', (1984) 70 Virginia Law Review 549-644 at 595-607.
[466]B. S. Black (2001) *supra* note 370 at p.788
[467] *Ibid*
[468] *Ibid* 789

reputational intermediaries vouch for different aspects of a company's disclosure, while the government, private plaintiffs, and self-regulatory organisations police the reputational intermediaries can work well".[469]

The foregoing shows that there are three aspects to reputational intermediaries relevant to the effectiveness of the market. The first one is the existence of reputational intermediaries. The second aspect is liability risk in the event of a reputational intermediary giving misleading advice or being complicit of provision of misleading advice. Thirdly, it is how these reputational intermediaries are policed or regulated. Liability risk in itself would be meaningless unless sufficient monitoring and enforcement system is in place. As stated above it is recommended that there should be a multi-tier framework of regulating reputational intermediaries. The final aspect is whether the regulatory framework includes self-regulatory organisations (SROs). SROs would be useful as they help to instil a culture of compliance by setting best practice standards to which all its members are supposed to sign up.

Again, the proposed institutions and organisations under this category may also fall under both the formal and informal limbs of North's model as shown below.

6.4.1 Stock Exchange

[469] *Ibid* 789

As noted above the central reputational intermediary will be the stock exchange. The stock exchange is an organisation while its requirements are institutional. Stock exchange listing requirements play a crucial role in ensuring that companies that list their shares with the exchange have put in place necessary corporate governance structures to facilitate full disclosure of information and to provide sufficient checks and balances on company insiders. Further, exchange listing rules provide for continuous disclosure obligations.

6.4.2 Accountants and the Accountancy Profession

Accounting firms are in themselves organisations but the rules that regulate their services will take the form of formal rules. Also, viewed from the perspective of the client firm the accountant can serve as "gatekeeper" or more formally as the "mediators" of the regulatory rules. If the auditor refuses to sign off on an annual audit it operates as a very serious sanction upon the company and its directors.

Since by selling their services in preparing and auditing financial statements, accounting firms 'rent out' their reputations for conducting a careful audit that can catch some fraud, discourage most attempts at fraud, and for painting a tolerably accurate picture of a company's financial performance, some form of liability risk would be an important buttress for the accounting firm's concern for reputation. As such Black sets out, as one of the preconditions for strong capital markets "Securities or other laws that impose on accountants enough risk of liability to investors if the accountants have endorsed false or misleading financial statements or if the accountants have endorsed nondisclosure, or false or misleading disclosure of self-dealing transactions, so that the accountants will resist their client's pressure for more favourable disclosure or to let them hide self-dealing transactions".[470]

Basically, liability risk can help to persuade the firm to establish strong internal procedures to ensure that the audits it conducts, and the financial statements that it prepares or reviews, meet minimum quality standards and also provide a compelling argument that the accounting firm can offer to a client that is pushing hard for more favourable treatment than the accounting firm wants to offer.[471]

Also Black recommends "a sophisticated accounting profession with the skill and experience to catch at least some instances of false or misleading disclosure as well as some non disclosed self-dealing transactions, and insist on proper disclosure".[472] In so far as a sophisticated accounting profession cannot be legislated into existence, it is an informal institution. The conduct of accounting or investment firms, which are organisations, will be informed by formal and informal institutions. Professionalism is a virtue that is founded on one's belief system which determines one's ethical orientation. Black notes that 'audit requirements and accounting rules are no better than the accountants who conduct the audits and apply and interpret the rules'.[473] Accounting profession is therefore crucial to the process of information disclosure. Further, it is observed that for an insider who is determined to self-deal, having an accountant looking over his shoulder would be an obstacle but this could be overcome by suitably disguising the transaction, or his interest in

[470] B.S. Black (2001) *supra* note 370 at p. 809. A good example of the importance of reputation for auditing or accounting firms is the collapse of Arthur Andersen which followed collapse of its major client Enron in 2001. See Smith NC and Quirk M, 'From Grace to Disgrace: The Rise and Fall of Arthur Andersen',(2004),1 (1) Journal of Business Ethics Education 91-130.
[471] *Ibid* 794
[472] *Ibid* 793.
[473] *Ibid.* This may also present conflict of interest issues. The case of Enron offers a good example.

the transaction, by running one or both through multiple intermediaries.[474] Therefore, in order for the accounting profession to be effective, accountants 'must be sophisticated enough and auditing standards rigorous enough, to catch at least the less subtle subterfuges.'[475] This would raise the transaction costs of self-dealing and thereby keep it in check.

6.4.3 Investment bankers

Similarly, investment banks are organisational while the rules governing investment banks are institutional. Just as in the case of accounting firms, liability risk can help to persuade an investment banker to establish strong internal procedures to ensure that the companies whose shares it underwrites meet minimum quality standards and provide a compelling argument that the investment banker can offer to a client that is pushing hard for more favourable disclosure, or a higher offering price, than the investment banker wants to offer.

The formal rules required therefore are "securities or other laws that impose on investment bankers enough risk of liability to investors if investment bankers underwrite securities that are sold with false or misleading disclosure, so that the bankers will resist their client's pressure for more favourable disclosure."[476]

Further, Black recommends the existence of a "sophisticated investment banking profession that will investigate the issuers of securities that the investment bank underwrites because

[474] *Ibid*. at p. 809
[475] *Ibid.*
[476] *Ibid at* p. 795.

the investment banker's reputation depends on not selling fraudulent or overpriced securities to investors."[477] An important part of investment bankers' role involves conducting a "due diligence" investigation of the issuer, to satisfy themselves that the issuer's future prospects are reasonably stated in the offering documents and oral sales presentations, that the issuer's managers appear to be honest, and that investors understand the major risks of the investment. Investment bankers therefore should ensure that they conduct credible background checks on issuers and avoid underwriting offerings of shares by fraudulent companies, which may collapse in price when the fraud is discovered. Existence of credible investment bankers is an informal phenomenon.

6.4.4 Lawyers and the Legal Profession

Lawyers play a central role in drafting and interpreting legal rules when there is a dispute. This means lawyers and legal firms within whom they operate form a vital plank of the reputational intermediation structure. Also lawyers play a significant role in corporate governance. Involvement of lawyers in any transaction lends it some level of credibility. Therefore as with accountants and investment bankers, formal rules that apportion liability risk to lawyers and legal firms is a necessary precondition for strong capital markets. Lawyers need to be sufficiently regulated. This can be done by establishing a self-regulatory organisation responsible for the legal profession.

Specifically Black recommends that there must be "sophisticated securities lawyers who can ensure that a company's offering documents comply with disclosure requirements". This

[477] *Ibid.*

requires skilled and honest securities lawyers who can detect breaches of securities law and successfully prosecute perpetrators. Existence of skilled and honest lawyers is an informal constraint. Securities lawyers usually "walk a fine line between accepting the positive-sounding statements that the issuer wants to make, and insisting on the need to disclose risks and problems"[478] Like the other professions, effective securities lawyers will only exist within a milieu of ethical and honest culture. The role of effective lawyers will become more relevant with increasing liability risk for accountants and investment bankers and the lawyers themselves.[479] The more the risk of liability for accountants and investment bankers the more they will be more careful and involve the services of lawyers. With their own liability hanging over their heads, the lawyers will ensure that they are honest with their advice.

6.4.5 Regulation of Reputational Intermediaries

As observed above, some form of regulation of reputational intermediaries is vital to ensure that they operate themselves in a credible fashion. This can be done in a number of ways including the following:

(i) Licensing of reputational intermediaries.

Subjecting reputational intermediaries to regulatory licensing scheme would be another way of ensuring that they adhere to set minimum standards although this is not regarded as a core institution because where there is sufficient liability to investors, private enforcement is likely to be more effective that public enforcement.

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[478] *Ibid* at p. 795.
[479] *Ibid*

(ii) Existence of self-regulatory organisations.

As stated above, self-regulation, through a voluntary or mandatory self-regulatory organisation that is itself subject to regulatory oversight, is a useful supplement to government regulation of reputational intermediaries.[480] Again this is not a core institution as the quality of a particular SRO is dependent on the quality of intermediaries that comprise it.

6.5 DISCLOSURE OF INFORMATION

Disclosure requirements are an important tool for effective regulation of the market. In the context of North's framework, disclosure would help reduce uncertainty and therefore help investors' make informed investment decisions. Strict requirements for firms to effectively disclose any information that would affect their share prices including financial statements, corporate transactions, details of company directors as well as details of any shareholding or any transactions involving directors would effectively help reduce the ills of information asymmetry and self-dealing. It is argued that strict disclosure requirements lead to liquid and efficient markets in financial securities and reduce the cost of capital for firms.[481]

Black lists the core institutions that would facilitate effective disclosure of information, some of which are formal in nature while others are informal as outlined below.

6.5.1 Accounting and auditing rules that address investors' need for reliable information.

[480] *Ibid* 800

[481] Anat Admati and Paul Pfleiderer, 'Forcing Firms to Talk: Financial Disclosure Regulation and Externalities', (2000) 13 Rev. Fin. Stud. 479 at 480.

Accounting and auditing rules are formal institutions. It is said that good accounting rules should require companies to provide information in a form that is useful to investors and facilitate evaluating a company's past performance, and comparing it with similar companies, in the same country and internationally, and limit managers' flexibility to pick and choose among alternate accounting practices in order to make their own firm appear more profitable[482]. Good accounting is important to the integrity of the markets as well as an important corporate governance tool as it provides "the brightest light and the most objective, detailed, and textured portrait of managerial performance."[483]

Generally, overly flexible rules can reduce comparability, increase opportunities for fraud, and increase overall information asymmetry between companies and investors. At the same time, the accounting rules must strike a sensible balance among investors' desire for information, the cost of providing the information, and companies' concern that giving detailed information to investors means giving the information to competitors as well[484].

As observed above, the effectiveness of the rules is determined by the level of its enforcement. As such, it is also important that the rules should be clear and specific to ensure that even the most corrupt of the regulators or prosecutors or judges has no room for manoeuvre to protect those who fall foul of the rules.

6.5.2 A rule-writing institution with competence to write good accounting rules and an incentive to keep the rules up to date.

[482] B.S. Black (2001) *supra* note 370 at p 792

[483] Louis Lowenstein, 'Financial Transparency and Corporate Governance: You Manage what You Measure', (1996) 96 Columbia Law Review 1335 at 1361.

[484] B.S. Black (2001) *supra* note 370 at p 793

In "Northean" terminology this is a rule-writing organisation. The nature of the rule-writing organisation matters in terms of the effectiveness of the rules it designs. Writing good accounting rules requires close knowledge of how companies operate, appreciation for changes in corporate practices, which are often intended to take advantage of loopholes in the existing rules so as to portray a firm's performance as better than it really is, and the ability and incentive to write new rules and interpret old ones with reasonable dispatch[485]. It is therefore suggested that the best approach would be to vest rule writing responsibility in a quasi-public organization run by accountants,[486] rather than a government agency like Finance Ministry, which tends to write the rules with a view to providing the information needed to collect taxes, rather than the information needed to attract investment or manage the business.[487]

6.5.3 Securities or other laws that require extensive disclosure of self-dealing transactions.

Disclosure of self-dealing transactions is very crucial because until such transactions are brought to light, other forms of protection like legal liability to investors will be rendered ineffective.[488] As stated above, self dealing occurs in different forms and at different levels. It is therefore important that such rules should be textured and nuanced enough to capture each and every possible form of self-dealings. The rules should also be aligned with liability of intermediaries to avoid any instances of deliberate let-ups in accounting reports and auditing exercises.

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[485] *Ibid* 793
[486] This can be done by establishing an SRO for the accounting profession as discussed above at section 6.3.3.
[487] Brian Cheffins, Company *Law; Theory, Structure, and Operation,* (Oxford Univ. Press 1997) at 378-420.
[488] Black (2001) *supra* note 370 at p. 808

6.5.4 Extensive financial disclosure, including independent audits of public companies' financial statements.

Given that a stock market cannot thrive if listed companies are unable to provide investors with audited financial statements, it is important to ensure that practices for auditing listed companies are widely adopted in the market to avoid fraudulent or misleading statements. This may call for a cultural change among all the players in a particular market. Such disclosure requirements may be imbedded in the rules regulating the operation and conduct of accountants and investment bankers as discussed above.

6.5.5 Company law or securities law that establishes procedural protections for self-dealing transactions, such as approval after full disclosure by independent directors, non-interested shareholders, or both.

It is observed that, while disclosure alone will deter some self-dealing, a lot of self-dealing may still take place if the underlying transactions are lawful. Consequently, sufficient protection may be achieved by making significant self-dealing transactions subject to a review by independent directors, non-interested shareholders or both.[489] However, since often the nominally independent directors won't be all that independent in fact, especially for a company with a controlling shareholder, where the directors serve at the controlling shareholder's pleasure, it may be important to place approval power, especially for larger transactions, in the hands of non-interested shareholders.[490] It should however be noted that Black's analysis is based on neo-classic economics assumptions and as such the

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[489] *Ibid* p. 808

[490] *Ibid*.

effectiveness of these rules would be subject to North's caveat with respect to transaction costs and belief system. For instance, effectiveness of the rules will depend upon the interest and capacity of minority shareholders to investigate and police management or other insider activity.

6.5.6 Ownership disclosure rules that ensure that outside investors know who the insiders are, and that interested shareholders in fact cannot vote to approve a self-dealing transaction that requires approval by non-interested shareholders.

If non interested shareholders are given decision making power over self-dealing transactions, insiders will have an incentive to disguise their share ownership, in order to pretend to be non-interested. Disclosure rules are needed to prevent this. More generally, as long as insider self-dealing is a significant risk, it will be important for outside investors to know who the insiders are. This will both help the outside investors to determine how much to trust the insiders this time, and give the insiders an incentive to develop reputations for not abusing their power.[491]

6.5.7 A culture of disclosure that develops over time, among accountants, investment bankers, lawyers, and company managers, that concealing bad news is a recipe for trouble.

[491] *Ibid* p. 809. This may not hold very true with publicly held companies where outside investors are usually artificial and may not have much interest or may not spend much time in a firm's affairs.

This is an informal institution within North's framework. A culture of disclosure usually develops on the back of strong sanctions against misbehaviour.[492] Such a culture will prevent managers from undertaking clearly illegal actions, because they grew up in a culture where disclosure is the norm, and where others are occasionally disgraced, or even sent to jail, for falsifying financial statements and the like.[493] The interplay between laws requiring disclosure and a culture that supported disclosure is still subject to scholarly debate although it is considered that the two develops together over time, and are mutually reinforcing.[494]

6.6 INSIDER DEALING LIABILITY

As stated above, the prevalence of insider self-dealing gives rise to a "lemons market", which results in investors discounting the prices they will offer for the shares of all issuers thereby driving honest issuers out of the market. It is therefore important for any capital market to put in place robust institutions to prevent insider dealing. Suggested formal and informal rules that would help control insider self-dealing include the following.

6.6.1 Securities or other laws that impose severe sanctions on insiders for false or misleading disclosure or violation of self-dealing rules.

[492] Black (2001) *supra* note 370 at p. 799
[493] *Ibid*.
[494] Pistor and Chenggang, 'Governing Stock Markets in Transition Economies: Lessons from China,' (2005) 7 (1) Am Law Econ Review 184-210.

Direct sanctions against companies and insiders who attempt fraud is said to be the first line of defence against securities fraud.[495] Thus formal rules that impose civil liabilities on directors and officers for using inside information to their benefit will provide a powerful regulatory weapon in this regard.

6.6.2 Criminal liability for insiders who intentionally mislead investors and insiders who intentionally violate the self-dealing rules.

It is recognised that most insiders have little wealth outside their company or usually hide their wealth out of investors' reach.[496] As such, criminal sanctions become a critical supplement to civil or financial liability.

6.6.3 Securities or Other laws that prohibit inside trading, suitably defined, and government enforcement of those rules.

According to Black, in order for a ban on insider trading to be effective, it must include a ban on tipping others, as well as on trading yourself.[497] Further the rules must be enforced lest the insiders will learn that they can violate the rules with impunity.[498] This is where a skilled and honest legal profession as well as an effective judicial system, as discussed above, becomes handy.

[495] *Ibid* p. 796
[496] *Ibid* p. 797
[497] *Ibid* p. 811
[498] Bhattacharya & Daouk, 'The World Price of Insider Trading' (1999) available at http://papers.ssrn.com/paper.taf?abstract_id=200914. (Last visited on 15/08/2014) Found that (i) many countries have bans on insider trading that are never enforced, (ii) enforced insider trading rules have a measurable effect on share prices estimated at 5% and (iii) unenforced rules have no significant effect on share prices.

6.6.4 Company or other laws that (a) require public companies to have a minimum number of Independent directors; and (c) impose on independent directors enough risk of liability for approving self dealing transactions that are grossly unfair to the company, so that they will resist pressure from insiders to approve these transactions.

Although approval by nominally independent directors is usually insufficient safeguard against self-dealing transactions, because the directors' independence will often be in doubt, it remains an important safeguard, especially when combined with directors' potential liability for not behaving independently.[499] Also company liability can help to persuade the independent directors to reject transactions that are not on arms-length terms and may offer a powerful argument that the independent directors can use when insiders propose a dubious transaction.[500]

6.7 MARKET TRANSPARENCY

Investors will be attracted to a particular market if it is transparent. Again market transparency would be a useful tool to combat market uncertainty within the context of North's framework. Market transparency entails that all transactions are accurately and promptly reported to ensure that all investors and potential investors are aware who is purchasing shares in the market and at what price. This is important because one of the key sources of information about value that investors rely upon is the prices paid by other investors for the same securities as this help investors know that others share their opinions

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[499] *Ibid* 810
[500] *Ibid*.

about the value they attach to the shares.[501] The proposed formal and informal institutions that may help to promote market transparency include the following:

6.7.1 Rules ensuring market "transparency": the time, quantity and price of trades in public securities must be promptly disclosed to investors.

Stock exchanges will need to have enough market power to force all trades to be reported to it and the government must mandate prompt reporting and require all trades to be reported in a single consolidated source, lest exchanges compete for business by offering delayed or no price reporting at all.[502]

6.7.2 Rules banning manipulation of trading prices and enforcement of those rules.

It is noted that in 'thin markets', insiders can manipulate trading prices to create the appearance that the shares are highly valued by outside investors, while dumping their own shares on the market and that the principal response to this risk is rules against manipulating trading prices. Of course the rules will need to be enforced, which calls for a specialized regulator, because manipulation is notoriously hard to prove.[503]

6.7.3 An active financial press that can uncover and publicise instances of misleading disclosure, and criticise not only the company, but (when appropriate) the investment bankers, accountants and lawyers as well.

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[501] Black, (2001) *supra* note 370 at P. 797
[502] Robert Bloomfield & Maureen O'Hara, 'Can Transparent Markets Survive' (2000) 55 J. Econ 425.
[503] Black, (2001) *supra* note 370 at 798.

This is an example of an informal institution in Northean terms. An active financial press is an important source of reporting of disclosure failures as well as market malpractices by both companies and reputational intermediaries. It is observed that markets for reputation can work only if there is a mechanism for distributing information about the performance of both companies and intermediaries.[504] This is so because while disclosure rules for companies and reputational intermediaries' incentive help to advertise their successes, most companies or intermediaries can hardly be expected to publicize their failures.[505] Similarly, insiders will be more reluctant to engage in self-dealing, and independent directors, accountants, and securities lawyers, will be more vigorous in policing it, if a country has a financial press that is ready and eager to publicize misdeeds.[506]

One factor that would hamper the effectiveness of financial press especially in developing economies would be lack of specialised knowledge. As already noted above, fraudulent reporting or insider dealing transactions are usually complex in nature and unless members of the press are properly trained, most malpractices will go unnoticed. It is therefore imperative to ensure that the press is educated on the operation of the capital market.

The role of the financial press can be propped up by a country's libel law. Carefully crafted libel laws would provide a shield to members of the press from unnecessary law suits. Otherwise the press can be chilled by libel laws that make it easy for deep-

[504] *Ibid* p. 798
[505] *Ibid*
[506] *Ibid* p.812

pocketed companies or intermediaries to sue anyone who is bold enough to criticize them.[507]

6.8 THE CULTURE OF THE MARKET: INSIDERS, OUTSIDERS, INTERMEDIARIES AND REGULATORY BODIES (STATE AND SRO)

Finally Black has emphasised on the importance of developing a culture of disclosure that develops over time, among accountants, investment bankers, lawyers, and company managers, that concealing bad news, self-dealing transaction, approving a seriously unfair transaction, or trading on inside information is improper and is a recipe for trouble.[508]

According to North's framework, such cultural shift shall emanate from individual experience which shapes belief systems and thereby inform the interpretation of new events. Essentially, culture and the internalisation of an ethical perspective is dependent upon the prior experience of the individual actor, the culture she grew up in, and the culture of the organisation. The culture of the organisation is dependent upon the experience of the organisation which has led to its developing a belief system and how it has adapted to incorporate that belief system in its investment in skills and training and job role.[509]

Being an informal institution, such a culture will develop over time through learning and reduced incentive to non-compliance following robust enforcement of the formal rules in

.[507] Black gives an example of physical retaliation by Russian businessmen against reporters and other critics ranging from beatings to murder. See p. 798.
[508] Black (2001) *supra* note 370 at p. 799
[509] See: J Knight and DC North (1997), *Supra* note 437.

place. This will result in the change of belief system of the players of relevant market as the cost of non-compliance will be more than the cost of complying with the rules.

6.9 NECESSARY AND "MERELY NICE" INSTITUTIONS

Black recognises that some of his suggested core institutions may be necessary for strong capital markets while others may be just "extra frosting on an already tasty cake".[510] He notes that both in America and Britain strong securities markets developed with some of the institutions but also predates some of them. According to Black, the United States had active securities markets long before it had a strong central securities regulator and didn't enforce insider trading rules until 1960.[511] Similarly in Britain many stock promoters invested little in reputation until the middle of twentieth century, arguably after it had already developed strong stock market.[512]

Black concludes that the fact that different types of interrelationships among the institutions, complimentary in some respects and substituting in others, means that there is no simple answer as to which of these institutions are necessary or merely nice. His advice is that one must evaluate how important each institution is, both by itself and as part of an overall system.[513]

[510]Black, (2001) *supra* note 370 at p. 803
[511] *Ibid*.
[512] *ibid*
[513] *ibid*. Black observes that local enforcement is critical and that therefore honest courts and regulators are critical as a strong stock market cannot exist if major players can escape liability by bribing a judge to forgive their trespasses, bribing a prosecutor or a regulator to ignore them, or bribing politicians to call off the prosecutors or regulators. See P. 804

Black's observations and advice above, is in perfect alignment with North's concept of path dependence. The evaluation and ultimately the choice of which institutions should be adopted first in a particular market will be dependent on the historic development of the economy in question. Institutions that may stimulate market growth in one economy may not have similar impact in another. This is crucial for policy makers to avoid the trap of merely copying institutions from economies that are historically and functionally different from their economy.

6.10 BLACK'S ANALYSIS OF TRANSFERABILITY OF CORE INSTITUTIONS FROM ONE JURISDICTION TO ANOTHER

Professor Black has conducted a very interesting analysis of the ease with which, and the extent to which a company, located in a country that lacks many or all of the institutions that control information asymmetry and self-dealing, can rely on other countries' institutions or an entire country adapt other countries' institutions for its own use, a process he calls piggybacking.[514] This analysis is very relevant to the purpose of this section which is integrating Black's core institutions into the North's framework. Black has ranked his suggested core institutions on a scale of 1-5 translated as follows:[515]

5: easy to piggyback/adapt (as easy or nearly as easy for a company already located in the foreign country)

4: piggybacking is feasible, not too difficult, and likely to work reasonably well

[514] *Ibid. p.* 816
[515] *Ibid*

3: piggybacking is possible but difficult and/or will work only moderately well if achieved

2: piggybacking is very difficult and/or won't work very well if attempted

1: significant piggybacking is not feasible

Black's overall observation is that while reliance on foreign institutions is feasible, only a few institutions are easily transplantable.[516] As between an individual company and a country, Black observes that it is easier for a single company on average to effectively rely on institutions of another country than a country to import institutions from outside. This can be easily done through a company's promise to obey another country's tougher rules by listing on a foreign stock exchange and hiring world-class accountants, investment bankers and lawyers.[517] This is demonstrated in Table 2 below.

Table 2 : Rankings of Black's Core Institutions in Thematic Order

[516] *ibid*
[517] *Ibid*, p. 819

Core Institutions	Needed for		Piggybacking Ease	
	Information Disclosure	Self-Dealing	For a Company	For a Country
Local Enforcement and Culture				
1.An honest, sophisticated securities agency (and prosecutors for criminal cases)	X	X	1	1
2. Honest, sophisticated, well-functioning courts	X	X	1	1
3. Good civil discovery rules and a class action or similar procedure	X	X	1	2
4. A culture of compliance with the disclosure and self-dealing rules by managers, reputational intermediaries, and independent directors	X	X	2	1
Disclosure Rules				
5.Rules requiring full disclosure of financial results and self-dealing transactions	X	X	4	3
6. Good accounting and auditing rules	X	X	4	3
7. Requirements of audited financial statements	X	X	4	3
8.Ownership disclosure rules	X	X	4	3

Table 2 Continued/...

Core Institutions	Needed for		Piggybacking Ease	
	Information Disclosure	Self-Dealing	For a Company	For a Country
Reputational Intermediaries and Independent Directors				
9. A sophisticated accounting profession.	X	X	4	2
10. A sophisticated investment banking profession.	X	X	4	2
11. Sophisticated Lawyers.	X	X	4	2
12. A stock exchange with meaningful listing standards and an active insider trading surveillance operation	X	X	5	3
13. Inclusion of independent directors on company boards.		X	3	2
Liability				
14. Civil liability risk for insiders who violate the disclosure and self-dealing rules	X	X	2	1
15. Criminal liability risk for insiders who violate the disclosure and self-dealing rules	X	X	1	1
16. Civil liability risk for Accountants	X	X	3	2
17. Civil liability risk for investment Bankers	X		3	2
18. Civil liability risk for independent directors if they approve gross self-dealing		X	3	1

Table 2 Continued/...

Core Institutions	Needed for		Piggybacking Ease	
	Information Disclosure	Self-Dealing	For a Company	For a Country
Market Transparency				
19. Transparency of trading prices	X	X	4	3
20. An enforced ban on market manipulation	X	X	3	2
Self-Dealing Rules				
21. Procedural controls on self dealing transactions (review by independent directors, non interested shareholders, or both)		X	4	3
22. Accountant review of the disclosure of self-dealing transactions		X	4	2
23. Enforced securities or other rules banning insider trading		X	3	2
Other Institutions				
24. An active financial press and security analysis profession	X	X	3	2
25. A good organisation to write accounting rules	X	X	5	3

Source: B.S. Black, Legal and Institutional Preconditions for Strong Securities Markets, pp. 817-819.

As stated before, the above analysis is very relevant to the overall thesis of this work. An examination of the above table reveals a general trend which shows that institutions that are informal in nature are, in general, not easily transplantable while formal institutions are generally easily adaptable. This neatly fits into the North's framework which posits that formal rules can be changed within a short period of time whereas informal rules change over a longer period of time. A cross section of the Black's core institutions and their rankings clearly depicts this trend as shown in Table 3 below, which lists a selection of formal and informal rules and their respective country ranking.

Table 3: Rankings of Selected Formal and Informal Institutions

Core Institutions	**Country Ranking**
Informal Institutions	
1.An honest, sophisticated securities agency (and prosecutors for criminal cases)	1
2. Honest, sophisticated, well-functioning courts	1
3. A culture of compliance with the disclosure and self-dealing rules by managers, reputational intermediaries, and independent directors	1
4. A sophisticated accounting profession.	2

5. A sophisticated investment banking profession.	2
6. Sophisticated Lawyers.	2
7. An active financial press and security analysis profession	2
Formal Institutions	
8.Rules requiring full disclosure of financial results and self-dealing transactions	3
9. Good accounting and auditing rules	3
10. Requirements of audited financial statements	3
11. Ownership disclosure rules	3
12. A stock exchange with meaningful listing standards and an active insider trading surveillance operation	3

Source: Adopted from Table 2 above.

The table above clearly shows that it is difficult if not impossible for a particular country to borrow informal rules from another country. This is depicted by low rankings for informal rules with a highest ranking of two. On the other hand, a country can adopt foreign formal rules with relative ease as the rankings above display a uniform higher ranking of 3.

Black observes that the most basic institutions like honest and competent courts, regulators, and prosecutors are the hardest to transplant.[518] Consequently, one can't transplant local enforcement.[519] Therefore, the state of local enforcement as well as local professional culture determines the extent to which foreign formal rules can be effectively transplanted. Thus while it is not hard for a company to borrow audit requirements and accounting rules from abroad, weak local enforcement will still limit the credibility of its financial statements.[520] Also, although a country can adopt foreign accounting rules and audit requirements, its local accountants must implement these rules.[521]

Further, it is possible for a single company to take some steps to import a culture of disclosure and compliance by hiring foreigners to sit on its board of directors, and in its financial department. However this will be limited by the fact that the bulk of the staff will still be local, and can often hide local "skeletons" from the foreigners and that their thought processes, as they think about disclosing something they would rather hide, will be influenced primarily by national culture and expectations, not the perhaps different norms their company has tried to instil.[522]

Black also observes that it is much harder for a country to borrow disclosure rules. He states:

> "...American securities laws can't be simply copied and transplanted wholesale to another country. They won't mesh with other local institutions, will likely conflict with other local laws, will be far more complex than needed, and will in some

[518] Black, (2001) *supra* note 370 at p. 817.
[519] *Ibid*.
[520] *Ibid*, p. 824
[521] *ibid*
[522] *Ibid* p. 827

> respects be *weaker* than needed, because official rules can be less strict when informal enforcement is strong".[523]

Finally, although, a country can attempt to introduce rules attaching liability to accountants, investment bankers and lawyers, such rules will only be as strong as the country's local enforcement regime. Hence Table 1 shows low country rankings for liability institutions. For Instance, with respect to civil liability risk for independent directors, Black explain the low ranking as follows:

> "Independent directors will generally be locals and hold their assets locally. In practice, they will be liable (if at all) only under local law. That brings us back to local courts, which aren't transplantable, and local rules, which are only moderately transplantable. Hence the country ranking of 1."[524]

6.11 CONCLUSION

As stated above, despite some quite important methodological differences, Black's analysis reinforces North's thesis that economic change can only be achieved by changing both formal and informal rules. The foregoing conclusively confirms that the effectiveness of formal rules is dependent on the culture and belief system of the receiving country. Proper understanding of this dynamic is very crucial when formulating a national reform strategy with respect to capital market development.

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[523] *Ibid* p. 823
[524] *Ibid* p. 827

Taking North's approach as a Meta theory, Black's work stands as a mid-tier theory of capital market development translating the abstract propositions expounded by North into the practice of capital market reform. As stated above however, Black and North have different theoretical underpinnings. Black's assumptions are based on the neo-classical rational actor whereas North is coming from a much richer and more nuanced brand of institutional economics. However, the fact that Blacks practical observations confirm North's propositions is an endorsement of the methodology adopted in this work as set out in chapter 1 above.

Further, Black's thematic list of core formal and informal institutions as well as organisations for strong capital markets provides a ready tool kit for policy makers seeking to design a capital market reform agenda. For purposes of this work, Black's regulatory themes nevertheless provide a very helpful methodological tool of analysis of the state of capital markets in our selected case studies discussed in the next section.

7. CHAPTER SEVEN: REGULATION OF CAPITAL MARKETS IN DEVELOPED ECONOMIES AND SADC COUNTRIES - A COMPARATIVE ANALYSIS.

7.1 INTRODUCTION

The purpose of this chapter is to examine and compare the capital market regulatory regimes both in developed market economies and developing economies in general and SADC countries, in particular. For developed economies we will use United Kingdom, it being one of the recognised developed capital markets. It is important to emphasise that the United Kingdom capital market rules are only considered as examples of rules, both formal and informal, that may be adopted and adapted to the regulatory frameworks of capital markets in developing countries as they have proved effective in attracting investors to and preventing capital flight from the market. Sight is however not lost to the fact that the UK capital market operates within a different economic and institutional milieu to that existing in most developing economies, its current regulatory framework having been heavily influenced by UK membership of the European Union. As such these rules may not be fully compatible with the conditions in developing countries.

With respect to SADC countries, we will examine capital markets in South Africa and Malawi. SADC like many other economic regions has seen a number of capital markets being established in its member states in the recent past. Most of the capital markets in the region, with the exception of South Africa, are embryonic and authorities in these countries are still grappling with the task of developing their markets with the aim of realising the full economic benefits of capital markets. The SADC region therefore presents itself as a classic case study of unique problems facing capital markets in developing countries and how these markets can be developed.

Our selection of the two countries is based on the fact that South Africa has the most developed capital market in the region while Malawi's capital market is one of the least developed in the region. It is hoped that a comparison of the two capital markets, which operate in the same economic region but sit on the opposite side of the spectrum will enable us better understand the dynamics of capital market growth.

In examining the three case studies, we will use the six themes developed by Professor Black as tools of analysis. These will provide us with a standard set of parameters as we look at each of the three case studies. The six themes include the following:

vi. Local Enforcement (Effective Regulators, prosecutors and Courts)

vii. Reputational Intermediaries

viii. Disclosure Regime

ix. Liability for Insider dealing

x. Market Transparency

xi. Liability of issuers, directors etc for Market Misconduct

It is hoped that this comparative analysis will help identify effective policy prescriptions that may be considered by authorities in the SADC region and other developing countries as they seek to develop their capital markets.

7.2 UNITED KINGDOM CAPITAL MARKET REGULATORY FRAMEWORK

The main securities market in the United Kingdom is the London Stock Exchange (LSE). LSE is one of the world's oldest stock exchanges and can trace its history back more than 300 years[525] when organised trading in marketable securities in London is believed to have started.[526] The first regulated exchange came into existence in London on 03 March 1801 when the exchange started operating under a formal membership subscription basis.[527] In 1836 the first regional exchanges opened in Manchester and Liverpool.

A major revolution of the exchange took place in 1986 following deregulation of the market, which is commonly known as "Big Bang". The main changes were as follows[528]:

(i) Ownership of member firms by an outside corporation was allowed.
(ii) All firms became brokers/dealers and were able to operate in a dual capacity.
(iii) Minimum scales of commission were abolished.
(iv) Individual members ceased to have voting rights.
(v) Trading moved from being conducted face-to-face on a market floor to being performed via computer and telephone from separate dealing rooms.
(vi) The Exchange became a private limited company under the Companies Act 1985.

[525] This was around 1898.
[526] See, London Stock Exchange Website at http://www.londonstockexchange.com/about-the-exchange/company-overview/our-history/our-history.htm. Last visited on 15/08/2014.
[527] *Ibid.*
[528] *Ibid.*

In 1991, the governing Council of the Exchange was replaced with a Board of Directors drawn from the Exchange's executive, customer and user base and the trading name became “The London Stock Exchange”. In 1995, the exchange launched its alternative international market for growing companies, AIM. In order to bring greater speed and efficiency to the market, the Exchange launched SETS (Stock Exchange Electronic Trading Service) and the CREST, its settlement service in 1997. The Exchange listed on its own Main Market as a public limited company, London Stock Exchange plc, in July 2001. Another notable technological development took place in 2003 when EDX London, a new international equity derivatives business, in partnership with OM Group was created. In the same year the exchange acquired Pro quote Limited, a new generation supplier of real-time market data and trading systems. The London Stock Exchange merged with Borsa Italiana, creating London Stock Exchange Group in 2007.

In terms of market structure, the LSE has 4 different markets. The Main Market is its flagship market for larger, more established companies, and is home to some of the world’s largest and most well-known companies. On the other hand, AIM is the London Stock Exchange’s international market for smaller growing companies. A wide range of businesses including early stage, venture capital backed as well as more established companies join AIM seeking access to growth capital. Professional investors seeking to raise capital through the listing of specialist securities, including debt and depositary receipts trade through the Professional Securities Market.[529] Finally, the Specialist Fund Market serves as the

[529] http://www.londonstockexchange.com/companies-and-advisors/psm/home/psm.htm. Last visited on 15/08/2014.

Exchange's regulated market for specialist investment funds, targeting institutional, professional and highly knowledgeable investors.[530]

7.2.1 Legislation

United Kingdom (UK) capital markets regulatory framework is derived from European Union (EU) directives and local statutes including the Financial Services and Markets Act (FSMA) 2000 and the Companies Act (CA), 2006. As stated above, following the harmonisation program of company law within the Member States of the European Union, the UK securities law has been, to a large extent, influenced by the EU directives.[531] The relevant EU directives that affect the UK securities law include, the Prospectus Directive,[532] and the Market Abuse Directive[533] which replaced the previous Insider Dealing Directive,[534] with combined rules to combat both insider dealing and market manipulation.

The FSMA has recently been extensively amended by the Financial Services Act 2012 which came into force on 1st April 2013.

7.2.2 Local Enforcement

Prior to the Financial Services Act 2012 (FS Act 2012), financial services in the UK were regulated by the Financial Services Authority (FSA) which was initially established as the Securities and investment Board (SIB) under the Financial Services Act of 1986 and it was

[530] http://www.londonstockexchange.com/companies-and-advisors/sfm/home/sfm.htm. Last visited on 15/08/2014.
[531] Article 94 of the European Community Treaty.
[532] 2003/71/EC
[533] 2003/6/EC
[534] 89/592/EEC

retained and endorsed by the FSMA 2000. However, FS Act 2012 abolished FSA and replaced it with two main bodies, the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA).[535] As a result, the majority of the functions of the FSA have been transferred to the FCA and the PRA. The FCA inherited the majority of the FSA's roles and functions and also adopted the legal corporate identity of the FSA. The FCA is responsible for the conduct of business regulation of all firms**,** including those regulated for prudential matters by the PRA. It is also responsible for the prudential regulation of firms not regulated by the PRA.[536] Further, the FCA inherited the FSA's market conduct regulatory functions, with the exception of responsibility for systemically important infrastructure which was transferred to the Bank of England (BoE). The strategic objective of the FCA is to ensure that the "relevant markets" function well while its operational objectives include (i) securing an appropriate degree of protection for consumers (ii) protecting and enhancing the integrity of the UK financial system; and (iii) promoting effective competition in the interests of consumers.[537] The FCA is the competent authority for purposes of listed securities and it is responsible for the maintenance of the UK Official List and creation of Listing Rules.[538]

On the other hand, the PRA is a subsidiary of the BoE and is responsible for micro-prudential regulation[539] of systemically important firms, including banks, insurers and certain investment firms.[540] The PRA's general objective is to promote the safety and soundness of

[535] Parts 1A and 2A of the FS Act 2012.
[536] These firms are sometimes referred to as FCA-only firms or FCA-authorised firms.
[537] Part 1B of FS Act 2012
[538] Section 16 of FS Act 2012
[539] Micro-prudential regulation seeks to enhance the safety and soundness of individual financial institutions, as opposed to the systemic regulation which focuses on welfare of the financial system as a whole.
[540] These firms are referred to as PRA-authorised firms and also as dual-regulated firms because, while the PRA regulates prudential issues, the FCA acts as these firms' conduct regulator.

regulated firms by minimising any adverse effects of firm failure on the UK financial system and ensuring that firms carry on their business in a way that avoids adverse effects on the system.

The general macro-prudential regulation of the UK financial system is assigned to the Financial Policy Committee (FPC), which is a committee of the Court of Directors of the BoE. The FPC's objective is to contribute to the BoE's achievement of its financial stability objective[541] by identifying, monitoring and taking action to remove or reduce systemic risks.[542]

The FSMA 2000 gives the relevant regulator (FCA or PRA), a range of investigation[543] and enforcement powers.[544] The regulators' enforcement powers include disciplinary action, varying or cancelling offender's permission, requiring the offender to pay restitution to those who have suffered loss or to disgorge profits it made, disciplining any approved persons who were involved, removing their approval or imposing a prohibition order preventing a particular individual from being involved in the industry and bringing criminal prosecutions where necessary.[545]

There are also a number of provisions aimed at assisting the regulators in the investigation and enforcement process including the ability to bring contempt of court proceedings for those who fail to comply with the provisions,[546] ability to obtain a warrant to search

[541] This is provided under section 2A of the BoE Act 1998.
[542]Section 9C (1) and (2), BoE Act 1998.
[543] Part XI of the FSMA 2000.
[544] Part XIV of the FSMA 2000.
[545] Andrew Haynes, *Financial Services Law Guide*, (3rd edition, Tottel Publishing, West Sussex 2006) p. 361.
[546] Section 177 (1) FSMA.

premises and seize documents[547] as well as the criminal offences of knowingly or recklessly providing false or misleading information.[548]

FSMA 2000 also appoints the relevant regulator as the prosecuting authority for a large number of criminal offences. The powers to prosecute criminal offences are set out in section 401 of FSMA, which empowers the relevant regulator to prosecute any offence that is an offence under FSMA or its subordinate legislation and section 402 of FSMA, which gives it power to institute proceedings for insider dealing offences under Part V of the Criminal Justice Act 1993 (CJA). In the case of *R v Rollins*[549], which was decided in July 2010, the Supreme Court held that the prosecution powers conferred on the then FSA are not restricted to the prosecution of the offences set out in sections 401 and 402 of FSMA. Its view was that section 401(2) operates to limit the power to prosecute for offences under FSMA itself to certain authorities, including the FSA, but not to limit which offences can be prosecuted by the FSA more generally, and that section 402 should not be interpreted as an exhaustive list of the offences that the FSA (now either the FCA or PRA) can prosecute.

Further, with regard to market conduct offences the relevant regulator has power to work in coordination with other prosecution bodies like the Serious Fraud Office (SFO), the Crown Prosecution Service (CPS) and the Police in accordance with the Prosecution Guidelines which help to determine which prosecuting agency is responsible for pursuing a particular incident of market misconduct.[550]

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[547] Section 176 FSMA.
[548] Section 177 (4) FSMA.
[549] [2010] UKSC 39,
[550] For instance in order to determine whether the SFO should take action in a particular fraud case, it should take into account factors such as the financial value of any crime, the national interest, specialist knowledge

As a safeguard for those subjected to the enforcement process, the FSMA 2000 also provides for a right of appeal to the Tax and Chancery Chamber of the Upper Tribunal, formerly, the Financial Services and Markets Tribunal,[551] which is an independent body entirely different from the regulators. In order to ensure the transparency of its decision making process, the Tribunal proceedings are normally held in public and its judgements are pronounced publicly.[552] Further, either party to a reference to the Tribunal may appeal to the Court of Appeal, on a point of law.[553] A decision of the Court of Appeal may also be appealed against but such appeal may only be made with the leave of the Court of Appeal or the Supreme Court.

Part 14 of FSMA sets out the sanctions that are available to the FCA and the PRA in respect of authorised firms that are in breach of the FSMA regulatory regime. These include public censures, financial penalties and suspending permissions to perform regulated activities.

The United Kingdom enforcement regime therefore offers an example of how regulators, prosecutors and the courts of law can effectively work together to regulate capital markets. The existence of the specialised Tribunal is one of the unique features of UK regulatory system, which make it possible to have cases of market misconduct dealt with by judges with specialised knowledge of capital markets.

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required for the investigation, and any international dimension of the case. See Prosecution Guidelines, Appendix 1, para. 3.3.

[551] The Financial Services and Markets Tribunal was abolished on 6 April 2010 and its functions has since been transferred to the Tax and Chancery Chamber of the Upper Tribunal.

[552] See, *Eurolife v FSA* (2002) Unreported, for the Tribunal's stance on public hearings.

[553] Section 137 of FSMA 2000.

The foregoing shows that the United Kingdom regulatory framework ticks most of the boxes on Black's preconditions with regard to local enforcement by having a well-established securities regulator and prosecutor in the form of the FCA and PRA which has honest and skilled staff. The regulators' role is complemented by a robust judicial system with well-developed procedural rules which have proved effective over the years.

7.2.3 Reputational Intermediaries

The United Kingdom has a robust system of reputational intermediaries, which consists of accountants, investment bankers, stock brokers, lawyers and other professional advisors. These professional groups play important roles in different ways both in the primary and secondary securities markets.

In terms of regulation of reputational intermediaries, the UK capital market regulatory framework exhibits characteristics of self-regulation although, it is argued, not in its purest form.[554] Cheffins, observes that organisations of self-regulatory nature which currently supervise company affairs, equity markets and financial services each has some level of involvement with the government, ranging from simply receiving assistance with resources to being entities established with the primary objective of carrying out tasks designated by legislation.[555]

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[554] Brian Cheffins, *Company Law; Theory, Structure, and Operation*, *Supra* note 487 at p. 365
[555] *Ibid*, 365.

In general, the United Kingdom capital market regulation, with regard to conduct of business, would be described as having a two-tier regulatory structure.[556] The first and top tier is provided by the FCA, which, acts as a senior regulator and administers and enforces the provisions of the FSMA 2000. As a statutory regulator, the FCA, authorises the establishment and supervises the operations of the bodies that make up the second tier of regulation. These include (i) institutions designated as Recognised Investment Exchanges (RIEs) - organisations that provide a market within which transactions in investments can be affected[557], (ii) Designated Professional Bodies (DPBs) – covering professionals such as lawyers and accountants carrying on investment business and other self-regulatory organisations encompassing financial intermediaries such as stock brokers, unit trusts investment trusts and life insurance companies who deliver front-line supervision of markets and investment business.[558]

FCA's oversight of market professionals is effected through designated professional body (DPB) regime. Section 19 of FSMA (the general prohibition) prohibits persons who are not authorised or exempt from carrying on any regulated activity in the UK. Breach of section 19 is a criminal offence.[559] This means that professional firms have the choice either to:

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[556] A. Large, *Financial Services Regulation: making the two Tier System Work* (London: Securities and Investment Board, 1993) at 22.

[557] There are currently six RIEs in the UK listed by FCA:
(i) EDX London Limited
(ii) London Stock Exchange plc
(iii) LIFFE Administration and Management
(iv) the London Metal Exchange
(v) ICE Futures Europe ; and
(vi) PLUS Markets plc

[558] Brian Cheffins, (1997) *supra* note 487 at 366

[559] Section 23 of FSMA.

(i) Seek authorisation directly from the FCA so that they may carry on mainstream regulated activities or

(ii) Carry on exempt regulated activities under the designated professional bodies (DPB) regime.

The DPB regime broadly allows firms, who comply with the necessary rules for exemption, to undertake a certain amount of investment work that is incidental to the work that they carry out.

A regulated activity is an activity of a kind specified by the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (*SI 2001/544*) (as amended) (RAO), which is carried on by way of business in relation to an investment of a kind also specified by the RAO. An exempt regulated activity is a regulated activity which may, as a result of Part XX of FSMA (Provision of Financial Services by Members of the Professions), be carried on by members of a profession supervised and regulated by a DPB, without breaching the general prohibition.

An exempt professional firm is a person, under section 327 of Part XX of FSMA, to whom the general prohibition does not apply. Exempt professional firms can carry on exempt regulated activities and obtain the benefit of the exemption from the general prohibition.[560] These firms are therefore not directly regulated by the FCA, but by the

[560]There are a number of conditions set out by the FSA, which must be met for a member of a DPB to be treated as an exempt professional firm, and for its regulated activities to be treated as exempt regulated activities, one of which is that the person must be a member of a profession or be controlled or managed by one or more such members. Section 327 (1) – (7) of FSMA.

relevant DPB which is accountable to the FCA in relation to the activities carried out by the firms they regulate.

Section 326 of FSMA sets out the conditions a body must satisfy before it can be designated. The basic condition is that the body has rules applicable to the carrying on by members of the profession, in relation to which it is established, of regulated activities which, if the body were to be designated, would be exempt regulated activities.[561]

In the UK, the Treasury has named ten bodies as DPBs under *The Financial Services and Markets Act 2000 (Designated Professional Bodies) Order 2001)*[562] and these include:

(i) The Law Society of England and Wales.

(ii) The Institute of Chartered Accountants in England and Wales.

(iii) The Association of Chartered Certified Accountants.

(iv) The Institute of Actuaries.

In this way the FCA regulates the professional bodies that in turn regulate the individual firms that are within their respective remit. Solicitors and solicitor practices in England and Wales are regulated by the Solicitors Regulation Authority (SRA), which is an independent regulatory body of the Law Society in England and Wales. The FCA has entered into a memorandum of understanding (MoU)[563] with the SRA which provides a framework for the working relationship between the FCA and the SRA in discharge of their duties under FSMA, relating to exempt regulated activities and authorised professional firms.

[561] Section 326 (4) of FSMA
[562] (SI 2001/1226) (as amended)
[563] See: www.fsa.gov.uk/pubs/mou/fsa_sra.pdf. Last visited on 16/08/2014.

Again the United Kingdom framework fares well on Black's core institutions with respect to reputational intermediaries. With regards to formal institutions there is a robust legal framework that imposes liability to investors if accountants and investment bankers are involved in market misconduct. Also the London Stock Exchange has sufficient listing rules which ensure that issuers are complying with their disclosure obligations. The accountancy and investment professions are also arguably well regulated[564] and most reputational intermediaries are required to have a licence in order to transact on the market. As set out above, there are also a number of SROs that exist in United Kingdom. Finally, the accounting and investment profession are sufficiently regulated as are the securities lawyers.

Of course despite this somewhat robust regulatory framework, regulatory lapses still occur in United Kingdom as evidenced by the recent matter involving the Russian firm, Eurasian Resources Corporation, (ENRC) as discussed in Chapter 5 above.[565]

7.2.4 Disclosure of Information

There are a number of provisions that need to be complied with regarding listing of securities, market conduct and reporting of issuers' financial affairs. Section 79 of the FSMA 2000 provides that no securities (other than new securities) may be admitted to the official list unless listing particulars have been submitted to, and approved by, the competent authority, currently the FCA and the PRA, and published. The listing particulars must contain

[564] There is still public clamour for more and tight regulation of investment banking in the United Kingdom. These have now been set out in the final report of the Independent Commission on Banking (The Vickers Report) published on 12 September 2011. See: http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf. Last visited on 16/08/2014.
[565] See note 334 above.

all such information as investors and their professional advisers would reasonably require, and reasonably expect to find there, for the purpose of making an informed assessment of (a) the assets and liabilities, financial position, profits and losses, and prospects of the issuer of the securities; and (b) the rights attaching to the securities.[566]

In terms of new issues of securities, all issuers of securities admitted to trading on regulated markets must provide a prospectus that will be approved by the FCA before the securities are listed.[567] The prospectus must contain all information which is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer of the securities and the rights attaching to them.[568] It is an offence to contravene the requirement for a prospectus and offenders are liable to be sued for breach of statutory duty by anyone who suffers loss as a result of the contravention.[569] Further the FCA have power to suspend or prevent a public offer of securities or impose a financial penalty or issue a statement of censure if there is suspicion of or there has been a contravention of prospectus rules.[570] There is also civil liability for misleading statements and omissions in the prospectus.[571]

The UK Listing Rules contain a number of provisions requiring issuers or prospective issuers to provide information to the FCA. When a prospective issuer has made an application for admission to listing, the FCA may request any information which the FCA may "reasonably

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566 Section 80 of FSMA 2000
567 Sections 84 and 85, FSMA, 2000, Article 13 of the EU Prospectus Directive, 2003/71/EC
568 S. 87A (1) (b) and (2), FSMA 2000 and Art 5(1), Directive 2003/71/EC
569 S. 85 (3) and (4), FSMA.
570 Ss 87K, 87L and 91, FSMA, 2000.
571 S. 90, FSMA, 2000.

require to decide whether to grant an application for admission."[572] Further, the issuer is under a duty to "take reasonable care to ensure any information it makes available through the FCA is not misleading false or deceptive and does not omit anything likely to affect the import of the information".[573] The FCA may also require that the issuer provide any information which the FCA considers "appropriate to protect investors or ensure the smooth operation of the market."[574] The FCA is also empowered to request any further information which it requires to verify whether or not the listing rules are being complied with or whether the listing rules have been complied with at some point in the past.[575]

Disclosure rules also contain some disclosure requirements. DTR 2 contains the key general obligation of disclosure. It provides that issuers must notify a Regulatory information Service[576] (RIS) as soon as possible of any inside information which directly concerns the issuer.[577]

The accounting rule writing institution in United Kingdom is the Financial Reporting Council (The FRC) and is independent from government. The FRC has two boards, namely, the Accounting Standards Board (ASB) which drafts accounting standards and the Auditing Practices Board (APB), which drafts auditing standards.

[572] Listing Rules, Chap. 1, para. 1.3.1(1) R.
[573] Listing Rules, Chap. 1, Para. 1.3.3R
[574] Listing Rules, Chap. 1, para. 1.3.1(2) R
[575] Listing Rules, Chap. 1, para. 1.3.1(3) R
[576] An information service that is approved by the Financial Services Authority (FSA) as meeting the Criteria for Regulated Information Services and that is on the FSA's list of Regulated Information Services.
[577]DTR 2.2.1R. There is an exception to this requirement under DTR 2.5.1R, which allows the disclosure of inside information to be delayed.

The foregoing shows that the United Kingdom regulatory regime satisfies most of the core institutions for information disclosure as recommended by Black. These are supported by a culture of disclosure that has developed over a long period of time among market players.

7.2.5 Liability for Insider Dealing

The United Kingdom has both civil and criminal liability regimes for insider dealing. Insider dealing occurs where an individual or organisation buys or sells securities while knowingly in possession of some piece of confidential information which is not generally available and which is likely, if made available to the general public, to materially affect the price of these securities.[578]

The civil liability is based both at common law and statute. Imposing civil liability for insider dealing has proved problematic under English common law. For example, in the case of *Percival v Wright,*[579] directors had purchased a member's shares in the full knowledge that there was a ready buyer for all the shares of the company at a higher price than they paid him. It was held that the transaction could not be set aside for the director's failure to disclose the negotiations which were already taking place at a higher price because there was no fiduciary relationship between the directors and individual shareholders and therefore no duty of disclosure to the shareholder as the duty was owed to the company alone. In *Allen v Hyatt,*[580] the court held that in some special and very limited circumstances a duty to disclose might be owed by directors to individual shareholders. In that case it was

[578] Steve Girvin, Sandra Frisby and Alastair Hudson (eds), *Charlesworth's Company Law*, (Eighteenth edition, Sweet & Maxwell, London , 2010) 592.
[579] [1902] 2 Ch. 421.
[580] (1914) 30 TLR 444.

found that a duty existed where the directors had profited through share purchases from members because they had purported to act as agents for the members by inducing the later to give them purchase options over each member's shares supposedly to facilitate a proposed amalgamation.[581]

The civil liability regime has now been bolstered by the market abuse provisions under section 118 of FSMA 2000. This particular provision was slightly amended in 2005 following the UK implementation of the Market Abuse Directive (MAD).[582] Section 118 (2) states that market abuse shall be established where there is market behaviour "based on information which is not generally available to those using the market but which, if available to a regular user of the market, would or would be likely to be regarded by him as relevant when deciding the terms on which transactions in investments of the kind in question should be effected." Where the FCA is satisfied that a person is engaged in market abuse behaviour it may impose on him a penalty of such amount as it considers appropriate.[583]

In the case of *Parker v FSA*,[584] the Financial Services and Markets Tribunal (FSMT) (whose functions were transferred to the Upper Tribunal on 6 April 2010) confirmed that the standard of proof to be applied in market abuse cases is high and could be similar to the criminal burden of proof. It upheld the decision of the RDC that the applicant, James Parker,

[581] The need for special relationship in order to impose the duty was also confirmed in the case of *Munro v Bogie* [1994] 1 BCLC 415.

[582] The UK however did not fully align its civil market abuse regime with MAD as it retained two subparagraphs of its original section 118 of the FSMA, namely s. 118 (4) on misuse of information and s. 118 (8) about misleading behaviour and market distortion. These provisions (known as super-equivalent elements of the FSMA), were made subject to sunset clauses under which they would expire after a three year period, pending the outcome of a review by HM Treasury. The provisions have subsequently been extended, on three occasions, most recently in December 2011. They will now expire on 31 December 2014.

[583] Section 123 of FSMA 2000.

[584] See: http://www.tribunals.gov.uk/financeandtax/Documents/decisions/FSMTribunal/037_JamesParker.pdf

a senior accountant at Pace Micro Technology plc (Pace) (a listed company), had engaged in behaviour which constituted market abuse (misuse of information) under *section 118* of FSMA by selling, and placing spread bets on, shares in Pace when he knew that a profit warning was imminent. However, it reduced the financial penalty imposed by the RDC. The FSMT held that market abuse, even when punished in accordance with *section 123* of FSMA and therefore by a route which is classed as civil for domestic law purposes, has to be treated, for the purposes of the European Convention on Human Rights, as a criminal charge. However, it determined that this does not lead to the conclusion that the standard of proof must be the domestic criminal standard and it referred to a "sliding scale" of proof, depending on the severity and complexity of the case. The FSMT took the view that, in the particular case at issue, it was difficult in a practical sense to draw a meaningful distinction between the civil standard of proof which must be applied and the criminal standard.

Criminal liability for insider dealing is provided under Part V of the Criminal Justice Act (CJA) 1993.[585] Section 52 of CJA 1993 creates three separate offences which may be committed by an individual within the United Kingdom. The offences are:

i. Dealing offence – where an insider deals in securities to which inside information relates.[586]

[585] This Act, which incorporates the requirement to implement the EU directive on insider dealing (Directive 89/592/EC [1989] OJ L334/30) repealed the Company Securities (Insider Dealing) Act 1985 which previously contained criminal offences for insider dealing.
[586] Section 52 (1) of CJA 1993

ii. Encouraging offence – where an insider encourages another person to deal in such securities knowing of having reasonable cause to believe that the other would have cause to do so.[587]

iii. Disclosure offence – where an individual who has information as an insider discloses that information to another person otherwise than in the proper performance of his functions of his employment, office, or profession.[588]

The dealing and encouraging offences may be committed either when the dealing in securities takes place on a regulated market[589] or where the person dealing in the price-affected securities relies on a professional intermediary[590] or is himself acting as a professional intermediary.

The offences must be proved by the prosecution beyond reasonable doubt. On conviction of any of the three offences an individual can be sentenced to a maximum of seven years' imprisonment on indictment or six months on a summary conviction together with a fine[591]. The criminal nature of this liability has been confirmed by the courts. It is therefore "*malun*

[587] Section 52 (2) (a) of CJA 1993
[588] Section 52 (2) (b) of CJA 1993
[589] The regulated markets which are regulated in the United Kingdom for the purposes of Part V of the Act of 1993 are markets established under the rules of—

(a)the International Stock Exchange of the United Kingdom and the Republic of Ireland Limited, other than the market which operates in the Republic of Ireland known as the Irish Unit of the International Stock Exchange of the United Kingdom and the Republic of Ireland Limited;
(b)LIFFE Administration & Management; and
(c)OMLX, the London Securities and Derivatives Exchange Limited.

[590] A professional intermediary is a person who carries on a relevant business activity and holds himself out as willing to engage in any such business or is employed to carry out any such activity. See: http://fs.practicallaw.com/3-107-4017?q=&qp=&qo=&qe=#a926438
[591] Section 61 (1) CJA 1993

in se", not merely regulatory "*mala prohibitum*". In *R. V McQuoid*[592] Lord Judge C.J. stated that:

> "Those who involve themselves in insider trading are criminals: no more and no less. The principles of confidentiality and trust which are essential to the operations of the commercial world are betrayed by insider dealing and public confidence in the integrity of the system which is essential to its function is undermined by market abuse..."[593]

In this case the court provided guidelines for sentencing a convicted perpetrator of insider dealing offence.[594]

Section 53 of the CJA 1993 provide for a number of defences to the three offences which must be proved on the balance of probabilities.[595] There is a defence for the dealing and/or encouraging offences if an individual is able to prove any of the following:

(i) No advantage was gained.[596] This is known as the "no profit/no loss" defence. A person will have a defence if he can show that, at the time, he did not expect the dealing or encouraging to result in a profit (or the avoidance of a loss) attributable to the fact that the information he possessed was price-sensitive information in relation to the securities.

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[592] [2009] 4 All E.R. 388
[593] *Ibid* para. 8
[594] *Ibid* at para 14.
[595] There are three defences for the dealing and encouraging offences under section 53 (1) and (2) and two defences under the disclosure offence.
[596] *section 53(1)(a), CJA*

(ii) Adequate disclosure was made.[597] This is known as the "equality of information" defence. The defendant must prove that he believed on reasonable grounds:

- (in relation to the dealing and encouraging offences) that the information had been sufficiently widely disclosed to ensure that no-one taking part in the dealing would be prejudiced by not having the information; or
- (in relation to the encouraging offence only) that sufficiently wide disclosure would be made and prejudice avoided.

(iii) He would have traded anyway.[598] In order to rely on this defence, the defendant must prove that he would have done what he did even if he had not had the inside information.

With respect to the disclosing offence, an individual has defence if he is able to prove that:

(iv) He did not expect dealing to occur.[599] This is where the defendant did not at the time expect any person to deal in securities on a regulated market or by or through a professional intermediary as a result of his disclosure.

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[597] *section 53(1)(b), CJA*
[598] *section 53(1)(c), CJA*
[599] *section 53(3)(a), CJA*

(v) He did not expect a profit to result or a loss to be avoided.[600] This defence will apply where, although the defendant had such an expectation at the time, he did not expect the dealing to result in a profit made or loss avoided attributable to the fact that the information was price sensitive.

Schedule 1 of the CJA provides three further special "market" defences to the dealing and encouraging offences (*Schedule 1, CJA*). These relate to activities carried on by market makers, the dissemination of market information and permitted price stabilisation activities.

The United Kingdom framework therefore exhibits a very robust set of liability risks for those contemplating insider dealing transactions. The framework provides for both civil and criminal liability for breach of insider dealing rules. There are clearly severe sanctions for violation of these rules. Under the current UK corporate governance regime, companies are public companies obliged to have a specific number of independent directors who are equally liable as other directors. These provisions are capped by a culture of compliance among accountants, lawyers, independent directors and company managers.[601]

7.2.6 Market Transparency

Ensuring market transparency requires prompt and accurate reporting of all trades and trading prices and also avoiding practices that manipulate share prices to create a false market. In the United Kingdom market transparency is regulated under provision against

[600] *section 53(3)(b), CJA*
[601] Charles R.P. Pouncy (2002) *supra* note 26 at p. 111

market abuse. The FSMA 2000 provides for a primary market abuse offence[602] and a secondary offence.[603]

Under section 118(1)(a) of FSMA, market abuse is behaviour (that is, action or inaction) which both:

(i) "occurs in relation to:

- qualifying investments admitted (or in respect of which a request has been made for admission) to trading on a prescribed market; or

- in the case of the insider dealing (*section 118(2), FSMA*) and improper disclosure (*section 118(3), FSMA*) market abuse behaviours only, investments which are relate to such qualifying investments, (that is, an investment whose price or value depends on the price or value of the qualifying investment);

(ii) falls within any one or more of the seven types of behaviour set out in sections 118(2)- (8) of FSMA".[604]

The secondary offence is provided under section 123(1)(b), FSMA and involves taking, or refraining from taking, action which requires or encourages another person to engage in behaviour which would be market abuse if the encourager had carried out the behaviour.

[602] Section 118, FSMA.
[603] Section 123, FSMA
[604] These include, (i) insider dealing, (ii) improper disclosure of inside information (or "tipping off"), (iii) misuse of information, (iv) manipulating transactions, (v) manipulating devices, (vi) dissemination and (vii) misleading behaviour and market distortion.

The person required or encouraged does not need to have actually engaged in market abuse and there is no requirement that he should have benefited from it.

Further requirements to disclose inside information are provided by the Disclosure Rules and Transparency Rules sourcebook (DTR). Thus under DTR 2.2.2R, an issuer of shares must notify a regulatory information service (RIS) as soon as possible of any inside information which concerns the issuer.[605] Also, persons discharging managerial responsibilities (PDMRs) of the issuer company must notify all transactions conducted on their own account in the company's shares or derivatives relating to those shares.[606]

In terms of accounting records, s. 386 of the Companies Act 2006, requires every company to keep accounting records which are sufficient to show and explain the company's transactions and also to disclose, with reasonable accuracy, the financial position of the company at any time. A company's accounting records must be open, at all times, for inspection by the company's officers.[607] There is a criminal sanction for failure to comply with this provision.[608] Section 441 of CA, 2006 requires the directors of a company to deliver a copy of the company's annual account and reports to the Companies House. Failure to do so is a criminal offence on the part of every person who was director of the company immediately before the period ended.[609]

[605] Under DTR 1.4.1R, the FSA may require trading to be suspended if there are reasonable grounds to suspect a failure to comply with disclosure rules and may impose a financial penalty in the event of breach-DTR 1.5.3G.
[606] DTR 3.1.2R
[607] Section 388 (1) CA, 2006.
[608] Section 389 (1), CA 2006.
[609] Section 451, CA, 2006.

Finally, the United Kingdom capital market is always under the spotlight through a very active and specialised financial press. This helps to ensure prompt and accurate reporting by companies who fears being named and shamed in the press. Also exclusive financial papers like The Financial Times (FT) and television channels like Bloomberg, serves as constant feeds for up to date market information including daily share prices. This also helps the disclosure of information.

The United Kingdom's regulatory framework sufficiently promotes market transparency. There are specific rules coupled with effective technology which ensures that time, quantity and price of trades in public securities are promptly disclosed to investors. Further, there are clear rules banning manipulation of trading prices and enforcement of the same. This is supported by active press that is ready to uncover and publicise any instances of market misconduct.

7.2.7 Liability of Issuers, Directors and Reputational Intermediaries for Market Misconduct

The United Kingdom regulatory regime provides for liability of the issuer companies as well as reputational intermediaries through statutory provisions and common law. The relevant provision under the FSMA 2000 is section 90, which provides for a general civil liability to *any person* who has acquired securities on the basis of information contained in the listing particulars and has as a result suffered a loss due to incorrect or misleading statements.

Also the Public Offers of Securities Regulations 1995[610], sets out who are responsible for, and thus who are competent defendants in any proceedings in respect of, the prospectus or supplementary prospectus or listing particulars[611] and these include the issuer of the securities and (where the issuer is a body corporate) the directors of the issuer at the time when the document was published and where the issuer is not the offeror (e.g. under an offer for sale by a merchant bank) then the offeror is also a responsible person in addition to the issuer.[612] Further, any person who accepts and is stated as accepting responsibility for any part of the prospectus or listing particulars is also a responsible person and therefore a potential defendant.[613] This is the provision that attaches investor liability to any professional who assisted the issuer during the offering process.

At common law, the general approach is that those preparing a prospectus relating to the issue of securities must do so with complete honesty.[614] Those who issue a prospectus inviting the public to acquire shares of the issuer are bound to state everything with "strict and scrupulous accuracy."[615] There have, however, been two different judicial approaches for attributing liability to investors for professional negligence. In the landmark case of *Caparo Industries Plc v Dickman*[616] the House of Lords advocated a narrow view of proximity when determining liability to third parties. In this case it was argued that auditors owed both shareholders and potential investors a duty of care in their certification of accounts. The court however held that liability for economic loss due to negligent misstatement would

[610] SI 1995/1537
[611] SI 1995/1537, reg 13(1)
[612] SI 1995/1537, reg 13(1)(f)
[613] SI 1995/1537, reg 13(1)(d)
[614] Steve Girvin, Sandra Frisby and Alastair Hudson (ed), *Charlesworth's Company Law*, (Eighteenth Edition, Sweet & Maxwell, London, 2010) 261.
[615] *New Brunswick, etc., Co v Muggeridge* (1860) 1 Dr. & Sm. 363 at 383.
[616] [1990] 2 A.C. 605

be confined to those cases where the statement or advice was given to a known recipient for a specific purpose of which the maker was aware and upon which the recipient had relied to his detriment.[617] The court therefore restricted defendant's liability to those it knew would receive the statement and rely upon it for the purposes of a particular transaction.[618]

A more relaxed approach was adopted by the Court of Appeal a year later in the case of *Morgan Crucible Co Plc v Hill Samuel Bank Ltd*,[619] where the directors and financial advisors of the target company had made express representations in the course of a contested takeover forecasting a 38 percent increase in pre-tax profits at a time when an identified bidder of the company had emerged in order to induce the bidder to make a higher bid. The Court of Appeal held that there was a relationship of sufficient proximity between the bidder and those who had been responsible for the statements to found a duty of care in negligence. In another case of *Possfund Custodian Trustee Ltd v Diamond*[620] the prospectus prepared in relation to initial placement of shares on the Unlisted Securities Market greatly understated the issuer's liabilities to pay extra premiums to syndicates at the Lloyds of London insurance market, and the company subsequently went into receivership due to the burden of paying those extra premiums. It was argued, *inter alia*, that those responsible for the prospectus had breached a duty of care owed to the purchasers of the shares. The court held that investors had been justified in relying on the statement made in the prospectus when making their investment decisions and that a duty of care would exist if subsequent

[617] Ibid at 638 Per Lord Oliver.
[618] This approach was also followed in *Al-Nakib Investments (Jersey) Ltd v Longcroft* [1990] 3 All E.R. 321.
[619] [1991] 1 All ER 148.
[620] [1996] 2 All ER 774

purchaser could show the following things (1) that he relied reasonably on the prospectus, (2) that he reasonably believed that the defendant intended him to act on them and that there was a sufficiently direct connection between the parties to make such a duty fair, just and reasonable.

It has been suggested that the effect of the FCA Prospectus Rules, is that the entire investing public is necessarily within the cognisance of any person involved in the preparation of a prospectus for an offer of securities to the public and as such any loss caused by a negligent misstatement in such a prospectus must now be actionable in tort.[621]

Finally, promoters, directors, experts or the persons making an offer for sale are liable for fraud if it can be shown that they signed, or authorised the issue of, a prospectus containing a false statement which they did not honestly believe to be true with the intention that another person should act upon it, and that he acted on it to his detriment.[622]

There is also specific liability for contravention of specific provisions of legislation. Thus, there are a number of sanctions that may be imposed by the FCA for non-disclosure of information. The FCA may impose the following sanctions for breach of the Disclosure Rules and Transparency Rules:

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[621] Steve Girvin *et al* (2010) supra note 599 at p. 267. Girvin, *et al*, further conclude that' the precise *ratio decidendi* of the decision of House of Lords in *Caparo v Dickson* has now been superseded in relation to securities failing within s. 85 of the FSAMA 2000 becasuse the makers of representations in prospectuses may not necessarily be able to hide behind a claim that their statements were intended to be made only to limited class of buyers. Ibid at p. 267.

[622] *Derry v Peek* (1889) 14 App. Cas. 337. Per Lord Herschell at p. 374.

(i) Censure the issuer and/or any person who was at the material time a director of the issuer and was knowingly concerned in the contravention.[623] This includes an ex-director if he was a director at the material time.[624]

(ii) Fine the issuer and/or a director knowingly concerned in the breach.[625]

Additionally, in the case of breach of the Disclosure Rules:

(iii) censure or fine persons discharging managerial responsibility (PDMRs) within an issuer or any connected person ;[626]

(iv) suspend the issuer's securities from trading.[627] Examples of when the FCA may impose suspension for breach of the Disclosure Rules include where an issuer fails to make an announcement to a Regulatory Information Service (RIS) as required by the Disclosure Rules within the time limit or where there is a leak of inside information and the issuer is unable to issue an appropriate RIS announcement within a reasonable time.[628]

Further, for breach of the Transparency Rules:

(v) censure an issuer where the FCA finds that it failed to comply with an applicable transparency obligation.[629]

(vi) suspend the issuer's securities from listing.[630]

(vii) fine a person who has contravened a provision of the Transparency Rules.[631]

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[623] Section 91(2) and (3), FSMA
[624] Section 91(2), FSMA.
[625] Section 91(1), 91(1ZA), 91(1A) and 91(2), FSMA.
[626] DTR 1.5.3R
[627] DTR 1.4.1R.
[628] DTR 1.4.4G
[629] Section 89K, FSMA.
[630] Section 89L, FSMA;

Also, in the case of breach of the Listing Rules:

(viii) censure a sponsor where the FCA considers that the sponsor has contravened any requirement imposed on him by the Listing Rules.[632]

(ix) suspend the issuer's securities from listing.[633]

(x) cancel the issuer's listing of securities where the FCA is satisfied that there are special circumstances that preclude normal regular dealings in them.[634]

And finally, in the case of breach of the Prospectus Rules:

(xi) suspend or prohibit the offer to the public of transferable securities.[635]

(xii) suspend or prohibit admission of transferable securities to trading on a regulated market.[636]

Section 91 of FSMA contains the FCA's power to fine issuers and others for breach of the Listing, Prospectus, Disclosure or Transparency Rules. The FCA may impose a penalty of such amount as it considers appropriate.

Under s. 123 (1) (a), FSMA, if the FCA is satisfied that a person is, or has, engaged in market abuse, it may impose a financial penalty, or publish a statement to the effect that the person has engaged in market abuse. Also under sections 89 and 90 of Financial Services Act, 2012, it is a criminal offence for any person to do any act, or engage in any course of conduct, which creates a false or misleading impression as to the market in, or price or value

[631] section 91(1B), FSMA;
[632] section 89, FSMA and LR 8.7.19R
[633] section 77(2), FSMA, LR 5.1.1R and 5.1.2G;
[634] section 77(1), FSMA and LR 5.2.1R.
[635] section 87K, FSMA;
[636] section 87L, FSMA

of, any relevant investments. Finally as stated above, insider dealing is also a criminal offence under the Criminal Justice Act 1993 which carries a penalty of imprisonment for up to seven years and/or a fine for which there is no limit.[637] We therefore argue that the UK regulatory regime is sufficiently robust for the efficient, fair and transparent operation of its capital market.

7.3 CAPITAL MARKETS IN SOUTH AFRICA

Like many other African countries, South Africa has one Stock Exchange, the Johannesburg Stock Exchange (JSE). However unlike many African countries, the South African capital market is far more advanced and developed. The JSE is Africa's largest and most vibrant stock market accounting for over 90 per cent of the total market capitalization of sub-Saharan Africa and over 76 per cent of the entire continent.[638] In this respect, South Africa forms a very good case study of development of capital markets as it stands out as a success story among failing and underdeveloped markets on the African continent.

In 2003 the JSE had 472 listed companies and a market capitalisation of US$182.6 billion (€158 billion) as well as an average monthly traded value of US$ 6,399 million (€5.5 billion). As of 30 September 2006, the market capitalisation of the JSE was at US$579.1 billion. The JSE is presently the 16th largest stock exchange worldwide.[639]

[637] Section 61 (1)
[638] Kenneth Kaoma Mwenda; *The Dynamics of market integration: African Stock Exchanges in the New Millennium,* (Brown Walker Press, USA, 2000) 86.
[639] JSE Website at http://www.jse.co.za/

The need for a stock exchange arose following the discovery of gold on the Witwatersrand in 1886 which had led to many mining and financial companies opening. This resulted in the establishment of the *Johannesburg Exchange & Chambers Company* by a London businessman, Benjamin Minors Woollan.[640] The JSE was born out of this company on November 8, 1887. The Exchange expanded at a rapid pace resulting in its moving from one building to another as buildings were being outgrown within short periods of time. By 1963, the JSE became a member of the Federation International Bourses de Valeurs (FIBV) and in 1993 the JSE became an active member of the African Stock Exchanges Association.[641] A landmark development of the JSE took place on June 7, 1996 when the open outcry system of trading was changed to a new era of computer trading. The JSE adopted a fully automatic electronic trading system named the JET System (Johannesburg Equities Trading), which is an order-driven automated trading system acquired from the Chicago Stock Exchange.[642]

On 2 May 1996 a Memorandum of Understanding was signed between the banks (represented by BankServ) and the JSE, to establish an electronic settlement system for the South African equities market known as STRATE (Share Transactions Totally Electronic), in order to facilitate settlement and the transfer of ownership by electronic book entry.[643] The electronic system was vital to enhance the security of settlement in the market and brought South Africa in line with international practice. In August 1997, the JSE launched the real-time Stock Exchange News Service (SENS) to enhance the market transparency and investor confidence.[644]

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[640] See: https://www.jse.co.za/about/history-company-overview
[641] *Ibid*
[642] *Ibid*
[643] *Ibid.*
[644] *Ibid.*

Another important milestone for the JSE was the strategic alliance that was formed with the London Stock Exchange (LSE) in 2002. As part of the JSE's alliance with the LSE, its trading system was replaced with the SETS system hosted by the LSE.[645] This proved to be more than just a change in technology platforms as this change also improved the international visibility and acceptability of the JSE. In addition, the JSE modernised its operations with the launch of a new indexing system in conjunction with the Financial Times Stock Exchange (FTSE) index, the FTSE/JSE African Index Series and free-float adjusted series. This system provided international investors with an indexing system with which they are familiar.[646]

The JSE enrols shares on two separate markets, the Main Board and Alternative Exchange (Alt-X). A company applying for listing on the Main Board may qualify for one of the three possible listings, the Main Board, the Development Capital Market (DCM), or the Venture Capital Market (VCM).[647] The DCM exist to encourage the growth of small to medium size businesses and companies which are not able to list on the Main Board by offering less onerous listing criteria while the VCM aims at assisting companies specializing in venture companies by offering even less onerous listing criteria.[648] Further, the JSE has introduced to the Main Board the Financial-Redevelopment sector[649] to promote the socioeconomic development of South Africa and the Industrial-development stage sector[650] to promote industrial development in South Africa.

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[645] *Ibid*.
[646] *Ibid.*
[647] R.A. Clark, *The Africa's Emerging Securities Markets: Developments in Financial Infrastructure,* (Quorum Books, London, 1998) 156.
[648] *Ibid*, p. 157.
[649] In evaluating a listing of a redevelopment entity, the JSE will have regard, inter alia, to the fundamental principle that the principal objective of the redevelopment entity must be the provision of assistance, whether through investment, loan, or other means acceptable to the JSE, to persons, communities, or undertakings which, in the opinion of the JSE, are of a socioeconomic development nature.
[650] This allows for securities of substantial industrial companies that are in the developmental stage and which accordingly, do not have the profit history required for a main Board listing to be listed.

The Alt-X on the other hand is the JSE's market established to accommodate small and medium sized high growth companies. The Alt-X was therefore designed to appeal to the investor who understands the nature of such a market and who is prepared to accept the potential risks and rewards in investing in growing companies.[651]Alternative markets like the Alt-X help reduce market uncertainty as well as the free-rider problem as allowing growth companies on the main market would increase uncertainty as to which companies are risky and if any such small companies gets into trouble, the reputation of the entire market would be called into question. Having a special market for small and usually risky companies, alerts investors to the potential risks in those companies and this help investors to make an informed decision to invest in such companies.

7.3.1 Legislation

The main piece of legislation governing the securities markets in South Africa is the Securities Services Act of 2004 (SSA 2004).[652] Section 2 of the Act set out its objectives as follows:

(a) to increase confidence in the South African financial markets by –

(i) requiring that securities services be provided in a fair, efficient and transparent manner; and

(ii) contributing to the maintenance of a stable financial market environment;

(b) to promote the protection of regulated persons and clients;

(c) to reduce systemic risk; and

[651] Alt-X has implemented best practice principles in order to mitigate the potential risks associated with small to medium companies, including good corporate governance and rigorous market surveillance. See: www.psgonline.co.za

[652] The Securities Services Act, No. 36 of 2004, (SSA) came into operation on 1 February 2005, replacing the Stock Exchanges Control Act, 1985, the Financial Markets Control Act, 1989, the Custody and Administration of Securities Act, 1992 and the Insider Trading Act, 1998.

(d) to promote the international competitiveness of securities services in the Republic.

7.3.2 Local Enforcement

The regulatory mandate of capital markets in South Africa is in the hands of the Financial Services Board (FSB), which is an independent institution established by statute[653] to oversee the South African Non-Banking Financial Services Industry in the public interest. The FSB is committed to promoting and maintaining a sound financial investment environment in South Africa.[654] There is also a Financial Markets Advisory Board (FMAB)[655] which may on its own initiative, and must, at the request of the Minister of Finance or the Registrar of Securities Services, investigate and report or advise on, administrative and technical matters concerning regulated persons or the provision of securities services.[656]

The SSA 2004 also established the Directorate of Market Abuse (DMA) which has statutory mandate to investigate cases of market abuse and to enforce the prohibitions against market abuse in the Act. The DMA has wide powers of interrogation, search and seizure of records and documentation, and the ability to obtain details of the beneficial owners of securities held by nominees, to deal with market abuse investigations.

If the DMA is of the opinion that the SSA 2004 has been contravened, it can take enforcement action against the offender. Such cases could be referred to the Enforcement Committee of the FSB, or handed over to the prosecuting Authorities if there is a criminal

[653] Financial Services Board Act, 1990 (Act No. 97 of 1990).
[654] See Financial Service Board website at www.fsb.co.za.
[655] The Financial Markets Advisory Board established by section 3 of the Financial Markets Control Act, 1989 (Act No. 55 of 1989), continues to exist by virtue of section 6(1) of the 2004 Act.
[656] Section 6 (7) of the SSA 2004. Regulated person means a self-regulatory organisation or any other person who provides or who previously provided securities services. (see Section 1 of the SSA 2004).

element. The DMA makes a media release after every meeting to update the public on its current investigations and every enforcement action is published once it is completed.

The frontline detection and prevention of market abuse is undertaken by the JSE Surveillance Division, which has in place a number of proprietary systems that have been specifically designed to detect unusual trading volumes and price movements, which could be indicative of insider dealing or market manipulation. When there is an alert of a possible market insider dealing or manipulation, the Surveillance Division undertakes an initial investigation and the results are brought to the attention of the DMA. Staff in the Market Practices Department of the Surveillance Division are responsible for detecting any signs of market abuse using this proprietary technology, which refreshes the trading information every half hour. When unusual activity is detected, and there appears to be no obvious cause, the surveillance officers may contact the sponsors of a listed company and request that they ask the directors if they know of any price-sensitive information that is due to be released. Should this be the case, the company is requested to make the relevant announcement as soon as possible through SENS. If there is a delay in making an announcement, the JSE may halt trading in the company's shares until the announcement has been made.

Responsibility for prosecutions lies solely with the Directorate of Public Prosecutions. A person aggrieved by a decision of the registrar of the FSB or an exchange under a power conferred or a duty imposed upon the registrar or the exchange by or under the SSA 2004, has a right of appeal to the board of appeal established under section 26 of the Financial Services Board Act, 1990.[657]

[657] Section 111 of the SSA 2004.

There is however no right of appeal to a court of law, although it is possible that an aggrieved party may institute judicial review proceedings in the event of an unsatisfactory decision of the board of appeal. The High Court or regional courts have statutory jurisdiction to try criminal offences under the SSA 2004.[658] Also in order to enforce civil remedies, the FSB may apply to a Court for an order of attachment of assets or disclosure of evidence to prevent their concealment, removal, dissipation or destruction.[659] The board may also institute any interdict or interlocutory proceedings against a person who made a profit or avoided a loss or whom the board reasonably believes may have made a profit or avoided a loss through insider dealing.[660]

South Africa demonstrates a high level of local enforcement and it fares very well with Black's preconditions in this respect. It has a well-established securities regulator, the FSB, which is well resourced with sufficient and skilled staff. Investigations and prosecution of market misconduct are done by the DMA and the Director of Public Prosecutions respectively. The judicial system in South Africa is also well established. Although South Africa has decent regulators, prosecutors and Judges. However this may not be comparable to the level of competence and honest exhibited by law enforcement agencies in the United Kingdom.

7.3.3 Reputational Intermediaries

A number of reputational intermediaries operate in the South African capital market including financial advisors and intermediaries (which are usually accountants and auditors), investment bankers and stock brokers and other licensed members of the Stock Exchange.

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[658] Section 79 of the SSA 2004
[659] Section 81 (1) of the SSA 2004
[660] Section 81 (2) of the SSA 2004

In terms of regulation of these intermediaries, the South African regulatory framework exhibits a number of layers of regulation which seek to ensure that every agency that advises investors is properly kept in check. The FSB has broad regulatory authority over the JSE Exchange and the Bond Exchange of South Africa Ltd (BESA), financial advisors and intermediaries (FAIS), collective investment scheme operators (CIS), pension funds, and insurance companies.[661] The FSB has authority to perform on-site examinations, to require reports, and to investigate misconduct and to impose penalties for violations of applicable laws.[662] The FSB itself is subject to the general authority of the Ministry of Finance who appoints the members of the Board and selects the senior officers, after consultation with the Board.[663]

SROs are said to be critical components of the regulatory system. Both the JSE and the BESA, which is the principal bond exchange, operate as SROs and have primary regulatory responsibility for licensing members (authorized users) and employees and to enforce the exchange's listings requirements. STRATE (Share Transactions Totally Electronic) Ltd[664] is an SRO that functions as the central securities depository for both listed equity securities and debt (government and corporate).[665] The South African Reserve Bank (SARB), the nation's central bank, has regulatory responsibilities over investment bankers.

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[661] See, The IMF Financial System Stability Assessment Report for South Africa, 2008. **http://www.imf.org/external/pubs/ft/scr/2008/cr08349.pdf** para 64.
[662] *Ibid*.
[663] *Ibid* para. 63
[664] Strate Ltd is a licensed Central Securities Depository (CSD) for the electronic clearing and settlement of financial instruments in South Africa. See: http://www.strate.co.za
[665] *Ibid*

While the foregoing shows some level of interaction between multiple government agencies, oversight committees and SROs, the IMF has described the system as complex and recommended clearly delineating responsibilities to minimise gaps and overlaps.[666]

As demonstrated above, the South African regime shows some level of existence of reputational intermediaries. One problem however would be lack of clear provisions imposing liability on accountants and investment bankers in the event of non disclosure or disclosure of misleading information[667]. The JSE however has sufficient listing rules that ensure market transparency. There are also a number of SROs with their own licensed members. The long trading history of the South African market has resulted in existence of skilled and experienced accounting and investment professions as well as sophisticated securities lawyers. Overall, therefore, South African regulatory framework compares positively to Black's recommendations on reputational intermediaries. There are a number of reputational intermediaries in existence in South Africa with sufficient capability to provide checks and balances on companies trading stock.

7.3.4 Disclosure of Information

There are a number of provisions both under the listing rules and the SSA 2004 that aim at promoting market transparency in South Africa.

The JSE Listing requirements (LRs) obliges applicant companies seeking to list their securities on the market to disclose various forms of information that will help investors make informed investment

[666] *Ibid,* p. 32
[667] The only provision that may be used by investors would be section 104 of the new CA, 2008 and section 76 of the Securities Act 2004.

decisions. There are also various continuing obligations that are imposed on existing issuers to disclose information. LR 1.25 provides the JSE with general mandate to require an applicant issuer to disclose to it, such information at the applicant issuer's disposal as the JSE may determine, save to the extent that the issuer has obtained a court order excusing it from such disclosure. If the JSE is satisfied that the disclosure of that information to the registered holders of the securities in question will be in the public interest, it may by notice in writing require such applicant issuer to publicly disclose that information within the period specified in the notice.

Further, a new applicant or an issuer who applies for a listing of securities that requires the publication of a pre-listing statement must provide a pre-listing statement/prospectus containing:

> i. "the information pertaining to the nature and circumstances of the applicant and the type of securities concerned as specified in this section; and
>
> ii. such additional information as the JSE may consider investors reasonably require for the purpose of making an informed assessment of the prospects and status of the applicant."[668]

A new issuer is also required to submit to the JSE a report of historical financial information when the new issuer makes an application for listing and issuing a prospectus/pre-listing statement providing the following[669];

i. statements of comprehensive income;
ii. statements of financial position;
iii. statements of changes in equity;

[668] LR 6.1 and 6.6
[669] LR 8.1, 8.3 and 8.11

iv. statements of cash flows;

v. accounting policies;

vi. notes thereto;

vii. segmental information; and

viii. any major change in the nature of property, plant and equipment and any change in policy regarding the use thereof as well as details of any material loan receivable.

LR 3.4 stipulates a general continuing obligation of disclosure of any material price sensitive information. Thus with the exception of trading statements, an issuer must, without delay, release an announcement providing details of any development in such issuer's sphere of activity that is not public knowledge and which may, by virtue of its effect, lead to material movements of the reference price of such issuer's listed securities[670]. Further all issuers must disclose periodic financial information including dividends and interests and interim and yearly reports must be sufficiently published.[671] Also an issuer must publish audited annual financial statements for its financial year, as specified in the prospectus/pre-listing statement, irrespective of the fact that the company may have subsequently changed its year-end.[672]

According to LR 3.9 when an issuer acquires knowledge of any material price sensitive information and the necessary degree of confidentiality of such information cannot be

[670] LR 3.4 (a). However under LR 3.10, if the directors of an issuer consider that disclosure to the public of information in accordance with paragraph 3.4 will or probably will prejudice the issuer's legitimate interests, the JSE may grant a dispensation from the requirement to make such information public.
[671] LR 3.11 and 3.15
[672] LR 4.13 (b)

maintained or if the issuer suspects that confidentiality has or may have been breached an issuer must immediately submit a copy of a cautionary announcement[673] to the JSE for approval, and once such approval has been obtained, must publish such cautionary announcement and must provide updates thereon in the required manner and within the time limits.[674]

There is also a disclosure requirement targeting trading activities of directors. LR 3.63 states that an issuer, via its sponsor, must announce the following information:

(a) details of all transactions (including off market transactions) in securities relating to the issuer by or on behalf of:

- (i) a director and company secretary (held directly, indirectly, beneficially or non-beneficially) of the issuer;
- (ii) a director and company secretary (held directly indirectly, beneficially or non-beneficially) of a major subsidiary company (as defined in 3.35) of the issuer;
- (iii) any associate of 3.63 (a) (i) or (ii) above (collectively referred to for the purposes of this section as "directors"); or
- (iv) any independent entity, and, in terms of which, any party in paragraph 3.63 (a) (i)-(iii) may derive any beneficial interest now or in the future;"

[673] The purpose of the cautionary announcement is to alert existing and potential future shareholders to exercise care in trading before the company is in a position to make a detailed announcement. One reason for making a cautionary announcement would be to signal to the market that the company posting the announcement is in a price-sensitive situation, such as merger, acquisition or disposal discussions with another party or where it is in a legal dispute with another company.

[674] See LRs 11.40 and 11.41

Price-sensitive information may only be disseminated to a broad audience once it has been published by SENS. Hence, an issuer that has its own website address on the internet may make an announcement on its website or release information to the media only after the announcement has been released through SENS.

Under Section 15 of the SSA 2004, an exchange may require an issuer of listed securities to disclose to it or to the registered holders of the securities any information at the issuer's disposal about those securities, or about the affairs of that issuer, if such disclosure is necessary to achieve one or more of the objects of the Act within a period specified by the exchange.[675] Where the issuer refuses to disclose the information to the exchange or the registered holders of the securities the exchange may, unless the issuer obtains a court order excusing it from such disclosure, suspend trading in those securities until such time as the required disclosure has been made to the satisfaction of the exchange.[676] Further, when an issuer discloses information in terms of this section to the registered holders of securities that may influence the price of those securities, the issuer must at the same time make the information available to the public.[677]

Financial institutions, whether in the business of buying or selling listed securities or not, must report any transaction in listed securities resulting in a change of beneficial ownership of those securities and concluded by it outside of an exchange to the registrar who must in turn disclose the information to the exchange on which the securities are listed and the

[675] See, section 15 (1)(a) of the SSA 2004.
[676] Section 15 (1) (c) of SSA 2004.
[677] Section 15 (2) of SSA 2004

public, unless the registrar is satisfied on reasonable grounds that such disclosure will be contrary to the objects of the Act.[678]

Finally section 63 of the SSA 2004 requires a self-regulatory organisation to disclose information relating to or arising from its functions to any other self-regulatory organisation or supervisory authority, whether domestic or foreign, if such disclosure will further one or more of the objects of the Act.

It is clear that both the JSE listing rules and the SSA 2004 provide for extensive disclosure of information to investors as recommended by Black. However, the regulatory framework does not clearly provide for ownership disclosure rules so that outsiders know who the insiders are. Also there is no specific rule writing organisation with respect to accounting rules.

7.3.5 Insider Dealing Liability

South Africa has made significant strides in its efforts to prevent insider dealing. Initially the prohibition of insider dealing was contained in the Companies Act of 1973,[679] which made insider dealing a criminal offence but no provision was made for civil liability. The provisions under the Companies Act were replaced by the Insider Trading Act (1998) which provided for both criminal prosecution and civil action. The 1998 Act has now been repealed by the SSA 2004 which has maintained the criminal and civil liability regimes.

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[678] Section 21 (1) and (3) of the SSA 2004

[679] This was provided under section 440 of the 1973 Companies Act.

The criminal liability is provided under section 73 of the SSA 2004, which sets out four different forms of insider trading offences as follows:[680]

i. An insider dealing in the securities for his own account.[681]
ii. An insider dealing in the securities on behalf another person.[682]
iii. An insider disclosing inside information.[683]
iv. An insider encouraging or discouraging others to trade.[684]

Jurisdiction to try any of the above offences is reserved for a High Court or a regional court.[685] A person convicted of these offences is liable on conviction to a fine not exceeding R50 million or to imprisonment for a period not exceeding 10 years, or to both such fine and imprisonment.[686]

Civil liability is provided for under section 77 of the SA 2004 which provides that where an insider commits any of the offences set out in section 73 above and makes a profit or would have made a profit if he or she had sold the securities at any stage or avoids a loss, through such dealing is liable, at the suit of the board in any court of competent jurisdiction, to pay to the board:

i) the equivalent of the profit or loss

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[680] There are statutory defences to all insider trading offences.
[681] **S**ection 73(1)(a) of the SSA 2004
[682] Section 73 (2) (a) of the SSA 2004
[683] Section 73(3)(a) of the SSA 2004
[684] Section 73(4) of the SSA 2004
[685] Section 79 of the SSA 2004
[686] Section 115 of the SSA 2004

ii) a penalty, for compensatory and punitive purposes, in a sum determined in the discretion of the court but not exceeding three times the amount referred to in paragraph (i);

iii) interest;

iv) the commission or consideration received for such dealing, if any; and

v) cost of suit on such scale as may be determined by the court.

The foregoing shows that the criminal and civil liabilities run concurrently and in parallel to each other with the later instigated wherever a profit has been realised from the dealing or loss avoided due to the dealing. This is clearly a robust way of combating insider dealing and measures well against Black's recommendations. Also, the corporate governance provisions under the King Report on Corporate Governance[687] require public companies to have independent directors.

7.3.6 Market Transparency

The SSA 2004 prohibits a number of market practices that would amount to market abuse in order to promote market transparency.

Section 75 (1) of the SSA 2004 contain a general prohibition of any practice that will have the effect of manipulating the market. This include directly or indirectly using or knowingly participating in the use of any manipulative, improper, false or deceptive practice of trading

[687] The King Report on Corporate Governance for South Africa refers to the South African Codes of corporate governance issues by the King Committee on Corporate governance. These were issued in 1994 (King I), 2002 (King II), and 2009 (King III).

in a security listed on a regulated market, which brings about a false or deceptive appearance of the trading activity or creates an artificial price for the security.

The Act also sets out a number of specific practices that will be deemed to be manipulative, improper, false or deceptive trading practices.[688] Issuing of false statements is prohibited because it can harm the integrity of and undermine public confidence in markets. Incorrect published information regarding the financial state of a listed company may encourage investors to trade in the company's shares at prices that would not be sustainable were the true facts known.[689]

Consequently the SSA 2004 prohibits false statements under section 76 which states as follows:

> "(1) No person may, directly or indirectly, make or publish in respect of listed securities, or in respect of the past or future performance of a public company-
>
> (a) any statement, promise or forecast which is, at the time and in the light of the circumstances in which it is made, false or misleading or deceptive in respect of any material fact and which the person knows, or ought reasonably to know, is false, misleading or deceptive; or
>
> (b) any statement, promise or forecast which is, by reason of the omission of a material fact, rendered false, misleading or deceptive and which the person knows, or ought reasonably to know, is rendered false, misleading or deceptive by reason of the omission of that fact.
>
> (2) A person who contravenes subsection (1) commits an offence."

[688] Employment of price stabilising mechanisms that are regulated in terms of the rules or listing requirements of an exchange, however, does not constitute a manipulative, improper, false or deceptive trading practice for the purposes of this section or insider trading. Section 75 (3).

[689] See, JSE Booklet on Insider Trading and other market abuses found at *www.jse.co.za/.../JSE...Insider_Trading/Insider_Trading.sflb.ashx* *at* page 24

This prohibition also applies to cases where negligence causes the misleading statement to be made and also relates to any other person who is responsible for a false or misleading statement including stockbrokers and market analysts.

South Africa has an active and well informed financial press that help to report any undisclosed market information as well as insider dealing attempts by company insiders.

South Africa, like the United Kingdom, has sufficient rules, which ensure that time, quantity and price of trades in public securities are promptly disclosed to investors. This is also propped up by advanced technology, SENS information system. Further, there are specific rules banning manipulation of trading prices and enforcement of the same. As stated above, there is an active press in South Africa that help to uncover and publicise any instances of market misconduct. This checks most of the recommendations by Black regarding market transparency.

7.3.7 Liability for issuers, directors etc, for market misconduct

Liability for contravention of obligations under the SSA 2004 is provided for under section 115 of the Act which states that a person who commits an offence referred to in sections 73, 75 or 76 is liable on conviction to a fine not exceeding R50 million or to imprisonment for a period not exceeding 10 years, or to both such fine and imprisonment.[690] Further, a person who commits an offence referred to in section 92(2) is liable on conviction to a fine or to imprisonment for a period not exceeding 5 years, or to both a fine and such imprisonment. Finally, a person who contravenes or fails to comply with section 4(1) or (2),

[690] Section 115 of SSA 2004.

19, 20, 21, 22 or 29 is liable on conviction to a fine or to imprisonment for a period not exceeding 5 years, or to both a fine and such imprisonment.

In addition to the criminal liability, the DMA may refer cases of market abuse to the Enforcement Committee established in terms of section 97 of the Act, who may impose unlimited penalties.

Further, the registrar may impose a fine in the case of any failure by a regulated person to submit to the registrar within any period specified by or under the Act any statement, report, return or other document or information required by or under this Act to be so submitted, not exceeding R1 000 or such other amount prescribed by the registrar for every day during which the failure continues.[691]

Also the court has power, in addition to any sentence it may impose under the Act, to declare the person concerned disqualified, for an indefinite period or for a period specified by the court, from carrying on business or being employed in a capacity of trust.[692]

The new South African Companies Act of 2008 (CA 2008) provides liabilities of company directors relating to securities trading. Section 77(3) of the CA 2008 stipulates that a director of a company is liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director having signed, consented to, or authorised, the

[691] Section 95 (1) of SSA 2004.
[692] Section 96 (1) of SSA 2004.

publication of any financial statements that were false or misleading in a material respect or a prospectus, or a written statement containing false, misleading or untrue information.[693]

Further section 104 of CA 2008 provides that directors, company promoters and issuers of prospectus of a company are liable to compensate any person who bought securities of the company relying on the information contained in the prospectus and has incurred a loss following acquisition of the said security.

Finally, section 165 of the CA 2008 provides for a statutory derivative action to shareholders allowing them to institute proceedings on behalf of the company against directors, management or majority shareholders in the event of an unratifiable wrong against the interest of the company. This will provide a powerful tool to investors in the South African market.

In summary, the foregoing shows that the South African regulatory regime for capital markets is relatively robust and compares well to Black's list of core institutions for strong capital markets. South Africa has a number of law enforcement agencies which are fairly robust. Also reputational intermediaries do exist to some level and are functional. There is also a satisfactory set of insider dealing and market manipulation rules. Finally liability for reputational intermediaries as well as insiders in also well catered in both the Companies Act 2008 and the Securities Act 2004.

[693] Section 77 (3) (d).

7.4 CAPITAL MARKET IN MALAWI

Malawi has a single stock market, the Malawi Stock Exchange (MSE). The MSE is still embryonic having been in existence since 1994 and only started equity trading in November 1996 when the first company was listed on the exchange.[694] Prior to the listing of the first company, the major activities that were being undertaken were the provision of a facility for secondary market trading in Government of Malawi bonds namely, Treasury Bills and Local Registered Stocks.

Unlike the London Stock Exchange (LSE) and the Johannesburg Stock Exchange (JSE), which were created by traders, the MSE is a creature of Government having been established through an Act of Parliament.[695] The MSE is said to have been set up to serve a critical need in the Malawi economy of offering an alternative avenue of raising capital for companies to grow and provide a link between capital raisers and investors seeking profitable investment and also to serve as a vessel through which Government would successfully privatize companies into the hands of many Malawians.[696] The specific objectives of the MSE are outlined as follows:[697]

- Promoting development of the capital markets in Malawi by, inter alia, mobilization of savings and related funds for investment in long-term assets and other productive enterprises.
- Promoting just and equitable principles of securities trading.

[694] The first listed company in Malawi was the National Insurance Company Limited (NICO).
[695] Capital Market Development Act of 1990.
[696] See: MSE website http://www.mse.co.mw/ Last visited on 16/08/2014.
[697] *Ibid.*

- Preventing fraudulent and manipulative acts and practices by securities issuers, brokers, dealers, market markers, underwriters, and all participants in the market.
- Preventing and/or removing impediments to, and promote a free and open market.
- Protecting both investor and public interest in the market.

7.4.1 Legislation

The current legislation for securities trading in Malawi is the Securities Act, 2010 (SA 2010) which repealed the Capital Market Development Act, 1990.[698] The SA 2010 applies in tandem with the Financial Services Act 2010 (FSA 2010), which is umbrella legislation for financial services[699] in Malawi.

7.4.2 Local Enforcement

The SA 2010, like the repealed Capital Market Development Act, has not provided for an independent market regulator. The regulator of the capital market, therefore, remains the Reserve Bank of Malawi. The function of supervising the capital market has been vested in the office of Registrar of financial institutions who is the governor of the Reserve Bank of Malawi.[700] The registrar is required to establish departments to supervise the operations of

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[698] Since the inception of the MSE, the only source for capital market regulation in Malawi was the Capital Market Development Act 1990 and the Companies Act, 1984[698](CA 1984). The MSE listing rules also added some flavour to the regulatory frame work. This regulatory regime however fell far too short of the regulatory standards required to develop a successful capital market, hence the introduction of new legislation.

[699] Section 2 of the Financial Services Act, 2010 defines financial services as services related to financial matters.

[700] Section 8 of the Financial Service Act of 2010. In an informal interview with one of the officers of the Reserve Bank of Malawi involved is capital market supervision, I was told that the policy consideration that was taken into account in considering whether to have an independent regulator or not was problems of funding a separate office to regulate capital markets. He said it was felt that the capital market in Malawi had not developed to a level where an independent regulator, which is usually funded by commissions and market fees, could be sustained.

banking, insurance, retirement benefits schemes and securities markets[701] and has the power to delegate his supervisory functions to, inter alia, a director or employee of the Reserve Bank.[702] In practice, the supervisory functions of the registrar, with respect to securities market, are more or less permanently delegated to the Director of Non-Bank Financial Institutions who is an employee of the Reserve Bank. There is no separate prosecutor of criminal offences under the SA 2010. It is assumed that the power to prosecute is assigned to the Director of Public Prosecution.

Enforcement powers of capital market rules are vested with the registrar in the first instance.[703] A party dissatisfied with a decision of the registrar has a right of appeal to the Financial Services Appeals Committee.[704] Appeals against decision of the Financial Services Appeals Committee lie to the High Court of Malawi.[705]

The Malawi framework fails to meet Black's benchmark for local enforcement institutions. There is a lack of an independent securities regulator as well as a specialist prosecutor. The mandate to regulate capital markets is vested in the Reserve Bank of Malawi and there is no known prosecutor of market abuse cases. The fact that the location of the power and duty to prosecute is obscure suggests a lack of prosecutorial zeal. It is assumed that this responsibility would be with the Attorney General's office or the Director of Public Prosecution where there is a criminal element. These offices are likely to have neither the capacity nor the expertise to deal with such cases. Further, the judicial system in Malawi

[701] Section 8 (4) of the Financial Services Act of 2010.
[702] Section 20 (1) (a) of the Financial Services Act of 2010.
[703] Section 4 of the SA 2010.
[704] Section 82 of the Financial Services Act 2010.
[705] *Ibid*, section 92.

lacks sophistication and expertise especially with respect to commercial cases. These weaknesses are exacerbated by a lack of honest staff due to a predominant culture of corruption, which will be discussed below.

7.4.3 Reputational Intermediaries

The regulatory framework in Malawi does recognise the role of professional advisors such as accountants, investment bankers, stock brokers etc. For instance, section 1 of the MSE listing rules states that an issuer seeking to apply for listing on the Malawi Stock Exchange must appoint a sponsoring broker. Further, the prospectus must contain an auditor's report and other financial information prepared by the accountants.

With regards to regulation of reputational intermediaries, the registrar of financial services sits on top of the pyramid. Under section 45 of the FSA 2010, the Registrar is mandated to declare a person or body that has functions in relation to a class of financial institutions as a self-regulatory organization and enter into arrangements with such person or body so that the person or body performs regulatory or supervisory functions in relation to a class of financial institutions it is associated with. So far the only registered SRO in Malawi is the Malawi Stock Exchange (MSE). In turn the MSE supervises its members, which are mainly stockbrokers. While accountants and lawyers are internally regulated by the Society of Accountants in Malawi (SOCAM) and the Malawi Law Society, respectively, there is no regulatory link between these bodies and the registrar of financial services.

While there are some reputational intermediaries in Malawi as observed above, the framework does not fare very well against Black's recommendations. Malawi does not have a sophisticated accounting profession, and the investment profession is still in its infancy. While there are a number of banks that provide investment advice, these banks are not fully regulated in that there is no specific regulatory framework for the banks' investment business. Skilled and experienced securities lawyers are also a rare commodity. While there are some provisions in the CA, 2013 and SA 2010 that would be regarded as imposing liability to investors such rules are not effective in the absence of an independent regulator and sophisticated securities lawyers. Also as stated above only one SRO exists and very few reputational intermediaries are licensed.

7.4.4 Disclosure of information

Disclosure requirements are contained in the SA 2010, the CA 2013 and the Malawi Stock Exchange (MSE) listing rules.

The SA 2010 requires a registration statement and/or a prospectus containing information about a security to be published before an issuer or underwriter of the security directly or indirectly sell, offer to sell or enter into a contract to sell that security to any person.[706] This requirement is supplemented by Section 3.1 of the Listing Rules, which requires new issuers to advertise a statement or a summary prospectus in the leading daily newspapers in Malawi. The pre-listing statement must contain sufficient information to allow investors to

[706] Section 28 of the SA 2010. Section 260 of the CA, 2013 stipulates specific information to be contained in a prospectus.

make informed decisions whether to invest in the securities or not.[707] This information should include, inter alia, details about the business of the issuer, its directors and management, its capital, loan capital and borrowings and financial information.[708]

Continuous disclosure obligation on the part of an issuer of any security registered under the Act is provided under section 31 (1) of the SA, 2010, which states that:

> "An issuer of any security registered under section 27 shall inform and keep the public informed of all matters which affect the value of the security immediately upon their becoming known to the directors of the issuer, by placing an advertisement in a newspaper of general circulation and by reporting to the Registrar and to any licensed stock exchange on which the securities are listed."

The MSE listing rules also provide for various continuing obligations which a listed company is required to comply with once any of its securities have been admitted to listing, in order to maintain an orderly market in securities and to ensure that all users of the market have simultaneous access to the same information.[709]

Further, any person who is the beneficial owner of more than five per cent of any class of publicly-traded security, or who is a director or officer of the issuer of such security is required to file a statement, with the Registrar, and any securities exchange of which such security is traded either at the time such security becomes publicly-traded or within five

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[707] Section 3.11 of the Listing Requirements
[708] Section 4 of the Listing Requirements.
[709] Section 7 of the Listing Requirements.

days after that person acquires beneficial ownership of such security.[710] The statement should specify the name, address, citizenship, and position of the person making the statement; and the amount of all publicly-traded securities of which such person is the beneficial owner.[711]

In addition, the CA 2013 has comprehensive rules concerning keeping and publishing company accounting records and preparing auditor's reports.[712]

The above exhibits a fair amount of rules ensuring that investors are kept informed of the affairs of the issuer at all times. However, as with the South African regulatory framework, there are no specific ownership disclosure rules and also there is no clearly identifiable rule writing organisation for accounting rules.

7.4.5 Liability for Insider Dealing

The SA 2010 proscribes insider dealing and other market abuse practices with the aim of ensuring sufficient protection of investors.

Under section 49 (1) of the SA 2010, "no person shall, directly or indirectly, purchase or sell, or counsel or procure another person to purchase or sell, securities of an issuer concerning which he has knowledge that - (a) is not publicly available; and (b) would, if it were

[710] Section 32 of the SA 2010.
[711] Section 32 (1) (a) and (b) of the SA 2010.
[712] Part X of the CA 2013.

publicly available, materially affect the price of the security."[713] There is criminal liability for insider dealing.[714]

Under section 194 of the CA 2013, where a director of a company acquires any special information which may substantially affect the value of companies securities and buys or sells, he will only be allowed to buy or sell such securities where he pays or receives fair value of the securities and where he pays less than the fair value to acquire the shares or receives more than the fair value on disposition of the securities, the director shall be liable for the difference between the price paid or received and the fair value of the securities. This provision however does not go far enough in proscribing insider dealing as a director with such privileged information would be happy to pay or receive what would be regarded as a fair value of the shares at the material time well knowing that the value of the securities would go down or up sharply few months down the line.

Again the Insider dealing provisions in Malawi fail to meet most of Black's recommended institutions. Firstly, the SA 2010 does not define what inside information is. Secondly the Act does not provide for civil liability of the issuer. Although criminal liability is provided for under the Act, no sanctions are stipulated. There are also no specific provisions for public companies to have independent directors. And as with South Africa, the culture of compliance among accountants, lawyers, company directors and investment bankers is not well developed.

[713] The Act does not specifically define who an insider is and what information will be deemed price sensitive information.
[714] Section 49 (2) (b) of SA 2010

7.4.6 Market Abuse

The SA 2010 sets out a number of prohibited market practices as follows:

(i) False trading and manipulations. This include bringing about a "false or misleading appearance of the volume of trading in any securities on any licensed stock exchange; or a false or misleading appearance of the market for, or the price of, any securities"[715]. False trading and manipulation may also occur where a person seeks to maintain, inflate, depress or cause fluctuations in the market price of any securities through fictitious transaction or device.[716]

(ii) Use of deceptive statements as inducements.[717] This include where a person induces or attempts to induce another person to deal in securities by publishing statements, promises or forecasts he knows to be false or misleading or by dishonest concealment of material facts.

(iii) Fraudulent Transactions. These include, where a person, in connection with any transaction with any other person involving the purchase or sale of securities, uses any device or scheme to defraud the other person or "engages in any act, practice or course of business which operates as a fraud or deception or is likely to operate as a fraud or deception on that other person".[718]

[715] Section 45 (1) of SA 2010.
[716] Section 45 (2) SA 2010
[717] Section 46 (1) SA 2010
[718] Section 47 (1) SA 2010

(iv) False or misleading statements in connection with sale of securities. This is where a person makes false or misleading with respect to any material fact or conceals material facts for the purpose of inducing the sale or purchase of securities of any issuer.[719]

Market transparency is also underpinned by the provisions of the CA 2013 which requires every company to prepare and file with the registrar of companies, within six months of its balance sheet date, financial statements and annual accounts presenting a true and fair view of the companies state of affairs at the balance sheet date and of its profit or loss as well as cash flows for the accounting period.[720] Further, any prospectus prepared by a company offering securities to the public should contain all such necessary information as investors and their professional advisers would reasonably require or reasonably expect to find in there for the purpose of making an informed assessment of the company's affairs.[721]

The foregoing shows that Malawi has sufficient rules banning manipulation of trading prices. As stated above, however, the enforcement regime is not sufficient. Also, Malawi lacks specific rules and the technology to ensure prompt disclosure of the time, quantity and price of trades in public securities to investors. Perhaps the major limitation to effective market transparency in Malawi is a lack of active financial press that can uncover and publicise as well as criticise, issuers, accountants, lawyers and investment bankers. Again, therefore, Malawi does not fare very well on Black's core institutions for market transparency.

[719] Section 48 (1) SA 2010
[720] See, sections 245-252 of the CA, 2013.
[721] Section 260 of the CA, 2013.

7.4.7 Liability of issuers, directors etc for market misconduct.

The SA 2010 has provided for criminal liability on the part of any person who contravenes its provisions on disclosure,[722] false trading and manipulation,[723] use of deceptive statements as inducements,[724] fraudulent transactions,[725] False or misleading statements[726] and insider dealing.[727] However, as observed above, the Act does not specify any sanctions for the offences. Also, the Act is completely silent on civil liability of issuers and their officers.

In addition, the CA 2013 provides for general penalties for the insider dealing and market manipulation offences.[728] All offences are punishable with imprisonment and/or a fine to be determined by the court dependent on the gravity of the offence.

7.5 ANALYSIS OF THE CASE STUDIES

The foregoing examination shows that the UK capital market regulatory regime is sufficiently robust in line with Black's recommended core institutions. The UK regulatory framework ticks most of the boxes of the formal and informal institutions dealing with information asymmetry and insider dealing. However, as stated above sight is not lost of the fact that due to a long history of securities trading in UK, the market has built a formidable foundation of investor trust and therefore it cannot be concluded that the success of the UK capital markets is solely and squarely due to its regulatory institutional framework.

[722] Section 31 (3) of SA 2010
[723] Section 45 (4) of SA 2010
[724] Section 46 (2) of SA 2010
[725] Section 47 (2) of SA 2010
[726] Section 48 (2) of SA 2010
[727] Section 49 (2) of SA 2010
[728] Sections 345 and 346 of the CA 2013

The capital market in Malawi has until recently operated with a skeleton regulatory framework under the Capital Market Development Act 1990. The SA 2010 only came into force in 2010. The new legislation has bolstered the regulatory framework significantly. The SA 2010 brought in internationally compatible rules for capital market regulation in Malawi.

There are, however, still some gaps in the new legislation that may need attention. Firstly, the Act requires issuers of securities to inform and keep the public informed of all matters which affect the value of the security immediately upon their becoming known to the directors of the issuer.[729] The Act however does not specify what such information may be. While it is appreciated that it is difficult to come up with an exhaustive list of such matters, it would be argued that an indicative list would be helpful so that issuers have an idea of what such matters may be. Further, the Act does not explain what is meant by '*immediately upon their becoming known'* and when it could be deemed that matters became known to the directors. This lack of detail could generate unnecessary litigation that may result in offenders getting off scot free.

With regard to inside trading offences, the Act does not indicate what information will be regarded as '*material'* for purposes of proving the offence. Also, the Act does not provide statutory defences to insider dealing. This may be a disincentive to potential issuers and investors who would find the regulatory regime unduly harsh in this regard.

[729] Section 32 (1) of the 2010 Act

Another weakness of the Malawi regulatory framework is its glaring lack of an independent regulator. The new legislation, like the repealed Capital Market Development Act, has not provided for an independent market regulator and therefore the regulator remains the Reserve Bank of Malawi.

Further, the new legislation does not provide for any civil liability for non-disclosure of information, insider dealing and other market abuse practices. Criminal liability is always difficult to prove as it requires a high standard of proof and as such it is always ideal to provide for civil liability which may be used in parallel to a criminal action or as a fall back where a party is unable to meet the evidential high threshold of a criminal offence.

Also self-regulation is underdeveloped in Malawi. So far, the Malawi Stock Exchange (MSE) is the only recognised Self-Regulatory Organisation (SRO) with respect to securities trading.

Finally, as is the case with South Africa, the main weakness is likely to be the existing informal rules. Although the new legislation has introduced formal rules comparable to those in developed markets, the presence of adverse informal rules are likely to slow the growth of capital market in Malawi.

The South African capital market is in a very unique position, as we will discuss below, and would therefore offer some helpful insights to the thesis of this research. As discussed above, South Africa, like other developing economies, has put in place formal rules that incorporate international best practices for capital market regulation. South African regulatory framework has a very good mechanism for market surveillance and monitoring for purposes of detecting market misconduct. The transaction reporting system is also very robust and strict. The only Achilles heel for the South African regulatory framework, with respect to formal rules, would be lack of a specialised court of the first instance as is the case in the UK. This is helpful because it allows for market misconduct cases to be dealt with by specialist judges in the first instance before they move to the higher courts as well as expeditious disposal of the cases. Also the regulation of reputational intermediaries and SROs, as observed, is a bit complex and may need proper delineation of regulatory powers.

However, despite its robust formal rules, the South African capital markets operate in a similar cultural environment to other SADC countries and, as such, the market should be expected to be subject to similar informal rules that exist in other countries. However, as stated above, South Africa is the most developed market in the region. It is in fact so developed that it is sometimes comparable to capital markets in developed economies. The uniqueness of South Africa and its relevance to this work is discussed in section 7.8 below.

7.6 COMPARISON OF INFORMAL RULES IN UNITED KINGDOM, SOUTH AFRICA AND MALAWI.

As observed above, most developing economies, including Malawi and South Africa, have adopted formal rules that are comparable to those that exist in developed economies in the hope that this would speed up growth of their capital markets. However, as North hypothesised, and as was confirmed by Black, changing formal rules only is not sufficient. Also, according to Black, informal rules are the most difficult to borrow from other countries. This entails that any reform agenda should be mindful of specific informal rules that can scupper its chances of success. Discussed below are some of the informal rules that are considered relevant to capital market development in developing economies in general and SADC region in particular and may account for the significant disparities of development with regard to the three case studies discussed above.

7.6.1 A Culture of Compliance and Honesty

One of the basic differences between developing economies and developed economies is that self-enforcing attitudes like honesty, integrity and cooperative norms are not common place in the former. This means it is difficult to have honest regulators, prosecutors or judges. Also a lack of the culture of compliance entails that professionals who are expected to guide issuers through the regulatory requirements are themselves not willing to comply with the rules and therefore amenable to the persuasion of issuers to ride roughshod over disclosure or insider dealing rules. United Kingdom has the highest level of compliance culture compared to South Africa and Malawi.

7.6.2 Political stability

It is clear that the United Kingdom is a true democratic society with stable political systems. It is a mature Open Access Order (OAO).[730] It is therefore safe to say that developed countries like the United Kingdom are less affected by effects of informal political rules or power relationships which rarely determine economic issues in these countries. However, as

[730] North *et al,* (2013) *supra* note 317.

stated above, in most developing economies including our case studies, South Africa and Malawi, informal political rules are prevalent. Richard Sandrook[731] observed as follows:

> "African states are not, in any real sense, capitalist states. The peculiar conditions of postcolonial Africa impel an adaptation of colonial-inspired political structures and processes in a patrimonial, or rather neopatrimonial, direction. The omnipresent danger in this adaptation is a degeneration of neopatrimoialism into an economically irrational form of 'personal rule'. This decay manifests in political instability, systemic corruption and maladministration..."

It will be noted that South Africa and Malawi, although officially democratic countries, are both dogged with an undercurrent of neo-patrimonial practices of their ruling elites and their henchmen.[732]

Collier in his recent book, *The Bottom Billion,*[733] identifies four development traps that causes economic stagnation in poor countries and these include (i) conflict trap, which manifests itself in the form of civil wars and *coup d' etat;* and (ii) the trap of bad governance. This is echoed by North et al, in their analysis of Limited Access Orders and Open Access Orders. The problem of violence or restriction of entry into economic markets and rent-seeking, are linked in this analysis.

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[731] Richard Sandbrook, *The Politics of Africa's Economic Stagnation* (Cambridge university Press, 1985) p. 12
[732] See, Tom Lodge, 'Neo-Patrimonial Politics in the ANC' African Affairs, Vol. 113, Issue 450, pp 1-23. Also at: http://afraf.oxfordjournals.org/content/113/450/1.full.pdf+html?sid=7d6524a0-015f-4a25-8e19-0b2eb1f03ce5 Last visited on 16/08/2014.
[733] Paul Collier, *The Bottom Billion: Why the Poorest Countries Are Failing and What Can Be Done About It*, (Oxford University Press, 2007) 5

7.6.3 Corruption

As stated above, corruption is one of the obstructive informal institutions in most emerging economies including countries in the SADC region. In "Northean" terms, this is so because the current institutional structures in these countries create incentives for corrupt practices. According to North, "the structure that humans create to order their political/economic environment provides the incentives which shape the choices humans make" and these will usually take the form of activities with highest pay-offs.[734] In most emerging economies, corruption, in the form of bribery, extortion, and rent-seeking, presents highest pay-offs amongst political and government officials, as well as private sector players.

Corruption is rampant both in Malawi and South Africa. For instance, there have been high profile corruption scandals in South Africa, notably, the arms procurement scandal in which the current president, Jacob Zuma, was implicated while he was serving as a vice president.[735] Also during his presidency, Zuma was embroiled in massive corruption scandal relating to abuse of public resources to build his personal compound.[736] Malawi has had its fair share of high profile corruption incidents. The former president, Dr Bakili Muluzi and a number of his cabinet members are currently under investigations and some have already been convicted of corruption offences. Also recently the politicians, including cabinet ministers and civil servants have been in a heinous scandal involving looting of government resources amounting to millions of US Dollars, which has been dubbed the "Capital Hill

[734] North, (2005) *supra* note 8 at pp 48 and 61.
[735] Global Corruption Report, *Transparency International* (2004) p. 259.
[736] Andrew Endland 'Damming Report Finds Zuma Used Tax Millions on Private Estate' *Financial Times,* 19 March 2014. Also at: http://www.ft.com/cms/s/0/6b2d5630-af60-11e3-bea5-00144feab7de.html#axzz34EMJ1KP6. Last visited on 16/08/2014.

Cashgate" scandal[737]. These high profile cases are clearly a microcosm of the culture of corruption that is prevalent in emerging economies, generally and in SADC region, in particular.

The literature on the effect of corruption on investment is growing. Corruption increases transaction costs and creates uncertainty with regards to future returns on investment.[738] In order for a foreign company to invest in a host country, they will need licences, permits, passports, visas etc in order to comply with the host country's laws and regulations.[739] In developing countries, including African countries, government officials demands bribes before issuing such requirements.[740] Consequently potential investors are put off from taking the risk of investing in an environment where they will have to pay more and above the normal capital investment. It is observed that concerns about corruption, most of the times, shape companies' decisions to invest in Africa as navigating red tape and corrupt administrations in Africa may prove to be costly.[741]

In terms of development of capital markets, unchecked corruption by government officials strains the growth of local firms and prevents foreign firms from investing in the local economy. This would result in few companies floating on the local stock exchange resulting in low market capitalisation levels. It is observed that in emerging and developing

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737 Javier Blas, Financial Times, "Malawi 'Cash-Gate' Corruption Scandal Unfolds Like A Thriller" Financial Times (FT), 19 November 2013. Available at http://www.ft.com/cms/s/0/c17480e0-50fb-11e3-b499-00144feabdc0.html#axzz2mo10TrX5. Last visited on 16/08/2014.

738 A.S. Dixit, and R.S. Pindyck, *Investment Under Uncertainty*. (Princeton, NJ: Princeton University Press, 1994).

739 Andrei Shleifer; Robert W. Vishny 'Corruption' *The Quarterly Journal of Economics*, Vol. 108, No. 3. (Aug., 1993), pp. 599-617.

740 *Ibid*, p. 599.

741 See: http://www.enca.com/south-africa-africa/us-investors-avoid-africa-over-corruption Last visited on 16/08/2014.

economies, corruption practices threaten to undermine both the growth and the stability of global trade and financial system and that as these economies open their doors to foreign investment and trade, corruption tends to thrive.[742]

According to the South African Country Corruption Assessment Report of 2003 a survey of South African businesses revealed that 62% of businesses agreed that bribery is becoming an accepted business practice and 90% of respondents agreed that once employed, bribery opened a company to further demands.[743]

Thus although countries such as South Africa have strong regulatory structure for capital markets, the culture of corruption still affects the level of growth of its capital markets in comparison to capital markets in developed countries.

While cases of corporate fraud have been reported in developed economies such as UK and US,[744] the difference is that these were exclusively perpetrated by greedy corporate executives and one would safely say they do not represent a social-cultural problem as is the case in African economies. Further, each wave of corporate scandals in developed economies has always been followed by tough legislative reforms to keep such practices in check.[745] In emerging economies however, corruption remain rampant. The difference in

[742] See: Soma Pillay, 'Corruption – The Challenge to Good Governance: A South African Perspective' The International Journal of Public Sector Management, Vol. 17 No. 7, 2004.

[743] Country Corruption Assessment Report, South Africa, April 2003 at: http://www.westerncape.gov.za/text/2004/4/sacorruptionassessmentreport2003.pdf

[744] Examples include, BCCI, Poly Peck, Enron and WorldCom scandals.

[745] These include a review of Corporate Governances rules in UK and the enactment of the Sarbanes Oxley Act of 2002 in US.

corruption levels in the case studies we have used is confirmed by the Corruption Perception Index of 2013, which ranks them as follows:

Table 4 : Extract of the Corruption Index of 2013

Rank	Country/Territory	CPI 2013 Score	Surveys Used	Confidence Range
14	United Kingdom	76	8	74 - 78
72	South Africa	42	9	37 - 47
91	Malawi	37	8	34 - 40

Source: Transparency International's Corruption Perception Index 2013. (The countries are ranked on a score of 0-100, 0 being most corrupt and 100 being corruption free.)

7.6.4 Culture of Capitalism

It may be said that in UK the culture of individualism and classical liberalism as described above are well entrenched. In contrast, in most African economies, including our two case studies, the dominant cultural and religious beliefs lean towards the collectivist side of the individualist/collectivist continuum and this promotes collective decision making. Also the tenets of classical liberalism, including individual liberty, openness to new ideas, tolerance of all views, private property rights, rule of law and the freedom of contracts are in short supply in Africa and this affects the level of innovation and adoption of new ideas, like the capitalist idea.

7.6.5 Impersonal Exchange

Decades of economic experience in UK has given rise to a fully-fledged pattern of impersonal exchange. Coupled with technological development the UK market is predominantly contract-based and not based on relational ties. This is however not the case in most developing economies. Tan and Meyer[746] describe this distinction as follows:

> "In developed economies, institutional frameworks foster market-based competition based on impersonal exchange. Firms' primary strategic challenge is to develop competitive resources and capabilities to outperform competitors in the market place (Peng, 2003). In contrast, emerging economies often lack institutions that support arm's length impersonal exchange, such as reliable intermediaries and a transparent and effective legal framework (Khanna and Palepu, 2000; Khanna and Rivkin, 2001). The weak institutional frameworks have two major implications for businesses in emerging economies. First, firms often respond to this institutional challenge by developing 'institutionally embedded resources,' defined as 'the informal linkages with dominant institutions that confer resources and legitimacy' (Peng, et al., 2005:622). These institutional resources include for instance informal linkages with governmental institutions, which may take the form of managers' personal networks".

In their empirical study, Zhou et al,[747] have found that while impersonal exchanges are being adopted by Chinese businesses, when business transactions are becoming more complex,

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[746] Danchi Tan and Klaus E. Meyer, 'Business Groups' Outward FDI: A Managerial Resources Perspective', 2009. Available at http://www.klausmeyer.co.uk/publications/2010_Tan_Meyer_JIM_business-group-FDI.pdf p.6

[747] Kevin Zhou and Laura Poppo, 'Relational Contracts in China: Relational Governance and Contractual Assurance', Research Paper, 2005.

managers, due to increasing uncertainty, revert back to personal exchange. This suggests that the concept of impersonal exchange has not yet grown roots in developing economies.

7.6.6 Lack of Specialised Knowledge

Most developing economies as stated above lack specialised knowledge in the operations of capital markets. Consequently, most of the market players including, accountants, lawyers and judges lack the necessary skills to operate and regulate the market. This is aptly depicted by Professor Stuart Cohn experience when he was teaching securities regulation to Ugandan market professionals which he described as follows:

> "Nothing exited except the laws, a Capital Markets Authority that had no capital markets to regulate, and a stock exchange devoid of stock. Broker-dealers existed in creating public issues. There were no private companies that had engaged in a public offering, and privatisation offerings were still in the planning stages. There were few if any, trained and knowledgeable lawyers and accountants prepared for the demands of a securities markets...I had assumed that the statutes, regulations, and organisational structure reflected market realities and developments-an assumption based on US experience, where securities laws came well after the development of primary and secondary securities markets. I had never seen a different model and did not appreciate that sophisticated rules and institutions could be – and indeed had been – promulgated in an experiential vacuum."[748]

South Africa may be an exception as it has a well developed accounting and legal profession probability due to the fact that the South African capital market has existed for a considerably long period of time. However such specialist knowledge is clearly lacking Malawi.

[748] Stuart R. Cohn, 'Teaching in a Developing Country: Mistakes Made and Lessons Learned in Uganda, 48 J. Legal Educ. (1998) 101 at p. 104.

7.7 THE SIGNIFICANCE OF INFORMAL RULES TO THE REFORM PROCESS

Having asserted that there are a number of informal constraints in developing economies that do not exist in developed economies, it is important to consider how this would affect the reform agenda for capital market regulation in these countries.

Firstly, as stated above, this would entail that any formal rules that are being introduced in these economies are supposed to be adjusted to the existing informal rules. For instance, the fact that self-enforcing altitudes like honesty, integrity and cooperative norms are not common place in developing economies would necessitate stricter rules for promoting market transparency and preventing market abuse. Further, the prevalence of relational transacting and lack of impersonal exchange would require strengthening of effective contract laws that would help to take away reliance on relational ties. Similarly, any reform agenda should take into account the fact that corruption is the norm in these economies. The possibility that officials throughout the entire market infrastructure would be corrupt, needs to be fully factored into the process and necessary safeguards need to be embedded in the regulatory framework.

According to North, the process of changing informal rules is slow and takes time. This means that reformers should not expect overnight change of behaviour and should consider ways of getting round the constraints that the informal institutions would give rise to the capital market development process while any obstructive informal rules are being transformed.

Also, the consequences of "non-ergodicity" should be fully considered. It is obvious that the introduction of new formal rules will bring about a level of uncertainty to market players in these economies, which would encourage them to find new ways of evading the intended consequences of the new rules. For instance introduction of stringent rules may encourage market participants to resort to bribes in order to get their way round the rules. Promotion of whistle blowing culture by introducing rules rewarding whistleblowers or exonerating informants from liability for conspiracy would be one of the ways of shifting incentives to let people comply with the rules.

One institutional aspect that needs to be considered when dealing with the consequences of informal rules and the accompanying consequences of non-ergodicity that result from changes in formal rules is the enforcement regime to be adopted. In their study, Garoupa and Klerman[749] considered the effect of corruption under monopolistic enforcement by a single private enforcement agency and under competitive enforcement by many private enforcers. Their observation was that:

> "Under monopolistic enforcement, corruption is used to generate additional rents to the enforcement agency. Under competitive enforcement, the analysis is complicated by the possibility that bribing one enforcer may not prevent prosecution by another".[750]

The South African regulatory framework offers an example of competitive enforcement. As discussed above, the SSA 2004 established the Directorate of Market Abuse (DMA) which has statutory mandate to investigate cases of Market abuse and to enforce the prohibitions

[749] N. Garoupa and D. Klerman, 'Corruption and Private Law Enforcement: Theory and History', Illinois Law and Economic Research Papers Series, Research Paper No. LE09-016 at http://papers.ssrn.com/pape.tar?abstract_id Last visited on 16/08/2014.
[750] *Ibid.* p. 4.

against market abuse in the Act. However, the frontline detection and prevention of market abuse is undertaken by the JSE Surveillance Division, which has in place a number of proprietary systems that have been specifically designed to detect unusual trading volumes and price movements, which could be indicative of insider trading or market manipulation. This arrangement would make it difficult for a wrongdoer to bribe his way through the system with impunity.

Further, self-regulation may also be one way of dealing with the consequences of negative informal institutions. Self-regulation through common codes of conduct within groups of market players is considered an effective informal institution for regulating the market. North has expressed the importance of self-enforcing codes of behaviour as follows:

> "The importance of self-imposed codes of behaviour in constraining maximising behaviour in many contexts also is evident. Our understanding of the source of such behaviour is deficient, but we can frequently measure its significance in choices by empirically examining marginal changes in the cost of expressing conviction" [751]

The importance of using market self-regulation has been recently echoed by Carson (2010) who stated that:

> "Arguably, the main reason to consider using self-regulation is that it enables additional resources and expertise to be applied to regulation. In large and complex securities markets, even large and well-resourced regulatory authorities find it a challenge to set all the rules and standards and to deploy thorough supervision programs that will monitor

[751] North (1990) *supra* note 191 at p. 43.

compliance in all activities. This challenge applies to both developed and emerging markets."[752]

7.8 THE UNIQUENESS OF CAPITAL MARKET IN SOUTH AFRICA

As observed above, although South Africa operates in an environment facing many of the same problems of obstructive informal rules as Malawi and other SADC countries, South African capital markets are far more developed than most markets in the region. As stated above, the JSE is Africa's largest and most vibrant stock market accounting for over 90 per cent of the total market capitalization of sub-Saharan Africa and over 76 per cent of the entire continent. This makes the South African case special and fascinating.

There are a number of factors that may help to explain the uniqueness of South Africa. Such factors may include the following:

i. The South African capital market has a long history of trading with the first stock exchange established in 1887. On the other hand stock exchanges in Malawi and most countries in the region, were only established recently mostly in the 1990s. This long trading history may suggest that the South African informal rules that used to affect the market in its initial stage have now changed over a period of time. The informal rules likely to have developed would be the following:

    a) Culture of compliance with disclosure and insider dealing rules

[752] J. Carson, 'Self-Regulation in Securities Markets', (2010), Working Paper for World Bank Financial Sector Policy Group.

b) Specialised knowledge in capital markets resulting in skilled capital market professionals

c) Impersonal exchange

ii. The South African capital market was established independently of state forces and was supported by strong mining industry that provided demand for capital while capital markets in Malawi and other countries were established as a state machinery to help in the process of divesting state-owned companies.

iii. The South African capital market is supported by modern technological advances, which have not yet been adopted in most SADC countries. This is of course arguable as a causative factor considering that most of the technological advances have only been realised in the recent past.

iv. The South African capital market is also supported by a strong surveillance and monitoring system for purposes of detecting market malpractices.

The South African case may therefore serve to confirm North's Model in the following ways:

i. With proper alignment of formal and informal rules currently underdeveloped markets can grow to the levels approximating capital markets in developed economies

ii. Since informal rules change over time such growth will only be realised after years of operation of the capital market.

7.9 CONCLUSION

The discussion in this section shows that developed economies like UK have put in place formal institutions to support their capital markets which, together with favourable informal institutions that exists in these economies, have supported the operation of strong capital markets. The formal rules in these economies are propped up by robust enforcement regimes that have been established.

On the other hand, while developing countries such as those examined from the SADC region have introduced similar formal rules for regulating their capital markets most of which are quite nascent, the formal rules are of doubtful efficacy due to the informal institutions that are prevalent in these economies.

The above analysis therefore clearly shows that there is a real need to reform not only the formal rules but the informal rules as well. However, as posited by North, the process of changing informal rules is slow and therefore takes a long time. The South African capital market offers an example of how underdeveloped markets are able to develop with proper alignment of formal and formal rules over a period of time.

The foregoing calls for a unique reform agenda that will take into account the unique informal institutions that have capability to render standard formal rules adopted from developed economies ineffective. There is therefore need for a dynamic model of development that will have present informal institutions and structures as its starting point and that will quickly respond to any consequences of interaction between existing informal rules and any adopted formal rules. Some possible ingredients of such reform agenda are suggested in Chapter 9 below.

8 CHAPTER EIGHT: THE MECHANICS OF INSTITUTIONAL CHANGE AND CAPITAL MARKET DEVELOPMENT REFORM.

8.1 INTRODUCTION

Having looked at the current state of development and regulation of capital markets in the SADC region which may be regarded as representative of the state of capital market development and regulation in many developing countries, this chapter seeks to explore the mechanics of institutional change, which is very crucial to the effective design and implementation of capital market reforms in developing countries. We shall therefore start by looking at the process of institutional change according to North's framework. We shall then explore practical ways through which formal and informal rules may be changed and the practical problems that result from interaction of formal and informal rules and their effect on institutional reform. We shall also examine some suggested theories for achieving efficiency-friendly institutional change. Finally we shall look at some practical examples of institutional development within North's framework.

8.2 THE PROCESS OF INSTITUTIONAL CHANGE – NORTH'S FRAMEWORK.

North describes institutional change as the process through which existing formal and informal rules change through the agency of organisations.[753] North asserts that institutional change is induced by organisations and their entrepreneurs.[754] Organisations are understood to be purposive entities that are designed by their creators to achieve

[753] North (1990) *supra* note 202 at 73
[754] *Ibid*

specific objectives like profit or income maximisation, winning elections, regulating businesses, or educating students as defined by the opportunities afforded by the institutional structure of the society.[755] This entails that entrepreneurs or decision makers in organisations are agents of institutional change while the opportunities as perceived by their mental models are the sources of institutional change.[756] North therefore introduces the concept of belief system in the process of change. The extent, speed and direction of institutional change is thus contingent on the ability of social actors of a particular society to perceive opportunities or incentives in a particular institutional structure.

North notes that more often than not, human improvement has been a 'trial and error process of change with lots of errors, endless losers and no guarantee of continued progress.'[757] According to North, in order to get institutional change right through time there is need to 'perceive correctly changes in the human environment, incorporate those perceptions in our belief system, and alter the institutions accordingly.'[758] North provides a step by step process of change as follows[759]:

i. Understand the implications of novel changes with respect to their effects on three fundamental sources of change – demography, the stock of knowledge, and institutions – and the resultant new interaction among them;

[755] *Ibid*
[756] Douglass North, 'Institutional Change: A Framework of Analysis, Working Paper Series', (02 September 1999)2 at 4, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=6041 accessed on 19 February 2012.
[757] North (2005) *supra* note 8 at p 116
[758] *Ibid.*
[759] *Ibid*.

ii. Incorporate this new knowledge in the belief systems of those in position to modify the institutional matrix;

iii. Alter the formal rules, the informal constraints, and the enforcement characteristics accordingly and the result will be the desired changes.

According to North, two key issues that need to be the focus of any development strategy are (i) how humans make decisions in the face of strong uncertainty and (ii) how humans learn.

8.2.1 Decision making, Uncertainty and Institutional Change.

As discussed in the preceding chapters, North has identified uncertainty over time as one of the key issues that economic agents have problems with in the process of economic exchange. North observes that the world is 'non-ergodic' in its character in that it is constantly changing such that it is always impossible to predict with certainty the outcome of one's action. This is so because actions that are intended to deal with a perceived uncertainty may themselves generate novel situations that give rise to more uncertainties.[760] Therefore human beings usually find themselves in situations where they are supposed to make decisions without being certain of the outcome. It is this process of decision making in the face of uncertainty that is crucial to institutional change.

The influence of decision making by social actors on institutional change occurs both at macro and micro levels. At macro-level, institutional change will occur when accumulated

[760] See, Graham Ferris, (2012) *supra* note 220.

experiences and beliefs from the past provide a correct guide to future decision making. In practice however accumulated knowledge or past beliefs are not usually integrated into future decision making process resulting in humans getting institutional change wrong.[761] North observes that this happens either because the 'set of mental models, categories and classifications of the neural networks that have evolved in our belief system through which the new evidence gets filtered have no existing patterns that can correctly assess the new evidence'[762] or because the dominant organisations and their entrepreneurs may see the necessary changes as a threat to their survival and therefore resist the change.[763] The starting point of effective institutional change is to correctly comprehend what is happening to us and design institutional adjustments accordingly.[764] A relevant example in this regard is the shift from personal to impersonal exchange which gave birth to modern global economy. Impersonal exchange came about after noting the restraints and restriction on trade that were imposed by personal exchange that largely relies on reciprocity and repeat dealings. However impersonal exchange requires the 'development of economic and political institutions that alter the pay-offs in exchange to reward cooperative behaviour.'[765] North notes that the successful evolution from personal to impersonal exchange in the Western world required radical alteration in economic institutions in order to make such long distance and impersonal trade viable. Further, growth of long distance trade exerted pressure on the economic system and necessitated the state to intervene and provide for legal enforcement of contracts.[766]

[761] North (2005), *supra* note 8 at p 117.
[762] *Ibid.*
[763] *Ibid.*
[764] *Ibid.*
[765] *Ibid* at p.118
[766] *Ibid* p. 118

Further, institutional change occurs at macro level through integration of dispersed knowledge at low cost of transacting. Acquisition of new knowledge shall give birth to different institutions aimed at pulling together the dispersed knowledge in order to use it effectively in the growth of productivity of the modern economy.[767] Specialisation has resulted in increased specialised knowledge and less general knowledge. In turn, the decrease of general knowledge has increased the risk of uncertainty and such uncertainty can only be reduced by exchanging specialised knowledge at low cost of transacting.[768] Some of the institutions and organisations that have arisen to facilitate low cost exchange of specialised knowledge include warranties, guarantees and trademarks. Finally there is need for a lot more complex institutional structures to integrate specialised knowledge into productive knowledge. North observes that although Germany was the pioneer in the application of scientific principles to technology in the chemical industry, it is the United States that combined chemical knowledge a nd engineering principles by developing a curriculum in chemical engineering in universities and that this resulted in revolutionary developments.[769] In this case the university was a necessary organisation/institution to help integrate dispersed knowledge at low cost of transacting.

On the other hand, micro-level institutional change, involves adjustments to factor and product markets. North says that factor and product markets must not only be structured at a moment of time to get the players to compete via price and quality but also the conditions

[767] *Ibid* p. 120. North notes that the evolution of the Western world resulted from the process of change through gradual accretion of an ever more comprehensive price system which was supplemented and complemented by rules and regulations which were only occasionally deliberately enacted to effectuate more efficient combinations of knowledge. He then observes that in order for developing countries to compete with the developed world they must deliberately construct an effective price system and supplement it by creating the institutions and organisations to integrate that knowledge at low cost of transacting.

[768] *Ibid* 121

[769] *Ibid* at p.121. A good example of the outcomes of the integration of pure and applied knowledge is the Silicon Valley.

for maintaining market efficiency must vary over time with changes in technology, human capital, market conditions, and information costs.[770] This therefore calls for constant adjustments to the institutional framework within which markets operate. Given that each factor and product market is characterised by an institutional structure that defines the margins at which the players can operate to affect the profitability of their operation, what is needed is the maintenance of an institutional structure that will provide players with incentives to compete at these margins. The margins are usually defined by rules, regulations, norms and enforcement regimes in place.

Institutional change, therefore, will be effected through marginal adjustments to the complex set of rules, norms and enforcement that constitute the market institutional framework.[771] The incremental process of change is facilitated by the overall stability of an institutional framework which allows for complex exchanges to take place across time and space.[772] Institutional stability results from a complex set of formal rules 'nested in a hierarchy, where each level is more costly to change than the previous one'[773] as well as informal rules which are extensions, elaborations and qualifications of the rules and 'have tenacious survival ability'[774] as they become part of habitual behaviour.

Institutional stability will only be disturbed when there are changes in relative prices as relative price changes alter incentives of individuals in human interaction.[775] Changes in relative prices will result from the process by which organisations and their entrepreneurs

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[770] *Ibid* at p.122
[771] *Ibid* at 83
[772] *Ibid.*
[773] *Ibid.*
[774] *Ibid.*
[775] *Ibid at* 84

acquire skills and knowledge as the acquired skills and knowledge will change perceived costs of measurement and enforcement as well as alter perceived costs and benefits of new bargains and contracts.[776] However changing relative prices will still have to be filtered through pre-existing mental constructs or belief system of entrepreneurs and this will shape their understanding of price changes.[777]

In light of the above, an institutional framework would be stable resulting in institutional equilibrium[778] where given the bargaining strength of the parties and the set of contractual bargains that make up total economic exchange, none of the parties would find it advantageous to devote resources into restructuring the agreements regardless of whether everyone is happy with the existing rules and contracts.[779] However, a change in relative prices will lead to one or both parties to an exchange to perceive that either or both could do better with an altered agreement or contract. Because contracts[780] are nested in a hierarchy of rules any attempt to renegotiate the contract will not be possible without changing a higher set of rules.[781] This will result in the party who stands to improve his or her bargaining position devoting resources to restructuring the rules at a higher level. A change in formal rules will give rise to disequilibrium in the institutional framework and alter transaction costs.[782] This will spark efforts on the part of entrepreneurs to evolve new

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[776] *Ibid*
[777] *Ibid* at 85.
[778] Institutional equilibrium refers to a state where there is no change to the rules and norms or enforcement thereof.
[779] North (1990) *supra* note 202 at 86
[780] Here the term "contract" is used with reference to social or political contract rather than private contract which would be changed by agreement of the parties without necessarily changing the rules.
[781] North (1990) *supra* note 202 at p 86
[782] *Ibid*

conventions or norms and a new informal equilibrium will evolve gradually following a change in informal rules.[783]

Thus deliberate institutional change will come about as a result of the demands of institutional entrepreneurs in the context of the perceived costs of altering the institutional framework at various margins.[784] Entrepreneurs who perceive themselves and their organizations as relative (or absolute)losers in economic exchange as a consequence of the existing structure of relative prices can turn to the political process to right their perceived wrongs by altering that relative price structure.[785] Again whether a party perceives itself as a loser or winner depends on their belief system at the time.

Further, changes in enforcement rules will provide entrepreneurs with new avenues of profitable exploitation that will also result in changes of both formal and informal constraints.

It is, however, observed that creating efficient markets both at the moment of time and over time is associated with a number of problems. The following are identified as problems associated with creating efficient markets at the moment of time:

i. Although it can be assumed that the choices of market players will be guided by income and wealth maximisation – subject to the usual caveats about making choices in the world of uncertainty and the constraints imposed by the state of

[783] *Ibid* 88
[784] Douglass North (1999) *supra* note 756 at p. 5
[785] *Ibid* at 5.

technology and competitive conditions, a combination of these two variables produces an immense variety of margins at which the players can and will act. This makes the task of knowing what set of incentives and disincentives will provide players in each factor and product market with the correct inducements not an easy one.[786]

ii. The performance characteristics of each market will be a consequence of both the formal rules and the informal norms of behaviour that modify, qualify, or even negate the formal rules and therefore the transaction costs in each market will reflect the combination of formal and informal constraints. Consequently, although it is easy to provide for specific rules, say for example property rights, both measurement and enforcement of the rules will usually be imperfect since the rules will only provide general rules rather than "cater" to the specific characteristics of each market.[787]

iii. Additional specific rules for each market will be made by a government that is hardly a disinterested party and at times with its own political agenda. As a result, the structure of political market will determine whose voices are "heard" in shaping additional rules governing each market.[788]

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[786] North (2005) *supra* note 8 at 123
[787] *Ibid.*
[788] *Ibid*

iv. Even when the ostensible objective of government policy is economic efficiency, it is not obvious that the government players will possess sufficient economic sophistication to achieve that objective.[789]

v. Finally in most cases enforcement will be made by agents-whether regulatory bodies or courts-with their own agenda.[790]

With regard to problems with creating efficient markets over time, North observes that not only does each factor and product market require different specific constraints so that it will provide the right incentive structure for the players, but economic change requires continual alteration in the institutional structure in order to maintain efficiency.[791] This is so because incentives of the players in a particular market, say capital market, will be determined by the structure of the market and with changes in market conditions the incentives that at time *t* would induce the players to make an efficient capital market may in time *t + 1* induce the players to engage in activities that undermine, weaken, or indeed destroy the capital market with consequent adverse effects on the economy as a whole.[792]

Development of efficient markets over time is complex because successful adaptation to changing conditions entails altering economic institutions, which frequently entails the enactment through the polity of new rules. This is less of a problem where market players

[789] *Ibid*

[790] *Ibid*.

[791] *Ibid*. North observes that continual alteration of institutional structure is particularly critical for capital markets, which however well they may serve to facilitate growth at one time, may become obstacles to growth at another time; and there is no guarantee that they will automatically evolve as the economy evolves.

[792] *Ibid* 124. North cites the history of Japan in the 1990s is a classic instance of a capital market that initially fueled extraordinary development-that of post-World War II-only to develop the sclerosis that followed.

(entrepreneurs of economic organizations) are able to perceive the need for adaptation and are in a position to make the necessary alterations themselves.[793] However, where change involves the political enactment of new rules, the adaptation is much less likely to be forthcoming as the polity becomes the battleground for those who believe they would be adversely affected by the rule changes. North observes that while Neo-classical economists have generally come to perceive that institutions are important and that an underpinning of property rights and the rule of law are necessary conditions for a successful economy, there is little evidence that neo-classic economic advisors and international organizations they advise, properly perceive the need for ongoing institutional change as the fundamental characteristics of a particular efficient market are altered.[794] The result of prolonged failure to improve individual factor and product market is declining overall rates of growth and economic stagnation.[795]

Specific issues involved with maintaining efficient markets over time are summarised as follows:

i. 'Alterations in the performance characteristics of a market require an initial understanding of the source(s) of such change.

ii. 'Successful' alterations designed to improve market performance require the correct theory of the overall process of change.

[793] North gives the successful adaptation of American firms in automobiles, steel, and soft-ware to Japanese competition in the 1980s, which led in the 1990s to successful organizational innovation in American firms as an example of this situation. (*Ibid* 124)
[794] *Ibid* 124.
[795] *Ibid*.

iii. Implementing that correct theory entails that the key players (that is the entrepreneurs in a position to alter that market structure) possess such theory, through their belief system and are willing and able to act upon it.

iv. Where the alterations entail changes that must be enacted by the polity, there is an additional hurdle in enacting such political policies in that the existing institutional structure will have spawned organizations with a stake in that existing institutional structure and such organizations will attempt to thwart the changes.'[796]

8.2.2 Learning and Institutional Change

As stated above, institutional change will also result from the process of human learning. As organisations pursue wealth-maximising activities, they incrementally alter the institutional structure. Members of the organisation acquire productive knowledge, skills and learning necessary to maximise profit of the organisation and to enhance their survival possibilities in the context of ubiquitous scarcity.[797] Incentives that are built into the institutional framework determine the kinds of skills and knowledge that pay off.[798] Further, the process of learning by doing and development of tacit knowledge will lead individuals in decision making processes both within (e.g. company directors) and outside (e.g. regulators) the

[796] *Ibid* at p. 125.
[797] North (1990), *supra* note 202 at p. 74. North says the most relevant type of knowledge is tacit knowledge which is learnt by doing and is usually not fully communicable.
[798] *Ibid* at 78.

organisation to gradually evolve new systems different from old ones.[799] This will in the long run result in institutional change.

The firm's maximising behaviour can take one of the two forms; (i) making choices within the existing set of constraints through learning and investing in skills and knowledge with highest payoff, and (ii) devoting resources to alter the existing constraints.[800] The entrepreneur will assess the gains to be derived from re-contracting within the existing institutional framework compared to the gains from devoting resources to altering that framework[801]. Organisations with sufficient bargaining strength will use the political process to change political rules in order to increase their profitability when the payoff from maximising in that direction exceeds the payoff from investing within the existing constraints.[802] Further, organisations will also encourage the society to invest in the kinds of skills and knowledge that indirectly contribute to their profitability and that this investment ultimately shapes the long-run growth of skills and knowledge[803]. An ideal interaction between the market for knowledge i.e. overall stock of knowledge and the subjective knowledge of the players will coincide to produce a private and public investment in knowledge that will approximate the social rate of return.[804]

The systemic investment in skills and knowledge and their application to an economy over time will result in a dynamic evolution of the economy through adaptively efficient

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[799] *Ibid* at 81
[800] *Ibid* at 79
[801] Douglass North (1999) *supra* note 756 at 5.
[802] Douglass North (1990), *supra* note 202 at 79.
[803] *Ibid.*
[804] *Ibid* 80. North notes that in Third World countries incentives to invest in productive knowledge are frequently misdirected due to high transaction costs which result imperfect markets and also faulty subjective models of the actors.

organisations.[805] North draws a distinction between allocative efficiency, which is premised on neoclassical pareto conditions and adaptive efficiency which is concerned with rules that shape the way an economy evolves through time and the willingness of a society to acquire knowledge and learning, to induce innovation, to undertake risk and creative activity as well as to resolve problems and bottlenecks of society through time.[806] North explains that since in a world of uncertainty no one knows the correct solution to the problems confronted, it is the society that permits maximum generation of trials that will be most likely to solve the problems through time.[807] For this reason adaptive efficiency will provide the incentives to encourage the development of decentralized decision-making processes that will allow societies to maximize the efforts required to explore alternative ways of solving problems.[808]

Adaptive efficiency will help societies to learn from failures and will result in organisational trials and elimination of organisational errors.[809] Consequently, an institutional structure that provides for competition, decentralised decision making, well specified contracts of property rights and bankruptcy laws will promote adaptive efficient organisation.[810] North therefore counsels that it is important to have a structure of rules that not only rewards success but also vetoes the survival of maladapted parts of the organisational structure.[811]

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[805] *Ibid.*
[806] *Ibid.*
[807] *Ibid* 81
[808] *Ibid*.
[809] *Ibid*
[810] *Ibid.*
[811] *Ibid.*

8.2.3 Institutional Change and Path Dependency

The final and perhaps the most important aspect of the process of institutional change is the path of economic change. North has argued that there are basically two forces that shape the path of institutional change, namely (i) increasing returns and imperfect markets characterised by significant transaction costs.[812]

Increasing returns is an economics concept, which basically holds that the probability of further steps along the same path increases with each move down the path because the relative benefits of the current activity compared with other possible options increases over time,[813] According to W. Brian Arthur,[814] increasing returns processes come into being as a consequence of the following self-enforcing mechanisms:

(i) Large set-up or fixed costs. When set-up or fixed costs are high, individuals and organisation have a strong incentive to identify and stick with a single option.

(ii) Learning effects. Knowledge gained in the operation of complex systems leads to higher returns from continuing use because with repetition individuals learn how to use products more effectively and their experiences are likely to spur further innovations in the product or related activities.

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[812] *Ibid*. 95

[813] Paul Pierson, 'Increasing Returns, Path Dependence and the Study of Politics' (2000) 94 (2) American Political Science Review 251-257 at 252.

[814] Brian W. Arthur, *Increasing Returns and Path Dependency in an economy*, (Ann Arbor: University of Michigan, 1994)

(iii) Coordination effects. The benefits of an organisation using a particular institution will increase as others adopt the same institution.

(iv) Adaptive expectations. Projections about future aggregate use patterns lead individuals to adapt their actions in ways that help make those expectations come true.

North asserts that all these four mechanisms apply to institutions in that institution creation is usually associated with large initial set up costs and also that there are significant learning effects for organisations that arise in consequence of the opportunity set provided by the institutional framework.[815] Also coordination effects exist directly via contracts with other organisations and indirectly by induced investment through the polity in complementary activities as well as by way of creation of informal rules in response to formal rules. Finally adaptive expectations occur because increased prevalence of contracting based on a specific institution will reduce uncertainties about the permanence of that rule.[816] This shows that the interdependent web of the institutional matrix produces huge increasing returns which shape the long run path of economies.

The path of institutional change is further shaped by incomplete markets, fragmentary information feedback and significant transaction costs. Divergent paths and persistently poor performance then prevail due to subjective models of actors that are modified both by very imperfect feedback and ideology.[817] Increasing returns and imperfect markets therefore make institutional change path-dependent and once a development path is set on

[815] North (1990) *supra* note 202 at 95
[816] *Ibid* at 95
[817] *Ibid.*

a particular course, network externalities, the learning process of organisations, and the historically derived subjective modelling of the issues reinforce the course.[818] Thus increasing returns characteristic of an initial set of institutions that provide disincentives to productive activity will create organisations and interest groups with a stake in the existing constraints and will therefore resist change.[819]

North observes that the artifactual structure including institutions, beliefs as well as various problem solving tools and techniques are inherited from the past as part of our 'cultural heritage.'[820] Usually cultural heritage will impose severe constraints on the ability to change institutional structure either 'because the proposed changes run counter to the inherited belief system or because the proposed alteration threatens the leaders and entrepreneurs of existing organisations.'[821]

The foregoing therefore explains why fundamental change in relative prices affect two societies differently as in each society the change will result in adaptations at the margins and the margins affected will be those where the immediate issues require solution and the solution will be determined by the relative bargaining power of the participants which are the organisations that have evolved in the specific overall institutional context.[822] Consequently a common set of fundamental changes in relative prices or the common

[818] *Ibid* at 99
[819] *Ibid*.
[820] North (2005), *supra* note 8 at 156
[821] *Ibid* at 157
[822] *Ibid* at 101

imposition of a set of rules will lead to widely divergent outcomes in societies with different institutional arrangements.[823]

Path dependency is thus very crucial to the process of institutional change like legal reform because it provides a general theoretical explanation for the relative unpredictability of legal transplantation as a policy or methodology of legal reform.[824] Mere copying of legal rules and systems will not produce the same results in their new environment as were produced in their original environment because the new environment will respond to the transplanted law in novel ways peculiar to the new social environment, as it will be a function of the path dependant situation at reception and response to the novelty of the recipient society.

8.2.4 Need for a clear Theory of Institutional Change

The overarching thesis of North's model is that neo-classical economic theory is static and as a consequence has tended to misinform policy makers deriving their inspiration from that theory. All too frequently this result in policy prescriptions that produce results at odds with intentions because policy derived from static theory in a dynamic setting is bound to produce unanticipated (and unpleasant) outcomes.[825] While North advocates a clear theory of change, he realises that such a theory may not easily evolve but believes that it is

[823] *Ibid* at 101. This is why transplanting Western rules in developing countries will yield different outcomes as the enforcement mechanisms, the way enforcement occurs, the norms of behaviour and the subjective models of the actors are not the same.
[824] R.J. Daniels, M. Trebilcock and L. Carsen, 'The Legacy of Empire: The Common Law Inheritance and Commitments to Legality in Former British Colonies' (2011) 59 Am. J. Comp. L. 111.
[825] *Ibid.*

possible to have a limited but manageable approach to dealing with dynamic change. He sets out the following realities that may inform such an approach:[826]

1. Changes in the human environment will broadly mirror the changes in institutions and will have as their source the underlying beliefs of those organizational entrepreneurs (political, social, and economic) in a position to enact alterations in the institutional environment.

2. Such initial changes can alter the perceived opportunity costs of complementary or substitute organizations. Consequently there is need to have a detailed understanding of the complex interdependent institutional matrix to unravel those connections and to know the new opportunity costs of the affected organizations. North observes that 'economics and political economy have not devoted resources to understanding the complex interdependent character of market structures so as to be self-conscious about the secondary consequences of an initial change.'[827]

3. Therefore Policy makers need more detailed knowledge than is currently possessed of the institutional structure of an economy so that they are aware of the existing institutional matrix and therefore are self-conscious about the interconnections. This will put them in a position to perceive the alterations in the opportunity costs of affected organizations and take that information into account in making policies.

[826] *Ibid* 126.
[827] *Ibid* 126.

8.3 CHANGES OF FORMAL RULES

By way of recapitulation, formal rules are constitutions, statutes, common laws and other governmental regulations.[828] Unlike informal rules, formal rules are a policy variable because they can be changed by changing policies.[829] Generally, formal rules can be introduced for one of the following purposes:[830]

(i) Institutionalisation of customs and traditions in order to make informal rules more uniform, predictable, enforceable and transparent.

(ii) Enactment of new rules in order to accommodate changes in the economic conditions of life so as to reduce transaction costs of economic exchange.

(iii) New rules being introduced as an outcome of top-down decision making process in response to the majority rule, lobbying and the pressure from rent-seeking groups.

Formal rules may therefore be altered through legislative changes like enactment of new statute, judicial changes through court decisions, regulatory changes enacted by regulatory agencies and as a result of constitutional rule changes that alter the rules by which other rules are made.[831] According to Perjovich the incentives and constraints under which the makers of laws and regulations operate are crucial to the process of institutional change.[832]

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[828] S. Perjovich (2008) *supra* note 288 at 141.
[829] *Ibid*.
[830] *Ibid*.
[831] Douglass North (1999) *supra* note 756 at 6
[832] S. Perjovich (2008) *supra* note 288 at 141. Perjovich claims that these incentives and constraints differ in common law countries and civil law countries. It is observed that in common law countries, the bulk of its formal rules are made by judges through legal precedents while in civil law countries formal rules are mainly made by the legislature. Judges are usually independent and make decisions according to the prevailing

8.4 CHANGES OF INFORMAL RULES

As stated above, changes in informal rules occur gradually and sometimes quite unconsciously as individuals evolve alternative patterns of behaviour consistent with their newly perceived evaluation of costs and benefits.[833] This may occur through a gradual withering away of an accepted norm or social convention or the gradual adoption of a new one as the nature of the political, social, or economic exchange gradually changes.[834] Informal rules change slowly because they are essentially a synthesis of a community's traditions, customs, moral values, religious beliefs and all other informal norms of behaviour that have passed the test of time and that bind the generations.[835] Informal rules may change due to factors either coming from within the institutional system (endogenously) or from outside the system (exogenously).[836]

8.4.1 Exogenous change of Informal Rules.

This mainly involves changes to informal rules that are effected through deliberate change of formal rules in a bid to bring about behavioural change in society. North asserts that institutional change is induced by organisations and their entrepreneurs.[837] The question whether formal rules can change informal rules has generated considerable scholarly

culture of the society. On the other hand parliament makes laws to suit the interest of the political elite. As such, common law countries are likely to have effective formal rules than civil law countries. However, the idea that common-law and civil law Nations have different developmental trajectories has been questioned by several scholars including R.J. Daniels *et al* (2011) *supra* note 809, who provide evidence of different institutional development among countries within the same legal jurisdictional origin.

[833] North (1999) *supra* note 756 at 6
[834] *Ibid* at 7
[835] North, (1990) *supra* note 202 at 34.
[836] S. Perjovich, (2008) *supra* note 288 at 156.
[837] *Ibid* at 73.

debate. Richard McAdams[838] has argued that new formal rules are capable of changing informal rules and has cited laws restricting smoking, bans on duelling, and anti-discrimination laws in the United States as examples of formal rules that created incentives resulting in behavioural modifications. On the other hand, it is argued that formal rules cannot change informal institutions but rather they can only suppress them.[839] Perjovich[840] has argued that McAdams' observations do not have general validity as economic history is full of formal rules and ideologies that have failed to change prevailing informal rules.[841] They agree that in cases relied on by McAdams there were observable changes in informal rules but argued that McAdams failed to distinguish between formal rules that support the already emerging changes in informal rules and formal rules that do not.[842] They therefore suggest that formal rules can only institutionalise ongoing cultural changes.[843] This study agrees with Perjorvich's position that informal rules will only change exogenously where a cultural shift is already underway.

8.4.2 Endogenous Change of Informal Rules

This occurs when informal rules change from within the system. According to Perjovich et al, cultural changes from within a given institutional system can be properly understood by

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838 Richard McAdams, "The Origin, Development, and Regulation of Norms," (1977), 96 Michigan Law Review 338-433 at p. 349.

839 Svetozar Pejovich, 'The Effects of the Interaction of Formal and Informal Institutions on Social Stability and Economic Development'(1999) 2 Journal of Markets and Morality 164-181 at 170.

840 S. Perjovich (2008), *supra* note 288 at 156.

841 *Ibid*. Perjovich cites the Sarbanes Oxley Act that was enacted by US Congress in the wake of Enron's bankruptcy and Affirmative Action provisions in US as such rules. Other examples of formal rules not working due to informal resistance include the Equal Rights Amendment of the USA Constitution and Jim Crow (equal but separate – *Plessy v Ferguson*, de facto disenfranchisement, political terrorism through the Ku Klux Klan, segregation and impoverishment); the prohibition amendment of the USA Constitution and consequential gangsterism and mass disregard of the law – see Herbert L Packer, Limits of the Criminal Sanction.

842 *Ibid.*

843 *Ibid.*

using the margin of acceptable behaviour, which is a line that separates intramarginal from submarginal behaviours.[844] An addition of a previously submarginal behaviour to the set of acceptable rules result from a change in the margin of acceptable behaviour.[845] In order to change the margin of acceptable behaviour there must be an individual willing and able to take the risk of overcoming the objective and subjective costs of carrying out the submarginal activity.[846]

In this regard, the process of change will start with the emergence of a new idea or opportunity in a community or an organisation and perception of prospects of personal gain from exploiting the opportunity by a member of the community or organisation.[847] The new opportunity may require a sub marginal behaviour and given the potential gains from exploiting the opportunity, some individuals might choose to pursue actions that are below the margin of acceptable behaviour and consequently attract strong opposition and bear the costs of breaching the norm.[848] If engaging in the sub marginal activity turns out to provide the pathfinder (the risk taker) with a differential return, incentives will be created for others to pursue the same activity. Continued returns from the activity will result in an ever-increasing number of individuals joining in and this will eventually lead to spontaneous

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[844] *Ibid* at 160. "Submarginal" in this context would mean something like a decision that in the given institutional structure is less rewarding that an available option, but one that, given an appropriate shift in informal rules, will become more rewarding than the available choices under either institutional structure. On the other hand intra-marginal would be a decision that is within the norm of that institutional structure.

[845] *Ibid.*

[846] *Ibid*. This basic model can apply outside economic markets. An illustrating example is the rejection of foot-binding by Chinese Society in the first half of twentieth century. Initially refusal to bind was submarginal because it jeopardised marriage prospects. However as men became willing to marry women with unbound feet, it became advantageous to not bind, as binding carries health and welfare costs. See Kwame Antony Appiah, *The Honour Code: How Revolutions Happen*, (WW Norton Company Inc, New York, 2010).

[847] According to North's Model, the perception of personal gain from a given opportunity will be determined by an individual's belief system. This means that a change in the mental constructs of individuals will determine the rate at which individuals will be prepared to engage in a "submarginal" activity.

[848] Perjovich (2008) *supra* note 288. Such costs may include financial losses, losing friends or job as well as alienation from the community.

pressures from within the system to 'incorporate the novelty'[849] into informal rules. This process shall however be subject to the realities that arise from uncertainty and non-egordicity as expounded within North's model.

In order to increase the rate of change in informal rules, the costs of carrying out sub marginal activities will have to be lowered.[850]

8.5 INTERACTION BETWEEN FORMAL RULES AND INFORMAL RULES

Another concept that is helpful in understanding the process of institutional change is the nature of the interaction between formal and informal rules in a given economy. Formal rules and informal rules interact at different levels depending on the prevailing incentive structure at any given time. According to J Winiecki,[851] the starting point is the balance conditions between formal and informal rules, which result from harmonious co-existence of the prevailing formal and informal rules so that little further behavioural adaptations are necessary on the part of economic agents.[852] The balance conditions entail that neither decision makers nor economic agents perceive that their interests require fundamental institutional change.[853] In practical terms this will be a situation where rulers do not feel, according to their belief system at the time, the need to change the structure of incentives by introducing new formal rules in order to increase their share of created wealth or where no organised groups of economic agents is able to successfully lobby for changes in formal

[849] *Ibid.*
[850] *Ibid* at 162.
[851] J. Winiecki, *Supra* note 380.
[852] *Ibid* at 151.
[853] *Ibid.* It is however acknowledged that although the interaction exhibits an overall stability, some adjustments in either formal rules or informal rules still occur at the margin.

rules to improve the structure of incentives that would increase wealth creating capability of the economy that would allow them increase their wealth.[854]

Winiecki perfectly depicted the possible interaction scenarios by using the cross-tabular form set out in Table 5 below.

Table 5 : Interaction between Formal and Informal Rules

FORMAL RULES

		Continue Unchanged	Change
INFORMAL	Continue Unchanged	1 **Balance** [No need to make fundamental adaptations]	2 **Imbalance** [Informal Rules adapt]
RULES	Change	3 **Imbalance** [Formal Rules adapt]	4 **Extreme Imbalance** [Few rules in discord with each other]

Figure 1: Adapted from J. Winieki[855] at page 154

[854] *Ibid.*
[855] *Ibid.*

The above cross-tabulation serves as a very helpful tool in understanding what happens when changes are made to formal rules or informal rules or both. Quadrant 1 depicts the stable situation where no adjustments are attempted because there is no force either willing or able to change the existing formal rules. Quadrants 2 and 3 represent the situation of imbalance where there is potential of adjustments. Quadrant 2 shows that when formal rules change while informal rules remain unchanged, there will be an imbalance as the existing informal rules are adapting. On the other hand, quadrant 3 shows that changes to informal rules will result in another imbalance situation as existing formal rules may have to be changed to adapt to the new informal rules. Finally, quadrant 4 depicts a situation where both formal rules and informal rules are changed at the same time and rapidly. This scenario will result in 'extreme fluidity'[856] as there will be a discordance of some rules as the system stabilises. Obviously the situation in quadrant 4 is one of great uncertainty for organisations.

There may be different causes of adjustments/adaptations to both informal rules and formal rules. Informal rules may adjust either because the structure of incentives in new formal rules is so rewarding that it overwhelms the resistance of informal rules despite the latter being in conflict with the former or because the new structure of incentives is only moderately more rewarding than the old one but the informal rules have already been roughly in concordance with the new formal rules.[857] In the case of formal rules, adaptations may be due to the fact that either the resistance of new informal rules is very strong in spite of relatively strong influence of formal rules or the structure of incentives provided by

[856] *Ibid* at 155.
[857] *Ibid*

formal rules now only influences the behaviour of economic agents relatively weakly such that existing informal rules prevail.[858]

It is therefore important to have these possible interaction scenarios in mind when designing any institutional reform agenda in order to predict possible outcomes of the reform process and to be able to choose the most optimal outcome. The probability of success of any reform program is negatively correlated with the degree of discordance between formal rules and informal rules. Thus the smaller the divergence, the greater the probability of success.[859]

8.6 THE INTERACTION THESIS

The above discussion has shown that the interaction between new formal rules and informal rules is very crucial to the process of institutional change. Perjorvich has encapsulated the relationship between new formal rules and prevailing informal rules as discussed above into what he calls the Interaction Thesis.[860] According to Perjorvich, when a new formal rule is enacted, it creates new choices for human interactions or modifies the old choices thereby changing the opportunity set or the incentive structure within which exchange occurs[861]. The actual economic outcome of a new formal rule is, therefore dependent on how individuals perceive and subjectively evaluate new incentives[862]. This

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[858] *Ibid*
[859] *Ibid* at p. 156
[860] S. Perjovich, (2008), *supra* note 288 at 121.
[861] *Ibid*. Obviously the thesis assumes some degree of effectiveness of formal rules, which may not always be present. See: T.A. Kelly, 'Exporting Western Law to the Developing World: The troubling Case of Niger' (2000) 39 George Washington International Law Review 321.
[862] *Ibid* at 121. This is in line with North's model as it is laying an emphasis on individual perception which is based on one's mental construct.

means that the effect of a new formal rule on economic performance is the joint product of the interaction of the new rule with the prevailing informal rules and it is not possible to evaluate the impact of the new rule alone to the total result.[863]

A new formal rule may be in conflict with old formal rules and/or prevailing informal rules. Given that, as stated above, formal rules are a policy variable, the rulers may enact secondary rules to reduce or eradicate the conflict between the new rule and the old formal rules but there is little, if any, that the authorities can do to avoid the conflict between the new formal rule and prevailing informal rules.[864] The significance of prevailing informal rules is that they determine the transaction costs of integrating the new formal rule into the prevailing institutional structure.[865] Specific transaction costs that derive from the reaction of the prevailing informal rules to the enactment of a new formal rule include the effect of the new rule on the predictability of behaviour, the risks associated with non-routine behaviours imposed by the new rule, the estrangement of those who are quicker to accept the new rule from friends and neighbours who are slower in abandoning old rules, sunken investments in the prevailing informal rules, and the resistance of the groups and coalitions that stand to gain from preserving the status quo.[866]

According to Winiecki, interaction of formal rules and prevailing informal rules will produce two alternative outcomes.[867] On the one hand, where new formal rules are largely in harmony with the prevailing informal rules, harmonious interaction will rapidly reduce

[863] *Ibid.*
[864] *Ibid.*
[865] *Ibid.*
[866] *Ibid* at 121. The transaction costs will be even more in the case of a formal rule that completely fails to take off, that is, it does not have any impact on the society.
[867] Winiecki, *supra* note 380 at 153.

transaction costs by releasing resources from their present uses to those with greater potential for increases in wealth.[868] On the other hand, if formal rules conflicts with informal rules, the resultant friction ties resources largely where they have already been employed and limits gains from expected reduction in transaction costs.[869] This shows that discordance between formal rules and informal rules creates an economy with higher transaction costs than otherwise would have been the case.

The interaction thesis therefore posits that:

> When the members of the community perceive the consequences of a new formal rule to be in conflict with their prevailing culture, the transaction costs of integrating that rule into the institutional framework will be high, consume more resources, and reduce the production of wealth. And when the members of the community perceive the consequences of a new formal rule to be in harmony with their prevailing culture, the transaction costs of integrating that rule into the institutional framework will be low, consume fewer resources, and increase the production of wealth.[870]

According to Perjovich[871] the conflict between the prevailing culture and new formal rule manifests in three major ways:

(i) Massive resistance to the new rule that result in an increase in illegal activities beyond government's control.[872]

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[868] *Ibid* at 155
[869] *Ibid* at 155. Obviously the extent of transaction costs will vary according to the degree of the conflict across these two extremes.
[870] S. Perjovich, (2008), *supra* note 288 at 121.
[871] *Ibid* at 122

(ii) Increased cost of enforcement of the new rule. Cost of enforcement will increase either because there will be more offenders or because people shall develop sophisticated ways of circumventing the new rule.

(iii) Need for secondary or follow up laws or regulations either to compromise or strengthen the scope or sting of the new rule. This is always a costly exercise at the expense of the tax payer.

Understanding the effect of interaction between new formal rules and prevailing informal rules as discussed above is vital to the process of designing and implementing effective reform programmes.

8.7 THE THEORY OF EFFICIENCY-FRIENDLY INSTITUTIONAL CHANGE

Using insights gleaned from the relationship and interaction between formal rules and informal rules as discussed above, Perjovich[873] has put together a theory of efficiency – friendly institutional change within the framework of tradition, which may be used as a tool for the implementation of efficiency-friendly institutional change. According to Perjovich, the theory has both a positive component and a normative component. The positive component is that the process of institutional change should be consistent with economic efficiency, economic efficiency being the process through which voluntary interactions are

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[872] *Ibid* at 122. An example cited here is the XVIII amendment to the US Constitution in 1919 prohibiting manufacture, sale and importation of liquors. As this rule was in conflict with American culture of social drinking it resulted in an increase in illegal production and sale of liquor that government could not stop. Eventually the rule was repealed in 1933 by amendment XXI.

[873] *Ibid* at 115.

carried out leading to known results.[874] The normative component of the theory is that the process of making rules should encourage voluntary choice of capitalism so that capitalism develops voluntarily and from within the community.[875]

The concept of 'efficiency-friendly institutional change' is based on the understanding that, in a world of uncertainty and incomplete information we can never be sure whether an outcome of a new rule is efficient and therefore that any method of analysis of economic exchange can do no more than determine whether the incentive effects of new rules are expected to move scarce resources from lower to higher valued uses.[876] As such a formal or informal rule would be regarded more efficient than another rule if it offers greater incentives for voluntary interactions than the other rule that provides weaker incentives for free exchange.[877]

The theory of efficiency-friendly institutional change is said to be based on the interaction thesis discussed above, on two postulates, which are the rule of law and markets for institutions and on three building blocks namely, the agents of change, formal rules and informal rules.[878] The theory states that:

> "The four basic institutions of capitalism embodied in the rule of law, namely, the law of contract, private property rights, a constitution and an independent judiciary, promote economic progress because of their incentive effects and the

[874] *Ibid* at 115

[875] *Ibid* at 116. Perjovich says imposing capitalism from above does not work because the transaction costs of integrating its institutions into the social system can be very high.

[876] *Ibid.*

[877] *Ibid.*

[878] *Ibid* at 118.

efficiency of that economic progress depends on the interaction between formal and informal institutions."[879]

The rule of law is thus said to be the foundation from which capitalism has emerged and upon which it rests.[880] According to Perjovich, private property rights and the law of contract generate efficiency friendly incentives that move resources to their highest-valued uses while an independent judiciary and constitution protect those incentives from decision makers in government, rent seeking coalitions and majority rule. The incentive effects of the rule of law include (i) reducing the transaction costs of identifying and exploiting all exchange opportunities i.e. allocative efficiency (ii) encouraging the acceptance of risks associated with creating new opportunities of exchange (entrepreneurship) (iii) eliminating bias against decisions that have long-lived consequences and (iv) enhancing the adaptive behaviour.

This entails that the involvement of government in the process of institutional change should be limited to the enactment of new formal rules that will promote rule of law as its incentive effects would reduce the cost for individuals, as agents of institutional change, who shall have freedom of choice to determine the direction of institutional change.[881]

In terms of the second postulate of the theory, the market for institutions, it is stated that given that both formal and informal rules change, albeit slowly, with respect to informal rules, there is a market for institutions and what is important is to ensure that the market of

[879] *Ibid* at 165
[880] *Ibid*.
[881] *Ibid* at 168. Individuals or entrepreneurs may determine the direction of institutional change by either embracing or resisting institutions introduced by relevant authorities.

institutions that exists is economically efficient.[882] A set of institutions will be regarded as more efficient if it offers greater incentives for new rules to emerge and reduces transaction costs of their voluntary acceptance than another set of institutions that offers weaker incentives.[883] The efficiency of the market for institutions depends on the incentives of rule makers, the procedures for making rules and the constraints under which the rule makers operate.[884]

With regards to the building blocks of the theory, agents as carriers of change contribute to efficiency friendly institutional change in that as more entrepreneurs operate in a competitive market they reach a point where prevailing formal rules are impeding further expansion of extent of their exchange resulting in high transaction costs.[885] The entrepreneurs' bid to reduce rising transaction costs shall create incentives to lobby for new rules that support available exchange opportunities and adjustments in formal rules that shall result from this process are likely to be efficiency-friendly.[886]

With respect to formal rules as stated above, formal rules may be institutionalised customs or traditions or may be enacted in order to accommodate changes in the economic conditions of life or may be a result of top-down decision making process. According to efficiency-friendly theory of institutional change, formal rules arising from the first two sources are efficiency-friendly as they adjust rules 'to the requirements of the game'

[882] *Ibid* at 165. Market for institutions here refers to the diversity of institutions that economic or political authorities in a given society may adopt and avail to individuals (entrepreneurs).
[883] *Ibid* at 165
[884] *Ibid* at 165
[885] *Ibid* at 166
[886] *Ibid* at 166

whereas formal rules imposed from above force the game to adjust to new rules making its efficiency to be accidental or incidental and at best uncertain.[887]

With regard to informal rules, it is said that changes in culture are efficiency-friendly because the carriers of change, who are the pathfinders, bear the cost of their attempts to change the margin of acceptable behaviour and at the same time capture the benefits as the margin of acceptable behaviour can only be changed when the benefits to the pathfinders are greater than the costs they have to bear like community's resistance.[888] Because the changes in informal rules are always voluntary, they are efficiency-friendly.

The above assertion however may not always be true as it is possible for a pathfinder to instigate an informal rule change that may turn out to be inefficient for example where the benefits are wholly appropriated to the pathfinder who may manage to lock out competitions.[889]

Finally, as stated above the theory of efficient friendly institutional change hinges on the interaction thesis as discussed earlier in that the question whether a new formal rule is efficiency-friendly will in the end be answered by the overall effect of the interaction between the new rule and the prevailing informal rules which is itself dependent on the transaction costs involved in integrating the new rule in the social system.[890]

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[887] *Ibid* at 167

[888] *Ibid* at 168

[889] Modern examples may include the Rupert Murdoch's News International monopoly on newspaper reporting and the BCCI scandal.

[890] *Ibid* at 169

The theory of efficiency-friendly institutional change shows that both the “Law and Development movement” and “Washington Consensus” ideologies were correct in so far as they emphasised on the importance of the rule of law. However, both concepts came unstuck due to their failure to recognise the importance of agents of change and the consequences of the interaction between formal rules and informal rules.

We consider the theory of efficiency-friendly institutional change to be a helpful step in the right direction in the search for an appropriate theory of institutional change. However as Perjovich[891] himself conceded, only more research would confirm whether the interaction thesis provides a good roadmap for such a theory.

8.8 INSTITUTIONAL CHARACTERISTICS CONDUCIVE TO EFFICIENT INSTITUTIONAL CHANGE.

Winiecki[892] has also provided a guide on how efficient institutional change could be implemented despite the conflict between formal and informal rules. According to Winiecki major changes in formal rules may succeed even if they are relatively clashing with the existing informal rules as long as the new structure of incentives is strongly and positively influencing choices made by economic agents.[893] Winiecki’s method is premised on the observation that there is a range of generalisable institutional characteristics that intervene in a more or less predictable way in the interaction between a new formal rule and

[891] *Ibid* at 169
[892] J. Winiecki, *Supra* note 380 at 156
[893] *Ibid.*

prevailing informal rules and create either hospitable or inhospitable environment in which formal rules are passed or implemented resulting in informal rules affecting positively or negatively the economic outcome of the new formal rules.[894] These institutional characteristics are regarded as institutional variables the presence or absence of which would help explain and predict economic outcomes of the interaction between formal rules and informal rules in any given economy. This would mean that in order to achieve efficient economic outcomes, authorities simply need to ensure that institutional change is implemented within the environment created by institutions with efficiency enhancing characteristics.

The institutional characteristics in question are mostly derived from a given government system as it is the system of government that usually determine the incentive structure under which decision makers operate and constraints on their opportunity to pursue their own interests, which in turn determine the perception of opportunity sets and trade-offs they face in the decision making process.[895] The institutional characteristics selected by Winiecki are discussed below.

8.8.1 Centralization/Decentralisation of power

Winiecki notes that decentralisation of power has historically created a conducive environment for the emergence of incentive structure encouraging economic agents to strive for the betterment of their conditions and has in turn given rise to vibrant

[894] *Ibid*.
[895] *Ibid* at 156.

economies.[896] Political decentralisation may be territorial where the right to make rules is given to lower level political units or may be functional where the right to make rules concerning different functions or behaviours are given to different institutions.[897] Political decentralisation is important in economic decision making because it provides 'greater room for manoeuvre'[898] to economic agents. Specifically, territorial decentralisation offers local economic rules that are usually more suitable for the economic and social conditions of life in a given local environment and insulates local economic activities, conducted in accordance with such suitably adapted rules from the arbitrariness of central power.[899] Another significance of decentralisation is offered by Lavoie[900] who noted in his study that decentralisation of decision making in capitalist market economy, dramatically reduced the costs of experimenting as it was only experimenters and perhaps their relatives who suffered in case of failure.

According to Winecki, therefore, the greater the level of decentralisation, the greater the probability that formal rules aimed at improving incentive structure to create wealth will encounter less friction in interaction with informal rules.[901]

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[896] *Ibid* at 157. Winiecki cites studies of R.S Lopez, *The Commercial Revolution of the Middle Ages, 950-1350* (Cambridge University Press, 1979) and Douglas North, *Structure and Change in Economic History* (New York Norton 1981) as providing evidence of this assertion.

[897] A good example of functional decentralisation is the separation of the right to make rules concerning lay function of the state from the right to make rules concerning religious behaviour of the individuals.

[898] J. Winiecki, *Supra* note 380 at 157.

[899] Ibid.

[900] D. Lavoie 1985, *National Economic Planning. What is Left* (Cambridge Mass: Ballinger 1985) cited in J. Winiecki, *Supra* note 380 at 158.

[901] J. Winiecki, *Supra* note 380 at 158

8.8.2 Discretion/Interaction in Formal Rule-making

Freedom of economic agents to voluntarily organise themselves and bargain with "the powers that be" is said to be crucial for the successful long run economic performance.[902] Bargaining during rule-making produces rules that are more conducive to the creation of wealth than to redistribution which is associated with rent-seeking. This is so because wherever potentially affected parties are able to interact with the decision maker and wield at least some power to wring concessions, there will be mutually acceptable rules and the probability that a formal rule made in such way will last and realise its full potential will be greatly strengthened.[903] Further, informal rules will accommodate more easily to formal rules because active participation in the process of rule-making reshapes the old rules and shapes the new conventions in a given social setting.[904] This may therefore mean that the more interaction there is between the ruler and the affected parties, the greater the potential for successful restructuring of incentives in the direction of wealth creation rather than redistribution.[905]

8.8.3 Degree of Regulation vs. Degree of Economic Freedom

The degree of economic freedom, that is, the degree of freedom of economic agents to eliminate existing errors and to pursue new trials to improve performance determines the competitiveness of markets.[906] On the other hand, regulation constrain economic actors as

[902] *Ibid* at 158
[903] *Ibid* at 158
[904] *Ibid* at 159
[905] *Ibid* at 159
[906] *Ibid* at 160

to what, when, where as well as how and from what they should produce.[907] It follows that in overregulated markets, freedom to begin new trials and eliminate revealed errors is severely constrained. On the contrary in an environment where both formal and informal rules allow more economic freedom there would be less friction between the formal rules and informal rules as customs and other social conventions would not be expected to congeal because ongoing trials and errors would instil enough adaptability into the economy. Thus a sufficient degree of economic freedom shall breed adaptive efficiency.

8.8.4 Existence/Non-existence of competitive pressures upon rulers to follow arrangements successful elsewhere.

Existence and recognition of institutional competition by rulers of a given society will orchestrate imitation of technical, organizational and social innovations taking place in outside centres of political power. One way of initiating competitive pressures is said to be some regional political set-up where emulation of the more successful presses resistant rulers to accept solutions that would help them increase their country's economic pie.[908] Winiecki cites the economic region in East and South East Asia as an example of a region where emulation of each other's successes resulted in a progressively freer economic landscape throughout the region.[909] By the same token, this offers an explanation why regimes like Communist China and Iran sought to cut their population from the international market place of ideas.

[907] *Ibid* at 160
[908] *Ibid* at 162
[909] *Ibid* at 163

8.8.5 The Level of Corruption

Corruption may exist as an informal rule in its own right but in some instances may exist as response to a conflict between a new formal rule and other informal rules. Where corruption exist as an informal rule, it may weaken or distort new formal rules by increasing transaction costs or cause transaction costs to decrease by much less than expected from the original restructuring of the property rights.[910] It can therefore be concluded that the more corruption is already rooted in a given economy, the greater will be the conflict between formal rules and informal rules and therefore the greater the differential between the potential and actual effects of the wealth creation enhancing formal rules.[911]

8.8.6 Belief System

Belief system is considered as an institutional variable because systemic differences are observed between ethnic and other groups in their ability to better their living conditions and such differences are considered to emanate from divergent philosophies, worldviews, religious or ideological beliefs.[912] Winiecki counsels that as part of the process of institutional change, an effort should be undertaken to evaluate what the actual belief system is and how it fits into the continuum along the collectivists/individualist lines and how it compares with a reference country or a group of countries.[913]

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[910] J. Winiecki, Supra note 380 at 163

[911] *Ibid*.

[912] *Ibid*, citing T. Sowell 1996, *Race and Culture*. *A World View,* (New York Basic Books, 1996). The effect of belief system on economic development is also the running theme of North's Model.

[913] *Ibid* at 164

The foregoing approaches and theories are very helpful in the search for an effective theory for institutional change and all of them come very close to the approach that North is advocating. The only shortfall is their lack of emphasis on the significance of the mental construct of the institutional entrepreneurs which determine the extent, speed and direction of institutional change. Further some of these theories are premised on the neo-classical presumptions of symmetric information and rational thinking individuals. It is for this reason that we should revert to North's approach to institutional change and determine how his approach would help tie any loose ends in the above theories.

8.9 PRACTICAL EXAMPLES OF INSTITUTIONAL CHANGE.

In order to give some practical perspective of the theories or approaches to institutional change, discussed above, we shall look at some relevant practical examples of institutional change that, we consider aptly demonstrate the theoretical credibility of the said approaches. Specifically, these examples show that positive interaction between formal and informal institutions in a given society will result in economic development and vice versa. They also show economic development is "path dependent" on the institutional structure of a particular society.

8.9.1 Chinese Capital Market Development Reform

China adopted a very unique model of capital market development. When the Chinese authorities wanted to establish their modern day stock market, they were faced with the same problem faced by many developing economies seeking to establish capital markets namely lack of effective legal and market governance structures.[914] Despite this weakness however China was able to establish a relatively strong capital market in short order. Pistor and Xu[915] argue that China managed to achieve rapid capital market development because it substituted legal governance with administrative governance of capital markets. It is believed that 'pre-existing modes of administrative governance introduced incentives that mitigated information asymmetry problems inherent in initial public offerings (IPOs) and contributed to enhanced market valuation during the post-IPO phase.'[916] The Chinese authorities employed two unique institutions in order to kick start their stock exchanges. These were the quota system used for equity share issuance and the Special Treatment (ST) system which was used in relation to underperforming issuers. It is believed that these administrative governance structures compensated for corporate governance which was practically non-existent[917]. Caragliano notes that:

> "During the early years of China's experiment with stock markets, ... these institutions filled a void and jump-started the markets in a way that newly introduced laws (mandatory disclosure and criminal and civil liability) and immature institutions (courts, market regulators, and intermediaries) could not."[918]

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[914] Katharina Pistor and Chenggang Xu, 'Governing Stock Markets in Transition Economies: Lessons from China', (2005) 7 (1) Am Law Econ Rev 184-210 at 184.
[915] *Ibid* at 184
[916] David A. Caragliano, 'Administrative Governance As Corporate Governance: A Partial Explanation For The Growth Of China's Stock Markets', 30 Michigan Journal of International Law at 1273
[917] *Ibid* at 1277
[918] *Ibid* at 1277

The quota system involved the People's Bank of China (PBC) establishing a certain amount of shares that firms would be allowed to issue to the public each year. This was followed by a negotiation process between the provincial government and the provincial branch of the China Securities Regulation Commission (CSRC) on the size of the quota for the region. Once an agreement has been reached, the request, together with information about the companies selected by the province to go to the market were submitted to CSRC who decided over the allocation of quotas to different provinces and ministries on the basis of the information and with the quantity constraint established by PBC.[919] After allocating the regional quotas, the selected companies were subjected to an individual approval process. This involved vetting applicants for compliance with the formal merits and disclosure requirements prescribed within relevant statutes and regulations.[920] Pistor and Xu observes that the quota system offered incentives to local owners of companies to provide accurate information about their firms (i) by offering carrots to regional governors in the form of future quotas and (ii) by threatening with sticks in the form of delisting firms and forced bail outs by the region in the case of underperformance.[921]

On the other hand, the ST system was a delisting mechanism which involved labelling a listed company as an ST firm if it experienced one of the following:[922] (1) negative net profits (loses) for two consecutive fiscal years; (2) the shareholders' equity is lower than the registered capital (the par value of the shares); (3) negative opinions or inability to issue opinions by the firm's auditors on its financial soundness; (4) a company's financial

[919] Pistor and Xu, *supra* note 914 at 197
[920] *Ibid* at 197.
[921] *Ibid* at 199
[922] Julan Du, Lucy Yajun and Sonia Wong, 'Special Treatment (ST) Firms and Administrative Governance of Capital Markets in China', in Thomas Eger et al eds, *Economic Analysis of Law in China* (Cheltenham, UK, 2007) at 164.

condition is considered abnormal by the stock exchanges or CSRC. The ST designation came with serious consequences for the designated firm. Firstly, the company's interim report would be audited, and daily share price fluctuations would be limited to 5 percent to prevent market manipulation and secondly, if an ST company continued to incur losses for more than one year, it would be delisted.[923]

Like the quota system, the ST system created a number of incentives that promoted information sharing and effective corporate governance of listed companies post IPO stage. For instance, once a company is labelled as an ST firm, it would usually face pressure from both its insiders and outsiders with an aim to pull the firm's business operations and performance back onto the right track as soon as possible.[924] Also, since regional quota allocations of IPO listings was dependent on the economic performance of a particular region including performance of individual listed companies, designation of ST status on a firm within a particular region and the possibility of its eventual delisting, had adverse effect on the region's listing opportunities that it could obtain from the central government.[925] Finally, the ST designation incentivised the central regulatory authorities (CSRC) to effectively regulate the affected firms. It is noted that 'by announcing a company with continuous unsatisfactory performance as an ST firm, the central regulatory authorities put themselves under public scrutiny for the fulfilment of their promise to delist a company

[923] *Ibid*. Prior to 1 January 2002, an ST firm would initially be downgraded to a particular transfer (PT) firm before being delisted. The price a PT share were allowed to drop without limit and could only be traded on Fridays.
[924] *Ibid* at 168.
[925] *Ibid* at 168

once the company's operational performance keeps deteriorating.'[926] This helped to make the delisting threat credible.

The features of these two systems that make them compatible with the theory of institutional change as discussed above include the following:

(i) The two institutions were built on the basic premise of decentralisation of power. The central government delegated the task of selecting companies to go on the market to regional governments. According to the theory of institutional change decentralised decision making results in efficiency friendly institutional change.[927]

(ii) The two systems also offered the market players an opportunity to participate in key decision making and to bargain with authorities on matters concerning the market. This according to Winiecki is another key institutional characteristic that would guarantee effective restructuring of incentives.[928]

(iii) Competition among local leaders created significant pressure on the leaders to imitate technical and organisational know-how with regard to management and restructuring of their companies.

[926] David A. Caragliano, *supra* note 916 at 1317
[927] North (1990) *supra* note 202 at 80 and J. Winiecki *supra* note 380 at 158.
[928] J. Winiecki, *Supra* note 380 at 159.

(iv) By forcing poorly performing companies to be delisted from the market, the ST system ensured that 'maladapted parts' of market institutional structure were weeded off.[929]

(v) As stated above, the mechanics of both the quota system and the ST system created incentives to local corporate owners that encouraged disclosure of information both before and after IPO stage.

8.9.2 The Integration of Traditional and British Governance Models in Botswana

In their article, *The Legacy of Empire: The Common Law Inheritance and Commitments to Legality in Former British Colonies,*[930] Daniels, Trebilcock and Carson, analyses the process of institutional building in selected British colonies[931] specifically looking at how the degree of representation afforded to the native population in national legislative bodies and the extent to which indigenous and British dispute resolution systems were integrated to allow for a localized common law jurisprudence to develop.[932] We find the observations of this study particularly relevant to this work especially with regard to the process of institutional change. We have selected Botswana because it is one of the countries in the SADC region and has a vibrant capital market compared to the rest of the countries in the region with the exception of South Africa. The history of Botswana's institutional structure offers a good example of the process of efficient institutional change as discussed above.

[929] North (1990) *supra* note 202 at 81.
[930] Ronald J. Daniels et al (2011) *supra* note 823 at p. 111.
[931] The countries studied included Barbados, Botswana, Burma, India, Jamaica, Kenya, Nigeria and Singapore.
[932] Daniels *et al*, (2011) *supra* note 823 at p 128

Daniel's *et al* note that the colonial presence in Botswana was minimal as it was held as a protectorate rather than a colony until the years leading up to its independence. The British authorities implemented a cooperative indirect rule system which was administered through pre-existing indigenous institutions by according free rein to indigenous authorities, allowing them to organise and govern their communities as desired.[933] As a result, for the majority of the colonial period, Tswana indigenous leaders retained significant autonomy, governing through largely traditional structures with enduring popular legitimacy.

It is noted that Tswana lawmaking arrangements were broadly compatible with British rule of law values as they emphasised on public discussion and consultation.[934] Under this arrangement each tribe was headed by a hereditary chief assisted by a Kglota, which was an assembly of tribesmen who would advise and inform the chief's decisions. The opinions of the members of the Kglota carried weight and although the chiefs were not compelled to accept the advice given to them by their tribe, they usually did because individuals or groups who were not satisfied with their leader would vote with their feet by leaving the tribe and forming another of their own.[935]

The Tswana lawmaking process was also broadly democratic in nature as the chief generally announced laws in public where all men had the right to speak.[936] Further, the chief was not above the law and could even be tried in the Kglota if his subjects felt that he had abused his powers. This provided checks on executive power and promoted both the voice

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[933] *Ibid* 141.
[934] *Ibid*.
[935] Laura Alfaro, Vinati Dev, Faheen Allibhoy and Debora L. Spar, 'Bostwana: A Diamond in the Rough', (2003) Harvard Business School, Case 9-703-027.
[936] Daniels *et al,* (2011) *supra* note 823 at 142

and exit options for individuals who thought their leaders were protecting their interests ineffectively.[937]

Because of the compatibility of the Tswana lawmaking process with British political values colonial authorities avoided legislating for the Botswana population, allowing the traditional chiefs to make, administer and enforce the laws.[938] And when British administration did legislate, the chiefs often managed to secure an active dialogue with the administration in order to ensure that laws affecting the tribes would not depart radically from tradition.[939]

As a result of the British colonial approach in Botswana, it is observed that the country has never suffered a period of authoritarian rule and has retained without interruption since independence a Westminster-style Parliament complete with checks and balances and a broad political base.[940] Thus by respecting the colony's traditional governance structures while still ensuring popular representation, the British were able to guarantee that the governing mechanisms in place at independence had legitimate roots in society.[941]

The history of institutional development in Botswana demonstrate North's approach to institutional development in that informal (indigenous) institutions were respected and retained and any new formal institutions that were subsequently introduced were not

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937 *Ibid.*

938 Isaac Schapera, 'Tribal Legislation among the Tswana of the Bechuanaland Protectorate: A Study in the Mechanism of Cultural Change', In MONOGRAPHS ON SOCIAL ANTHROPOLOGY No.9 (1943).

939 Isaac Schapera, 'Tribal Innovators: Tswana Chiefs And Social Change;1795-1940' (The Athlone Press,. London, UK 1970) 7.

940 John Hatchard, Muna Ndulo and Peter Slim, *Comparative Constitutionalism and Good Governance in the Commonwealth: An Eastern and Southern African Perspective* (Cambridge University Press, Cambridge, 2004) 19-21.

941 Daniels *et al* (2011) *Supra* note 823 at p. 144.

imposed on the people of Botswana but allowed for consultation and dialogue with the local authorities.

8.9.3 Path Dependence: The Divided Existence of the Population of the City of Nogales

In their recent book, *Why Nations Fail: The Origins of Power, Prosperity and Poverty,*[942] Acemoglu and Robinson, describe the diametrically opposite life experiences of the people of the city of Nogales that is situate along the border of United States of America and Mexico. The authors observes that in the American part of the city, Nogales Arizona, average household income is about $30,000 a year, most teenagers are in school and the majority of the adults are high school graduates. The population is relatively healthy with high life expectancy of around 65. The government provides electricity, telephones, sewage system, public health and law and order. The people of this part of the city can go about their daily activities without fear for life or safety. They are not constantly afraid of theft, expropriation, or other things that might jeopardize their investments in their businesses and houses. And most importantly, the people of Nogales, Arizona can vote to replace their mayor, congressmen and senators as well as vote in the presidential elections to determine the president of the country.[943]

In contrast, life on the Mexican side of the city is completely different to that experienced by their American counterparts. The average household income of residents of Nogales,

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[942] Daron Acemoglu and James A. Robinson, *Why Nations Fail: The Origins of Power, Prosperity and Poverty,* (Profile Books, London 2012) 7.
[943] *Ibid at p.* 7

Sonora, is about one-third that of Nogales, Arizona.[944] Many teenagers are not in school and most adults in Nogales, Sonora do not have high school degree. There is high infant mortality rate and poor public health conditions.[945] Law and order is in worse condition and high crime rate makes opening a business a risky activity because apart from risking robbery, getting all the permission will require greasing different palms which is not an easy endeavour.[946] Further, democracy is a very recent experience for the residents of Nogales Sonora and as a result they live with politicians' corruption and ineptitude every day.[947]

The two halves of the city of Nogales, despite having the same geography and exposed to the same environment are this different simply because they lie on different sides of the border and are exposed to different institutional infrastructures.[948] Inhabitants of Nogales Arizona have access to the economic institutions of the United States, which enable them to choose their occupations freely, acquire schooling and skills and encourage their employers to invest in the best technology resulting in higher wages for them.[949] Further, the American residents of the city have access to political institutions that allow them to take part in the democratic process, to elect their representatives and replace them if they misbehave.[950] Consequently, politicians provide the basic services that the citizens demand. On the other hand the residents of Nogales Sonora live in a different world shaped by different institutions. The different institutions create very different incentives for the inhabitants of the two sides of the city and for the entrepreneurs and businesses willing to invest there. It

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[944] *Ibid* at p. 8
[945] *Ibid*
[946] *Ibid*
[947] *Ibid*
[948] *Ibid*, p 9
[949] *Ibid*
[950] *Ibid*

is these incentives created by the different institutions of the two halves of the city and the countries in which they are situated that give rise to differences in economic prosperity on the two sides of the border.[951]

Acemoglu and Robinson observes that the institutional structure of the United States and Mexico are so different because of the way two countries were formed during the colonial period, which resulted in an institutional divergence with implications lasting into the present day. The political elites in Mexico deliberately kept institutions that would enrich them further at the expense of economic development of the country and any attempt to change such institutions to allow equal and fair distribution of wealth in the country would be opposed by the powerful politicians and businessmen. Consequently institutional reform in Mexico did not mean uprooting the colonial institutions and replacing them with institutions similar to those in United States. Rather their reform has been 'path-dependent change leading only to the next stage of the institutions that had already made much of Latin America poor and unequal.'[952]

8.10 THEORY OF LEGAL REFORMS.

Finally in a bid to demonstrate the relevance of the above dynamics of institutional change to the process of legal reform we shall look at what has been referred to as the 'theory of

[951] The authors give a classic example of two renowned businessmen in USA and Mexico, Bill Gates and Carlos Slim respectively. They observe that despite the wealth that Bill Gates has and his influence both in the corporate and political world, the U.S. State Department filed civil actions against his Microsoft Corporation on 8 May 1998 for alleged abuse of monopoly power by Microsoft. On the other hand Carlos Slim made his money largely through political connections rather than innovation to built a telecommunication monopoly in Mexico called Telmex. In 1997 the Mexican Competition Commission declared that Telmex had monopoly power in telecommunication industry. However efforts to limit Slim's monopoly proved futile. (pp38-40)

[952] *Ibid* at 36.

legal reform'. In their article, *Towards a theory of Legal Reform,*[953] Hay *et al*, looked at how legal rules in what they called a 'dysfunctional legal system' like Russia would be reformed in order to make private agents rely on the legal system rather than alternative systems like the mafia in structuring their transactions. Hay *et al*, identified some characteristics of a dysfunctional legal system that make people not to use the legal system to resolve disputes. While these characteristics were drawn from the Russian legal system they can be generalised to most legal systems in developing countries and therefore useful in this study.

The first characteristic identified by Hay et al, is that private parties find the formal legal system expensive compared to other alternative methods of dispute resolution.[954] This may be the case because of highly inflated court fees or because judges are corrupt such that parties have to bribe a judge in order to get a good outcome.[955] Sometimes courts may be politicised so that they favour the political elite or high ranking government officials or may be so inefficient that it takes years to get a dispute resolved and when that happens the value of the collectable may have fallen to zero in real terms.[956] In other instances courts may be unpredictable because they refuse to take some cases or because their decisions are difficult to forecast from the law or because judges are uninformed and incompetent.

Another reason, identified by Hay et al, why parties shun away from the legal system is the existence of bad laws on the books.[957] An example would be laws that contradict standard

[953] Jonathan Hay, Andrei Shleifer and Robert Vishny, 'Towards a theory of Legal Reform', (1996) 40 European Economic Review 559-567.
[954] *Ibid,* 560
[955] *Ibid.*
[956] *Ibid.*
[957] *Ibid.*

business practice and common sense making it difficult for courts to reach a decision.[958] It is observed that if laws on the books are so bad that courts cannot reach a decision then there would be no point for parties to use the court. Another problem with the available laws would be lack of clarity or specificity of the law making it difficult for courts to verify whether a violation has taken place. Hay et al cites Russian securities law which does not specify who is liable when a buyer of securities discovers that these securities have been previously stolen.[959] It is observed that in well-functioning legal systems a great deal more information is verifiable in court and the body of law and precedent is much more extensive thereby providing courts with much more guidance on what to do.[960]

Another prevalent problem in dysfunctional legal systems is lack of enforcement of court decisions by the coercive force of the state.[961] Where parties have to enforce court decisions on their own they will usually choose alternative methods and in case of Russia parties resort to the mafia system.

As stated above although the above problems were identified in the context of the Russian legal system, we find them to be of general application to legal systems in most, if not all, developing countries. Identification of problems like these would help reformers to devise targeted legal reforms aimed at reducing or eliminating all together the structural hurdles that make parties not to use the legal system. There is likely to be variations in different

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[958] Hay *et al*, cites articles 56 and 105 of the Russian Civil Code which requires courts to enforce debts of a bankrupt company against its shareholders because there is no limited liability principle.
[959] This is the *bona fide* principle.
[960] Hay *et al*, (1996) *supra* note 953 at p. 561.
[961] *Ibid*.

countries but by using this methodology the process of legal reform would be guaranteed a fair chance of success.

Hay et al suggests that any new laws that may be introduced by way of legal reform should take the following three effects. Firstly they should reverse the effects of the bad laws that keep private parties away from using the legal system more effectively.[962] They observe that even the repeal of few bad rules on the margin brings more activity in the legal system.[963] Secondly, the new rules should facilitate and support the existing contractual arrangements and market transactions[964]. One way of doing this is to ensure that the new rules legalise already existing market transactions previously not recognised by the law.[965] This would enable parties to rely on the legal system to resolve disputes in their already on-going activities. On the other hand if the new rules make existing business practices more difficult or out rightly outlaw them, parties will resort to other non legal alternatives to enforce the existing practices.[966] Finally, the new rules should enable very imperfect courts to verify violations and correct wrongs.[967] In this regard bright line rules should be used rather than vague rules which in most cases give the court too much discretion. Also since in most developing countries judges are often corrupt and/or incompetent; the vague rules may either not be used at all or may be abused by the courts. Bright-line rules would also help with the enforcement of the rules. It is observed that enforceable rules even with poorly run

[962] *Ibid,* at p. 565.
[963] *Ibid*.
[964] *Ibid*.
[965] Hay *et al*, cites the Russian Securities Law and the Law on Fund Transfers as an example of laws that essentially legalised existing market transactions.
[966] Hay *et al, supra* note 953 p. 566.
[967] *Ibid.*

courts serve the critical function of providing the threat points in private negotiations.[968] Thus introduction of a simple legal system that addresses the most egregious yet still verifiable cases of contract violation can do a great deal in facilitating private contract enforcement thereby reinforcing public contract enforcement.[969]

According to Hay et al therefore, to get the rule of law in the intermediate term, the reforming country should begin with rules that are suitable to both private agents and courts and then allow the system to develop as the needs of private agents and the capabilities of the courts develop over time. As laws are used more, courts will begin to gain credibility for dispute resolution.[970] They will also become more predictable as a body of precedents develop and private parties will begin to anticipate more clearly how courts make decision and eventually laws will converge to those of developed market economies although the initial system is more primitive.[971]

8.11 CONCLUSION

The foregoing shows that entrepreneurs or decision makers in organizations are the agents of change and that their subjective perceptions or mental models determine the choices they make. The sources of change are the opportunities or incentives perceived by entrepreneurs arising from either external changes in the environment or the acquisition of learning and skills and their incorporation in their mental constructs. One of such external changes is change in relative prices. Institutional change will occur through decision making

[968] Jonathan Hay, 'Law without Enforcement: The Case of Russia, Mimeo (Harvard University, Cambridge, MA) quoted in Hay *et al supra* note 953 at p. 566.
[969] Hay *et al supra* note 953 p. 566.
[970] *Ibid* at p. 567
[971] *Ibid.*

processes by entrepreneurs as well as the acquisition of knowledge and skills, which will lead to the construction of new mental models by entrepreneurs through which they will decipher the environment and in turn, the new models will alter perceived relative prices of potential choices. The process of institutional change will however usually be 'path dependant' as it is contingent on 'cultural heritage' of the society. This explains why similar changes to formal rules introduced in different countries produce different outcomes.

While institutional change shall result from changes in formal and informal rules, it is the interaction between formal and informal rules that determines the efficiency of a particular institutional change. Efficiency-friendly institutional change shall be achieved by the introduction of new formal rules that are broadly in harmony with prevailing informal rules as this shall reduce transaction costs of integrating the new rule into the existing institutional framework. Harmonious integration between formal and informal rules is likely to result from, inter alia, decentralisation of power, participatory rule-making, sufficient degree of economic freedom and some level of pressure on authorities to learn from their neighbours.

Since formal rules cannot, by themselves, change informal rules, the involvement of government in the process of institutional change should be limited to the enactment of new formal rules that will promote rule of law, which will in turn create an incentive structure that will reduce the cost to entrepreneurs and provide to them freedom of choice to determine the direction of institutional change.

The validity of North's framework to institutional change is reflected in a number of practical institutional development processes including the legal reforms in Russia, the Quota system and the special treatment system employed by the Chinese authorities as part of their capital market reform, the development of legal system in Botswana and the parallel institutional development of the American and Mexican sides of the city of Nogales.

The foregoing therefore provides the theoretical framework within which any institutional and legal reforms for purposes of capital market development ought to take place. The final chapter below seeks to set out some of the possible ways of implementing such reforms. However, as we sated before, the jury is still out on the most appropriate theory of institutional change and what we are attempting to do in this work is to suggest possible building blocks for such a theory in relation to capital market development in developing countries.

9 CHAPTER NINE: POSSIBLE IMPLEMENTATION OF NORTH'S FRAMEWORK THROUGH INSTITUTIONAL AND LEGAL REFORM

9.1 INTRODUCTION

Given that North's framework for institutional change, as discussed above, is a Meta theory, it is important that we look at how this framework would be implemented at practical level and in our case, through institutional and legal reform in order to orchestrate capital market development in developing market economies, like those in the SADC region. Any such reform process would involve changes of both government policies and legal rules. In this chapter therefore we shall look at different policy options that may form and inform any such reform agenda within the tenets of North's framework.

North emphasises the importance of specific institutional and social histories. Economic actors behave according to belief systems that have been formed by past experience. These belief systems are perpetuated by informal institutions. What we need is an analysis and methodology for taking these factors into account. North tells us why we cannot ignore the institutional structures, but is weaker on how we take them into account. Discussed below are some suggested methodologies that may be employed by policy makers in their bid to reform capital market institutional structures in their respective countries and/or economic regions.

9.2 POLICY REFORM WITHIN NORTH'S FRAMEWORK

Industrial policy is one of the readily available levers of change that government can use in order to bring about institutional change. Policy is part of the formal institutions that can be changed at will. However as discussed above, care must always be exercised when seeking to change formal institutions so as to ensure that any such changes receive local legitimacy and recognition.

Rodrik in his book, *One Economics Many Recipes: Globalisation, Institutions and Economic Growth,*[972] offers a very good guide to the policy reform process that is capable of bearing fruit. Rodrik posits that appropriate growth policies are invariably context-specific not because economics works differently in different settings but because the 'environments' in which households, firms, and investors operate differ in terms of opportunities and constraints they present.[973] As such, while learning from other countries is useful, 'straightforward borrowing or rejection of policies without a full understanding of the context that enabled them to be successful or led them to be failures is a recipe for disaster.'[974]

Rodrik further observes that many policy advisors look at economic problems exclusively from the perspective of their own area of speciality and as a result governments are presented with a long list of institutional reforms by different advisors. However, since governments are constrained by limits on their financial, administrative, human and political

[972] Dani Rodrik, *One Economics Many Recipes: Globalisation, Institutions, and Economic Growth*, (Princetown University Press, Oxford, 2007).
[973] *Ibid*, p 4.
[974] *Ibid*, p 5.

resources, implementation of such reforms proves difficult.[975] Consequently, Rodrik has developed a three step approach to policy reform comprising (i) Growth Diagnostics (ii) Policy design and (iii) Institutionalising reform.

Under the first step of growth diagnostics, Rodrik says that given the administrative and political limitations that governments face, it is imperative that they should know and make choices on which constraints on economic growth to attack first and what kind of reform they need to spend their political capital on. A reform agenda should therefore not take the form of a laundry list but rather should involve a diagnostic exercise that seeks to identify 'priorities based on local realities.'[976] This entails that the first step in any reform process, should be to undertake a diagnostic analysis of the economic structure of the country in question to figure out where the most binding constraints on growth lie.[977] This will help finding areas of reform that will yield greatest return. According to Rodrik, in developing countries, economic activity is usually constrained by at least one of the three factors (i) high cost of financing economic activities (ii) low economic (social) returns to economic activity and (iii) low private appropriability of the social returns. The first step in the diagnostic analysis should therefore be to find out which of these conditions more accurately characterises the economy in question. Once this analysis is put in motion further diagnostic signals will be identified that will help pining down the most binding constraints that need to be targeted first in the reform process. In the context of North's framework,

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[975] *Ibid*, p 5

[976] *Ibid*.

[977] *Ibid,* at p 57. Rodrik observes that poor economies suffer from a variety of afflictions including lack of human capital, ineffective use of capital and other resources, poor institutions, unstable fiscal and monetary policies, inadequate private incentives for investment and technology adoption as well as poor access to credit. Therefore to say that these countries have to overcome all these problems in order to develop would be a tautology and unrealistic. See *Ibid*, at p 89.

this would essentially involve a detailed assessment binding informal institutions and underlying belief systems with some capability of interacting negatively with the proposed market reforms.

The second step is policy design. The aim of this step is to provide an appropriate policy response to key problems that have been identified following the diagnostic analysis in step 1. This process involves focusing on the market failures and distortions associated with identified binding constraints and target the response as closely as possible at the source of the distortion.[978] It is also noted that in order to come up with best policy, policy designers need not concentrate on the 'first-best' responses to the identified constraints because usually they would be operating in a second-best environment due to other distortions or administrative and political constraints and as such first-best solutions are likely to produce other unforeseen complications and unexpected consequences.[979] Experiences of different countries show that successful policy reform emanated not from first best responses but rather from second best recommendations.[980] This entails that policy framers should not be quick to jump on what appear to be the first-best solutions to the identified problems because effective reform can be achieved in a variety of ways that usually take unconventional forms. This echoes North's observation of path dependent nature of institutional change. What may be best policy in one country may be ineffective in another due to existing informal institutions and underlying belief systems. It is therefore important to be innovative in policy design and to look for home grown solutions and be prepared to

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[978] *Ibid*, p 90. Rodrik refers this as the "principle of policy targeting".

[979] *Ibid*. 91. This observation reflects North's concept of non-ergodicity i.e. change brings further uncertainty.

[980] Rodrik cites examples of the Chinese agricultural reform relating to its purchase system and the communal ownership of land and the reforms in South Korea, Taiwan and China that were aimed at integrating their respective economies with the world economy.

experiment.[981] This will ensure that reform is appropriately tailored to the existing informal institutions as well as the underlying belief system.

Finally, the last step involves institutionalising reform. It is observed that the identity of the binding constraint will change over time as the country's economy grows. Thus while the poor quality of the judiciary may not be a binding constraint at a time of economic underdevelopment, legal and judicial shortcomings are likely to become a constraint when the economy develops and becomes more sophisticated. Similarly poor financial regulation may not be an issue while the financial markets are still underdeveloped but will pose real problems when the economy begins to boom.[982] This dynamic nature of institutional change is at the centre of North's framework, which is premised on the fact that we live in a non-ergodic world which is constantly changing and producing novel problems. According to North, the success of a given society depends on whether its institutional entrepreneurs have the necessary cultural heritage or belief system to deal with such problems and 'make responses that make their environment predictable.'[983]

Consequently, it is important to put in place strategies that will sustain development as the policies are deployed and begin to work. Policies must therefore ensure that the momentum is maintained with ongoing diversification into new areas of economic activity.[984] The process of reform should, thus, be as extensive as possible so that it includes institutions that would support and sustain economic growth. For instance policy reform should aim at strengthening of domestic institutions of conflict management. This will

[981] Rodrik (2007) *supra*, note 972 at p 93.
[982] *Ibid.*
[983] North (2005) *supra* note 8 at p.18.
[984] Rodrik (2007) *supra*, note 972 at p. 94.

require strengthening the rule of law, solidifying democratic institutions, establishing participatory mechanisms and erecting social safety nets.[985] This will provide economic growth with the necessary resilience and tenacity against external shocks like terms of trade decline or reversals in capital flows.[986]

The above approach would be very useful to the process of capital market development reform in developing countries. It is indeed the case that different analysts have provided different policy prescriptions to these countries aimed at igniting growth of capital market activities. There is as such no single agreed policy response to the malaise of capital markets in developing countries including in the SADC region. However, a more targeted approach would be most appropriate and effective. What each country needs to do is to carry out a detailed diagnostic analysis to figure out which of the constraints, as we have outlined in chapter 5 above, presents the most binding constraints to capital market development in their country. This would help to innovatively think of the best policy response that would accurately target the constraint/s identified. This would need to be underpinned by the necessary institutions that would help sustain the resultant market growth.

9.3 SUGGESTED POLICITY PRIORITIES FOR THE SADC REGION

In light of the Rhodrik's theory of policy reform as discussed above, policy makers in the SADC region will need to concentrate on the most binding constraints to capital market development from Black's list of preconditions for strong capital markets as discussed in

[985] *Ibid*.
[986] *Ibid.*

chapter 6 above. We recommend the following as a priority list of capital market reform areas in the SADC region.

9.3.1 Enforcement Institutions

As discussed above, local enforcement of rules is one of the most crucial ingredients of strong capital markets. Strong enforcement regime instils confidence in prospective investors that they would be in a position to recover the value of their investment in the event of wrongful appropriation of the same by managers. As discussed in chapter 7 above, most countries in SADC region are characterised by weak enforcement regimes and as a result, investors are scared away from their respective capital markets. Policy makers should therefore, first and foremost, concentrate on establishing and strengthening local enforcement agencies, including investigators, prosecutors and the judiciary.

9.3.2 Market Transparency

Transparent markets attract both issuers and investors. As discussed above, where investors do not have full information about securities being offered on the market, they will discount the prices they are willing to offer for the securities. This would lead to a lemon market which would drive honest issuers and investors away due to undervalued securities circulating on the market. Policy makers in the SADC countries therefore will be well advised to put in place robust information disclosure rules, not only at the IPO stage but throughout the trading life of any exchange traded securities.

9.3.3 Liability for Insider dealing and market abuse

The third priority area for policy makers in the SADC countries would be putting in place rules that would attach sufficient liability to market players engaging in insider dealing and market abuse. Again such liability regimes would serve to assure investors that they would have sufficient recourse in the event of their investment being misappropriated. Currently, the anti-insider dealing and market abuse regimes in most SADC countries are not robust enough. Therefore policies that would sufficiently deal with this issue need to be prioritised.

9.3.4 Investor Education.

Finally investor education needs to be prioritised in SADC region in order to develop its capital markets. As discussed in the previous chapters, lack of knowledge of capital markets as alternative investment platform has resulted in thin markets because only a small proportion of a given country's population participate in the market. The majority of the people are yet to be convinced that they can secure better returns on their capital if they invest on the capital market instead of depositing their money in the bank. Converting many people to capital market investment would result in a broader base of investors and this would, in turn, give rise to liquid markets that would appeal to more investors. Policy makers should therefore develop education programs to reach out to the masses in order to increase the number of market participants.

9.4 LEGAL REFORM FOR CAPITAL MARKET DEVELOPMENT

Apart from policy reform, North's framework will also need to be reflected in legal reform. This will be more relevant with regards to reforming regulatory regimes for capital markets in developing countries. The exact nature and content of capital market regulatory reforms has attracted a lot of debate and there is yet to be a convergence of views on optimal policy initiatives with regard to capital market development. Three distinct strands of opinions on optimal capital market regulatory arrangements can be identified from the debate so far.[987]

The first school of thought holds that the most effective government policy is to leave securities markets unregulated.[988] This view is premised on the belief that issuers of securities will have sufficient incentive to disclose all available information to obtain higher prices as failure to disclose would cause investors to assume the worst.[989] Credibility of such voluntary disclosures would be ensured through other mechanisms like reputational, legal, and contractual penalties for misreporting as well as through auditors and underwriters who could credibly certify the quality of the securities being offered to safeguard their reputation and avoid liability under contract or tort law.[990] Also, private stock exchanges would help in this regard by mandating optimal disclosure and monitor

[987] Rafael LaPorta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'What Works in Securities Laws?' (2006) 61 (1) Journal of Finance 1-32.

[988] This is sometimes known as the "null hypothesis". See *ibid*. at p 2. This is the view that was pioneered by Coase who thought that law and regulation are not as important or effective at optimal allocation of resources as lawyers and government planners believe. See: Ronald Coase, 'The problem of social cost', (1960) 3 Journal of Law and Economics 1-44 at p. 9.

[989] See Sanford Grossman 'The informational role of warranties and private disclosure about product quality', (1981) 24 Journal of Law and Economics 461-483. Also Sanford Grossman and Oliver Hart, 'Disclosure laws and takeover bids', (1980) 35 Journal of Finance 323-334.

[990] See, George Benston, 'The market for public accounting services: Demand, supply and regulation', (1985) 4 Journal of Accounting and Public Policy, 33-79.

compliance by listed firms to facilitate trading.[991] According to the proponents of unregulated market, therefore, these market and legal mechanisms would be sufficient for securities markets to prosper.[992]

The second school of thought advocates active regulation of capital markets putting emphasis on the need for government to 'standardize the private contracting framework to improve market discipline and private litigation.'[993] According to this hypothesis, in the absence of such standardization, litigation will be governed by general contract and tort law, with grave uncertainty about outcomes because such matters as intent and negligence need to be sorted out in court through the medium of judges.[994] Such standardization would be in a form of a law mandating disclosure of particular information, such as profitability and ownership structure, in the prospectus. Where such rules are complied with they would make it easier for investors to value companies and therefore more willing to invest and where they are breached, they would create a prima facie liability of issuers or intermediaries.[995] Another aspect of the standardization would be rules specifying the liability standards facing issuers and intermediaries when investors seek to recover damages from 'companies that follow affirmative disclosure rules but fail to reveal potentially material information.'[996] This would significantly reduce the uncertainties and the costs of private litigation, in turn benefiting markets.[997]

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[991] See, Daniel Fischel and Sanford Grossman, 'Customer protection in futures and securities markets', (1984) 4 Journal of Futures Markets 273-295.
[992] See, Laporta et al (2006), *supra* note 987 at p 2.
[993] *Ibid* at p. 3
[994] See, Frank Easterbrook and Daniel Fischel, 'Mandatory disclosure and the protection of investors', (1984) 70 Virginia Law Review 669-715.
[995] Laporta et al (2006) *supra* note 987 at p 3
[996] *Ibid*.
[997] See, Nittai Bergman and Daniel Nicolaievsky, 'Investor protection and the Coasian view', (2002) Harvard University mimeo.

The final hypothesis is also premised on the 'law matters' point of view arguing that reputations and contract and tort law are insufficient to keep issuers from cheating investors because the payoff from cheating is too high and private tort and contract litigation is too expensive and unpredictable to serve as a deterrent.[998] However, unlike the second hypothesis that argues that the optimal government policy response would be to standardise disclosure of information and issuers' liability, this hypothesis advocates government intervention by way of public enforcement of securities laws.

Proponents of this hypothesis argue that even in the presence of a securities law that specifies both the disclosure obligations of various parties and liability standards, private enforcement incentives are often insufficient to elicit honesty from issuers.[999] As such, a public enforcer with the capacity to intervene ex ante, by clarifying legal obligations, or ex post, by imposing its own penalties or bringing lawsuits, would be needed to support the market.[1000] In order for public enforcement to work the enforcer must be independent and focused so that it can regulate markets free from political interference[1001]. The public enforcer can introduce regulations of market participants and impose sanctions. In this way the public enforcer will be in a position to secure information from issuers and market participants through subpoena, discovery, or other means more effectively than private plaintiffs.[1002] According to this view therefore, the optimal government policy for purposes of developing capital markets would be to strength its public enforcement capability.

[998] Laporta *et al* (2006) *supra* note 987 at p 2
[999] *Ibid* at p 4.
[1000] *Ibid.*
[1001] *Ibid*
[1002] *Ibid*

In their research, Laporta, Lopez-de-Silanes and Shleifer[1003], sought to explore the level of impact on the development of capital market of standardization of disclosure rules as well as liability of issuers and intermediaries and public enforcement of market regulation. The findings of this research confirmed the 'law matters' hypothesis concluding that financial markets would not prosper if left to market forces alone.[1004] With regards to what should be the main emphasis of government intervention, Laporta et al concluded that securities laws matter because they facilitate private contracting rather than provide for public regulatory enforcement. In their findings, aspects of public enforcement, like having an independent and/or focused regulator or criminal sanctions, do not matter. On the other hand they did find that both extensive disclosure requirements and standards of liability facilitating investor recovery of losses were associated with larger stock markets.

As stated before, there is still no universal agreement on which of these and other competing points of view with regards to optimal capital market regulatory arrangement. This is more so in developing countries. The null hypothesis would clearly not be suitable to developing countries as it is premised on the assumption of the existence of legal mechanisms (rule of law) and market mechanisms that are either non-existent in these countries or in their infancy stage. In any event the argument that specific capital market rules and regulations do not matter for purposes of capital market development would not fully conform to the North's framework which clearly recognises the role and significance of formal rules. Further, the null hypothesis presupposes the existence of symmetric

[1003] *Ibid*. Their research involved analysis of a database of rules and regulations governing security issuance from 49 countries and producing quantitative measures of securities laws and regulations, with a focus on mandatory disclosure, liability standards, and public enforcement.
[1004] *Ibid* at p. 22

information as well as the existence of rational market players, which are the key elements of the Efficient Market Hypothesis. As exposed by North, the market operates on asymmetric information and it is full of players who make irrational decisions depending on their mental constructs.

With regard to the alternative hypotheses of facilitating private contracting by way of standardisation of disclosure requirements and liability of issuers and intermediaries and supplementation of private enforcement with a strong public enforcement regime, this again is dependent on the existing informal institutions as dictated by the underlying belief system of the market players. The existence of standard disclosure requirements or liability of issuers would be ineffective in the midst of corrupt issuers who can bribe their way out of such obligations or incompetent regulators or judges who are not able to effectively interpret such disclosure requirements or liability to ensure robust enforcement of the same.[1005]

However, as a starting point, we would recommend parallel adoption and implementation of both approaches. The introduction of disclosure and liability standards would help to deal with uncertainty in the market and strong public enforcement would help to lend efficacy to the rules. Further both of the two approaches would be appropriate and relevant to capital markets in developing countries. Standardisation of disclosure requirements and liability of issuers and intermediaries would clarify legal obligations of market participants and the consequences of breach thereof. This would reduce opportunities for manipulation or deliberate misinterpretation of the principles of disclosure by self-interested issuers or

[1005] This is discussed in chapter 5 above.

other intermediaries or unsophisticated or corrupt lawyers and judges.[1006] Similarly public enforcement would bring about early intervention on noncompliance thereby saving parties from expensive litigation or whimsical determination of disputes by the courts.

The foregoing chimes with the comparative case studies in chapter 7 above and the discussion of the analysis of Black's preconditions in chapter 6, which clearly shows that all successful regulatory structures in existence abjure the first option and have laws that support private enforcement through disclosure and publicity and give enforcement powers to State institutions. In all the three case studies considered in chapter 7 above, there are statutory provisions on disclosure requirements and liability of issuers bolstered by public enforcement of the same. However, as it was observed, the existence of disclosure and liability standards as well as public enforcement regimes in South Africa and Malawi are less effective than those in the United Kingdom due to the differences in informal institutions that exist in these countries.

[1006] An example of problems that arise where there are insufficiently defined disclosure obligations and liability standards is provided by Velthuyse and Schlingmann in Heleen Velthuyse, and Francine Schlingmann 'Prospectus liability in The Netherlands,' *,* 1995, Journal of International Banking Law, 229-236*,* concerning a securities dispute where in 1987 and 1988, ABN Amro a Dutch bank underwrote some bonds of Coopag Finance BV, a Dutch financial company wholly owned by Co-op AG, a diversified German firm, which also guaranteed the bonds. The prospectus was drafted in accordance with the requirements of the Amsterdam Stock Exchange and included audited annual accounts provided by the issuer to ABN Amro. The (consolidated) financial statements included in the prospectus omitted 214 affiliated companies of Co-op AG with debts of DM 1.5 billion. The financial statements were however produced in conformity with the law on annual accounts. Shortly after the issue, Dutch newspapers published negative information about Co-op AG and the bond prices of Coopag Finance BV plummeted. The creditors of Coopag Finance sued the underwriter, ABN Amro, for losses on the ground that the underwriter failed to disclose material information about the finances of Co-op AG. In response ABN Amro argued that the damages, if any, did not result from the alleged misleading nature of the prospectuses but rather from unfavourable events that took place after the offering. ABN Amro also claimed that even if it had engaged in extensive investigation, it was not possible to discover deceit, because even the accountants appeared not to have discovered in time that something was wrong. The successive Dutch courts ruled that ABN Amro was liable and recognized explicitly that the underwriter's duty in presenting the prospectus to investors went beyond merely relying on the information provided by the issuer. In addition, the Supreme Court ruled that a distributor must conduct an independent investigation of the issuer and prove that it cannot be blamed for the damages caused by the misleading prospectus. (p. 233).

9.5 STRUCTURAL REFORMS: DISPERSED SHARE OWNERSHIP

Getting capital markets in developing countries up on their feet may require some level of structural reforms of the markets. One area of reform would be the share ownership structures. There are basically two models of ownership structures, namely, concentrated ownership and dispersed ownership. Markets potentially thrive where there is dispersed ownership as there are 'many small shareholders who will constantly be making portfolio revision decisions and trading as a result.'[1007] In other words, shares are likely to change hands more when they are held by a diverse group of people. Dispersed ownership therefore has the potential of increasing share trading, which in turn increase market liquidity.

It is further said that where ownership is concentrated in the hands of few share holders or blocks of shareholders, there is relatively low protection of minority investors and expropriation of minority shareholders by the controlling shareholders is rampant.[1008] It may therefore be said that concentrated share ownership increases risk of exploitation especially in countries with underdeveloped enforcement regimes. Unfortunately, concentrated shareholding is prevalent in developing countries, which makes it difficult for minority shareholders to effectively control the affairs of the firms in which they have stake. This may result in investors, especially small investors to shun the markets.

It is of course important to mention that, while in theory dispersed share ownership would guarantee protection to minority shareholders, there are practical problems for minority

[1007] John C. Coffee, 'Dispersed Ownership: Theories, The Evidence, and the Enduring Tension Between "Lumpers" and "Splitters"', (2010) Columbia Law and Economics Working Paper No. 363 at p. 38.

[1008] La Porta et al, 'Law and Finance', (1998) , *supra* note 314.

shareholders to effectively enforce their rights against the majority shareholders due to prohibitive enforcement costs. The minority shareholders may therefore feel that it is better to sell their shares and take the loss than attempt to obtain a remedy through legal action, which some may consider to be 'throwing good money after bad'. Further, as it was observed by Berle & Means[1009] dispersed share ownership structure brings to bare the problem of separation of ownership and control whereby managers who own few shares or none may lack the owner-entrepreneur's incentive to maximise profits and who, motivated by desire for personal monetary gain, could use their power position against the interest of ownership.

The problem of concentrated ownership may be explained through the concept of 'Limited Access Orders' (LAO) and 'Open Access Orders' (AOA) as developed by Douglass North *et al*[1010] as discussed in chapter 5 above. According to North et al, LAOs are characterised by limited access to economic activities imposed by the ruling elite. As such LAOs constrain economic development in that 'limited access to organisations and economic rights limits competition and economic productivity.'[1011] Also LAOs breed local monopolies and restrictions on economic entry thereby hindering competitive markets and long-term economic growth.[1012] LAOs are likely to shore up concentrated share ownership structures as access to the capital market activities would be limited to the powerful elites and their cronies. The purpose would be to keep control of the economy in the hands of the ruling elite.

[1009] Berle and Means, *supra* note 33 at p. 11.
[1010] North *et al*, (2009) and also North et al (2013) *supra* note 317.
[1011] North et al, (2013) *supra* 317 at p.8.
[1012] *Ibid* p.9

On the other hand, OAOs are characterised by institutions that support open access and political as well as economic competition. In OAOs 'entry into economic, political, religious, and educational activities is open to all citizens as long as they meet standard (impersonal) requirements.'[1013] OAOs thrive within the milieu of functional rule of law. OAOs are likely to promote dispersed share ownership as there are no barriers to access to the capital market.

In order for a LAO to transition to an OAO there is need to put in place institutional arrangements that support impersonal exchange[1014] and members of the dominant coalition must find it in their interest to expand impersonal exchange. The result will be a transformation from a system of 'limited access rent creation to open access entry.'[1015]

Structural reforms may therefore be needed in developing countries to move from concentrated ownership of shares (an equivalent of North *et al's* LAO) to dispensed ownership, which would bring similar benefits as those of an OAO. However it is acknowledged that the transition process from LAO to OAO is slow moving and according to North et al, the transition will only be realised after some 'door step conditions'[1016] have been institutionalised.

Concentrated ownership systems are characterised by a controlling shareholder, a family group, or a small number of block holders holding either majority or de facto control and

[1013] *Ibid* at P. 16.
[1014] *Ibid* at p 17.
[1015] *Ibid.*
[1016] These include the following (i) the rule of law for elites; (ii) perpetually lived organisations in the public and private spheres; and (iii) consolidated, civilian control of the military and legally accepted organisations with violence potential. See *Ibid* at p.17.

places their representatives on the controlled firm's board of directors[1017]. On the other hand, under dispersed shareholding system there is separation of ownership and control and neither the directors nor the senior executives hold significant blocks of the company's shares but share ownership is dispersed among many institutional and retail shareholders.[1018]

Perhaps the most pertinent question for policy makers in developing countries is how can dispersed ownership be induced, maintained and combined with effective corporate governance in their respective countries. The study by Coffee[1019] in which he sought to understand the drivers of the transition process from concentrated to dispensed ownership in USA and United Kingdom would offer some practical policy tools for inducing dispersed share ownership that may be deployed by policy reformers in developing countries. According to this study, dispersed ownership in USA was mainly orchestrated by the following factors:

(i) Emergence of financial intermediaries like investment banks who, among other things, helped with the process of share sales through their underwriting and advisory roles and also served as guardians of shareholder interests thereby attracting more individual and outside investors to buy shares off hitherto holders of blocks of shares.[1020]

[1017] John C. Coffee*,* (2010) *supra* note 1007.
[1018] *Ibid,* Specifically dispersed ownership system will exhibit (1) an independent board, whose members will typically have no business relationships with the corporation, and (2) relative investor passivity, in that to the extent that highly diversified institutional investors will not seek to actively manage the business or participate in most managerial decisions.
[1019] John C. Coffee*,* (2010) *supra* note 1007.
[1020] *Ibid* at p. 27 citing the role that one of the early investment banks in America, J. Pierpont Morgan helped to attract British investors to the American equity market.

(ii) Introduction of competition laws[1021] that resulted in a merger boom in 1890s. As a consequence the industry-wide mergers diluted controlling shareholding at individual firms creating dispersed ownership in the process. Also such mergers provided incentives to controlling shareholders to sell out their shareholding at a premium.[1022]

(iii) The emergence of self-regulatory organisation like the New York Stock Exchange which helped to inspire confidence in the market through its stringent listing standards and activist approach to corporate governance issues for its listed companies. The New York Exchange therefore assumed the role of a 'guardian of public shareholders.'[1023]

It has been observed that the dispensation of dispersed ownership in United Kingdom happened at a much later stage after the American transition and that a different set of forces orchestrated the transition process in the United Kingdom.[1024] The factors that played a role in bringing dispersed ownership in UK included the following:

(i) The rise of institutional investors. It is noted that between 1952 to 1990 there was a significant paradigm shift in the share ownership structure in UK with individual shareholders who held blocks of shares constantly selling their

[1021] The Sherman Antitrust Act, which was passed in 1890 outlawed price fixing and as result firms resorted to mergers to avoid stiff competition. See John C. Coffee, (2010) *supra* note 1007 at p. 35.
[1022] *Ibid.*
[1023] *Ibid* at p. 40.
[1024] *Ibid* at p.9

shares and institutional shareholders mainly insurance companies and investment funds acquiring most shares in the market and significantly increasing their portfolio in the process. One of the explanations for the growth of institutional shareholding is post-World War II changes in British corporate law and stock exchange regulations, which may have encouraged controlling shareholders to sell and institutional investors to buy shares[1025].

(ii) British merger activities that became common around mid-20th century resulted in the dilution of ownership. In order to make shares attractive to prospective buyers, most shares were given equal voting rights thereby reducing controlling power of shareholders.[1026]

(iii) Tax law also played a significant role in inducing dispersed share ownership in UK in that various tax considerations compelled controlling shareholders to sell off their holding on one hand and encouraged institutional shareholders to buy shares on the other. Examples of tax rules that forced block holders to liquidate their holdings include, high corporate tax rates introduced on the eve of World War II, which significantly reduced corporate profits, the provision that prevented director controlled companies from deducting remuneration paid to employee directors from corporate profits for tax purposes, a special surcharge on investment income, and an estate duty of between 50% - 80% charged on deceased estate above £100000 introduced

[1025] Brian R. Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford University Press, 2008) 356-360.
[1026] See John C. Coffee, (2010) *supra* note 1007. at p. 53

by Labour government after World War II. The cumulative effect of all these tax measures was that there was no incentive to have controlling shareholding in British firms, hence the decision of controlling shareholders to sell.[1027]

(iv) On the other side institutional shareholders were encouraged to buy due to favourable tax treatment of pensions and insurance products resulting in pension and insurance products growing significantly and excess assets were channelled into equity markets.[1028] This was coupled with exchange control regime that limited UK institutional shareholders from investing in foreign equities.[1029]

It is however important to note from the outset that the transition from concentrated to dispersed ownership, like any other transition concerned with informal constraints, will not happen overnight.

9.6 SELF-REGULATION AND ECONOMIC CHANGE

As stated above, self-regulation played a very significant role in the transition process from concentrated ownership system to dispersed ownership system especially in the USA. According to Coffee, due to the stiff competition between the New York Stock Exchange ("NYSE") and other regional exchanges like the Boston Stock Exchange, the NYSE took a different approach in its admission and supervision of companies listed with the

[1027] Cheffins, (2008) *supra* note 1025 at pp. 321-328.
[1028] *Ibid*. at pp 346-347.
[1029] John C. Coffee, (2010) *supra* note 1007 at p 55.

exchange.[1030] The NYSE sought to differentiate itself as a high-quality exchange by only listing companies that were considered 'safe and low-risk.'[1031] The exchange insisted on an adequate earnings track record before listing an issuer and was prepared to reject listing companies that did not meet its listing standards. In so doing the NYSE distinguished itself from its competitors and branded itself as the guardian of public shareholders.[1032] Coffee notes as follows:

> "This guardian role manifested itself in two concrete ways: (1) the NYSE, beginning in 1900, insisted that its listed companies publish annual audited financial statements, and (2) it protected shareholder voting rights by resisting attempts by issuers to deviate from the norm of 'one share, one vote.' These steps were taken by a private body as a matter of self-regulation, not mandatory law, but the result was to attract public shareholders to invest in NYSE stocks as safer and better monitored."[1033]

The NYSE, therefore, did not only contribute to the development of dispersed ownership in USA but also provided a monitoring and quality assurance mechanism that protected investors against the 'Berle and Means' fears. This shows that there is a special role that self-regulation could play as part of the process of developing capital markets in developing countries.

Self-regulation refers to the regulation of an industry by its own members, usually by means of a committee that issues guidance and sets standards that it then enforces. Self-regulation therefore allows those to be regulated to set their own rules and voluntarily comply with the rules. In this respect, self-regulation conforms to the tenets of North's

[1030] *Ibid* at p. 39
[1031] *Ibid.*
[1032] *Ibid* at p. 40
[1033] *Ibid*.

framework, which advocates a bottom-up approach to rule setting. When considered within the context of the formal rules - informal rules spectrum, self-regulation would be regarded as a very important 'transistor' that would help smooth transition from formal to informal rules. As discussed above, the process of change from formal to informal rules is always slow and sometimes when the change has occurred, it may give rise to unwanted consequences. By providing a 'bridge' between informal and formal rules, self-regulation may help to bring about change with fewer shocks.

With respect to developing countries self-regulation would play a vital role to the process of capital market development in more than one ways. Firstly, it would help to minimise the pervasiveness of the political elites in the regulation and operation of capital markets. Having rules set by market participants themselves, would create collective ownership of the rules as well as collective will to enforce them. Such collective responsibility would make it difficult for political elites to influence some of the members of the relevant self-regulatory organisation (SRO) to pervert the operation and enforcement of the rules. In other words it would be easier for members of the SRO to stand up to political pressure in defence of self-regulation than it would be the case with regards to statutory regulation. Further, non-observance of self-regulation, which takes the form of quasi-informal rules, would ultimately result in the alienation, in the form of expulsion, of the member from the group. This would discourage members from breaching self-regulation as they would fear the consequences of expulsion, which would include losing their licence and/or accreditation by the SRO.

As discussed above (section 8.3.2), one of the main drivers of institutional change is education. Self-regulation can be considered as a starting point of the learning process on the part of market players. Self-regulation would allow stakeholders to design rules according to their level of understanding of the industry at the time. As the rules are complied with and positive outcomes are registered, market players would be incentivised to modify the rules, as their level of understanding improves, for maximum impact. Ultimately, the rules may develop into fully fledged formal rules with a statutory foundation.

Further, self-regulation provides market players with some level of economic freedom which according to Winiecki[1034] is one of the institutional characteristics conducive to efficient institutional change (see section 8.9 above). It is believed that where more economic freedom is allowed there would be less friction between the formal rules and informal rules thereby breeding adaptive efficiency.

Historically, self-regulation has been associated with stock-exchanges.[1035] However, over the years the nature and scope of SROs has grown wider giving rise to a variety of organisation opting for self-regulation. According to a survey that was undertaken by the International Council of Securities Associations (ICSA),[1036] all SROs have the following core characteristics '(1) share a common set of public policy objectives including the enhancement of market integrity, market efficiency and investor protection; (2) are actively supervised by

[1034] J. Winiecki, *Supra* note 369 at 156

[1035] Early self-regulatory organisations include the London Stock Exchange (LSE) and the New York Stock Exchange (NYSE).

[1036] International Council of Securities Associations, 'Self-Regulation In Financial Markets: An Exploratory Survey', ICSA Secretariat, September 2006.

government regulators; (3) have statutory regulatory authority and/or authority delegated by the government regulator(s); (4) establish rules and regulations for firms and individuals subject to their regulatory authority; (5) monitor compliance with those rules and regulations; (6) have the authority to discipline firms and individuals that violate their rules and regulations; (7) include industry representatives on their Boards or otherwise ensure that industry representatives have a meaningful role in governance; and (8) maintain structures, policies and procedures intended to ensure that conflicts of interest between their commercial and regulatory activities are appropriately managed.'[1037]

Examples of SROs besides exchanges include Investment Dealers Associations, Securities Dealers Associations, Securities Investment Advisers Associations and Mutual Fund Dealers Associations. As it was the case with the NYSE, SROs collectively promote market confidence and efficiency resulting in many people being attracted to buying and owning shares available on the market. This would in the long run bring about dispersed ownership structure.

One area of reform therefore that developing countries may consider embarking on is the promotion of self-regulation by market participants. This can be done through, *inter alia*, competition law reform and tax law reform.

[1037] *Ibid* at p. 3.

9.7 THE SELF-ENFORCING MODEL OF CORPORATE LAW

Another practical model of legal reform that may form and inform the agenda for reforming laws to promote capital market development in developing countries is the 'self-enforcing' approach to drafting corporate law[1038] for emerging capitalist economies. This approach was developed by Black and Kraakman based on their work on Russian Corporate Law.[1039] Although their work is based on a case study of Russia, the considerations behind this model is capable of being generalised to most developing countries like those in the SADC region. Also the model is of particular relevance to this study given that we have adopted Black's recommendations on institutions that are necessary for a nascent capital market to develop, which were also based on his practical involvement in the institutional development in Russia and some Asian countries.[1040] In this model Black *et al* offer some solutions, in the form of the content of law reform that would help to deal with the institutional obstacles they observed.

Black *et al* note that although the problems that corporate law seeks to address are universal, the nature and content of corporate law is context-based.[1041] As such the law that works for developed economy may not work as effectively when transplanted to an emerging economy.[1042] It is further noted that based on the general economic function of corporate law, which is maximising the value of corporate enterprises to investors and therefore to society and minimise the sum of transaction and agency costs of contracting

[1038] Law is used here in its broad sense and it encompasses company law as well as securities law.

[1039] Bernard Black and Reiner Kraakman, 'A Self-Enforcing Model of Corporate Law' (1996) 109 Harvard Law Review 1911-1982.

[1040] Black, (2001) *supra* note 370. See Chapter 6 above.

[1041] Black et al, (1996) *supra* note 1039 at p. 2.

[1042] *Ibid.*

through the corporate form, corporate law should provide a set of rules that encourage profit maximising business decisions, provide professional managers with adequate discretion and authority, and protect outside shareholders and in some respects, creditors against opportunism by managers and other corporate insiders.[1043]

Black *et al*, however, observe that in developed countries corporate law accomplishes these objectives with the help of other control mechanisms that limit departures from the profit-maximisation norm. For instance managers are under pressure to enhance firm value through the existence of a competitive product market, a reasonably efficient capital market, an active market for corporate control, incentive compensation for managers. Also, sophisticated professional accountants, elaborate financial disclosure, an active press and strict anti-fraud provisions assure shareholders of reliable information about company performance. And finally sophisticated courts, administrative agencies and self-regulatory organisations help to detect and deter 'corporate skulduggery.'[1044] For this reason, corporate law play more or less a complimentary law in developed countries.

On the contrary, most of these mechanisms do not exist in developing countries. For this reason, Black et al, opine that corporate law must address a broader set of goals and that

[1043] *Ibid*, at p.8
[10441044] *Ibid*. This is reflected by the observation of Pouncy (2002) supra note 26, where he observed as follows:

> "The development of stock markets in England and the United States took place in an environment permeated by the common law, which had been in development for hundreds of years. The common law "filled in the blanks" necessarily created by the establishment of a new financial institution. The profession of lawyering was also well developed and formalized through education, practical experience, and judicial supervision. The professions of accountancy and bookkeeping were well established and were able to provide the ancillary services needed to maintain an exchange. Additionally, the fiduciary principles underlying the agency relationship were present to govern broker-client interactions." (at p. 111)

the balance between investor protection and the business discretion of corporate managers needed to achieve this goal will be quite different to that in developed economies.[1045] They suggest that corporate law in developing countries should be protective in nature due to severe information asymmetries, less efficient markets, high contracting costs as standard practices are not yet developed, weak courts, less experienced market participants, lack of reputable intermediaries or affordable intermediaries and most of the time weak economies.[1046]

Black *et al*, identify the following specific limitations that may constrain the discharge of protective corporate law in developing economies. The first constraint is lack of legal and market controls.[1047] While developed countries have sophisticated enforcement institutions that can implement complex and finely nuanced rules, in developing countries enforcement institutions are less sophisticated and as such simpler and more easily administrable rules would be more suitable. The most common limitation on enforcement is weak judicial enforcement. This may be caused by ill-defined or inadequate substantive legal remedies available to judges,[1048] cumbersome judicial procedures, overtaxed court system, which makes timely judicial action impossible to obtain, or the judges may lack experience in corporate law cases, or may be corrupt or may not be adequately paid to attract skilled lawyers to become judges.[1049]

[1045] *Ibid*, p 9.
[1046] *Ibid*, p 11
[1047] *Ibid,* p. 13.
[1048] Black *et al* cites the absence of a rule permitting judges to adjust damages for inflation in Russia as an example of such inadequate legal remedies.
[1049] Black *et al* (1996) *supra* note 1039 at p.14

Another source of enforcement limitation in developing countries is lack of proper administrative agencies to offer detailed rulemaking and administrative enforcement on issues like financial enforcement.[1050] Further, as observed above, developing countries do not have non legal enforcement resources like self-regulatory institutions or reputational intermediaries that protect clients and help reduce informational asymmetries.[1051] Also accounting rules are usually weak or non-existent altogether. Finally, in developing countries full disclosure is always problematic as companies are afraid of exposing themselves to extortionate tax regimes or mafia groups who may target them based on disclosed financial information. Consequently investors may not want the company they have invested in to make an honest report of their profits.[1052]

The second limitation for corporate law to be effective in its protective role in developing countries is the cultural norms for managers and large shareholder behaviour.[1053] In developed countries managers and shareholders generally operate in a culture that discourages opportunism and that reflects the underlying legal norms and the penalties for violating those norms and as such formal enforcement is infrequently needed as the said cultural attitudes exist independently of and reinforce the available legal norms.[1054] The culture that exists in developing countries however makes it difficult for business to fully follow the law and exist. Black *et al* observe that Russian enterprises 'must lie about their income to tax authorities, bribe the tax inspector, the custom inspector, the local police, and

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[1050] *Ibid*
[1051] *Ibid*
[1052] *Ibid* at 15.
[1053] *Ibid.*
[1054] *Ibid.*

many other government officials, pay off the local mafia'[1055] in order to stay in business. Other managerial cultural attitudes are reflected in lack of transparency with regards to share ownership, excluding unwanted shareholders from meetings, refusing to transfer shares if managers and internal shareholders disapprove of the new owner and other similar behaviours. In these countries, therefore corporate law needs to play a larger role by ensuring that standards by which corporate managers shall conduct themselves are clearly stipulated in order to instil a managerial culture of duty to shareholders.

It is against this background that Black *et al* recommends the adoption of a self-enforcement approach to corporate law in developing countries in order to protect investors and instil investor confidence in their respective underdeveloped capital markets. As stated above, we believe that this approach would be useful in designing a capital market development reform agenda. So what is the essence of the self-enforcement model to corporate law?

Basically, the self-enforcement approach seeks to build legal norms that managers and large shareholders will see as reasonable and comply with voluntarily.[1056] The desired outcome of this approach is to develop a set of rules that create corporate decision making processes that allow minority shareholders to protect themselves by their own voting decisions and by exercising transactional rights.[1057] As the aim is to induce voluntary compliance, procedural rather than substantive protection is preferred. By emphasising voluntary compliance, the self-enforcing approach diminishes the need to rely on courts and administrative agencies

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[1055] *Ibid.*

[1056] *Ibid*. P. 5. Obviously this is congruent with SRO and the need to assimilate elite concerns to bring them into a cooperative stance.

[1057] *Ibid,* p 17.

for enforcement, making it more apt for developing countries, which have weak enforcement institutions.

There are two elements of the self-enforcing model. The first element seeks to create *structural constraints* to decision making both at shareholder level and at the level of board of directors. At shareholder level, such constraints may be created by shareholder voting requirements or transactional rights[1058] triggered by specific corporate actions. For instance the law may require supermajority shareholder approval for key business decisions such as mergers, rather than simple majority approval.[1059] Also the law may require shareholder approval for a broader range of corporate actions like decisions to issue significant amounts of new equity or to purchase major assets. Also instead of proscribing out right self-interested transactions between the company and its directors, officers, or large shareholders, a self-enforcing statute may require approval by independent directors, a majority of non-interested shareholders, or both.[1060] In terms of the voting mechanism itself, the law may provide for a one share, one vote rule to prevent insiders from acquiring voting power not commensurate with their economic interest in the company. Procedures may also be put in place to ensure honest voting, confidential voting and independent vote tabulation. In order to increase influence of outside shareholders, a universal ballot can be provided to enable them to place cheaply and easily director nominations and other proposals on the voting agenda.[1061] And quality of information available to shareholders

[1058] Transactional rights include put options (the right to sell shares) and call options (a right to buy shares).
[1059] Black *et al*, (1996) *supra* note 1039 at p. 20. This concept was first recognised in the case of *Quin & Axtens v. Salmon, [1909] A.C. 442*, where the court rejected a resolution of a company passed by only one of the companies two directors because the company's Articles provided that decisions of that nature should be made with consent of both directors.
[1060] *Ibid*
[1061] I*bid*.

can be improved by mandatory disclosure rules and by cumulative voting as these would enhance large shareholders' access to information about the company.[1062]

Voting provisions may also be augmented by transactional rights that individual shareholders may exercise. Thus if a shareholder is unhappy with a particular corporate decision or action, he would be entitled to sell his shares. The law may also provide mandatory pre-emptive rights for shareholders to acquire shares in proportion to one's ownership stake, as protection against underpriced stock issues or give shareholders rights to sell their shares to a new controlling shareholder, as protection against transfer of control from 'known hands to less trusted ones.'[1063]

With regards to board of directors' level structural constraints, the law may provide for a prescribed proportion of independent directors who should be vested with authority over crucial corporate decisions such as approval of self-interested transactions.[1064] The law may also provide for mandatory board structures like audit committees. Other features of the statute may be cumulative voting rule[1065] for election of directors, complemented by a mandatory minimum board size and a ban on staggered terms of office.[1066]

The second element of the self-enforcing model is the introduction of *simple, bright-line rules and strong remedies*. As discussed above one of the problems in developing countries is weak enforcement institutions. This limitation can be minimized by simple, bright-line

[1062] *Ibid.*
[1063] *Ibid.*
[1064] *Ibid,* at p 21
[1065] Cumulative voting allows large outside shareholders to elect representatives to the board.
[1066]Black *et al*, (1996) *supra* note 1039 at p. 21.

rules and strong sanctions for violating the rules. The rules must be elaborate, precise, prescriptive and instructive in their content. The aim here is to give the judges, who may be unsophisticated or corrupt, as narrow room for manoeuvre as possible. Thus a rule requiring a shareholder approval of a decision to sell assets of the firm will need to clearly stipulate the threshold point of the value of the assets to be sold that will trigger a shareholder vote. For instance, the provision would need to state that any sale or purchase of assets that equals 50% or more of the book value of the firm's assets will require shareholder vote.[1067] The self-enforcing approach also discourages incorporation of ambiguous concepts like 'fairness' and 'reasonableness' in the rules as these may be open to interpretation, thereby exposing the effectiveness of the rules to the possible incompetence or corruption of the judges and directors.[1068] However when the rules are clear and comprehensive, the judges and directors would struggle to get round the intended purpose of the rule to favour company insiders or they will find it very easy to follow and apply the rule regardless of their competence levels.

Black summarises the key ingredients of the self-enforcing model as follows:

(i) "Enforcement, as much as possible, through actions by direct participants in the corporate enterprise (shareholders, directors, and managers), rather than indirect participants (judges, regulators, legal and accounting professionals, and the financial press).

(ii) Greater protection of outside shareholders than is common in developed economies, to respond to a high incidence of insider-controlled companies, the weakness of other

[1067] *Ibid.*
[1068] *Ibid* at p 22. Black *et al* observes that while judges in United States will have a cultural understanding that fairness hinges largely on price relative to market price, judges or directors in developing economies may not know or have a different understanding of what it means for a transaction to be 'fair'.

constraints on self-dealing by managers and controlling shareholders, and the need to control self-dealing to strengthen the political credibility of a market economy.

(iii) Reliance on procedural protections -- such as transaction approval by independent directors, independent shareholders, or both -- rather than on flat prohibitions of suspect categories of transactions. The use of procedural devices balances the need for shareholder protection against the need for business flexibility.

(iv) Whenever possible, use of bright-line rules, rather than standards, to define proper and improper behaviour. Bright-line rules can be understood by those who must comply with them and have a better chance of being enforced. Standards, in contrast, require judicial interpretation, which is often unavailable in emerging markets, and presume a shared cultural understanding of the regulatory policy that underlies the standards, which may also be absent.

(v) Strong legal remedies *on paper*, to compensate for the low probability that the sanctions will be applied *in fact."*[1069]

The self-enforcing approach, through its structural constraints and the simple, bright line rules as well as strong remedies, is likely to inculcate a culture of compliance in key market participants, over time as the mental constructs and ultimately the belief system, of shareholders, directors, judges and other market participants shift. It is of course noted that the self-enforcing approach would introduce new transactional costs, like costs for conducting shareholder voting and the associated delay this may cause.[1070] However, these costs are far less compared to the cost of having a 'lemon' market caused by lack of investor

[1069] *Ibid,* at p 4
[1070] *Ibid*, at p 23.

confidence in the market.[1071] It is however important that each country carries out a cost-benefit balance of the different rules in line with the strength of other institutions that are available in that country.[1072]

Black *et al's* self-enforcing approach to corporation law offers a real and possible framework for implementing institutional and legal reform within the context of North's framework for institutional change. This approach recognises the different environments in which markets operate and that therefore company and securities laws need to be designed at the level of the existing institutional framework of the country in question. The general direction of these rules in developing countries should be towards more protection of outside shareholders who are particularly at risk due to the prevalence of insider dealing and market manipulation. The recommended content of the actual rules is aimed at getting round the inherent limitations of weak enforcement regimes as well as corporate culture that exist in developing countries.

The suggested structural constraints through shareholder and independent director approvals of key corporate decisions and simple, bright line rules together with strong remedies would be vital in an environment where mental models or belief systems of inside shareholders, directors, judges and regulators are not supportive of the development and growth of an impersonal market. With such structural constraints and rules in place, it would be very difficult for these groups of market participants to ignore the due process in favour of their own self-interested pursuits. At the same time these groups can benefit from regular and impersonal rules. In the long run, this is likely to bring a cultural shift in the

[1071] George A Akerlof, (1970) *Supra* note 433 at p. 84.
[1072] *Ibid.*

markets towards honesty and more compliance. Consequently, more investors will be attracted and the market will ultimately achieve sustained growth.

Finally, the self-enforcement model would also provide a perfect starting point of the learning process that would ultimately entrench advanced knowledge and understanding of the mechanics of strong capital markets. By seeking to build legal norms that managers and large shareholders would find reasonable and comply with voluntarily and emphasising simple and bright-line rules for easy application by managers and shareholders and where necessary, by lawyers and judges, self-enforcement model would serve to build the initial knowledge base for market players, which would gradually advance to full understanding of the various preconditions for strong capital markets.

However, it is important to note that Black records failures on both formal and informal institutional arrangements, and misconduct by elite individuals who negotiate personal deals with public authorities. His analysis is generally consonant with North's general thesis, but he is concerned with a lower level of generality. Further the self-enforcement model is predicated on two crucial assumptions whereupon its efficacy may be hinged:

(i) That the share ownership structure is fairly dispersed

(ii) That there is a significant level of shareholder activism such that minority shareholders are prepared to actively exercise their rights in the management of the company.

By emphasising on shareholder approvals, shareholder appraisal rights, call and put options, the self-enforcing model seeks to operate primarily on Hirschman's[1073] 'voice' and 'Exit' mechanism for corporate governance. Voice refers to 'articulation of one's critical opinion'[1074] in a bid to influence corporate decision making. Voice is typical of political association. 'Exit' refers to a situation where a dissatisfied shareholder sells off his shareholding in protest of unfavourable decision. Exit is typical of economic association. In practice however not many shareholders exercise their rights through voice. This is so because, as it was observed by Berle and Means,[1075] shareholdings in large public companies are typically widely dispersed and shareholder's very small stakes make it economically irrational for them to incur the costs, including the costs of obtaining information and co-operating with other members, necessary for them to exercise their control rights.[1076] Even where a shareholder is able to exercise his right to exit, through such rights as the right to sell in the market, the purpose of the self-enforcing model, which is protection of minority shareholder from managerial arbitrary decision, would be defeated. Effective corporate governance seems to require the use of voice by shareholders.

Perhaps the only way the right to exit would have significant impact on corporate managerial decision would be where there is a forced buy back of the issued shares at a non-market price,[1077] and listing was linked to issued share capital so that exit of a

[1073] Albert O. Hirschman, *Exit, Voice, and Loyalty*, (Harvard University Press: Cambridge, 1970)
[1074] *ibid* at p 16.
[1075] Berle and Means, *supra* note 33.
[1076] Easterbrook and Fisher, *Supra* note 983 at pp 66-67. It is observed that concentrated large block holding affects the management expertise and company decisions as well as use, acquisition, or disposal of corporate assets. See: Iris Chiu (2008-2009), *supra*, note 341.
[1077] There would be no incentive on the part of shareholders to sell their shares if they risk incurring sunk costs (selling their shares at a loss) even if it is rational to do so.

substantial number of shareholders would expose the company to the risk of being delisted. Otherwise it is unlikely to be effective.

9.8 CONCLUSION

The construction of a capital market development reform agenda in developing countries is likely to be a tall order. The very concept of capital market, which is predicated on the idea of capitalism, is not fully understood in most developing countries. As stated above, the majority of capital markets were established on the back of the neoliberal philosophies of Washington Consensus, which as we have observed and discussed, was, inherently misconceived as a development theory. Most capital markets in Sub-Saharan Africa (SSA) including those in the SADC region were established at the behest of the Word Bank and the IMF as an additional element of the structural reform programmes[1078]. One of the key purposes of stock exchanges that were being established in SSA was to use them to float issues of privatised firms.[1079] It is noted that most of the IPOs on SSA stock exchanges have emanated from privatisations.[1080]

Upon their establishment, these capital markets were underpinned by institutional and legal frameworks modelled on the regulatory frameworks for capital markets in developed countries, mainly through legal and policy 'transplantation'. However, as Pouncy has

[1078] Pouncy (2002), *supra* note 26 at pp. 97-98.
[1079] Privatisation was one of the World Bank's and IMF's neoliberal economic policies for achieving political and financial liberalisation. See: Maxwell O. Chibundu, 'Law and the Political Economy of Privatisation in Sub-Saharan Africa', (1997) 21 MD. J. INT'L L. & TRADE 1.
[1080] Kathryn C. Lavelle, 'Architecture of Equity Markets: The Abidjan Regional Bourse', (2001) 55 INT'L ORG. 717.

observed, “the financial, political, social, and technological environments in which post colonial SSA stock exchanges were created differ dramatically from the conditions under which they originally arose in the West.”[1081]

The foregoing shows that although almost each and every SADC country has now established a capital market of some sort, , there is a lot of work, at institutional and regulatory level, to orchestrate some level of growth of these capital markets. This will require a careful diagnosis of capital market stagnation in SADC countries in order to come up with effective policy recommendations to governments and other relevant authorities in these countries. As Black has observed (chapter 6 above), capital markets will only thrive within the milieu of a network of specific institutions and organisations most of which are currently either present but not properly developed and/or executed or completely absent in SADC countries.

According to this study, North’s framework for economic change offers a very good starting point in a bid to understand the nature and scope of this problem. As discussed in this work, North’s framework offers policy designers with a very helpful tool of analysis. By emphasising on the role of mental models and belief systems of economic or political actors, North’s framework has the ability to explain why different countries have different development trajectories. North’s framework also offers a very helpful explanation of why wholesale transplant of institutions (rules and organisations) has failed to yield intended outcomes in most developing countries including SADC countries as the comparative case study in chapter 7 has confirmed. According to North, the belief system is an outward

[1081] Pouncy, (2002), *supra* note 26 at p.99.

expression of the collective mental models of the social, economic and political entrepreneurs of a given society. These entrepreneurs are subject to the informal rules of society and at the same time are entrusted with the interpretation and implementation of formal rules. The entrepreneurs are therefore very crucial agents of change.

As discussed in chapters 5 and 6, capital market growth in developing countries face a lot of hurdles due to lack of the necessary institutions to underpin it. These include macro-institutions such as the rule of law, property rights and an independent judiciary, as well as micro-institutions such as reputational intermediaries, sophisticated market professionals (accountants, lawyers etc) and effective disclosure and insider dealing rules. The informal rules that exist in these countries such as corruption, a culture of dishonesty and general distrust of the judicial system, make the task of designing and implementing capital market development reform even more daunting.

Further, it has been noted in chapter 8 that the actual process of change is significantly complex. While formal rules can be changed at will, informal rules change over a considerable period of time and do not ordinarily change through mere introduction of formal rules. When there is a conflict between new formal rules and existing informal rules, the formal rules will be resisted and consequently robbed of their intended effect. There is therefore always a need to seek to balance the interaction between formal and informal rules.[1082]

[1082] See Table 4 at page 282 above.

However by using North's framework as a tool of analysis, policy makers in developing countries stand a chance of coming up with effectual policies capable of sparking and sustaining capital market development. The approaches discussed in this chapter perfectly fit into North's framework in that they all recognise the sensitivity of institutional reform to local conditions. The three stages of policy reform advocated by Rodrik provide a very helpful tool for reform in developing countries where clarity of policy prescriptions is in short supply. By carrying out clear diagnostic analysis to identify the most binding formal and informal constraints (as discussed in chapters 5 and 6) and designing targeted policy response to these constraints, institutional reform is likely to be effective.

One such binding constraint is the prevalence of concentrated share ownership structure in developing countries. Corporate ownership is concentrated in the hands of the privileged few - the elite. These block owners, which in a way create a form of a Limited Access Order, will not be easily amenable to market mechanisms that have strengthened capital markets in developed countries. As discussed above, some structural reforms may therefore be necessary to ignite the transition from concentrated ownership to dispersed ownership. Transformation of LAO to OAO depends upon recruiting elites to reforms that when generalised will benefit non-elites. In the short term this means the interests of elite groups must feature prominently in the policy design. Elite interests must be taken into account so that in the medium term the benefits they enjoy can be generalised and shared more widely.

In terms of the reform of relevant laws, Black *et al's* 'self-enforcing' approach provides useful suggestions, at micro level, of implementing corporate law reform that would result in the development of capital markets. The emphasis of this approach is the introduction of simple and clear rules that would be easy to implement by the company directors as well as regulators and judges. There is, however, a need for more research in order to identify effective policy and legal tools, within the tenets of North's framework that may accelerate the process of capital market development in developing countries, including SADC Countries.

As stated in Chapter 1, part of the methodology of this work was to seek support from related empirical studies based on different philosophical underpinnings but that confirm our working hypothesis, which was based on North's framework. We have looked at different studies some of which were not necessarily based on the new institutional economics (NIE) paradigm but their findings confirmed the underlying thesis of North's framework.

For instance, the study of Berkowtz et al,[1083] found that where law develops internally through a process of trial and error, innovation and correction and with the participation or involvement of users of the law, legal professionals and other interested parties, legal institutions tend to be highly effective. By contrast where foreign law is imposed and legal evolution is external rather than internal, legal institutions tend to be weak. This is a clear affirmation of North's thesis. Also Black in chapter 6 engaged into a very interest analysis of the ease with which, a country can adapt other countries' institutions for its own use and

[1083] D. Berkowitz, K. Pistor and J.Richard, 'The Transplant Effect', *supra* note 137.

concluded that while reliance on foreign institutions is feasible, only a few institutions are easily transplantable.[1084] This also bears out the underlying theme of North's framework.

Further, in their study of why most people in Russia do not use the legal system to resolve disputes, Hay et al,[1085] found that one reason for this was that most of the laws on the statute books in Russia contradicted standard business practice and common sense of the Russian society and that this made it difficult for courts to reach "locally sensible" decisions.[1086] Again this is a classic illustration of ineffectiveness of imposed formal rules that do not conform with the informal rules on the ground. The foregoing therefore confirms North's framework for economic change as a credible tool for designing an agenda for capital market reform.

Finally, North's framework bears resonance with the work of William Easterly in his recent book, *The Tyranny of Experts: Economists, Dictators, and the Forgotten Rights of the Poor*,[1087] In this work, Easterly identifies what he calls three critical mistakes that technocrats and development experts today make in their approach to development as follows:

(i) They treat developing countries as "blank slates" when prescribing development solutions using a top-down approach that attempts to use specific interventions with

[1084] *ibid*
[1085] Hay *et al,* 'Towards a theory of Legal Reform', (1996) *supra* note 953.
[1086] Hay et al, cites articles 56 and 105 of the Russian Civil Code which requires courts to enforce debts of a bankrupt company against its shareholders because there is no limited liability principle.
[1087] William Easterly, The Tyranny of Experts: Economists, Dictators, and the Forgotten Rights of the Poor, (Basic Books, New York, 2013).

measurable results ignoring the history of societal development[1088]. This observation is similar to North's concept of path dependence of development.

(ii) They focus on development at the national level and sideline individual rights and ignore migration, people groups, and broader regional dynamics[1089]. Easterly recognises that individuals not nations are the proper agents of development. He says development policies should not only be directed at nations but should first and foremost target individual nationals.[1090] Again this chimes with North's emphasis on entrepreneurs and organisations as agents for developmental change.

(iii) Development experts and leaders approach problems by consciously designing solutions, while historically, the best problem-solving strategies have come about through the freedom for numerous people to experiment and come up with their own solutions.[1091] Easterly emphasises that we should rely upon bottom up spontaneous development rather than consciously designed solutions. This recognises the role of informal rules and the fact that top-down imposition of formal rules would take away the legitimacy of the rules. It is North's central observation that the path of development is discovered by trial and error and as such freedom to experiment on the part of entrepreneurs is vital.

As stated above, however, more research may be needed on the most effective practical ways of integrating North's framework into economic development.

[1088] Ibid p. 123
[1089] Ibid p.199.
[1090] Ibid. P. 215-216.
[1091] Ibid, p.237.

In terms of original contribution to knowledge, this work has clearly made a significant academic contribution to the economic development discourse generally and the development of capital markets specifically. The aim of this research was to help fill the gap in the current debate about capital market development. As it was observed in chapter 1, although most countries in the SADC region have established capital markets in the last 20 years, these capital markets are stuck at the infancy stage. Different policy prescriptions have been made but these have failed to stimulate measurable capital market growth.

This work has helped to provide a new diagnosis of this problem using the NIE scholarship. Specifically, this work has attempted to synthesise elements of the rather abstract North's framework for economic development with the more particular and anecdotal Black's core institutional requirements for capital market development. By linking NIE to legal discourse and to capital market development via Black's analysis, a new and more realistically theorised discourse is made possible. The analysis provided in this work is capable of facilitating the evolution of intellectual synthesis that will allow cross disciplinary scholarship and contribution to policy formation in the future.

By looking at the desirable institutional framework that would provide genuine incentives for investors, it is hoped that this work will be of real relevance to the current reform initiatives in the SADC region and other developing countries. Also, by setting in motion the quest for a theory for capital market development; this research will inform the agenda for future policy research on capital market development. Currently, the policy discourse on capital market development in the SADC region has revolved around the concept of capital market integration.[1092] However, as we have shown in this work, capital market integration, in itself, may not be a solution in so far as there is a misalliance between formal rules for capital markets and the informal rules on the ground.

Finally, this work has engaged in a unique comparative analysis of capital market regimes in three carefully selected jurisdictions by way of testing the theoretical framework derived from the synthesis of North's framework and Black's recommendations. Through this comparative analysis, as informed by the theoretical framework developed, this work has identified reasons for the observed differing outcomes in different jurisdictions in developed and developing countries. The contrasting development trajectories of the Johannesburg Stock Exchange and other stock exchanges in the SADC region such as the Malawi Stock Exchange is significantly telling of the role that institutional structures play in capital market development. This exposition should therefore help policy framers in the region as well as in other developing countries to focus on constraints that are relevant to their jurisdiction rather than engage in a one-size-fits-all approach to capital market reform.

[1092] K.K. Mwenda, *supra* note 638.

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11 TABLE OF CASES

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12 LIST OF TABLES