

Securities Laws Enforcement in the Baltic States

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Abstract

This study evaluates the enforcement of securities laws in the three Baltic States – Estonia, Latvia, and Lithuania. Following La Porta *et al.* (2005) we distinguish between the *public enforcement*, i.e. the view that a strong public enforcer, such as a Securities and Exchange Commission, is needed to facilitate the stock market development, and the *private enforcement*, i.e. the view that the securities laws should standardize the securities contracts and litigation in a way to reduce the costs of enforcing the contracts privately.

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Background

After the collapse of the socialist system, transition economies have implemented considerable economic and legal reforms. It has been documented that in many transition economies, the law on books is largely consistent or even better than in the Western countries, while the enforcement of these laws is often ineffective (Pistor et al., 2000). Many previous studies find that poor enforcement of investor protection laws has a negative effect on the financial sector development, stock market activity, availability of external funds, etc., but these studies do not analyze the reasons for the poor enforcement and what can be done to improve the situation.

Berkowitz et al. (2002) argue that the way the laws from other countries were initially transplanted into the recipient country has a strong indirect effect on economic development via its impact on enforcement. Hence, one of the reasons for poor law enforcement can be the inadequate transplantation of laws into the transition economies. Berglöf and Pajuste (2003) suggest that, in certain cases, poor enforcement can be intentional if the transplanted regulations do not bring the intended effect and may harm minority investors. Another reason can be an inappropriate allocation of enforcement rights between the judges and the regulators. Glaeser et al. (2001) present a trade-off between enforcement by *judges*, which are more unbiased in their decisions but can be rather unmotivated to enforce the securities laws, and *regulators*, which are more knowledgeable and motivated in enforcing the securities laws, but also can be over-motivated to find violations at the expense of doing justice. Authors use Poland as a positive example to demonstrate how strong investor protection rules combined with the presence of independent and highly motivated regulator stimulated rapid development of securities markets in the first years of transition.

La Porta et al. (2005) distinguish between public versus private enforcement and its effect on market development. *Private enforcement* hypothesis suggests that securities laws are beneficial if they reduce the costs of private contracting. The law should standardize securities contracts, as well as clarify the liability for non-compliance. With standardized contracts and procedures, the costs of enforcing contracts privately are lowered. *Public enforcement* hypothesis states that securities laws are beneficial if they provide power and incentives for a public enforcer, such as a Securities and Exchange Commission, to enforce the law. Using evidence from stock market development in 49 countries, the authors show that securities laws facilitating private enforcement benefit stock markets more than public enforcement.

In many transition economies, the costs of private enforcement are typically high not because of loosely specified securities law and commercial (company) law but rather because of unmotivated, unfamiliar with economic issues, or even corrupt courts. In early years of transition, Gray (1993) noted that judiciary [in Poland and the Czech Republic] lack experience and expertise to cope with the new challenges of the market economy, such as the issues related to an organized securities market, and that it would take time to overcome this constraint. In this situation, market regulators which hold considerable powers to enforce the laws (e.g. in Poland, Latvia, etc.) play a crucial role in setting the precedents and developing the expertise of the judiciary. Strong and knowledgeable regulator that has gone through several cases is presumably more respected by the courts than any single investor.

The main goal of this paper is to evaluate the current situation of the enforcement of investor protection laws in the Baltic States, and to derive some policy implications.

Results

This paper closely follows the methodology used by La Porta, Lopez-de-Silanes and Shleifer (2005) in their securities laws and enforcement project for 49 countries. The results of their project are presented in the paper “What Works in Securities Laws?” and the project documentation is available online in the home page of Professor Andrei Shleifer (<http://post.economics.harvard.edu/faculty/shleifer/data.html>). The data in their study was obtained from answers on a questionnaire describing the securities laws (including actual laws, statutes, regulations, binding judicial precedents, and any other rule with force of law) applicable to an offering of shares listed in the country’s largest stock exchange in December of 2000. We follow the same methodology and study the respective securities laws and their enforcement in the three Baltic States as of January 2005. One should take into account that in La Porta et al. (2005) the US securities laws and enforcement system is taken as a benchmark; for the US, all the three indices (*Disclosure requirements*, *Liability standard*, and *Public enforcement*) are the highest among all the 49 countries. Here, we disregard the discussion whether this coding methodology is appropriate or not, whether the US system is the best or not and just replicate the methodology in order to compare the indices with other countries.

Appendix A presents the summary of securities law of Estonia in the same style as in the La Porta et al. country chapters. In particular, we present four parts. First, the regulator and its supervisory and regulatory powers are discussed, which provides background material for coding the *Supervisor’s characteristics*, the *Rule-making power*, and the *Investigative powers* indices. Second, the duty to disclose material information in the issuing prospectus (for *Disclosure index*) is analysed. Third, sanctions for the failure to disclose (for *Orders index* and *Criminal index*) are presented. Finally, investor’s right of restitution for losses (for *Liability standard index*) is described. All the indices are defined in Appendix B and index values for the three Baltic States, the US, and averages for the 15 pre-enlargement EU States, “EU-15” are presented in Table 1.

The securities laws and enforcement in the three Baltic States have many things in common, because the countries largely follow the requirements set by different EU directives (in particular, Directive 2001/34/EC on the admission of securities to official stock exchange listing and on information to be published on those securities, “Directive 2001/34”). The EU standards set the minimum requirements, while individual member states can impose additional requirements to increase the investor protection. We take the Estonian case as a reference point and discuss the differences in other two countries, where applicable.

Table 1. Summary of variables by country
Variable definitions are provided in Appendix B.

Variable	Estonia	Latvia	Lithuania	Average 15 pre-enlargement EU	United States	EU Directive 2001/34/EC
Prospectus	0	0	0	0.20	1	0
Compensation	0.5	0.5	0.5	0.60	1	0.5
Shareholders	1	1	1	0.87	1	0
Inside ownership	1	0.5	0.5	0.67	1	0.5
Irregular contracts	0.5	0.5	0.5	0.33	1	0.5
Transactions	0.5	0.5	0.5	0.53	1	0.5
Disclosure requirements	0.58	0.50	0.50	0.53	1	0.33
Burden issuer/ director	0.33	0	0	0.43	1	
Burden distributor	0.33	0	0	0.37	1	
Burden accountant	0	0	0	0.53	1	
Liability standard	0.22	0.00	0.00	0.44	1	
Appointment	1	1	1	0.13	1	
Tenure	1	1	1	0.40	1	
Focus	0	0	1	0.53	1	
Supervisor characteristics	0.67	0.67	1.00	0.36	1	
Rule-making power	0.00	1.00	1.00	0.50	1	
Document	1	1	1	0.57	1	
Witness	1	1	1	0.27	1	
Investigative powers	1.00	1.00	1.00	0.42	1	
Orders issuer	0.5	0.25	0.5	0.25	1	
Orders distributor	0.5	0.25	0.5	0.35	1	
Orders accountant	0	0	0	0.18	1	
Orders	0.33	0.17	0.33	0.26	1	
Criminal director/ officer	0	0.5	0.5	0.53	0.5	
Criminal distributor	0	0.5	0.5	0.37	0.5	
Criminal accountant	0	0.5	0.5	0.53	0.5	
Criminal index	0.00	0.50	0.50	0.48	0.5	
Public enforcement index	0.40	0.67	0.77	0.40	0.9	

Disclosure requirements

The minimum disclosure requirements in the listing particulars are specified in the Directive 2001/34 and recently amended by Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading, “Directive 2003/71”. As of January 2005, the latest amendments are not yet transposed in the local laws of the three countries.

The Latvian and Lithuanian disclosure requirements closely follow the minimum settled in the Directive 2001/34¹, except that the reporting threshold for large shareholders is lowered

¹ However, all the requirements, except the disclosure of major shareholders, currently apply only to the official list securities, Tier 1 (and not to the current list, Tier 2).

to the 10% level in Latvia and to the 5% level in Lithuania. The Directive 2001/34 requires the large shareholder threshold to be not more than 20%.

The Directive 2001/34 requires disclosing the total number of shares held by the administrative, management and supervisory bodies. Estonian law requires that the number of shares held by each director and officer has to be disclosed. Therefore, Estonia gets a disclosure index of 0.58 which is higher than in the other two countries (0.50), as well as higher than the average in the EU-15 states, (0.53).

Liability standard

Securities law of Estonia includes a statement that the *issuer* and *offeror* (but not accountant) is liable to compensate the investor in case of false statement or omission of material information in the issuing prospectus. The liability standard is the same as in torts. Investor must show that the issuer or offeror was negligent in omitting information from the prospectus, as well as that investor relied on the prospectus to invest (reliance) and that his losses were caused by the misleading information in the prospectus (causality). As a result, Estonia gets a liability standard index of 0.22, which is half of the average in the EU-15 states (0.44).

The liability standard index in Latvia and Lithuania is 0 for the following reasons. In both countries, the investor can claim compensation for damages in the court from the persons which are responsible for the truthfulness of information included in the prospectus, if the losses were caused by the misleading information in the prospectus. However, the law does not explicitly require the issuer and offeror to sign the prospectus. In principle, it can be 'any person from street' signing the prospectus and then disappearing. This case is similar to Germany, where typically only those who initiated the issuance of the prospectus assume the responsibility for the prospectus. Therefore, Germany gets a liability standard index of 0.

The new Directive 2003/71 prescribes that Member States shall ensure that responsibility for the information given in a prospectus attaches at least to the issuer or its administrative, management or supervisory bodies, the offeror, the person asking for the admission to trading on a regulated market or the guarantor. Member States shall ensure that their laws, regulation and administrative provisions on civil liability apply to those persons responsible for the information given in a prospectus. Therefore, we may expect that once the new directive is transposed in Latvia and Lithuania, the liability standard will increase to at least the level of Estonia.

Public enforcement

Supervisor's characteristics. Lithuania gets the maximum possible supervisor characteristics index (1) for the only reason that the Lithuanian securities market supervision is separate from the banking and insurance market supervision. In Latvia and Estonia, the supervision of the three sectors is under one authority. As a result, according to La Porta et al. methodology these countries get the supervisor characteristics index of 0.67. We shall note that the supervisor characteristics indices in all the three Baltic States are closer to the US benchmark, and much higher than the average in the EU-15 states (0.36). In all the three countries, the regulator is rather independent, appointed through a system of checks-and-

balances (e.g. parliament) rather than unilaterally by the government, as well as it can be dismissed only after due process rather than at the will of the appointing authority.

Rule-making power. The power to regulate securities markets (particularly, primary offerings or listing rules) is delegated to the regulator in Latvia and Lithuania. Therefore, these two countries get the maximum rule-making power index (1). In Estonia, the market regulator only has the supervisory power while the regulatory powers stay with the Ministry of Finance. Estonia scores 0 on the rule-making power index. The average rule-making power index in the EU-15 states is 0.5, i.e. in exactly one half of the countries the supervisory and regulatory powers are combined within one institution.

Investigative powers. In all the three countries, the regulator has powers to require documents and testimony from any person connected to securities market fraud, thus the countries receive the maximum investigative powers index score (1).

Orders. All the three countries largely follow the Directive 2003/71 in regulator's powers against the *issuer*. In particular, the regulator is empowered to suspend or stop trading of securities if the issuer's situation is such that trading would be detrimental to investors' interests. In this respect, the regulator has discretion in suspending the trading of issuer's securities if the defective prospectus, in regulator's opinion, poses danger to market. All the three regulators may order the issuer to correct the defective prospectus, as well as to request additional information. Monetary sanctions upon issuer in case of submission of incorrect or deficient information in the prospectus are available in Estonia and Lithuania, but currently not in Latvia. Requirement to compensate investor is explicitly stated only in Estonian securities law. Therefore, the *Orders issuer* variable is 0.50 for Estonia and Lithuania (0.50 for do orders and 0.50 for stop orders), and 0.25 for Latvia (0 for do orders and 0.5 for stop orders). The *Orders distributor* variable is 0.50 for Estonia and Lithuania because in both countries the regulator can suspend the license (stop order) and impose monetary penalties on the distributor (do order); the variable is 0.25 in Latvia for the reason that currently the regulator cannot impose monetary penalties upon the distributor in case of a defective prospectus. In all the three countries, the regulator has no power to impose any stop or do orders upon the auditor in case of a defective prospectus. Typically, the regulator may only forward the case to the respective authority, such as the Lithuanian Chamber of Auditors or the Estonian Auditing Board. Therefore, the *Orders accountant* variable is 0 in all the three countries.

Criminal. Criminal sanctions may be imposed if a false statement or omission of material information in a prospectus is an element in the perpetration of a criminal act, such as fraud or market manipulation. Market manipulation is defined in the criminal law of Latvia and Lithuania as "those who, seeking to artificially increase or decrease the price of the securities, have disseminated the information about the issuer or its securities that is false or incomplete, and because of that have made material harm, are punished (...)". Although not likely to occur (there is effectively no precedent) such provision can be theoretically applicable to a case of false statements in a prospectus provided that the relevant circumstances described above are met. As of January 2005, market manipulation is not yet defined as a criminal abuse in Estonia. Therefore, the *Criminal index* is 0.5 for Latvia and Lithuania, and 0 for Estonia.

Conclusions

The enforcement of securities laws in the Baltic States currently largely relies on the public enforcement by the market regulator or judiciary. The study shows that the *public enforcement* index in the Baltic States is higher than the average in the EU-15 states. Meanwhile, the private enforcement (*disclosure requirements* and *liability standard* indices) is lagging behind the average in the EU-15 states.

The recent EU Directive 2003/71 on the prospectus disclosure is going to bring the disclosure requirements in the EU closer to the US benchmark. In particular, the new directive requires the disclosure of remuneration and stock ownership by each member of the managerial and supervisory body, as well as disclosure of related party transactions and material contracts. After transposing this directive into the local laws, the *disclosure requirements index* in the EU countries should increase from the current 0.5 level to close to 1 level. The Directive 2003/71 should also increase the *liability standard* in the EU by explicitly requiring the issuer, distributor and auditor to assume liability for the information provided in the prospectus. This focus on private enforcement tools in the EU suggests that also the law-makers believe the La Porta et al. (2005) argument that securities laws facilitating private enforcement should benefit stock markets more than public enforcement.

However, we should not forget the role of the regulator in countries with poor legal tradition, such as the Central and Eastern European countries. In the current situation, the role of the regulator in these countries is to set the precedents for various investor protection cases. Therefore it is not surprising that the public enforcement index in the Baltic States is much higher than in the Western Europe. In this context, we may argue that the public enforcement is an important transitional step towards more efficient private enforcement.

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SECURITIES LAW OF ESTONIA

Part 1. The regulator and its supervisory and regulatory powers

As of May 2005 the Financial Supervisory Authority (*Finantsinspeksioon*), “FSA”, is the main regulator for the securities market, banks, and insurance companies.

One half of the appointed members of the supervisory board of the FSA are appointed by the Government of Estonia on the proposal of the Minister of Finance and one half by the Board of the Bank of Estonia on the proposal of the President of the Bank of Estonia. Generally, members of the supervisory board of the FSA may only be discharged in case of a material misconduct (e.g. conflict of interest) or a material breach against the obligations or duties of such members.

Generally, the supervision of the Estonian securities market and the entities operating in such market is solely within the authority of the FSA, while the regulations of the financial markets are issued by the Ministry of Finance upon recommendations from the FSA. The FSA makes proposals for the establishment and amendment of Acts and other legislation concerning the financial sector and related supervision, and participates in the drafting of such Acts and legislation. The FSA has the right to issue advisory guidelines to explain legislation regulating the activities of the financial sector and to provide guidance to subjects of financial supervision.

In order to exercise supervision, the FSA has the right to obtain information, documents and explanations from any natural or legal person and from government agencies, supervisory bodies and state and local government databases free of charge (§ 231 of the Securities Market Act, “SMA”).

Part 2. The duty to disclose material information

The disclosure requirements largely follow the Directive 2003/71/EC of the European Parliament and the Council on the prospectus to be published when securities are offered to the public or admitted to trading.

In Estonia, there is no requirement to actually deliver the offering document to each potential investor, but the prospectus or listing particulars must be made available to them, free of charge.

Each member of the management board of the issuer or of the body substituting therefor and at least one member of the management board of the offerer or of the body substituting therefor who has the right to represent the offerer shall certify the accuracy of the information presented in the prospectus by his or her signature (SMA § 24(1)). An auditor shall confirm the accuracy of the information presented in the annual or semi-annual reports contained in the prospectus by his or her signature (SMA § 24(2)).

A prospectus shall contain all significant information needed to make an informed investment decision regarding the offer, the securities offered, the issuer, the financial

situation and future prospects of the issuer, and other circumstances which influence or may influence the price of the securities offered(SMA § 22).

The Regulation No. 14 of the Minister of Finance of 21 January 2003 (Listing Requirements) provides that the listing particulars shall contain detailed information of the issuer and the securities in question, including the following:

- 1) Remuneration paid and benefits granted by the issuer and its subsidiaries to members of the supervisory board, members of the management board and other persons belonging to the management, *in total amount for each such body*.
- 2) The names of the persons holding 5 per cent or more of the issuer's share capital and the number of shares with the voting right held by such persons, or an appropriate negative statement in the absence of such persons.
- 3) The number of the issuer's securities held by the members of the issuer's supervisory board and management and persons connected to them by category.
- 4) Description of the material terms and conditions of transactions executed by the issuer during the last three financial years preceding the application for official listing if such transactions were executed with the members of the issuer's supervisory board and management or with shareholders or companies having a significant business interest in the issuer, in which the members of the issuer's supervisory board and management or shareholders have a significant interest. An appropriate negative statement must be given in the absence of such transactions.
- 5) The total volume of off-balance sheet loans and credits granted to the members of the issuer's supervisory board and management by the issuer and of security provided for the benefit of such persons.
- 6) There is no explicit requirement to disclose any description of specific contracts made outside the ordinary course of business. Nonetheless, the listing particulars must include details of the investments and investment policy of the issuer as well as certain benefits and transactions, unusual in their nature or conditions, between the issuer and its directors.

Part 3. Sanctions for the failure to disclose

3.1 Administrative sanctions by the Regulator

In a case of defective prospectus, administrative sanctions may be available against the issuer and the distributor.

In order to protect the interests of investors, to avoid danger to the regular and lawful operation of the market or to protect any other significant interest or avoid any other threat, the FSA may suspend the listing of any particular security (SMA § 136) or issue a precept for the cessation of trading (SMA § 137). Also, the FSA may impose fines for failure to submit, refusal to submit or late submission of a report, information, an explanation or any other document, or submission of incorrect or deficient information to the Supervision Authority (SMA § 237).

The FSA may revoke the license of a distributor (i.e. investment firm under supervision of the FSA) if it violates the provisions of the SMA or legislation established on the basis thereof or the investment firm has materially or repeatedly violated other requirements provided for in legislation or if its activities or omissions are in contradiction with good

business practices (SMA § 58). The false statement or material omission in the prospectus would fall under the named violations.

The FSA cannot impose any sanctions on the auditor, except contacting the Estonian Auditing Board (a self-governing professional association).

3.2 Judicial sanctions

The securities laws in Estonia do not provide for criminal liability that may arise due to false information or material omissions in a prospectus for a public offer of shares. As of May 2005, market manipulation (which could potentially apply in the case of intentional publishing of false information or omission of material information in the prospectus to influence the market price of the share) is not yet defined in the criminal law.

Imposing criminal liability on the issuer's Board of Directors and Board of Management, Distributor or Auditor for a false statement or material omission in the prospectus is very unlikely, according to the legal department of the FSA.

Part 4. Investor's right of restitution for losses

Chapter 25 of SMA provides the basis for civil liability when the prospectus, in violation of the SMA, includes false statements or omits material information. The *issuer* or the *offeror* shall compensate the owner of the security for damage sustained due to false statement or material omission in the prospectus. To obtain restitution, the investor must prove that: (i) the false statement or the omitted information is material (ii) the investor suffered damages caused by the defective prospectus; (iii) there is causal connection between the false statement or material omission and the damages caused to the investor; and (iv) the defendant (issuer or offeror) was or should have been aware of the false statement or material omission in the prospectus.

The securities law does not set the requirement for compensation of damages from the auditor. The auditors, however, are required to sign under the information they have audited and that has been included in the prospectus. In this context, compensation of damages from the auditor can be sought on the basis of general tort law. To obtain restitution, the investor would have to prove that the auditor intentionally made the false statement or material omission or that he acted with gross negligence.

Appendix B. Definition of variables

Prospectus	Equals one if the law prohibits selling securities that are going to be listed on the largest stock exchange of the country without delivering a prospectus to potential investors; equals zero otherwise.
Compensation	An index of prospectus disclosure requirements regarding the compensation of directors and key officers. Equals one if the law or the listing rules require that the compensation of <u>each</u> director and key officer be reported in the prospectus of a newly-listed firm; equals one-half if only the <u>aggregate</u> compensation of directors and key officers must be reported in the prospectus of a newly-listed firm; equals zero when there is no requirement to disclose the compensation of directors and key officers in the prospectus for a newly-listed firm.
Shareholders	An index of disclosure requirements regarding the <i>Issuer's</i> equity ownership structure. Equals one if the law or the listing rules require disclosing the name and ownership stake of each shareholder who, directly or indirectly, controls ten percent or more of the <i>Issuer's</i> voting securities; equals one-half if reporting requirements for the <i>Issuer's</i> 10% shareholders do not include indirect ownership or if only their aggregate ownership needs to be disclosed; equals zero when the law does not require disclosing the name and ownership stake of the <i>Issuer's</i> 10% shareholders. No distinction is drawn between large-shareholder reporting requirements imposed on firms and those imposed on large shareholders themselves.
Inside ownership	An index of prospectus disclosure requirements regarding the equity ownership of the <i>Issuer's</i> shares by its directors and key officers. Equals one if the law or the listing rules require that the ownership of the <i>Issuer's</i> shares by <u>each</u> of its director and key officers be disclosed in the prospectus; equals one-half if only the <u>aggregate</u> number of the <i>Issuer's</i> shares owned by its directors and key officers must be disclosed in the prospectus; equals zero when the ownership of <i>Issuer's</i> shares by its directors and key officers need not be disclosed in the prospectus.
Irregular contracts	An index of prospectus disclosure requirements regarding the <i>Issuer's</i> contracts outside the ordinary course of business. Equals one if the law or the listing rules require that the terms of material contracts made by the <i>Issuer</i> outside the ordinary course of its business be disclosed in the prospectus; equals one-half if the terms of only some material contracts made outside the ordinary course of business must be disclosed; equals zero otherwise.
Transactions	An index of the prospectus disclosure requirements regarding transaction between the <i>Issuer</i> and its directors, officers, and/or large shareholders (i.e., "related parties"). Equals one if the law or the listing rules require that <u>all</u> transactions in which related parties have, or will have, an interest be disclosed in the prospectus; equals one-half if <u>only some</u> transactions between the <i>Issuer</i> and related parties must be disclosed in the prospectus; equals zero if transactions between the <i>Issuer</i> and related parties need not be disclosed in the prospectus.
Disclosure requirements index	The index of disclosure equals the arithmetic mean of: (1) Prospectus; (2) Compensation; (3) Shareholders; (4) Inside ownership; (5) Irregular contracts; (6) and Transactions.
Liability standard for the issuer and its directors	Index of the procedural difficulty in recovering losses from the Issuer and its directors in a civil liability case for losses due to misleading statements in the prospectus. We first code separately the liability standard applicable to issuer and its directors and then average the two of them. The liability standard applicable to directors of the issuer equals one when investors are only required to prove that the prospectus contains a misleading statement. Equals two-thirds when investors must also prove that they relied on the prospectus and/or that their loss was caused by the misleading statement. Equals one-third when investors must also prove that the director acted with negligence. Equals zero if restitution from directors is either unavailable or the liability standard is intent or gross negligence. The liability standard applicable to issuers is coded analogously.

Liability standard for distributors	Index of the procedural difficulty in recovering losses from the <i>Distributor</i> in a civil liability case for losses due to misleading statements in the prospectus. Equals one when investors are only required to prove that the prospectus contains a misleading statement. Equals two-thirds when investors must also prove that they relied on the prospectus and/or that their loss was caused by the misleading statement. Equals one-third when investors must also prove that the <i>Distributor</i> acted with negligence. Equals zero if restitution from the <i>Distributor</i> is either unavailable or the liability standard is intent or gross negligence.
Liability standard for accountants	Index of the procedural difficulty in recovering losses from the <i>Accountant</i> in a civil liability case for losses due to misleading statements in the audited financial information accompanying the prospectus. Equals one when investors are only required to prove that the audited financial information accompanying the prospectus contains a misleading statement. Equals two-thirds when investors must also prove that they relied on the prospectus and/or that their loss was caused by the misleading accounting information. Equals one-third when investors must also prove that the <i>Accountant</i> acted with negligence. Equals zero if restitution from the <i>Accountant</i> is either unavailable or the liability standard is intent or gross negligence.
Liability standard index	The index of liability standards equals the arithmetic mean of: (1) Liability standard for the issuer and its directors; (2) Liability standard for distributor; and (3) Liability standard for accountant.
Appointment	Equals zero if a majority of the members of the <i>Supervisor</i> are unilaterally appointed by the Executive branch of government; equals one otherwise.
Tenure	Equals one if members of the <i>Supervisor</i> cannot be dismissed at the will of the appointing authority; equals zero otherwise.
Focus	Equals one if separate government agencies or official authorities are in charge of supervising commercial banks and stock exchanges; equals zero otherwise.
Supervisor characteristics index	The index of characteristics of the <i>Supervisor</i> equals the arithmetic mean of: (1) Appointment; (2) Tenure; and (3) Focus.
Rule-making power Index	An index of the power of the <i>Supervisor</i> to issue regulations regarding primary offerings and listing rules on stock exchanges. Equals one if the <i>Supervisor</i> can generally issue regulations regarding primary offerings and/or listing rules on stock exchanges without prior approval of other governmental authorities. Equals one-half if the <i>Supervisor</i> can generally issue regulations regarding primary offerings and/or listing rules on stock exchanges only with the prior approval of other governmental authorities. Equals zero otherwise.
Document	An index of the power of the <i>Supervisor</i> to command documents when investigating a violation of securities laws. Equals one if the <i>Supervisor</i> can generally issue an administrative order commanding all persons to turn over documents; equals one-half if the <i>Supervisor</i> can generally issue an administrative order commanding publicly-traded corporations and/or their directors to turn over documents; equals zero otherwise.
Witness	An index of the power of the <i>Supervisor</i> to subpoena the testimony of witnesses when investigating a violation of securities laws. Equals one if the <i>Supervisor</i> can generally subpoena all persons to give testimony; equals one-half if the <i>Supervisor</i> can generally subpoena the directors of publicly-traded corporations to give testimony; equals zero otherwise.
Investigative powers index	The index of investigative powers equals the arithmetic mean of: (1) Document; and (2) Witness.

Orders issuer	An index aggregating stop and do orders that may be directed to the Issuer in case of a defective prospectus. The index is formed by averaging the sub-indexes of orders to stop and to do. The sub-index of orders to stop equals one if the <i>Issuer</i> may be ordered to refrain from a broad range of actions; equals one-half if the <i>Issuer</i> may only be ordered to desist from limited actions; equals zero otherwise. The sub-index of orders to do equals one if the <i>Issuer</i> may be ordered to perform a broad range of actions to rectify the violation; equals one-half if the <i>Issuer</i> may only be ordered to perform limited actions; equals zero otherwise. We disregard orders that may be issued by Courts at the request of a private party in a civil lawsuit.
Orders distributor	An index aggregating stop and do orders that may be directed to the <i>Distributor</i> in case of a defective prospectus. The index is formed by averaging the sub-indexes of orders to stop and to do. The sub-index of orders to stop equals one if the <i>Distributor</i> may be ordered to refrain from a broad range of actions; equals one-half if the <i>Distributor</i> may only be ordered to desist from limited actions; equals zero otherwise. The sub-index of orders to do equals one if the <i>Distributor</i> may be ordered to perform a broad range of actions to rectify the violation; equals one-half if the <i>Distributor</i> may only be ordered to perform limited actions; equals zero otherwise. We disregard orders that may be issued by Courts at the request of a private party in a civil lawsuit.
Orders accountant	An index aggregating stop and do orders that may be directed to the <i>Accountant</i> in case of a defective prospectus. The index is formed by averaging the sub-indexes of orders to stop and to do. The sub-index of orders to stop equals one if the <i>Accountant</i> may be ordered to refrain from a broad range of actions; equals one-half if the <i>Accountant</i> may only be ordered to desist from limited actions; equals zero otherwise. The sub-index of orders to do equals one if the <i>Accountant</i> may be ordered to perform a broad range of actions to rectify the violation; equals one-half if the <i>Accountant</i> may only be ordered to perform limited actions; equals zero otherwise. We disregard orders that may be issued by Courts at the request of a private party in a civil lawsuit.
Orders index	The index of orders equals the arithmetic mean of: (1) Orders issuer; (2) Orders distributor; and (3) Orders accountant.
Criminal director / officer	An index of criminal sanctions applicable to the <i>Issuer</i> 's directors and key officers when the prospectus omits material information. We create separate sub-indexes for directors and key officers and average their scores. The sub-index for directors equals zero when directors cannot be held criminally liable when the prospectus is misleading. Equals one-half if directors can be held criminally liable when <u>aware</u> that the prospectus is misleading. Equals one if directors can <u>also</u> be held criminally liable when negligently <u>unaware</u> that the prospectus is misleading. The sub-index for key officers is constructed analogously.
Criminal distributor	An index of criminal sanctions applicable to the <i>Distributor</i> (or its officers) when the prospectus omits material information. Equals zero if the <i>Distributor</i> cannot be held criminally liable when the prospectus is misleading. Equals one-half if the <i>Distributor</i> can be held criminally liable when <u>aware</u> that the prospectus is misleading. Equals one if the <i>Distributor</i> can <u>also</u> be held criminally liable when <u>negligently</u> unaware that the prospectus is misleading.
Criminal accountant	An index of criminal sanctions applicable to the <i>Accountant</i> (or its officers) when the financial statements accompanying the prospectus omit material information. Equals zero if the <i>Accountant</i> cannot be held criminally liable when the financial statements accompanying the prospectus are misleading. Equals one-half if the <i>Accountant</i> can be held criminally liable when <u>aware</u> that the financial statements accompanying the prospectus are misleading. Equals one if the <i>Accountant</i> can <u>also</u> be held criminally liable when <u>negligently</u> unaware that the financial statements accompanying the prospectus are misleading.
Criminal index	The index of criminal sanctions equals the arithmetic mean of: (1) Criminal director; (2) Criminal distributor; and (3) Criminal accountant.
Public enforcement index	The index of public enforcement equals the arithmetic mean of: (1) Supervisor characteristics index; (2) Rule-making power index; (3) Investigative powers index; (4) Orders index; and (5) Criminal index.