

# **Development of Capital Markets and its Institutions in Estonia**

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## **Abstract**

This paper provides an analytical overview of the nature and evolution of the Estonian securities markets and its institutions. It focuses on the main problems encountered in the process of building securities markets from scratch. Critical issues within the development of securities markets and its institutions are identified and alternative solutions, discussed. Attention is given to the interactions between the economic-institutional framework and securities market development. The author suggests that the acceleration of securities market development in Estonia largely relied on Government voucher-based privatization policies. The author also discusses how and to what extent the development of securities markets can be promoted, and which issues are or may be faced in the process of further development of securities markets in Estonia.

## **Introduction**

Estonia represents an example where the functioning securities market has been built virtually from scratch within a few years only. Given the unfavorable start-up conditions and severe deficiencies in the overall economic-legal-institutional framework characteristic to transition economies, the Estonian case can in many respects regarded as a success story, which deserves attention.

The formation and evolution of securities markets and its institutions is inevitably a process, influenced by a large number of factors and complex relations between these. There are, yet, obviously critical issues within the process of the development of securities markets and institutions. However, an analysis of factors driving and determining the development of securities markets and its institutions, as well as the sophisticated and comprehensive studies regarding the evolution of the Estonian securities market and its institutions, have been practically absent, in Estonia.

The present study aims to fulfill the gap. It gives an overview of the development of securities markets and its institutions in Estonia and analyzes major issues and policy dilemmas encountered within the development of securities markets and its institutions in Estonia.

The first chapter briefly outlines general preconditions for the formation of securities markets. The second chapter of the study discusses the regulatory aspects of the securities markets and institutions. The third, fourth and fifth chapter, focus on the securities markets structural aspects, analyzing the institutions and development processes in the securities primary and secondary markets. Thereafter, an overview of the major issues related to the securities markets development, has been provided by chapter six. Finally, the conclusions are made with regard to the development of securities market and its institutions in Estonia.

It should be noted that the depth of the study reflects the constraints imposed by the availability and reliability of (non-restricted, public) information.

## 1. Preconditions for the establishment of securities markets

Securities markets in order to emerge (and develop) require a priori, the existence of certain legal, institutional, economic, social and political conditions. The exact range of necessary preconditions is rather wide and complex. However, there are several factors, which are fundamentally important. Among these, the existence of well-defined property rights based on private-property-doctrine, the existence of corporate (limited liability) forms of entrepreneurship, enforcement of contracts, free price formation based on demand and supply, should be mentioned at least.

In Estonia as well as in other former centrally planned economies most of these fundamental preconditions needed for the formation of securities markets came into existence just during the beginning of 1990s as a result of general transitional reforms carried out. One should mention:

- 1) private-property-doctrine-proceeding legal and institutional reforms (e.g. institutionalization of private ownership and entrepreneurship, ownership reform, privatization of state-owned enterprises, etc.);
- 2) market-economy-relevant economic and institutional reforms (e.g. monetarisation of the economy, price liberalization, corporatisation of businesses and enforcement of contracts, etc.);
- 3) political system reforms - institutionalization of multi-party system and principles of democracy<sup>1</sup>.

Besides the above-mentioned rather general transitional reforms, the development of securities markets has required also securities markets specific policies to be designed and implemented. Such policies have included:

- the creation of an appropriate regulatory framework for securities, securities markets and its participants;
- creation and encouragement of the development of appropriate infrastructure for securities markets;
- development of supervision and monitoring systems furnished with sufficient authority;
- training of professional personnel and educating the general public in securities;
- encouragement of the supply of securities into the public market;
- promotion of investors interest in securities investments;
- establishment of foundations for the creation and development of institutional investors;
- institutionalization of modern accounting standards and auditing.

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<sup>1</sup> Among the regulatory framework providing general preconditions for the emergence of securities markets, one should acknowledge the importance of such legal acts as: the Law on Privatization (June 17, 1993), Property Law (June 9, 1993), Commercial Code (February 15, 1995), Law on Accounting (in force from June 1995).

## **2. Regulatory Framework of Securities Market**

### **2.1. General issues and dilemmas**

The concrete need for regulative framework for securities market in Estonia became essential in 1991 with the spontaneous formation of securities market. Namely, in 1991 the first public issues of securities were launched in Estonia. The formal regulations (State/Governmental intervention) were necessary primarily in order to:

- establish some sort of control over the securities markets and its professional participants and to promote public confidence in securities and securities markets;
- provide basic investor protection (protect investors from fraud and manipulation) and to provide foundations for creation of fair, efficient, and orderly markets;
- protect the stability of the emerging system by preventing failures in the market<sup>2</sup>.

It should be acknowledged that the creation of regulatory framework for securities markets has not been an easy task. It has involved several important policy dilemmas and issues to be solved by the policymakers. First of all, which role should be given to market forces themselves to determine the securities markets, and to what extent formal intervention is necessary? Further on, more specific issues have included what has to be regulated, to what extent, how, when and by whom? It should be recognized that, the way these issues are solved could play a critical importance from the point of view how the securities markets and its institutions operate and develop<sup>3</sup>. However, there is obviously no single solution to these regulatory issues. In general terms, of course, it can be agreed that the amount of regulation must be related to the difference between what the economic agents do and what they would do in the absence of regulation as referred also by Gowland (1990). This generalization seems to provide a good explanation for the rationale and extent of regulation. However, it does not provide practical solutions as far as the behavioral aspects of economic agents are rather unpredictable in full extent. Hence also the regulatory issues in securities markets are highly disputed.

Few principles, still, have found rather wide support and general acceptance. Perhaps the most important of these is the principle of avoiding over-regulation. The importance of this principle should be especially highly recognized in the new markets, where the fast development processes continuously bring forward new needs. In such dynamic environment over-regulation and rigidity of laws may bear significant dynamic costs – i.e. act as a barrier to change (innovation) and so preserve inefficiencies, and slow down the overall development of securities markets. Hence, it is desirable that during this period the market forces enjoy considerable self-determination opportunities. This principle, partly intentionally, partly unintentionally, has been followed also in the process of building up securities market regulatory framework in Estonia. However, self-determinative opportunities must not necessarily mean the total absence of regulations.

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<sup>2</sup> Of course, the very essence of the need for regulation in financial markets is explained by several theories. Two major of them are the public good theory and the market failure theory.

<sup>3</sup> Issues such as the level of market efficiency, fairness, competitiveness, comparative advantages of particular financial markets, the institutions, the market participants and instruments issued and traded can be largely determined by the regulatory framework.

Rather, they assume flexibility (and some sort of vagueness) of the regulatory framework as well as proper division of regulative roles between Government (State) and market participants themselves. Within this highly dynamic environment, it can be suggested that the Government should limit its regulatory role only to providing fundamentals and general frames for the existence of securities markets and institutions (e.g. appropriate legislation on property rights, securities, public issue, investor protection, etc.). More detailed and specific regulation of the market, but especially the secondary market, would be expedient to leave under the competence of professional market participants. Several arguments can be found in favor of such division of competence and reliance on self-regulation in the securities secondary market. Self-regulation provided by professional private institutions (e.g. the stock exchange) relies heavily upon the expertise and experience of market practitioners (experts) who can formulate rules and regulations that are acceptable to both players and regulators (see Pawley, Winstone, Bentley 1991). The self-regulation is also more flexible and easier to amend compared with the rigidity and time-consuming amendment procedures of laws and Government regulations. This is an important factor, especially in the stages where the development processes in the market are fast (e.g. emerging securities markets). However, self-regulation has also several disadvantages. For instance, the enforcement of rules may be difficult, there is also a danger that self-interest will overshadow public interest and so sap the confidence of investors (see Thomas 1986).

In addition to these issues related to the dynamic costs, it should be acknowledged that the regulation could be accompanied also by other significant costs (see Gowland 1990). Such costs could be:

- the moral hazard – i.e. those changes in the behavior of regulated group, which occurring in response to some institutional or other change, produce undesirable, usually counterproductive, effects;
- compliance costs – i.e. extra costs imposed on private sector agents by the regulations;
- loss of economic welfare – i.e. when regulation induces the regulated group to perform less transactions than they otherwise would.

As it is possible to conclude, regulation is a delicate issue and the way it is solved evidently determines the speed and nature of evolution of securities markets and its institutions. Hence, the importance of regulatory issues should not be underestimated.

## **2.2. Formation of the Regulatory Framework of Securities Market in Estonia**

The regulatory framework for the securities market in Estonia was introduced in summer/autumn of 1993. This included the adoption of the frame law – Law on Securities Market (LSM) on June 2<sup>nd</sup>, 1993, and a number of normative acts needed for the application of the law. Among these the:

- Government decree on "Charter of the State Securities Board" (October 21, 1993);
- Government decree on "Rules on Issuing State Operating Licenses to Professional Participants of the Securities Market" (October 25, 1993);

- Government decree on "Procedures For the Public Issue of Securities" and the "Procedures For the Registration of a Public Issue of Securities" (October 29, 1993).

These regulatory steps in 1993 were important from three aspects: 1) the legal foundation for the existence of securities market was established, 2) a sort of control over the so-far spontaneous development of securities markets and its institutions, was established, 3) a set of quality standards/norms were introduced into the securities market. As a result of enactment of these acts the spontaneous development stage of the public securities market was ended and a regulative stage, which still emphasized the leading role of market forces in determining appropriate market patterns, began.

In 1994, largely in connection with the planned voucher-based privatization program as well as due to the spontaneous development of investment funds, the emphasis of regulatory efforts was put on the establishment of legal foundations and regulatory basis for the securities market infrastructure institutions and institutional investors<sup>4</sup>. On August 12<sup>th</sup>, 1994 the Government Decree "On Investment Funds", which legalized the activities of investment funds and set up frames for their activities, was passed. On October 14<sup>th</sup>, 1994 the Government Decree "On the Establishment of the Estonian Central Register of Securities", which provided legal ground for the implementation of the dematerialized securities markets approach, was passed.

In 1995 the regulatory breakthrough and significant improvement occurred in the sphere of corporate governance issues. On February 15<sup>th</sup>, 1995 the Estonian Business Code, which provided clarification of shareholders rights and corporate governance issues, was adopted. The year 1995 was remarkable also for another breakthrough. Namely, the self-regulation provided by market participants themselves was introduced into the market. This came in the form of rules established by the Estonian Central Depository of Securities (ECDS), aimed mostly for regulation of securities depository services, settlement and trading.

In response to the investment funds crises of 1995, which clearly brought into the fore the deficiencies of the legal and supervisory framework, alterations and amendments were made into the Law on Securities Markets in spring 1996. These furnished the supervisory body with greater authority and tried to fulfill the essential gaps in the insider trading issues related regulation. Of great importance for the Estonian securities market was the start of the Tallinn Stock Exchange (TSE) activities in June 1996. The launch of the TSE activities was important also from the regulatory aspect. The Rules and Regulations of Tallinn Stock Exchange, a self-regulatory act, which took effect, brought significant improvements into the securities market regulation by determining the secondary market microstructure and strengthening the investor protection. Aside the advances in the secondary market regulation, in 1996, also a revision of primary market regulation was undertaken. On July

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<sup>4</sup> The public offering of shares of SOEs, a part of the Government voucher-based privatization program, was envisaged by the Law on Privatization in June 1993. However, the procedure of public offering of shares of SOEs was adopted just in August 1994. According to it, the public offering of shares of SOEs can take place either, as a: 1) fixed price offering, where after 30-90 days subscription period special adjustment schemes, usually favoring small investors in the case of over-subscription, or 2) public competitive bidding - which allows to two types of bids, either with or without determining a bidding price.

16<sup>th</sup>, 1996 the Government decree on 'Registration and Announcement of Public Issue of Securities', which replaced the respective Government decrees from October 1993, and strengthened the primary market regulation, was adopted.

The regulatory steps taken in 1997 were largely induced by the need to improve/strengthen supervision over the securities market and its major professional participants. On February 17<sup>th</sup>, 1997 the Government Decree on the 'Charter of the State Securities Inspection', which strengthened the SSI authority, was passed. On April 9<sup>th</sup>, 1997 the Law on Investment Funds, which replaced the respective Government decree from August 1994, was passed. It tightened the activities of investment funds by attempting to bring the investment funds regulation more into the line with the principles followed in the EU countries.

Though the regulatory framework emerged covers a great deal of the major aspects of securities markets (providing guidelines for securities, issuers, securities trading on primary and secondary markets, professional participants in the securities markets, and supervisors), the existence of significant deficiencies in the regulatory framework, should still be acknowledged. Probably the major shortcoming is the outdated and too vague character of the Law on Securities Market, which along with the developments in the securities needs significant modification. Most obvious is also the absence of legislation regarding stock exchanges and depositories (e.g. Law on Exchanges, Law on Depositories, etc.) as well as on securities dealers. From the prospect of enforcement, the strengthening of the legal status of regulations, i.e. replacement of Government decrees by laws would be appropriate.

Further priorities in the regulation of securities markets in Estonia are largely determined also by two integration processes strategically envisaged: 1) the targeted EU membership of Estonia, 2) the planned integration of Baltic securities markets. The targeted EU membership means that a gradual adjustment of the securities market regulatory framework to the principles and standards followed in EU countries will take place. This will inevitably accompany with higher demands established for market participants, limit the self-determinative opportunities of market participants as well as strengthen the investor protection measures. Given the plans of further integration of the Baltic securities markets, harmonization of the securities market regulatory framework within the Baltic States, is envisaged.

However, the effect of regulation does not depend only on the regulations enacted but also on implementation and enforcement. Shortcomings in these areas have been faced in Estonia<sup>5</sup>. Often problems spring from the lack of sufficient integrity in the existing regulatory framework. This may concern either, shortcomings of the securities market legislation itself (e.g. 'holes' in the regulation, vagueness, etc.) or, due to the interdependence of legal acts, the absence of underpinnings by a general legal-institutional

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<sup>5</sup> For instance, despite that the LSM (June 1993) envisaged the sanctions against violations, these became applicable just from December 12, 1995 when the amendments to the LSM, establishing enforcement mechanisms against violations (violators), were passed.

framework<sup>6</sup>. These problems have been especially characteristic of the earlier stages of the securities market development, which have largely overlapped with the general transitional-institutional reforms. These shortcomings have been most apparent during crises, accelerating steps to cure the deficiencies of the legal framework (e.g. the investment funds crisis in Estonia in spring 1995).

### **2.3. Investor protection issue within the legal framework**

Empirical evidence suggests that issues related to the investor protection have certainly critical role for the securities market development. Aside the provision of well-defined and adequately backed ownership rights, the major role of regulation, from the point of view of investor protection, is to ensure the existence of 'fair markets'. In general, this assumes at least:

- the preventive measures against fraud and manipulations,
- enforcement of (periodic) disclosure of proper information by issuers of publicly tradable securities to investors in order to guarantee for investors the opportunity to assess their investments or investment opportunities (at minimum cost) and to take proper information-based actions,
- the preventive measures against insider trading and equally guaranteed access of all investors to information important for the pricing of a security,
- transparency of the market - some degree of disclosure of correct price quotations to ensure the ability of investors to see the prices and quantities that are being transacted in a market.

Most of these issues have served significant attention within the regulation of developed securities markets. At the same time it has been rather characteristic to the countries just introducing the securities markets that these issues have been initially left out of required attention. However, along with the development of securities markets, these issues have increasingly become into the fore. This holds true also in case of Estonia.

It should be noted that with regard to the investor protection issue, essential differences can be found between different market segments: between the securities market covered by the Tallinn Stock Exchange (TSE) regulation and off-exchange securities market, in Estonia. The TSE rules provide rather satisfactory coverage and enforcement of rules regarding disclosure as well as in some extent the prevention of insider trading. At the same time the Government regulations and actions in securities market, remain clearly inadequate for ensuring the proper investor protection and implementation of 'fair market' principles. Even though the disclosure of certain information by issuers, as well as prohibition of insider trading has been envisaged by the Law on Securities Markets<sup>7</sup>, there little effect from these in practice as far as enforcement is missing.

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<sup>6</sup> Namely, the proper enforcement of securities market legislation often assumes the pre-(co-)existence of several other legal acts (e.g. . law on contracts, which should specify the rights and liability of creditor and debtor).

<sup>7</sup> In essence, the insider trading prohibition is defined as 'prohibition to transact on the basis of confidential information' in the Law on Securities Markets. Within the Estonian legislation the term 'insider' is actually

As a result, the periodic disclosure is effectively followed practically only by issuers whose securities are traded on the TSE. With regard to other issuers of public securities, such periodic disclosure is practically absent. This confirms that without proper enactment and enforcement of disclosure requirements, there is little to expect that companies disclose enough financial information, since it can be often against their interests (e.g. the competitors, business partners may acquire commercially important information, etc.). Restrained information flow to the public may also provide the insiders superior advantages and opportunities to exercise insider trades or expropriate corporate resources. However, these securities suffer depressed liquidity. The difference between the disclosure and availability of information, may also be an explanation for the very low trading record of off-exchange securities compared to exchange-traded securities (see chapter: secondary market).

The effectiveness of the insider trading preventive measures is more difficult to observe. Good insider-trading-preventive-measures require well-defined and enforceable regulatory procedures and most importantly effective surveillance. This requires:

- the establishment and keeping of registers of insiders, as well as monitoring of the portfolio of insiders and transactions exercised by insiders,
- the regular surveillance of price movements (to focus on unusual price movements),
- the regular monitoring (analysis) of companies' activities,
- power granted to surveillance authorities to investigate insider dealing and to apply sanctions.

Despite that the creation and implementation of such framework would be seen as a task of the State Securities Inspection, the need for such framework of measures has so far been recognized only by the Tallinn Stock Exchange. Even though most of these measures have been applied by the TSE, it should be still acknowledged that it is very difficult, if not impossible to prevent insider trading in one form or another.

Investor (investment) protection can be provided also by (compulsory) insurance schemes (either concerning directly the investments of primary investor or via insurance of investments by financial intermediaries). Such insurance schemes are currently absent in Estonia. The introduction of insurance such is still rather problematic since it is difficult to predict the benefits and costs associated with insurance schemes. While the compulsory insurance schemes, in general, can be regarded as serving investors interests and providing confidence in the system, at the same time it involves several controversial issues:

- 1) there is a moral hazard case against insurance - i.e. that it may induce dishonest or reckless behavior by economic agents (Gowland 1990);
- 2) it maybe seen unfair that competent and careful (or lucky) participants in the scheme should pay insurance premiums to cover up the mistakes or worse of the imprudent and dishonest (Gowland 1990).

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missing. Instead, a term 'person close to the issuer', which for instance does not cover the Board members, is used.

### **3. Securities Market Institutions**

#### **3.1. Securities Markets Supervision**

Supervision comprises an important role within the securities market infrastructure. Its major task is to provide market discipline and ensure proper (fair) functioning of securities markets and, thus, also prevent the happening of systemic crisis in the financial markets<sup>8</sup>. Given the interactions within the financial system, the effective supervision over the securities markets and its participants, in general, can be regarded as being for the benefit of all participants of financial system.

Acknowledging the important role of supervision, Estonia started to build up its securities market supervisory structure quite soon after the evidence of the start of the spontaneous development of securities market. As a first step the Securities Division of the Ministry of Finance, in charge of co-ordination of the state's policy towards securities markets and drafting of regulatory framework for securities markets and its participants, was set up. The regulatory efforts were realized in summer/autumn 1993, when the basic legal framework for securities markets and its participants was established (see chapter 2.2). Following the establishment of the regulatory framework, a major supervisory body - the State Securities Board (SSB) subordinated to the Ministry of Finance, was established in October 1993. It began to operate from 1994. Aside the monitoring responsibilities the SSB became responsible also for licensing and registration of public issues as well as professional participants of the securities market. It also became involved in drafting of securities market related regulation. The current organizational structure of securities markets supervision evolved in June 1996, when the SSB was reorganized into the State Securities Inspection (SSI) and the Tallinn Stock Exchange began its activities. The reorganization of the SSB into the SSI brought along little changes. In essence, the SSI continued the basic functions of the SSB. At the same time, the launch of the TSE activities had a rather significant impact. The rules established by the Tallinn Stock Exchange for market participants and supervisory role performed, essentially strengthened the supervision over the securities market (that of under the control of the Tallinn Stock Exchange). It had also another significant importance. Namely, with the launch of the TSE supervisory activities the state-run supervision became supplemented by the supervisory structure organized by market-participants themselves.

Thus, the current supervision over the securities market is organized and exercised both, by the state (Government) and by market participants themselves. At the State level there are two government agencies in charge of supervision and regulation of the Estonian securities market: the State Securities Inspection, the major supervisory body of the securities markets in Estonia and the Securities Division of the Ministry of Finance. Within the authority of the Tallinn Stock Exchange, the state-run supervision is

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<sup>8</sup> It is well-known fact that financial markets are very sensitive towards failures. Even the single cases of failure/misconduct in the financial markets can significantly affect the trust and thereafter the stability of the whole system and lead to undesired consequences.

supplemented by the supervision carried out by the Tallinn Stock Exchange organized by the market participants themselves.

However, what counts in case of supervision, is its efficiency. The existence of supervisory structures does not necessarily mean that they are also effective in practice. Such evidence, for instance, can be found in Estonia. Despite of several suspicions of misconduct cases (e.g. insider trading, misinforming of investors, etc.), the SSI has been unable to verify even a single case and take proper actions. There are many reasons for this, but the primary one stem from shortcomings in the regulatory framework, which, do not provide adequate legal backing for SSI to take proper actions. Hence, the Estonian experience confirms that effective supervision requires adequate backing by laws and regulations, which could clearly specify misconduct cases and grant adequate power to the supervisory authorities to monitor the markets and its participants as well as enforce sanctions in case of misconduct. In addition, effective supervision requires also specialists with relevant qualification, capable to analyze the situation, to be employed in the supervisory structures.

It is important to note that with respect to efficiency, there exists still a difference between the State-run and market-participants-organized supervision in Estonia. The Estonian experience allows suggest that the supervisory structures organized by the market participants themselves are more efficient than state-run. For instance, the Tallinn Stock Exchange has proved that in response to misconduct by issuers of TSE listed/traded securities it can act operatively and impose also sanctions against violators of rules<sup>9</sup>.

Besides the efficiency issue mentioned above, the current supervisory structure evolved in Estonia deserves critics also with regard to its Government subordination and its separation from other financial sector's supervision. The independence (from Government, from political dependence) is important first of all from the point of view of confidence building with regard to objectivity of supervision. The integrity of securities markets supervision with the rest of financial sector supervision is mostly related to the efficiency issue. Given the close links between different sectors of the financial system (e.g. securities market, banking, insurance, etc.), it can be suggested that a supervisory body with a common responsibility for most sectors of the financial system may offer greater efficiency through synergy opportunities from closer co-operation and co-ordination. This, in turn, may facilitate a switch from post-factum measures to preventive measures, which should be one of the most important tasks of supervisory bodies. Evidence from several crises confirms that in Estonia significantly more attention needs to be paid to preventive measures. These may consist of:

- strengthening the monitoring capability and increasing of the regulator's interactive role;
- putting greater emphasis on the analysis of domestic (as well as foreign) economy, capital markets and institutions in order to predict trends which may affect the financial markets and institutions;

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<sup>9</sup> For instance, there are many cases where TSE has (temporarily) suspended the trading with securities of issuers. Mostly, in connection with issuers' misconduct with regard to disclosure requirements.

- the promotion of internal control (risk management) mechanisms among market participants;
- strengthening of sanctions against violations and ensuring their enforcement as well as applying personal liability.

While initially, the supervisory issues were not on the top of priority issues in the securities market, they gradually started to become into the fore during 1997. There are probably several reasons for this: 1) experience of several crises (e.g. the investment funds crisis in 1995, the stock market crisis in autumn 1997); 2) several cases of raised suspicions over practice contradicting the 'fair markets' principles (e.g. insider trading); 3) the increased competition within the securities market and financial market in general, which has encouraged mutual monitoring between market participants; 4) active engagement of commercial banks in the securities market (proprietary trading and repo deals), which has raised concerns of the excessive risk-taking by commercial banks; 5) the increased pricing efficiency (i.e. valuation of securities reached to the equilibrium level, where the prices became more sensitive towards information).

Given the need to accomplish better supervision over the securities market and financial sector in whole, the Bank of Estonia has already proposed to integrate the State's Banking, Insurance and Securities Inspections, which so far operate separately from each other. As the Estonian securities market and institutions have gradually become more integrated with Latvian and Lithuanian securities market and institutions, closer cooperation between the Baltic States securities market supervisory bodies has also been agreed in order to accomplish better monitoring of securities markets and institutions.

However, it should be clear enough that the supervision, in order to be efficient, requires aside above-discussed conditions also sufficient financial resources to be allocated for it. The question is who should cover these costs of supervision. While so far the supervision in Estonia is basically financed by the state, it is likely that in the future a great part of the costs of supervision will be shifted and imposed on market participants. If this occurs, it would evidently accompany with much higher demands for efficiency of supervision.

## **3.2. Infrastructure Institutions of Securities Markets**

### **3.2.1. Estonian Central Depository of Securities**

An important and in many respects the central role within the Estonian securities market infrastructure is played by the Estonian Central Depository of Securities (ECDS), which was established in spring 1994 as a non-profit joint-stock company by the Ministry of Finance, Bank of Estonia, Compensation Fund and seven commercial banks.

The ECDS acts as a keeper of the Estonian Central Register of Securities (ECRS) and provides securities markets and its participants with such functionally important services as:

- the registration and keeping of securities issued and/or existing in a dematerialized form in Estonia,

- the fixation of issuer and issuing conditions of securities,
- the fixation of the ownership rights for securities<sup>10</sup>,
- registration of investors (keeping of shareholder registers for issuers),
- registration and settlement of transactions with securities registered in the ECDS<sup>11</sup>.

In addition, the ECDS provides also services related to organizing public subscription of securities (incl. organizing the public offering of shares of SOEs), dividend payments, organizing of shareholders meetings, etc.

Within the dematerialized-type securities market approach adopted in Estonia all public issues in dematerialized form have to be registered and kept in the ECDS<sup>12</sup>. With this requirement it has been assured that both, the keeping of issuers' shareholder registers as well as the fixation of the ownership rights of investors, takes place in a centralized way, via ECDS. Besides providing better guarantees for ownership rights, such arrangement has also enabled shorter settlement terms, lowered transaction costs and thus promoted operational efficiency of securities markets.

The establishment of the ECDS has certainly been one of the highlights in the Estonian securities markets development. The start of ECDS activities was important from many aspects:

- it served as a cornerstone for the implementation of dematerialized securities market approach,
- it provided the securities market, in an organized and centralized way, with the functionally important securities-related services, such as registration, custody and settlement (whereas introducing delivery versus payment principle),
- it significantly reduced risks associated with securities ownership rights and securities transactions (e.g. the settlement risk), lowered transaction costs and improved the operational efficiency of securities markets,
- it also brought informational centralization as well as transparency into the securities market, which enabled better monitoring of the securities market.

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<sup>10</sup> The ownership rights of an investor are recorded on the securities account, an electronic entry in the investor database in the Registry. A securities account may be opened either to a physical person or to a legal person registered in Estonia or in any other country. A person may have more than one securities account in the Registry. In addition to ordinary securities accounts special purpose securities accounts (such as an investment management account, a pledge account, an establishment account, a temporary account and a clients account), can be opened.

<sup>11</sup> Investors' orders are submitted via banks-account operators. The ECDS account operators are required to be a shareholder of ECDS, have a license of a credit institution and a license of a securities intermediary. As at the end of May 1998 there were 11 account operators.

<sup>12</sup> Still, this requirement was introduced from summer 1996. Prior to summer 1996, issuers of public securities in dematerialized form had the option of keeping the share register by themselves, or to conclude a contract with ECDS.

**Table 1. Securities accounts registered at the Estonian Central Depository of Securities**

	10/11/95	01/01/96	01/08/96	01/01/97	01/08/97	31/12/97	31/05/98
Number of securities accounts registered in ECDS	53,465	54,534	62,677	70,324	82,212	92,306	96,108
Number of closed securities accounts in ECDS	7,404	27,452	29,755	29,051	30,202	30,843	32,387
Number of valid securities accounts in ECDS	46,061	27,082	32,922	41,273	52,010	61,463	63,721
Number of accounts with positive balance	n/a	n/a	24,989	n/a	37,062	43,481	43,874
Number of holders having Stock Exchange traded securities	n/a	n/a	11,074	n/a	29,574	35,026	34,653
Number of accounts with zero balance	n/a	n/a	7,933	n/a	14,948	17,982	19,847

*Source: Tallinn Stock Exchange, Estonian Central Depository of Securities*

### **3.2.2. Tallinn Stock Exchange**

The Tallinn Stock Exchange (TSE), which acts as a central organized market place for securities trading in Estonia, was established on April 19<sup>th</sup>, 1995. It is organized as a non-profit joint-stock-company established by 23 founders (10 commercial banks, 10 brokerage firms and fund management companies, the Compensation Fund, Bank of Estonia, Ministry of Finance).

Trading on the TSE started on June 3<sup>rd</sup>, 1996. TSE acts as an electronic securities market. The trading is open daily during weekdays from 10 a.m. to 2 p.m. The principal trading model chosen is that of dealer markets (see further chapter: secondary market microstructure). However, aside market maker based trading model, also the public order book method is applied. The settlement of Exchange transactions is effected on T+3 from the settlement date of transactions. All transactions, which are effected and reported to the TSE, are settled through the Estonian Central Depository for Securities.

Aside of the critical decision on principal trading model, one of the central issues to be solved by the TSE was the decision regarding the inclusion of securities for trading on the stock exchange (SE). In principle the TSE had to choose whether to trade with all publicly issued securities in Estonia or to limit the trade to those meeting particular requirements. The considerable trade-off inherent to this issue is evident:

- 1) the requirements for the acceptance of securities for trading on a SE may determine an image, reliability and recognition of the SE. In order to receive international recognition, the SE regulation as well as listing requirements should be comparable to those of internationally recognized, which hence means that there is little opportunity for compromises to the local conditions while designing the rules;
- 2) the listing requirements also determine the importance of the SE in the national economy as well as the cost-efficiency of the SE. The listing requirements may also largely determine the opportunity for the simultaneous existence of several organized markets. If a considerable number of shares are excluded from the trade on the SE, this is likely to inspire the emergence of other market structures (e.g. OTCs, unofficial

markets). Hence, there can be a strong pressure to include as many securities as possible in the SE list.

The Tallinn Stock Exchange has opted for limiting the inclusion of securities to its trading system. The system consisting of graduated series of markets, with progressively demanding requirements for firms seeking quotation, was designed (see table 2)<sup>13</sup>. Whereas, considering the prevailing characteristics of local businesses (e.g. small size) rather demanding requirements for issuers were applied (see table 2). It should be noted that the approach adopted by the TSE has proved to be successful. Evidence shows that the inclusion of all shares or lax listing requirements may bring only little actual effect for the stock exchange (in terms of turnover) and for the liquidity of securities<sup>14</sup>. At the same time the lax requirements can inevitably affect the image and recognition of the SE. Whereas the large number of listed/traded shares resulting from the lax requirements will make it also more difficult for the SE to exercise effective monitoring over the issuers.

**Table 2. Principal requirements for stocks to be listed/traded on the Tallinn Stock Exchange (as of 31/05/1998)\***

	<b>Market capitalization</b>	<b>Ownership dispersion</b>	<b>Performance</b>	<b>Profitability</b>
<b>Main List</b>	Min. 300 mill.EEK	Min. 25% of shares in public ownership; min. 300 investors each having min. 10,000 EEK worth of shares in market value or min.1000 investors	Min. 3 years active in the main field of activity	net profit, & operating profit at least 1 year prior to application for listing
<b>Secondary List</b>	Min. 10 mill.EEK	Min. 25% of shares in public ownership; min. 100 investors	Min. 2 years active in the main field of activity	-
<b>Free Market</b>	No min. cap. requirement	Min. 25% of shares in public Ownership; min. 100 investors	-	-

\* The Listing Committee of the Tallinn Stock Exchange has a right to make exclusions from above-listed general requirements. This occurs when it is assumed that the security will attract considerable interest by investors.

Even though only comparatively small number of publicly issued securities have been included into the trading system of the Tallinn Stock Exchange (see table 3 and 4), the TSE accounts as a major secondary market for securities in Estonia, leaving thus only comparatively little role for the OTC-market<sup>15</sup>. In terms of turnover the turnover at the TSE accounts roughly 81.3% from the total turnover of securities on the secondary market in

<sup>13</sup> In principle, this is important in order to provide an organized regulated market also for the shares of medium and small companies.

<sup>14</sup> One may find evidence of this from the Czech Republic in 1994. Although some 1,000 stocks were traded on the Prague Stock Exchange, only about 30 stocks appeared to be actively traded (see Crawford 1994). Less drastic in figures, but similar evidence can be found also in Lithuania, where a large number of shares included in the stock exchange trading system are not practically traded at all.

<sup>15</sup> However, the role of the OTC market should not be underestimated. OTC market has been a temporary stage for testing the investors' interest towards the security prior to including the security on the listing/trading at the Tallinn Stock Exchange.

Estonia (during June 1996 to May 1998). In case of equities only, the role of the TSE is even bigger, reaching 89.9% from the total equities turnover.

As at the end of May 1998 the market capitalization of equities traded on the Tallinn Stock Exchange was 10.76 billion EEK Total monthly turnover of equities (total) reaching 1.04 billion EEK a at the end of May 1998.

**Table 3. Number of listed/traded securities on the Tallinn Stock Exchange**

	3/6/96	1/10/96	1/1/97	1/4/97	1/7/97	1/10/97	1/1/98	31/5/98
Main List (shares)	5	5	6	6	9	12	12	10
Secondary List (shares)	0	0	2	2	4	8	10	14
Free Market (shares)	0	7	8	8	7	6	5	4
Investment Funds List	0	1	1	1	1	1	1	1
Bonds List	6	7	8	8	8	8	9	9
Total number of shares listed/traded	5	12	16	16	20	26	27	28
Total number of securities listed/traded	11	20	25	25	29	35	37	38

**Table 4. Listed/traded stocks on the Tallinn Stock Exchange by sector**

	3/6/96	1/10/96	1/1/97	1/4/97	1/7/97	1/10/97	1/1/98	31/5/98
<b>Main List (shares)</b>	5	5	6	6	9	12	12	10
1. Banks	5	5	5	5	5	5	5	5
2. Non-banking sector	0	0	1	1	4	7	7	5
2.1. Former SOEs privatized via public offering of shares	0	0	1	1	2	4	4	3
<b>Secondary List (shares)</b>	0	0	2	2	4	8	10	14
1. Banks	0	0	1	1	1	1	1	1
2. Non-banking sector	0	0	1	1	3	7	9	13
2.1. Former SOEs privatized via public offering of shares	0	0	0	0	1	1	2	5
<b>Free Market (shares)</b>	0	7	8	8	7	6	5	4
1. Banks	0	0	0	0	0	0	0	0
2. Non-banking sector	0	7	8	8	7	6	5	4
2.1. Former SOEs privatized via public offering of shares	0	7	7	7	7	5	4	3
<b>TOTAL (shares)</b>	5	12	16	16	20	26	27	28
1. Banks	5	5	6	6	6	6	6	6
2. Non-banking sector	0	7	10	10	14	20	21	22
2.1. Former SOEs privatized via public offering of shares	0	7	8	8	10	10	10	11

The opening of the TSE has certainly been one of the highlights within the Estonian securities market development. It meant the start of the centralized and organized securities market in Estonia. Significant improvements in the investor protection, co-ordination of supply and demand as well as transparency, accompanied. This has provided good ground for the activation of securities markets in Estonia and brought along increased liquidity (see

Chapter secondary market) and operational and informational efficiency of the securities markets.

### **3.3. Securities Firms**

The formation of securities firms (SFs) started in Estonia in 1993-94. However, initially the SFs had only a weak link with the domestic securities market, given the very limited availability of domestic public issues in that period. Instead of domestic securities, they rather specialized in intermediation of foreign securities, and/or in the privatisation securities (vouchers) (as a kind of quasi-securities) trade (see Kein, Tali 1994). The latter was induced by the huge mass of vouchers issued and backed by tradability of vouchers in 1994. The role of vouchers has been especially important for the development of SFs, as they have provided substantial turnover for the SFs, enabling to operate cost-efficiently.

The formal regulation of the SFs was brought about by the LSM (June 1993), which established that SFs and brokers (physical persons) (as well as the other professional participants of the securities market) in Estonia require a license to act. This requirement became effective from the beginning of 1994 after the "Rules on Issuing State Operating Licenses to Professional Participants of the Securities Market" (October 25, 1993), which specified requirements for SFs to obtain approval and the State Securities Board responsible for licensing of SFs, began its activities. The general requirements set for SFs are those of largely followed in international practice. These include: minimum capital requirements as well as qualification requirements for employees (e.g. employment of at least one qualified (licensed) securities specialist in the firm. Obtaining the title "qualified securities specialist" requires the passing of the special qualification exam arranged by the SSB).

The granting of qualifications for specialists and licenses for SFs started in Estonia from 1994. As of March 11, 1997, there were 39 licensed SFs (among them 14 commercial banks) in Estonia (Source: Estonian State Securities Board).

### **3.4. Investment Funds**

The first investment funds (IFs) emerged in Estonia in 1993. The evolution of investment funds in Estonia has been affected by several events:

1. The enactment of the Government decree on Investment Funds on August 12, 1994. This legalized IFs activities. Accordingly, 2 types of IFs were allowed in Estonia: open-end contractual funds, and closed-end corporate funds (among which a special type of closed-end IF - the privatization investment fund). The decree tried to adjust the existing IFs to internationally comparable standards, imposing several restrictions (e.g portfolio diversification) on the IFs. On the other hand, the decree provided a liberal and flexible framework for the activities of IFs, consistent with the domestic securities market development situation (limited availability of domestic securities).

2. The IFs crisis of March 1995, with the crash of the biggest IF and estimated losses of investors up to EEK 50 million. Rather than pointing to the individual IF problems, the crisis reflected the overall shortcomings of IFs: primarily the low liquidity of their portfolios, and the difficulties of functioning of open-end IFs in the conditions of illiquid securities markets.

The crisis of IFs was a double blow. Systematic failure to some extent meant it had a negative impact on the investor's trust of IFs and thus slowed down the so-far-rapid development of IFs industry (see Kein 1995). On the other hand, the crisis had induced:

- the IFs to concern themselves more with the liquidity of their portfolios and raised the general question whether the open-end IFs can operate at all in illiquid securities markets. While in spring of 1995, there were mainly open-end IFs active in Estonia (the choice being induced by the provision of liquidity for the shares of IFs, in order to attract investors' interest in an otherwise illiquid environment), then after the crisis the trend towards establishment of closed-end IFs occurred (see Kein 1995);
- the State Securities Board to strengthen the monitoring and supervisory systems and investor protection.

3. The start of the voucher privatisation at the end of 1994, which opened up new prospects for the development of IFs in Estonia, providing IFs an opportunity to participate in privatisation and collect vouchers<sup>16</sup>. However, unlike several other post-socialist countries, in Estonia, the IFs' role is rather limited in the overall process of privatisation: primarily due to the privatisation approach adopted - i.e. predominant core-investor-principle-based direct sales strategy with regard to the SOEs, and due to the lack a formal central role of IFs' within the Estonian privatisation scheme.

4. The enactment of the Law on Investment Funds (adopted on April 9, 1997) which tried to bring the investment funds regulation more into the line with the principles followed in the EU countries. As a result, tighter frames were established for investment fund's investment policies and higher demands for portfolio diversification, introduced.

As a results of above-mentioned events, there is rather well-developed IFs industry emerged in Estonia. The existence and development of IFs is essential for the securities market.

## **4. The Primary Market**

### **4.1. The Regulatory Framework of Primary Market**

Regulation of the primary market was introduced in Estonia in summer/autumn 1993 by the adoption of three regulative acts:

- Law on Securities Markets (LSM) (June 2<sup>nd</sup>, 1993);

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<sup>16</sup> Originally, the inclusion of IFs in the privatization process has been induced by the need to coordinate the core investor principle and dispersion of shares within the voucher privatization process (as the holding companies) as well as to provide diversification of risk for "ordinary investors" (as the financial intermediaries).

- Government decree on 'Procedures For the Public Issue of Securities' (October 29<sup>th</sup>, 1993);
- Government decree on 'Procedures for the Registration of a Public Issue of Securities' (October 29<sup>th</sup>, 1993).

These acts were aimed for establishing control over the public securities primary market, which had started to develop spontaneously since 1991. Thus, the licensing and registration of public issues was introduced and a set of requirements and procedures for public issue of securities, provided. Since the regulative steps of 1993 the regulation of primary market in Estonia has gone through only few changes, introduced by the Government decree on 'Registration and Announcement of Public Issue of Securities' (July 16<sup>th</sup>, 1996), which replaced the above-mentioned Government decrees from October 1993 and established higher demands for public issues.

According to the Estonian regulative framework, the issue of securities is considered 'public' if the issue exceeds 400,000 Estonian Kroons and there is no restrictions set either by the statute of the issuer or by the issue conditions for the trading of securities on secondary market. According to the LSM, the public issue of securities in Estonia requires formal registration and a license from the State Securities Inspection (SSI). Estonia follows a disclosure principle, which does not limit the circle of potential issuers, but obligates the issuer of public securities to provide the prospectus of emission containing adequate information about the issuer, for potential investors, prior to public issue. The prospectus of emission must include information about the economic and financial situation of the issuer (incl. the auditor's evaluation) and the general conditions of the issue (e.g. the aim; types of securities, the volume, rights connected with the securities, etc.). The disclosure principle presumes that investors have enough knowledge to make investment decision on the basis of information released, but of course, does not protect investor from making wrong decision. Given that the ability to evaluate risks associated with the investments differs largely between professional and 'ordinary investors', it may be recommendable to supplement the disclosure requirements with certain performance related requirements for issuers (e.g. the minimum time it has operated, the record of financial soundness, profitability) in order to protect 'ordinary investors' and avoid failures in the market, which could negatively affect the development of securities markets<sup>17</sup>.

The regulative framework of the securities market in Estonia enables both bearer and registered securities. Registered securities can exist either in the physical form or dematerialized form (as electronic securities accounts, i.e. in book-entry form). According to the Government Decree of July 16<sup>th</sup>, 1996 all public issues of dematerialized form should be registered and kept at the Estonian Central Depository of Securities<sup>18</sup>. Though the securities can exist in the physical form, the dematerialized form

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<sup>17</sup> The development literature suggests that the experience of failure (losses) by (vulnerable) investors could be even regarded as one of the major barriers for economic growth, as well, in many Third World countries (Gowland 1990).

<sup>18</sup> However, initially (up to July 1996) the depository contract with the ECDS was voluntary for issuers. Still, vast majority of issuers preferred the depository contract with ECDS as the benefits arising from it (e.g. the

has become entirely prevalent among public issues in Estonia. An essential precondition and motivation for this has been the establishment of the ECDS in autumn of 1994, which provided a set of functionally important services for the dematerialized-type securities market, and gave major advantages for the dematerialized approach (e.g. enhanced safety related to securities transactions and reduced transaction costs).

As far as the privatization of SOEs plays an important role in the supply of equities to the public securities market, the appropriate privatization regulation should be mentioned also within the regulatory framework for the primary market.

The public offering of shares was envisaged to be a method of privatization of SOEs already by the Law on Privatization in June 1993. However, the procedure of public offering of shares of SOEs was adopted just in August 1994. According to it, the public offering of shares of SOEs can take place either, as a:

- 1) fixed price offering, where after 30-90 days subscription period special adjustment schemes, usually favoring small investors in the case of over-subscription;
- 2) public competitive bidding - which allows to two types of bids, either with or without determining a bidding price.

Primarily, this method of privatization is part of the voucher privatization program, i.e. the public offering of the shares of SOEs will take place mainly for vouchers. Following the strategic 'core investor' principle, as a rule, the public offering is applied only for minority shares, usually only in case of viable enterprises and after the conclusion of the sales contract with the core investor.

## **4.2. Performance**

The first public issues of securities in Estonia took place in 1991 when several companies and commercial banks started to publicly offer their shares. During 1991-1993 there were about 20-25 public issues of securities (both equities and bonds) in Estonia (Kein 1995). This was despite of largely unfavorable external institutional conditions (e.g. the absence of a legal framework for securities markets, essential shortcomings in regulation of property rights, ineffective contract enforcement, the absence of secondary markets and securities market infrastructure, etc.) and often arguably rather high risks associated with issuers. Despite of rather high risks for investors, most of these public issues were still successful. The investors' interest at that time can probably be explained by two factors:

- the wide-spread application of guaranteed repurchase (buy-back) of securities by the issuers, which ensured the liquidity of securities;
- the existence of considerable savings by the public and lack of alternative investment (and reasonable consumption) opportunities under the high inflationary environment.

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enhanced liquidity of issuer's securities due to the increased safety for the investors) overweighted costs associated with it.

Since 1994, when the official registration of public issues at the State Securities Board (currently State Securities Inspection) started and the securities primary market became regulated, the number of public issues has grown rather significantly (see table 5). During 1994 – 1997 there were altogether 162 public issues of securities (mostly equities, but also bonds and investment funds shares) by 101 different issuers (according to different classes of securities issued) registered at the SSI (SSB) in Estonia (see table 5 and 6). Given the smallness of the Estonian economy and businesses as well as taking into account the just-recently-started-development of securities markets and institutions, this could be regarded as a high number. However, a look at the reasoning (background) of these public issues would suggest a more conservative evaluation with regard to the development of public primary market.

Several factors influence the supply of securities to the public market. In general, one can distinguish the economic (e.g. the need to finance growth), economic-political (e.g. privatization policies) as well as administrative factors (e.g. the enforcement of capital adequacy requirements for commercial banks) for public issues of securities. It is characteristic to Estonia (as well as to other Eastern-European countries) that a large proportion of corporate public issues are rather an outcome of the economic-political (i.e. privatization policies) or administrative decisions<sup>19</sup>. These public issues tend to be of great importance in the earlier stages of securities markets development, suggesting a critical role for Government policy at this stage. Thus, among 90 public issues during 1995 - 1996, there were 39 directly related to the Government privatization policies and, presumably, 11 induced by the administrative decisions, such as the minimum capital requirements established for commercial banks by the Bank of Estonia. In addition, also the significant increase in the issue of investment funds' shares/units, during this period, can be attributed to the launch and acceleration of the Government voucher based privatization program (see table 5). In case of equity issues (the most important segment of the securities market) the role of privatization policies and administrative decisions has been even more significant. During 1995 – 1996 the public issues of equities relied almost entirely on Government privatization policies and administrative decisions. During this period the privatization-related public issues of equities accounted for 68% of total equity issues and the issues of banks' shares (presumably induced by minimum capital requirements established) formed additional 23.4%. There appear to be only few voluntary public issues, purely on economic grounds, by corporate issuers, at this time, which also points to the insignificant role of public securities markets for corporate financing, at this time. The voluntary (self-determined) corporate issues, purely on economic grounds, remained depressed by demand and supply restraining factors, stemming both, from corporate characteristics as well as from the external environment. At the corporate level, factors such as size, growth opportunities, lack of tradition and knowledge about securities markets, or simply private owners' unwillingness to give up their ownership/controlling share have served as restrictions. The external factors were primarily related to the insufficient development of securities markets and its

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<sup>19</sup> Namely, it can be said that the public issues of shares of banks are mostly induced by the capital adequacy requirements established for banks. While, of course, the economic rationale can not be excluded.

infrastructure, which could affect the success of issues on the primary market. More specifically, one should mention the following:

- absence of the developed institutional infrastructure of the primary market – e.g. underwriters, investment banks, which could provide public issue related services, promote them and enhance their success;
- absence of sufficient base of institutional investors (e.g. pension funds, investment funds) which could enhance demand and liquidity for the primary issues;
- lack of well-developed and active secondary market (during 1991-1995) – raising liquidity concerns of securities offered in the primary market and making it more difficult to price the primary market issues.

Institutionally important breakthrough in the primary market occurred just in 1997, when the voluntary-decision-based-public-issues became dominant in the primary market. Essentially, it marked the increase of the role of the public securities market in corporate finance. Major foundations for this breakthrough were the advances in the securities market infrastructure as well as improving conditions in the market (i.e. increased demand for securities) rather favorable pricing opportunities of public issues for corporate issuers determined by the securities market boom in 1997.

The foundations for further expansion of the primary market lie, on the one hand, on the companies' business prospects and on the owners' willingness to obtain external finance (capital) from public markets. On the other hand, it is determined by the domestic demand. However, there are obvious limits to the further significant expansion of primary market. These obstacles exist both on the supply side and on the demand side. Going public evidently involves costs for issuers, whereas these costs can be relatively expensive for most companies Estonia. Given the smallness of companies in Estonia only comparatively few, those of larger companies may attract public interest<sup>20</sup>. At the same time there are also limits set by the domestic demand. Evidence from autumn 1997 confirmed that domestic demand remains insufficient in case of large public issues<sup>21</sup>.

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<sup>20</sup> The process of going public involves significant costs, which vary along with the particular securities, issue methods as well as the size of the issue. It is obvious that for smaller issuers, such as dominated in Estonia, the public issue can be relatively expensive.

<sup>21</sup> An example is the Estonian Savings Bank 690 million EEK public issue in October 1997, which was too large to digest by domestic public demand. However, its' success was finally saved by the bank's management, which bought significant part of the issue.

**Table 5. Public issues registered at the State Securities Inspection (State Securities Board)**

	1994	1995	1996	1997	TOTAL
<b>Total number of public issues</b>	<b>24</b>	<b>52</b>	<b>38</b>	<b>48</b>	<b>162</b>
<b>1. Equities</b>	<b>10</b>	<b>20</b>	<b>27</b>	<b>42</b>	<b>99</b>
1.1. of banks	5	4	7	5	21
1.2. of enterprises (non-banks)	5	16	20	37	78
1.2.1. under the privatization program	1	16	16	6	39
<b>2. Investment Funds' shares</b>	<b>4</b>	<b>15</b>	<b>7</b>	<b>4</b>	<b>30</b>
2.1 shares of closed-end investment funds	3	12	5	4	24
2.2. units of open-end investment funds	1	3	2	0	6
<b>3. Bonds</b>	<b>9</b>	<b>17</b>	<b>4</b>	<b>2</b>	<b>32</b>
3.1. Corporate bonds	6	8	1	0	15
3.2. Municipal bonds	2	5	0	0	7
3.3. Compensation Fund bonds	1	4	3	2	10
<b>4. Certificates of Deposit</b>	<b>1</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>1</b>

*Source: compiled on the basis of data from State Securities Inspection*

**Table 6. Number of different issuers of public securities registered at the State Securities Inspection (State Securities Board) (cumulative, by the end of year)**

	1994	1995	1996	1997
<b>1. Equities</b>	<b>8</b>	<b>28</b>	<b>48</b>	<b>69</b>
1.1. of banks	4	8	10	10
1.2. of enterprises (non-banks)	4	20	38	59
1.2.1. under the privatization program	1	17	33	36
<b>2. Investment Funds' shares</b>	<b>4</b>	<b>13</b>	<b>15</b>	<b>15</b>
2.1 shares of closed-end investment funds	3	9	9	9
2.2. units of open-end investment funds	1	4	6	6
<b>3. Bonds</b>	<b>9</b>	<b>16</b>	<b>16</b>	<b>16</b>
3.1. Corporate bonds	6	10	10	10
3.2. Municipal bonds	2	5	5	5
3.3. Compensation Fund bonds	1	1	1	1
<b>4. Certificates of Deposit</b>	<b>1</b>	<b>1</b>	<b>1</b>	<b>1</b>

*Source: compiled on the basis of data from State Securities Inspection*

## **5. Secondary Market**

### **5.1. Regulatory Framework of Secondary Market**

Estonia has followed the approach where the regulation of the secondary market is primarily provided by professional private institutions – the Tallinn Stock Exchange (TSE) and the Estonian Central Depository of Securities (ECDS)<sup>22</sup>. The State's role in regulating the securities secondary market has remained very limited consisting only in providing very general guidelines for the securities trading on the secondary markets. This general framework was established by the Law on Securities Market (from June 2<sup>nd</sup>, 1993), which treats such issues as the licensing of professional participants of securities market, investor protection, insider trading, disclosure, transparency of the markets, etc. More detailed regulation of secondary market and the above-mentioned issues is provided by professional private institutions: primarily by the Rules and Regulations of Tallinn Stock Exchange as well as by the Rules of the Estonian Central Depository of Securities (ECDS).

Several arguments can be found in favor of such division of competence and reliance on self-regulation in the secondary market. Self-regulation provided by professional private institutions (e.g. the stock exchange) relies heavily upon the expertise and experience of market practitioners who can formulate rules and regulations that are acceptable to both players and regulators. The self-regulation is also flexible and speedily amendable compared with the rigidity of the law (Thomas 1986). This is an important factor, especially in the stages where the development processes in the market are fast (e.g. emerging securities markets). However, self-regulation has also several disadvantages. For instance, the enforcement of rules may be difficult, there is also a danger that self-interest will overshadow public interest and so sap the confidence of investors (Thomas 1986).

### **5.2. Secondary market microstructure**

#### **5.2.1. Trading model**

Among two principal trading models - dealer markets and auction markets the dealer market model has been chosen as a principal trading model by the Tallinn Stock Exchange. However, given the need to provide centralized-organized market also for smaller and less frequently traded stocks, also the public order book method has been applied.

In case of the dealer market method the securities trading is based on the market-making activities of recognized dealers (market makers) who provide continuous two-way pricing for securities for which they are registered as market makers. Security, in order to be traded on the TSE dealer market, requires at least two Recognised Dealers (market makers), which have assumed an obligation to provide continuous bid and ask quotations for the security. If the security has less than two Recognised Dealers, the public order book trading model is applied, in which case all member firms are allowed to enter limit orders (either their own or their customers) into the trading system. The principal difference

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<sup>22</sup> Still, State institutions are shareholders in both, ECDS and TSE.

between these methods is the existence availability of continuous price. While the market-makers based trading system provides continuous pricing and ability to transact, then in case of public order book the trading (and price) is subject to availability of particular orders. As a rule the dealer market model is mostly applied with regard to more liquid securities (usually those of larger issuers and with larger freefloat). The public order book trading model is used for less liquid securities (usually those of smaller issuers and with smaller free float).

It is generally accepted that dealer markets seek to enhance liquidity, while auction markets emphasize an efficient price discovery. It is difficult to argue about the pricing efficiency. However, the liquidity effect from the application of the dealer-market model is well apparent while comparing Estonian dealer-market based model with the (formerly) auction-based markets in other Baltic States. The turnover on the Tallinn Stock Exchange exceeds many times that of the turnover on the other Baltic States stock exchanges<sup>23</sup>.

### **5.2.2. Settlement**

The settlement procedures are determined by the type of securities transaction made. For stock-exchange deals the settlement date T+3 and delivery versus payment principle applies. Off-exchange deals can be settled as T+1, or later due to the date provided by counterparties. Off-exchange deals can be settled either as delivery versus payment or simple securities transfer (without payment against securities) where the settlement risk associated with counterparty has to be born by counterparties themselves. Evidence shows that the settlement dates can be of primary consideration of traders, while choosing the transaction type, even overweighing the settlement risks associated (see Kein 1995).

## **5.3. Secondary market performance**

### **5.3.1. Formation of the secondary markets**

Despite that there had been already a number of public issues of securities during 1991-1994 (see table 5 and 6), the secondary market for securities in Estonia remained extremely thin, fragmented and practically unimportant until the beginning of 1995. There were obvious obstacles for the secondary market development, at that time:

- absence of securities market infrastructure with its services and co-ordinative role for demand and supply;
- limited number of publicly tradable securities, and lack (or very small number) of issues of considerable size and of large-scale and quality issuers, required for stimulation of public interest;
- very limited information about the securities, issuers and securities market; absence of transparency;

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<sup>23</sup> For instance, in 1997, the turnover of the Tallinn Stock Exchange was roughly 1.56 billion USD, while the turnover on the Vilnius Stock Exchange roughly 0.418 billion USD, on the Riga Stock Exchange 0.07 billion USD

- absence of well-organized (and reliable) shareholder registers and settlement and clearing systems, which could minimize settlement risk and simplify the securities transactions procedures;
- rather wide-spread application of guaranteed repurchase (buy-back) of securities by the issuers, which in principle eliminated the need (and rationale) for the existence of secondary markets.

In general terms, the securities secondary market development at that time was depressed by high risks associated (in terms of liquidity, credibility, and proper pricing due to limited information) as well as by high transaction costs for investors.

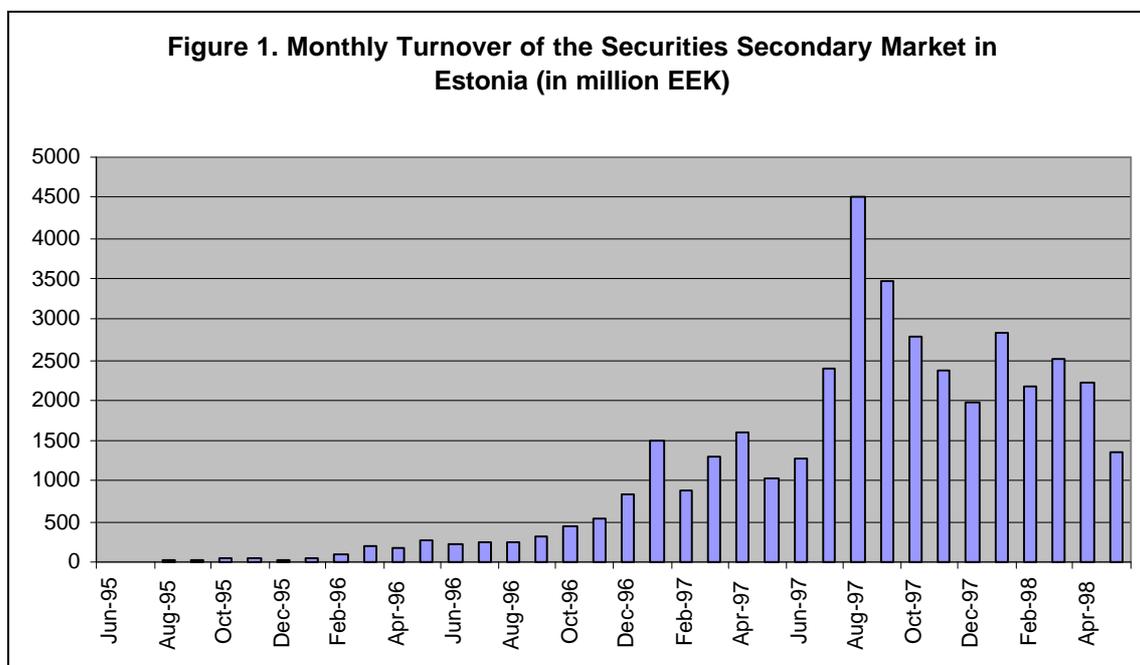
Essentially, the secondary market for securities started to function in Estonia in 1995. Its emergence was primarily facilitated by the:

- establishment of Estonian Central Depository of Securities, which provided reliable registration for securities (ownership) and safe settlement functions for the market participants; it also enhanced information availability and brought transparency to the market, as the first time the trading statistics was centralized and made publicly available through publication in newspapers;
- launch of voucher-based public offerings of shares of (large-scale) state-owned enterprises under the Government privatization program, which brought issues of considerable size and of rather attractive issuers to the public securities market. Given that at that time the private sector was just emerging and still small in size, the importance of this privatization program to the acceleration of secondary market formation should be especially emphasized;
- emergence of investment funds and securities firms, which enhanced the demand for securities and provided market making activities.

Still, until 1996, the trading activities in the secondary market remained rather modest, reaching only 213.3 million EEK in 1995. Major improvements in the market can be observed just from the beginning of 1996 when steep changeover occurred (see figure 1). During the first quarter of 1996 the turnover of secondary market increased by 3.5 times compared to the fourth quarter of 1995. At the same time, in terms of number of transactions, the activation of markets was even more significant - number of transactions increased by more than 6 times. In many respects the activation of secondary market can be largely attributed to the commercial banks active entrance into the securities business witnessed during this period. Besides the effect from proprietary trading, the brokerage services provided by banks brought essentially better co-ordination of securities demand and supply to the market and enhanced the information availability, which provided ground for activation of markets. Another important driving factor behind the activation of secondary market at the beginning of 1996 may be the development of investment funds industry. In 1995 15 new investment funds entered into the market, which inevitably boosted the demand for securities (see table 5 and 6).

Major boost for the secondary market development in Estonia was given by the start of the Tallinn Stock Exchange activities in June 1996. A launch of the centralized-organized securities market and introduction of market-makers based trading together with increased

information flows and transparency brought along substantial improvements in the securities secondary market: trading activities and liquidity increased substantially (see figure 1, and table 7 and 8), bid-ask spreads decreased and pricing became more efficient. In essence, a rather well-functioning securities secondary market emerged.



### 5.3.2. Characteristics of the Securities Secondary Market

There can be pointed out several characteristics of the securities secondary market in Estonia:

1. **Structure of securities traded at the secondary market:** The securities secondary market in Estonia is predominantly equities-centric. During July 1995 – May 1998, equities accounted for 90.1% of the total turnover of the Estonian securities secondary market (see table 7). The role of bonds and shares of investment funds is rather small in the secondary markets. During the period mentioned the bonds accounted only for 7% and shares of investment funds only for 2.9% of the total turnover (see table 7). Whereas among bonds only the Compensation Fund bonds are traded on the secondary market and can be considered as publicly traded<sup>24</sup>. The corporate and municipal bonds are traded in non-public market, and usually between banks or proper investment funds, as a

<sup>24</sup> Differently from other bonds, which have high nominal values and are sold through private placements (usually to very limited number of institutional clients), the Compensation Fund bonds have small nominal value (100 EEK) and have been sold through public offerings to rather wide range of small investors, which enables the development of (public) secondary market for them.

**Table 7. Monthly turnover of publicly traded securities by classes of securities (TSE & OTC)**

	Stocks		Bonds		Investment Funds		Total	
	mill EEK	%	mill EEK	%	mill EEK	%	mill EEK	%
May-98	1,040.6	77.5%	265.7	19.8%	37.2	2.8%	1,343.5	100.0%
Apr-98	1,815.7	82.1%	372.4	16.8%	22.4	1.0%	2,210.5	100.0%
Mar-98	2,082.8	82.9%	394.7	15.7%	35.1	1.4%	2,512.6	100.0%
Feb-98	1,773.0	81.6%	374.3	17.2%	24.2	1.1%	2,171.5	100.0%
Jan-98	2,482.9	87.5%	331.2	11.7%	22.6	0.8%	2,836.7	100.0%
Dec-97	1,710.4	86.9%	220.2	11.2%	37.3	1.9%	1,967.9	100.0%
Nov-97	2,028.5	86.1%	219.5	9.3%	108.6	4.6%	2,356.6	100.0%
Oct-97	2,426.6	86.9%	219.8	7.9%	146.2	5.2%	2,792.6	100.0%
Sep-97	3,228.0	93.2%	179.9	5.2%	56.6	1.6%	3,464.4	100.0%
Aug-97	4,175.9	92.6%	60.7	1.3%	274.8	6.1%	4,511.5	100.0%
Jul-97	2,249.2	94.3%	60.0	2.5%	76.7	3.2%	2,385.9	100.0%
Jun-97	1,251.2	96.8%	1.1	0.1%	40.3	3.1%	1,292.6	100.0%
May-97	981.3	95.4%	0.9	0.1%	46.8	4.6%	1,029.0	100.0%
Apr-97	1,551.8	97.2%	5.4	0.3%	39.7	2.5%	1,596.8	100.0%
Mar-97	1,292.4	99.2%	0.5	0.0%	9.3	0.7%	1,302.2	100.0%
Feb-97	883.0	98.9%	0.6	0.1%	9.1	1.0%	892.6	100.0%
Jan-97	1,480.1	98.8%	2.6	0.2%	14.7	1.0%	1,497.4	100.0%
Dec-96	828.9	98.2%	5.6	0.7%	9.4	1.1%	844.0	100.0%
Nov-96	530.4	97.8%	1.0	0.2%	11.0	2.0%	542.4	100.0%
Oct-96	400.1	92.0%	5.3	1.2%	29.6	6.8%	435.0	100.0%
Sep-96	311.9	96.4%	1.0	0.3%	10.7	3.3%	323.6	100.0%
Aug-96	225.6	93.6%	4.4	1.8%	11.0	4.5%	241.0	100.0%
Jul-96	247.3	96.6%	0.6	0.2%	8.2	3.2%	256.1	100.0%
Jun-96	175.2	83.1%	4.4	2.1%	31.2	14.8%	210.8	100.0%
May-96	249.5	89.1%	8.7	3.1%	21.8	7.8%	280.1	100.0%
Apr-96	156.5	92.0%	5.6	3.3%	7.9	4.7%	170.1	100.0%
Mar-96	195.1	94.1%	11.1	5.4%	1.2	0.6%	207.4	100.0%
Feb-96	95.0	90.9%	9.4	9.0%	0.1	0.1%	104.5	100.0%
Jan-96	35.4	79.7%	8.6	19.4%	0.4	0.9%	44.4	100.0%
Dec-95	17.6	84.8%	3.0	14.4%	0.2	0.7%	20.8	100.0%
Nov-95	31.0	77.4%	8.5	21.2%	0.6	1.4%	40.0	100.0%
Oct-95	34.5	82.6%	7.2	17.2%	0.1	0.1%	41.8	100.0%
Sep-95	25.6	82.4%	5.2	16.8%	0.3	0.8%	31.1	100.0%
Aug-95	13.0	95.3%	0.6	4.7%	0.0	0.0%	13.7	100.0%
Jul-95	3.5	58.1%	2.3	38.6%	0.2	3.2%	6.0	100.0%

Note 1: Rights excluded from the table

Note 2: Money market and predominantly Eastern European and Russian oriented funds excluded from investment funds data

Source: Compiled on the basis of data from Estonian Central Depository for Securities

**Table 8. Monthly number of transactions of publicly traded securities by classes of securities**

	Stocks		Bonds		Investment Funds		Total	
	<i>nr. of trades</i>	%						
May-98	10,118	95.5%	164	1.5%	312	2.9%	10,594	100.0%
Apr-98	10,482	96.0%	157	1.4%	281	2.6%	10,920	100.0%
Mar-98	12,704	96.8%	165	1.3%	249	1.9%	13,118	100.0%
Feb-98	9,192	96.3%	137	1.4%	219	2.3%	9,548	100.0%
Jan-98	16,173	97.1%	167	1.0%	314	1.9%	16,654	100.0%
Dec-97	13,929	96.9%	96	0.7%	351	2.4%	14,376	100.0%
Nov-97	19,179	96.5%	103	0.5%	601	3.0%	19,883	100.0%
Oct-97	15,343	93.9%	143	0.9%	859	5.3%	16,345	100.0%
Sep-97	17,628	95.2%	136	0.7%	759	4.1%	18,523	100.0%
Aug-97	18,491	96.1%	135	0.7%	615	3.2%	19,241	100.0%
Jul-97	11,218	93.3%	131	1.1%	678	5.6%	12,027	100.0%
Jun-97	6,911	92.9%	140	1.9%	392	5.3%	7,443	100.0%
May-97	6,934	91.1%	161	2.1%	513	6.7%	7,608	100.0%
Apr-97	11,600	92.4%	163	1.3%	792	6.3%	12,555	100.0%
Mar-97	9,105	92.2%	134	1.4%	640	6.5%	9,879	100.0%
Feb-97	6,715	92.4%	132	1.8%	424	5.8%	7,271	100.0%
Jan-97	11,499	93.4%	167	1.4%	647	5.3%	12,313	100.0%
Dec-96	6,847	93.5%	130	1.8%	348	4.8%	7,325	100.0%
Nov-96	5,380	94.6%	101	1.8%	205	3.6%	5,686	100.0%
Oct-96	4,911	94.0%	119	2.3%	195	3.7%	5,225	100.0%
Sep-96	3,167	91.9%	111	3.2%	169	4.9%	3,447	100.0%
Aug-96	2,301	91.4%	89	3.5%	128	5.1%	2,518	100.0%
Jul-96	2,305	89.9%	98	3.8%	160	6.2%	2,563	100.0%
Jun-96	2,227	87.4%	116	4.6%	205	8.0%	2,548	100.0%
May-96	3,860	90.5%	114	2.7%	290	6.8%	4,264	100.0%
Apr-96	2,036	89.1%	129	5.6%	120	5.3%	2,285	100.0%
Mar-96	2,412	86.6%	160	5.7%	213	7.6%	2,785	100.0%
Feb-96	1,201	83.8%	102	7.1%	130	9.1%	1,433	100.0%
Jan-96	506	77.4%	75	11.5%	73	11.2%	654	100.0%
Dec-95	259	85.2%	37	12.2%	8	2.6%	304	100.0%
Nov-95	289	85.3%	38	11.2%	12	3.5%	339	100.0%
Oct-95	158	76.3%	43	20.8%	6	2.9%	207	100.0%
Sep-95	162	79.0%	35	17.1%	8	3.9%	205	100.0%
Aug-95	122	78.7%	32	20.6%	1	0.6%	155	100.0%
Jul-95	114	74.0%	38	24.7%	2	1.3%	154	100.0%

Note 1: Rights excluded from the table

Note 2: Money market and predominantly Eastern European and Russian oriented funds excluded from investment funds data

Source: Compiled on the basis of data from Estonian Central Depository for Securities

general case. However, it is important to note the activation of the bonds market from September 1997, which is reflected in the remarkable increase, in absolute as well as in proportional terms. The change can be attributed to the widened gap between the bond yields and sharply declined interest rates.

2. **Secondary market segments:** The securities secondary market in Estonia is predominantly concentrated to the Tallinn Stock Exchange. In terms of turnover the turnover at the TSE accounts roughly 81.3% from the total turnover of securities at the secondary market in Estonia. In terms of transactions, the TSE accounts roughly 86% from total transactions at the secondary market in Estonia (see table 9 and 10). Even though the role of the OTC market is small at the securities secondary market in Estonia, its importance should still be acknowledged. OTC market has been a temporary stage for testing the investors' interest towards the security prior to including the security on the listing/trading at the Tallinn Stock Exchange.
3. **Liquidity:** Among publicly tradable (issued) securities only few are traded rather actively on the secondary market and could be considered as (comparatively) liquid (in terms of turnover, number of transactions and traded volumes in relation to total volume). Those of more liquid generally share certain characteristics. They are usually: 1) the securities listed/traded at the TSE; 2) the stocks of larger firms; 3) the stocks of issuers with larger number of shareholders. Among the publicly tradable non-TSE-securities (registered at the ECDS), the secondary market exists only for very small number of securities (ca 10 issues, as of the end of May 1998). In case of 73% of publicly tradable non-TSE-securities registered at the ECDS, there has been on average less than 10 transactions per month, whereas in case of 35% even less than 1 trade per month. Only less than 10% of publicly tradable non-TSE-securities are traded on the average more than 30 transactions per month (Source: compiled on the basis of ECDS statistics).

**Table 9. Distribution of turnover of publicly traded securities between stock-exchange and OTC market**

	Stocks				Bonds				Investment Fund shares			
	TSE		OTC		TSE		OTC		TSE		OTC	
	mill EEK	%	mill EEK	%	mill EEK	%	mill EEK	%	mill EEK	%	mill EEK	
<b>Apr-May 98</b>	2,588.8	90.6%	267.5	9.4%	2.4	0.4%	635.8	99.6%	11.6	19.5%	48.0	
<b>Q1 / 98</b>	5,792.8	91.4%	546.0	8.6%	1.6	0.1%	1,098.5	99.9%	8.3	10.1%	73.7	
<b>Q4 / 97</b>	5,805.4	94.2%	360.1	5.8%	1.8	0.3%	657.8	99.7%	4.9	1.7%	287.1	
<b>Q3 / 97</b>	8,592.2	89.0%	1,060.9	11.0%	1.4	0.5%	299.3	99.5%	9.7	2.4%	398.4	
<b>Q2 / 97</b>	3,422.7	90.4%	361.6	9.6%	7.3	99.8%	0.0	0.2%	8.7	6.9%	118.1	
<b>Q1 / 97</b>	3,505.7	95.9%	149.8	4.1%	3.2	89.1%	0.4	10.9%	10.2	30.8%	22.9	
<b>Q4 / 96</b>	1,677.0	95.3%	82.4	4.7%	4.9	41.3%	7.0	58.7%	12.1	24.2%	38.0	
<b>Q3 / 96</b>	505.5	64.4%	279.3	35.6%	5.0	82.4%	1.1	17.6%	0.6	2.0%	29.3	
<b>Q2 / 96</b>	85.3	14.7%	495.9	85.3%	4.0	21.2%	14.8	78.8%	-	0.0%	61.0	
<b>Q1 / 96</b>	-	0.0%	325.5	100.0%	-	0.0%	29.2	100.0%	-	0.0%	1.6	
<b>Q4 / 95</b>	-	0.0%	83.1	100.0%	-	0.0%	18.7	100.0%	-	0.0%	0.8	
<b>Q3 / 95</b>	-	0.0%	42.1	100.0%	-	0.0%	8.2	100.0%	-	0.0%	0.4	

Note 1: Rights excluded from the table

Note 2: Money market and predominantly Eastern European and Russian oriented investment funds excluded from investment funds data

Source: Compiled on the basis of data from Estonian Central Depository for Securities

**Table 10. Distribution of trades with publicly traded securities between stock-exchange and OTC market**

	Stocks				Bonds				Investment Fund shares		
	TSE		OTC		TSE		OTC		TSE		OTC
	nr.of trades	%	nr.of trades	%	nr.of trades	%	nr.of trades	%	nr.of trades	%	nr.of
<b>Apr-May 98</b>	16,861	95.6%	774	4.4%	189	76.8%	57	23.2%	119	20.1%	
<b>Q1 / 98</b>	32,163	95.7%	1,457	4.3%	271	73.8%	96	26.2%	99	12.7%	
<b>Q4 / 97</b>	40,776	95.1%	2,110	4.9%	213	74.5%	73	25.5%	156	8.6%	
<b>Q3 / 97</b>	37,680	92.2%	3,205	7.8%	269	89.7%	31	10.3%	214	10.4%	
<b>Q2 / 97</b>	20,357	93.0%	1,540	7.0%	409	99.0%	4	1.0%	244	14.4%	
<b>Q1 / 97</b>	22,141	95.2%	1,121	4.8%	350	97.8%	8	2.2%	230	13.4%	
<b>Q4 / 96</b>	13,437	96.0%	558	4.0%	271	95.8%	12	4.2%	174	23.3%	
<b>Q3 / 96</b>	4,546	72.5%	1,727	27.5%	200	79.7%	51	20.3%	27	5.9%	
<b>Q2 / 96</b>	1,131	19.7%	4,609	80.3%	79	32.0%	168	68.0%	-	0.0%	
<b>Q1 / 96</b>	-	0.0%	2487	100.0%	-	0.0%	196	100.0%	-	0.0%	
<b>Q4 / 95</b>	-	0.0%	706	100.0%	-	0.0%	118	100.0%	-	0.0%	
<b>Q3 / 95</b>	-	0.0%	398	100.0%	-	0.0%	105	100.0%	-	0.0%	

Note 1: Rights excluded from the table

Note 2: Money market and predominantly Eastern European and Russian oriented investment funds excluded from investment funds data

Source: Compiled on the basis of data from Estonian Central Depository for Securities

4. **Price Developments:** Despite of its short history the Estonian securities market has already undergone rather dramatic changes in terms of price movements and has tackled with both, speculation as well as crash (see figure 1, 2, 3 and 4). The first sharp upward correction can be observed in the Estonian securities market during March - May 1996, when the stock prices, in anticipation of the opening of the Tallinn Stock Exchange surged almost 80% (expressed in ECDS Index). The real speculative stage of the securities markets can be observed from the end of November 1996 till September 1997. During this period the prices on the Tallinn Stock Exchange climbed in average roughly 4.5 times (expressed in TALSE index terms) (see figure 1 and 2)<sup>25</sup>. Within this speculative stage two major price rallies can be distinguished: 1) From the end of November 1996 to middle of January 1997 (21/11/1996 – 13/01/1997), when during 35 consecutive trading days the stock prices on the TSE gained about 78% (expressed in TALSE Index change). This rally was largely driven by the optimistic 1997 profit forecasts announced by the issuers at that time (the end of 1996, the beginning of 1997). 2) The real boom and price rally in the Estonian stock market occurred during July-August 1997 when the stock prices on the Tallinn Stock Exchange almost doubled (expressed in the change of TALSE index) within two months only (see figure 1 and 2). It probably can be agreed that in many respects the prices increased beyond their fundamental levels. The price rise was largely pushed by the speculative short-term money, based on the margin loans. Several developments pointing to the boom-stage could be observed in the securities markets during this period: the number of securities accounts opened increased significantly, turnover on the TSE reached record highs, number of transactions increased, and shareholder basis widened, issues in the primary market were oversubscribed. The prices followed the upward trend until autumn 1997, showing accelerated growth during the end of 1996 and during the summer months of 1997. At its highest point (so far) on 29/08/1997, TALSE index reached to the level 492.97. The securities market crash occurred at the end of October and beginning of November (23/10/1996 – 11/11/1996) when within 13 consecutive trading days the TALSE index dropped almost 46%, whereas over 10% daily price drop could be seen in four days. With the previous price rise occurred, which lacked any fundamental justification and based on short-term loan resources (leverage), this crash was naturally inevitable. Despite several negative consequences, it has had also positive impact and turned market participants (foremost banks) to pay more attention on risks associated with securities markets, and promoted the implementation of better risk management.

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<sup>25</sup> TALSE index is calculated from June 3<sup>rd</sup> 1996 (TALSE = 100) on the basis of daily changes in prices of securities listed on the main list and secondary list of the Tallinn Stock Exchange. The market weights of securities. Initially TALSE index was calculated on the basis of weighted average prices. From February 17<sup>th</sup>, 1997 TALSE index is calculated on the basis of closing prices.



## 6. General Issues in the Securities Market Development

### 6.1. Securities Market and the Privatization Process

It is characteristic of most of the Eastern and Central European post-socialist countries that the formation of securities markets and its institutions in these countries has been largely, or even mostly encouraged/accelerated by the privatization process. However, the extent of the impact of privatization policies on the formation of securities markets and its institutions still varies being dependent on concrete privatization schemes applied. Evidence suggests that among different privatization methods, the voucher-based mass privatization approach has had the most significant contribution to the formation of securities markets and institutions.

Estonia has basically avoided the mass privatization scheme in case of the state-owned enterprises (SOEs) and opted for the direct sales privatization strategy that has been aimed to find a core/strategic-investor for the enterprises. Aside from this, there still exists in Estonia also a modest voucher-based privatization scheme for SOEs: namely the public offering of shares of SOEs. However, according to the privatization concept, only minority shares in selected SOEs (usually larger and profitable SOEs) are sold through public offering of shares. As a rule, this occurs after there has been a sales contract with the core investor purchasing the majority of shares (more than 50%). The reservation of minority shares for public offering started in May 1994. The first public offering (49% of the shares of the Tallinn Department Store) was announced in the beginning of November 1994. As the end of 1997 (the completion of the large-scale privatization program) the public offering had been applied with regard to state-owned shares in 37 companies (*Source: Ministry of Finance*). Even though the Government Privatization Program for 1998 envisages the start of privatization (of state-owned shares) of infrastructure enterprises (Estonian Oil Shale, Estonian Railways, Estonian Energy and Estonian Telecom), there is little to expect that the public offering will be applied<sup>26</sup>.

Although the mass privatization program has played only comparatively modest role in the Estonian privatization policies, and the economic benefits (from the point of view of post-privatization restructuring) of voucher-based mass-privatization schemes are debatable, its importance for the development of securities markets and its institutions is rather significant. In evaluating such a system the following must be considered:

- this approach has largely overcome the primary market and secondary market dilemma - contributing quickly to the critical mass of securities of sizable issues and issuers to the market<sup>27</sup>,
- it has enabled and promoted the emergence of a large number of shareholders and widely disseminated knowledge and interest in the securities among the general public,

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<sup>26</sup> According to preliminary plans, the privatization of infrastructure enterprises will take place in the form of extension of the share capital (to private strategic investor). The only exception is probably the privatization of the 49% of the shares of the Estonian Telecom, which are currently owned by the State, is planned to take place in the form of public offering of GDRs by the end of 1998. According to preliminary estimates, 10% of the 49%- holding will be listed in Tallinn and at least in one international stock exchange.

<sup>27</sup> Primary significance of privatization policies consists in the fact that they have enabled to overcome the supply constraints faced by the post-socialist countries, where the private sector is just emerging.

- the voucher based system has also accelerated the formation of securities market infrastructure (e.g. ECDS, TSE, investment funds, securities brokerage firms). Primarily, by supplying the mass of securities to the market, needed for securities markets infrastructure to achieve operational cost-efficiency.

## 6.2. Securities market and foreign investors

The fact that foreign capital can play an important role in boosting the economic growth of the developing countries (countries in transition) is well recognized. However, there are also several benefits from foreign investors for the development of securities markets, as well. Primarily, their participation can contribute to the size and liquidity of the markets facing the shortage of domestic capital<sup>28</sup>. In addition, their actions in the emerging market can raise the markets (informational) efficiency, as well, provided their actions are driven by fundamentals and knowledge-experience gained in other markets.

Benefits from foreign investors for the economy were recognized in Estonia already in the early stages of transition. The Law on Foreign Investments providing the rights and guarantees (e.g. guarantees for ownership rights, expatriation of profits, etc.) for foreign investors in Estonia was adopted already by September 1991. Since the very beginning of the Estonian securities market development, foreign investors have enjoyed unrestricted access to the Estonian securities markets. Unlike in several emerging markets, no differentiation of rights has been applied between domestic and foreign investors.

Such liberal policy has enabled foreign investors to become important players in the Estonian securities market. Their share has accounted roughly between 35-47 per cent of the market capitalization of securities listed/traded on the Tallinn Stock Exchange (see table 11).

**Table 11. Distribution of investments into the securities traded on the Tallinn Stock Exchange by countries**

Country	31/05/98	31/03/98	31/12/97	30/09/97	30/06/97	13/03/97	24/12/96
Estonia	54.92%	52.61%	54.93%	64.56%	61.32%	59.61%	60.28%
Foreign	45.08%	47.39%	45.07%	35.44%	38.68%	40.39%	39.72%
of which							
1) Finland	13.43%	13.55%	12.37%	8.88%	10.28%	10.48%	11.92%
2) United Kingdom	6.80%	8.92%	7.99%	5.60%	8.14%	8.19%	3.87%
3) Sweden	7.74%	8.82%	8.52%	7.29%	6.21%	8.08%	7.23%
4) United States	6.69%	2.57%	2.96%	3.15%	2.98%	2.44%	3.11%
- Latvia	1.64%	1.84%	0.72%	0.28%	0.20%	0.06%	0.00%
- Lithuania	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
- Russian Federation	0.11%	0.12%	0.13%	0.10%	0.10%	0.07%	0.00%

<sup>28</sup> In addition to direct purchases by foreign investors, their presence may also stimulate domestic investors' interest and demand for securities (see Bascom 1994).

*Source: Tallinn Stock Exchange*

There exists a set of factors, which can be regarded to have motivated this interest. At least the following should be mentioned:

- proper monetary policies – i.e. Estonia has very liberal foreign exchange rules and the monetary system is based on Currency Board principle (since June 1992), Estonian kroon is internally fully convertible and the exchange rate of the Estonian kroon is fixed with regard to DM (DM 1 = 8 Estonian Kroons), which considerably lowers the exchange rate risk, a critical consideration for international investors,
- advances in general economic and institutional reforms (e.g. privatization of SOEs), strong GDP growth prospects and rather stable economic policy and political line. Besides introducing proper economic-legal-institutional framework, these advances have brought also international publicity for Estonia and facilitated the foreign investors awareness of cross-border investment opportunities in Estonia,
- advances in securities market infrastructure development (e.g. establishment of the Central Depository for Securities, Tallinn Stock Exchange and development of securities markets professional participants), which have led to increased information flows (about the securities markets and issuers) and lowered the transaction costs related to securities trade, for investors,
- return prospects arising from the (comparative) undervaluation of markets (issuers).

However, it should be also acknowledged that besides the country-specific factors listed, there were also favorable external conditions existing for the attraction of foreign capital, as far as during 1995 – 1997 there was a general interest increasing towards emerging markets.

The decreasing investors' confidence and increasing cautiousness with regard to emerging markets witnessed since autumn 1997 have evidently made it more difficult to attract foreign capital. The attraction of foreign capital has become more complicated also due to the worsened macroeconomic situation of Estonia. The increasing foreign trade deficit and current account deficit have evidently raised foreign investors' concerns with regard to the sustainability of the exchange rate of the Estonian kroon and deterred the interest to invest in Estonia.

From positive side, still, it can be expected that the development of securities market professional participants in Estonia will facilitate the inflow of foreign portfolio investments further. Namely, due to professional services/advice provided it is likely that the foreign (institutional) investors would prefer to enter into the new market via local institutional investors. This can transfer some of the monitoring responsibilities to the host country's professionals and reduce thus the monitoring costs as well as risks through diversification. However, there are evidently limiting factors for participation of foreign investors in the Estonian securities market. Besides general risk considerations, the most

important ones are the size and liquidity of the market as well as of issuers<sup>29</sup>. These are particular concerns of large investors.

However, besides several benefits, there exist also several concerns in connection with large foreign share ownership. While the effect of longer-term foreign strategic (portfolio) investments can be regarded as a positive one for the securities market (and for the economy), at the same time, the effects of short-term speculative capital may be rather unfavorable. Especially relevant are these concerns in a thin market where the uncontrolled short-term capital flows can expose securities markets towards higher volatility and reason significant turbulence in the financial markets. It should be acknowledged that the issue of managing short-term capital flows is difficult to solve since the flows of foreign capital are often largely determined by the overall trends (e.g. emerging markets boom) and relative situation (e.g. valuation) on the world financial markets (inducing reallocations), which are not subject to host-country control. Pure administrative measures, while being effective, would yet bring undesired side-effects.

### **6.3. Securities market and corporate governance**

From the point of view of development of securities markets corporate governance issues certainly play an important role. While at the start of the formation of securities markets these issues have had only secondary importance, then gradually along with the securities markets development, they have gained considerable attention and became into the fore.

Stocks provide not only rights for participation in financial proceeds, but they also provide shareholders with the right to participate in company control by voting. Thus, concurrently with the development of securities market and shareholder institution, the corporate governance and agency costs issue arises. From the point of view of present study, the following three issues serve attention:

- 1) ownership and control in diffusely held firms;
- 2) protection of minority shareholders interests;
- 3) the role of institutional investors in corporate governance.

#### **6.3.1. Ownership and control in diffusely held firms**

Within diffusely held firms the issue whether the owners have de facto control over the firm, may arise. It is rather evident that along with the enlargement of corporations, diffusion of property rights and hence disappearance of direct personal contacts between the owners (shareholders) and managers, the separation of ownership and control may occur; danger of abuses by managers, may increase. This issue should be especially relevant to the economies in transition as the managerial behavior is more difficult to monitor than in established market economies, since firms are acting in emerging, very dynamic and hence rather

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<sup>29</sup> The size of the issuers may serve as a limit given the restrictions imposed on ownership stake limits for institutional investors.

unpredictable environments<sup>30</sup>. The occurrence of wide-spread spontaneous privatization exercised mostly by the managers of SOEs in the countries in transition, is evidence of this.

### **6.3.2. Protection of minority shareholders interests**

Large-block ownership may bear several dangers for minority shareholders. Large-block ownership may give rise to expropriation of corporate resources and exploitation of small shareholders. Basically, there exists danger that large-majority owners (e.g. in coalition with managers) may apply profit transfer schemes similar to those of spontaneous privatisation schemes. Hence certain safeguard mechanisms are needed for minority shareholders.

The Estonian legal framework (the Estonian Commercial Code) provides only few guarantees for minority shareholders. It grants minority shareholders the right to request the convocation of general meetings of shareholders and furnishes the minority shareholders with the right to request the carrying out of a special audit in the company.

As for further protection of minority shareholders interests, the inclusion of specific minority shareholders' rights into the shareholders' agreement (e.g. the right to elect as a separate group one member of the board of directors, a veto concerning the liquidation or closing down the company, transfer or sale of all or the substantial part of the assets, paying out extraordinary dividends and reducing the share capital, put options, etc.), can be taken into consideration (see Rojec, Jasovic, Kusar 1994). However, the inclusion of such safeguard mechanisms is rather problematic. While providing protection to the minority shareholders, these measures may deter the interest of core investors which maybe harmful from the point of view of privatisation and restructuring of SOEs. It can be argued that the interests of minority shareholders rather lie in the development of liquid secondary markets that permit them to exit at low cost rather than in exercising their rights to intervene (Corbett, Mayer 1991). At the same time an owner with sufficiently large fraction of shares has the incentive to exercise control over the enterprise and effectively intervene.

### **6.3.3. The role of institutional investors in corporate governance**

It has been often discussed whether institutional investors should be active investors. One may argue that the primary role of institutional investors is to provide risk pooling, aggregation of savings as well as reduction in transactions costs to (small) investors (i.e. to act as the financial intermediaries), rather than to concentrate ownership rights and act as a kind of holding company. In developed markets practice, the institutions are largely passive in exercising ownership rights and intervening (see Foley 1991). However, there is also different evidence. For instance, in the USA during 1920s it was widespread practice that

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<sup>30</sup> Here the ideas of Demsetz and Lehn have been applied with regard to the firms in transition economies. Demsetz and Lehn (Demsetz 1988, p.205) suggest that firm-specific uncertainty has an effect on control potential. According to Demsetz and Lehn firms that transact in markets characterized by stable prices, stable technology, stable market shares, and so forth are firms in which managerial performance can be monitored at relatively low cost. In less predictable environments, however, managerial behavior becomes more difficult to monitor.

the IFs were organized not for control of the firms in which they invested but simply as passive investors (Rose, Kolari, Fraser 1993). The idea of inclusion of IFs into the voucher-privatization schemes in Eastern and Central Europe also largely derives from the need to provide an active control mechanism over the post-voucher-privatization enterprises (in order to force restructuring).

It can be said that the activeness of institutional investors would be rather desirable, both from the point of view of investors as well as economy as a whole. Besides, it can be argued that within the illiquid securities markets where the institutional shareholders are practically locked-in and can not 'exit' easily from the inefficient investments, the possibilities to exercise 'voice' are rather important for institutional investors.

However, it is evident that the capacity and incentive of institutional investors to exercise ownership rights and intervene in portfolio-companies' management, is largely determined by the existing legal framework. The most obvious barrier to institutional investors to act as an active owners are the ownership restrictions with regard to the portfolio companies, particularly, the ceiling established on ownership of a single firm's stock. Hence, one should start by revising these restrictions while intending to encourage the institutional investors to become active owners. However, new issues arise while removing (liberalizing) ownership restrictions. Namely, the possibly resulting concentration of economic power (control) into the hands of institutional investors and cross-ownership may raise anti-trust issues. Besides, the participation of representatives of institutional investors in the Boards of portfolio companies raises an insider trading issue. It is not clear whose interests (either institutional investors or companies) are represented by these representatives in the Board. The Czech experience shows that while the IFs representatives were included in the Boards of the portfolio companies, they had little incentive to become involved in management affairs. They rather saw their primary role as that of conduits for information (much of it presumably non-public) about the company back to the fund manager (Coffee 1995).

#### **6.4. Securities Markets and Taxation**

Taxation can be regarded as one of the crucial regulatory means through which the development of securities markets can be directed. The tax policies are important from several aspects. The participation of issuers and investors in financial markets, the proportion of savings/resources allocated to securities markets, the choice of particular financial markets and intermediaries by issuers and investors, as well as the development of particular financial markets and intermediaries - all these can be largely directed through tax policies.

It should be noted that the Government's direct and purposeful intervention into the development of securities markets and its participants through tax policies, has been absent in Estonia.

From the point of view of investors, the tax policy has neither been an obstacle, nor has it provided any special incentives for the investments into the securities markets:

- 1) the income derived from **realized capital gains** is taxed on the basis of regular income tax rate - flat 26%. This applies both to legal persons and individuals. No differentiation exists between residents and non-residents. The only exceptions are the contractual type open-ended investment funds, which are exempt from income tax as well as the insurance companies for which different principles of taxation apply. Realized capital gains are taxed on annual basis, whereas the tax credit is extended up to six months from the end of taxable period;
- 2) **dividends** earned by residents (either individuals or legal persons) are exempt from income tax, while dividends earned by foreign residents (both, individuals and legal persons) are subject to an immediate 26% withholding tax (whereas for the residents of countries having double-taxation treaty with Estonia the withholding tax is 15%); As a rule, dividends are paid out of net income by issuers;
- 3) **interests** earned from bonds are in general taxed by 26% rate. As an exception, the interests earned by individuals-residents from Compensation Fund bonds are taxed by 10% rate.

However, the tax policies do not influence only the behavior of investors (demand-side), but they may also influence the issuers' (supply-side) choices. From the point of view of potential issuers it should be acknowledged that the impact of most tax system is not neutral with respect to the different possible types of business finance. Similarly to several other countries, the interest paid on debt finance is viewed as a deduction for corporate tax purposes, while dividends on equity are paid out of after-tax earnings. In principle, this may act as a constraint to the supply of equities as suggested also by Bascom (1994).

It should be noted that with regard to the development of different financial intermediaries the taxation policies are not impartial. Given the tax advantages applied with regard to the interests earned from bank deposits, the taxation policies in Estonia have rather favored the strengthening of banks than encouraging the securities markets intermediaries<sup>31</sup>. Among the securities market institutions, major differences from the point of view of taxation exist between open-ended and closed-ended investment funds. While in case of open-ended investment funds the taxation policies have been designed to avoid double-taxation (i.e. the open-ended investment funds are exempt from income tax), then in case of corporate type closed-ended investment funds a double-taxation issue arises as far as both, the income of the closed-ended fund as well as fund's investors' capital gains are subject to 26% income tax. The situation, where the investors' gains are eroded by double taxation has evidently put closed-ended funds into more unfavorable situation compared to open-ended funds and induced their liquidation which started in spring 1998.

Though the rather rapid development of securities markets and its institutions in Estonia has occurred without the Government's supportive tax policies so far, the application of several tax incentives would be recommendable from the point of view of further development of securities markets and its institutions in Estonia. It should be acknowledged that the current

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<sup>31</sup> Interests earned from bank deposits have enjoyed tax advantages being taxed by reduced tax rate - 10% from January 1<sup>st</sup>, 1995 to June 30<sup>th</sup>, 1998, and becoming completely tax exempt for individuals-residents from July 1<sup>st</sup>, 1998.

situation, where the securities markets predominantly rely on foreign and predominantly short-term domestic capital, does not provide sustainable basis for the securities markets development. From the point of view of underpinning of the development of securities markets and its institutions the formation of a long-term domestic capital is essential. Aside the pension reform and introduction of pension funds, favourable taxation policies can be certainly seen as a measure of promoting the formation of domestic long-term capital. Such tax incentives may exist in the form of tax exemptions, special long-term tax credits or deductions (e.g. the income tax relief of up to certain limit per annum on particular investments, or time-linked tax deductions of particular investments). These measures would stimulate the increase of financial investments as well as (in case of time-linkage) improve the term structure of financial investments and enhance the stability of securities markets<sup>32</sup>.

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<sup>32</sup> It can be said that the Estonian securities market is very speculative and dominated by short-term positions.

## Conclusions

Starting from scratch in 1991, during a short period, there has been a significant progress in the formation of securities markets and its institutions in Estonia.

1. This development process has been a gradual one, comprising such principal evolutionary stages as:
  - the spontaneous market stage (1991 - summer 1993) - an unregulated stage of the securities market and institutions development, beginning with the first public issues of securities and ended with the introduction of formal rules for securities markets and its institutions,
  - the formalizing market stage (summer 1993 – June 1996) – a stage when the formal rules (laws and regulation) were brought to the securities market and basic securities market infrastructure was created; (highlights: the Law on Securities Market; State Securities Board; Estonian Central Depository of Securities);
  - the organized market stage (since June 1996) - introduced by the start of functioning of Tallinn Stock Exchange

Distinction of these principal stages predominantly relies on legal, structural and institutional aspects. It should be noted that substantial improvements in relation to these aspects have accompanied the introduction of new stages. The major effect of these legal, institutional and structural changes/advancements has been the activation of securities markets (in terms of participation and liquidity) and improved operational and informational efficiency of securities markets.

2. It should be acknowledged that one of the major tasks faced in the process of building securities markets and its institutions from scratch has been to overcome the “primary and secondary market dilemma”, caused by the interdependence of primary and secondary markets. Namely, from the one hand, the primary market is slow to develop due to the absence of the secondary market of securities (for liquidity and pricing reasons, as well as demand constraints raising from the insufficient domestic resources). From the other hand, the emergence of the secondary market and its infrastructure is hampered by the insufficient supply of new issues into the securities market. Namely, for simple economies of scale reasons, the small number of public issues (small market capitalization) does not afford the secondary market infrastructure to develop, as it can not operate cost-efficiently. Evidence from Estonia suggests that the formation of securities markets from scratch and overcoming of ‘primary and secondary market dilemma’ would, require active Government support and intervention policies. The most evident need for this comes from the supply constraints faced by the post-socialist countries where the private sector is just emerging. Hence, the catalyst required to form a securities market effectively is active Government intervention through privatization policies, such as voucher-based privatization of SOEs.

3. The formation and evolution of securities markets and its institutions in Estonia has been inevitably a process, influenced by a large number of factors and complex relations within

the overall economic-legal-institutional-social-political framework. Essentially, this evolutionary model has been driven by initiatives of market forces as well as by Government direct and indirect policies. One of the critical issues in securities markets and institutions development is to achieve the proper relationship (balance) between the self-determinative opportunities of market forces and Government intervention policies. The evolutionary model of Estonian securities markets and institutions suggests in favor of rather extensive self-determination opportunities of market forces in initial stages of development.

4. Despite the considerable success in building securities markets institution, public securities market still plays relatively insignificant role in corporate long-term financing in Estonia. In case of external financing companies rely predominantly on bank loans. Even though the role of securities markets should grow gradually, as the expansion of economy/economic agents and limits on financial leverage will make the raise of equity capital imperative, there is still strong reason to believe that the Estonian financial system (capital market) will remain predominantly bank-central. The obvious factor limiting the expansion (in terms of size and role) of securities markets is the smallness of the economy and economic agents, depressing both, the demand and supply side of securities.

5. During the short period Estonia has already got lessons (drawbacks) from the securities market. Problems such as lax corporate governance, inadequate minority shareholder protection, insider trading issues, lax supervision over the financial sector in general, absence (delay) of policies which could promote long-term domestic capital formation, inadequate export-promotion (import substitution) policies, have gradually started to intensify and have definitely become critical from the point of view of further development of Estonian securities markets.

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