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ARE LEGAL OBSTRUCTIONS HINDERING LITHUANIAN CAPITAL MARKET GROWTH?

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Introduction

Many economists and lawyers are considering the benefits of a free market economy and the best ways to gain profit from it. However, the true free market, the one with perfect competition, is merely a fiction. In only a few instances the true free market model has been observed.¹ Even when they occur, they are characterized as rapid unstable and therefore not long lasting periods.

A free market with perfect competition is an ideal model in which there are no artificial regulations, no taxes, and there is movement of people, goods, services and capital at no cost.² While it is generally agreed that an ideal free market is rare, lawyers and economists differ in their views on the characteristics of a free market. Economists tend to follow the theoretical model, while lawyers adapt the free market model with practical modifications that make it more accessible. That is, lawyers believe that a free market can function with some regulations, taxation and other limitations as long as there are no regulations governing quantity and price.³ In this view, the objective of an ideal market system is to minimize restrictions necessary for its stability.

The capital market is an integral part of a democracy's economy⁴ that exercises a balancing function. A perfectly operating free market economy is balanced in its money market and capital market.⁵ The capital market is where large source amounts of money are transferred, and is the source for business expansion. On the other hand, it is where savings become investment – the backbone of long-term economic welfare. The equilibrium in the money and capital markets is ensured when household savings match corporate investment. A miserably functioning capital market destroys the major funding system for corporations and deforms household consumption and savings patterns if there is no efficient alternative to exchange current consumption to the future consumption with a benefit added.

Securities market growth is possible only if the benefit, which market participants get, is greater than the direct and indirect cost they incur from their transaction. However, an increase of market regulations brings a costly burden on market participants and this depletes the benefit of capital market transactions.⁶ Regulation is necessary to safeguard the balance of market forces. Although an unregulated market may perform better in a short run, but the lack of regulation creates a greater possibility of market failure.⁷ Therefore

¹ The traditional instances of free market include Netherlands at the moment of industrial revolution when unregulated economy boosted industrial growth, Scotland in 17th century, where financial sector was developing due to effective unregulated competition and some early stages of US capital market development.

² PAUL WONNACOTT, RONALD WONNACOTT, *Mikroekonomika* (Kaunas: Poligrafija, 1998), p. 23.

³ Bryan A. Garner, *A Dictionary of Modern Legal Usage*. (New York: Oxford University Press, 1995)

⁴ European Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing, Official Journal L 334, 18/11/1989, p. 30-32.

⁵ The money market is a financial market in which short term debt instruments are traded while the capital market is the market in which longer-term debt and equity instruments are traded (FREDRIC S. MISHKIN, *Financial markets, institutions and money*. (NY: HarperCollins College Publishers, 1995), p. 26).

⁶ Merrit B. Fox states that increased disclosure reduces rewards for product of market developments (MERRIT B. FOX, "Securities Disclosure in a Globalizing Market: Who Should Regulate Whom". 95 *Michigan Law Review*. 2498, p. 2550-52 (1997)).

⁷ Legal and regulatory framework for exchange-traded derivatives, International Organization of Securities Commissions// <www.iosco.org> visited 2001.05.08.

there is a much higher systematic risk⁸ in the unregulated market. The state policy is to ensure stability and long-term growth. Thus there is a need for regulations, although regulations should be limited because over-regulated markets have functioning problems and infringe other economic relations. Regulations are necessary for market integrity, efficiency, financial safety, customer protection and fairness.⁹

A capital market transaction is specific in its nature. It consists of two separate transactions: investor's contract with his broker and execution in the market. Only specialists have permission to act in the market and investor has no direct access to it. These specialists are financial intermediaries and they act as agents for investors. The first transaction is under the agreement between investor and the broker. This is the contract for the services of financial intermediary. These services include purchase and sale of client's securities in the market, consultancy, securities portfolio accountancy and others. The second transaction is brokering action in the market. This duality calls for both civil and administrative regulation.¹⁰ Security Exchange Commission has an administrative power¹¹ to regulate intermediaries' transactions in the market, while the transaction between investor and intermediary is the agency relationship and shall be subject to a civil regulation.

The broad objective of the securities laws is to provide full and fair disclosure for the protection of investors and to enhance the allocational efficiency of capital market.¹² The efficiency criteria come together with free market concept. However, the test for review administrative decisions is fairly high when the reviewing court cannot substitute its judgment for that of the agency and it must determine if the agency's interpretation is a permissible one.¹³ This principle has a potential conflict with the market efficiency and is analyzed below, in section 3.

Whether there are obstacles hindering capital market growth in Lithuania depends on understanding of what these obstacles are, and what effect they have on the market. Therefore the first two sections of the paper develop the definition of legal obstacles and the last one considers their effects.

The **objective** of this paper is to determine whether there are legal obstacles that hinder capital market growth in Lithuania by testing the **hypothesis** that the abundance of legislation regulating the capital market will hinder its growth.

There are several **methods** employed in this paper to reach the overall objective. To test this hypothesis, *logical analysis* and *extrapolation* are used to extract major policies of capital market legislation *semantic dependencies* illustrate where regulations conflict with major policies, and a *comparative method* in association with *logical analysis* illustrate where regulations hinder capital market growth.

⁸ Systematic risk is the type of risk investor faces that does not correlate with any specific investment. It reflects major collapse of the market when the value of every security is affected.

⁹ Objectives and Principles of Securities Regulation, International Organization of Security Exchange Commissions (1998) // <<http://www.IOSO.org/docs-public/1998-objectives.html>>, visited 2001.05.08.

¹⁰ KESTUTIS KVAINAUSKAS, "Kapitalo rinkos trikdžiai jos veikeju akimis" (Capital market obstacles from a market actors perspective), proceedings of the conference *What Hinders Capital Markets?* (LFMI, 2000).

¹¹ LR vertybinių popierių viešosios apyvartos įstatymas (Securities Public Circulation Law), Žin., (1996, No. 16-412).

Vertybinių popierių rinkos įstatymo projektas (Securities market law project), (*proposed by Lithuanian Securities Commission*) // <www.lsc.lt>, visited 2001.05.10.

¹² JAMES D. COX, "Premises for Reforming the Regulation of Securities Offerings: An Essay", 63 *Law and Contemporary Problems* (Duke University) 3, 12 (2000).

¹³ *Chevron v. Natural Resource Defense Council, Inc.* 467 U.S. 837, 842-43 (1984).

1. Securities regulation objectives

Like all markets, the capital market is where buyer meets seller. In the capital market, investors find desirable investments companies needing funds, resulting in businesses finding needed capital. Therefore the basic goal of the capital market is to increase investment opportunity and the possibilities to raise capital.¹⁴ There are three core objectives for securities regulation in this area: the protection of investors, ensuring that markets are fair, efficient and transparent, and the reduction of systematic risk.¹⁵

Classically, securities laws are intended to serve a variety of purposes. Mandatory disclosure seeks to protect investors, by reducing the incidence of fraudulent offerings, and generally arming investors with more information than they would otherwise possess, so they can make sharper comparisons among competing investment opportunities. The securities laws have the grand objective of nurturing the allocational efficiency of securities markets. Because mandatory disclosure rules are believed to provide more reliable analyses of the amount and timing of future cash flows presented by each issuer, securities laws facilitate a process by which each issuer's costs of capital can be determined relative to that of others. The weaker these laws, the less clear it is that this determination can be made. The securities laws also have salutary effects on managerial overreaching. Such opportunistic managerial behavior occurs through shirking, excessive consumption of perquisites, or simply condemning some portion of the fair value of minority's shares; each was seen as a harmful consequence that would occur in a *laissez faire* (state nonintervention) regime. Mandatory disclosure rules are intended to reduce the frequency and magnitude of such behavior.¹⁶

While the concept of *market efficiency* is a well known, the concept of *efficiency of legal regulations* is not.¹⁷ There is no universally accepted definition of "effective regulation". With regard to capital market it is possible to identify general attributes of effective regulation that are consistent with sound economic growth:

- 1) in the development of policy, regulatory bodies should consider the impact of the requirements imposed;
- 2) there should be no unnecessary barriers to entry and exit from markets;
- 3) the markets should be open to the widest range of participants who meet the specified entry criteria;
- 4) there should be an equal regulatory burden on all who make a particular financial commitment or promise.¹⁸

The primary problem in evaluating the efficiency of the regulations is the lack of quantitative measures in measuring the impact. Another obstacle is the limited ability in performing empiric research on the economic result of changes in legal regulation regimes.

¹⁴ See JAMES D. COX, *supra* note 12.

¹⁵ See Objectives and Principles of Securities Regulation, *supra* note 9.

¹⁶ Adopted from: JOHN C. COFFEE, JR., "Market Failure and the Economic Case for a Mandatory Disclosure System", 70 *Va. L. Rev.* 717, 722 (1984); JAMES D. COX, "Premises for Reforming the Regulation of Securities Offerings: An Essay", 63 *Law and Contemporary Problems* (Duke Univ.) 3, 12 (2000); PAUL G. MAHONEY, "Mandatory Disclosure as a Solution to Agency Problems", 62 *U. Chi. L. Rev.* 1047 (1995); Randall S. Thomas, James F. Cotter, "Measuring Securities Efficiency in the Regulatory Setting", 63 *Law and Contemporary Problems* (Duke Univ.) 3, 12 (2000), p. 106.

¹⁷ Geogre L. Priest states: "Inefficient rules impose higher social costs, tend to be challenged more often" (GEORGE L. PRIEST, "The Common Law Process and the Selection of Efficient Rules". 6 *Journal of Legal Studies*, 65, 72. 1977).

¹⁸ See Objectives and Principles of Securities Regulation, *supra* note 9.

Although it is possible to test the effect of regulations on the capital market in some states, it is difficult to compare this effect between states because of the different bases for regulations in different countries and also because of the obstacles for comparability regarding difference of economic systems. And still there is a need for some tools to measure efficiency, because a legislator needs "...measures to set threshold limitations on the applicability of rules".¹⁹ One solution is to examine the regulation in order to see if it serves its purpose and does not contradict with the legal principles related to that regulation. The analysis of legal principles is one of the possible ways to understand the actual meaning of a legal rule.²⁰ Legal rule should not contradict the legal principles, especially the constitutional ones.²¹ In case there is a competition or contradiction of legal principles the legislator should find the balancing point without ignoring or infringing them²². This applies to the goals of capital market legal regulation as well.

Capital market regulation has to accomplish the given goals and to comply with legal principles in order to be efficient. The most difficult task is to find the balance in the situations when embodying of one goal or principle in its full scope harms another one. If the balance is determined improperly the regulation becomes an obstacle for development and growth.

Investment as it is based on the contracts is subject to a civil regulation. However, out of complicated procedure of investment basis for administrative regulation is originating as well. There is an ongoing discussion²⁴ among scientists in Lithuania and as well as in the World as to upon which regulation method - civil or administrative - should be placed more reliance. In fact, this is a dispute as to which would provide more social benefit: civil regulation approach with its respect to disposition principle of the parties or heavy regulating administrative principle.²⁵

Capital market regulations must meet a broad set of principles. Legal theory recognizes that the supreme principles are incorporated in the State Constitution and that capital market regulation must comply with principles of liberty and property rights.²⁶ All other principles must not infringe these Constitutional rights, and are interpreted by referring to fundamental principles of honesty, fairness and reasonableness. These fundamental principles support the whole legal system; therefore they are repeated in Civil Code²⁷ as well.

¹⁹ R. S. THOMAS, J. F. COTTER, "Measuring securities market efficiency in the regulatory setting". *Law and Contemporary Problems* Vol.63 N.3., NC. p71-105. 2000.

²⁰ VALENTINAS MIKELENAS, *Civilinis procesas* (Civil procedure), (Vilnius: Justitia, 1997), p. 58.

²¹ *Id.*

²² *Id.*

²³ VALENTINAS MIKELENAS et al. *Civiline teise* (Civil law) (Kaunas: Vjusta, 1997), p. 26.

²⁴ *The Free Market*, (Lithuanian Free Market Institute, No.1, 2000); International Organization of Securities Commissions// <www.iosco.org>, visited 2001.05.08.

²⁵ See KVAINAUSKAS, *supra* note 10.

²⁶ Lithuanian Constitution in articles 23 and 46 states protection of liberty and property interests. Moreover, "Lithuania's economy shall be based on the right to private ownership, freedom of individual economic activity, and initiative" (LR Konstitucija (The Constitution of Lithuanian Republic), Žin. (1996, No. 64-1501)).

²⁷ This paper relies on the New Lithuanian Civil Code, which came into force on 1st of June 2001. Article 1.5 clearly indicated that honesty, fairness and reasonableness have to be respected at any time - at the moment of exercising one's rights, at the contracting moment when parties discuss their rights and obligations, as well as for the court when he makes the decision or interprets the law (LR Civilinis Kodeksas, Žin. (2000, No. 74-2262)).

The highest Constitutional principles are supplemented and enforced by national laws. Civil Code extends and draws implementational lines on how the major goals and principles are enforced. Common civil principles form the basis for civil law. They include:

- 1) legal equality of the subjects,
- 2) their initiative - *i.e.*, freedom to contract,
- 3) intercommunication of subjects,
- 4) honest execution of one's rights - *i.e.*, inadmissibility of misuse of one's rights (*article. 1.2*).

These principles are universal in western jurisdictions. In some states there is an additional principle – public commonwealth. In respect of capital market, civil law has some specific principles - property inviolability, nonintervention to private relations, legal determinability, and adequate and legitimate expectations.²⁸

Lithuanian law is influenced by European Union (EU) directives. Although EU law has no binding power on Lithuania yet, it is an important force that affects transformation of Lithuanian law and the goals and policies upon which it is based. The proposed new Securities Market Law proposed by Lithuanian Securities Commission²⁹ complies with the requirements of EU directives and will modify current regulatory regime.

There are eight primarily related directives that govern EU capital market regulation.³⁰ Those European Council Directives are primarily concerned about investor security protection, market efficiency guarantee and single market development. Investor security goal has three aspects: information, risk assessment and liquidity.

Information is essential for the investor to make a reasonable investment decision. In theory the more extensive information, the better investment decision will be made, thereby creating a lower risk of failure. The proper risk assessment correlates with information provided to the investor. The information must be reliable and clear, otherwise the investor would not be able properly interpret the acceptable tolerable risk. Liquidity is also necessary for investor security. If one invests in securities that have a low liquidity level the possibilities to sell them at the market price are very limited. Such securities could be sold only at a much-discounted price inconsistent with investor security protection and dissonant with the Constitutional property interest protection principle.

Such interpretation of investor security goal draws an explanation of investor security as a whole. Investor security protection is to be seen not as narrow as protection from possible fraud on the market, but also from undeserved losses that could be incurred by investor in not perfectly functioning securities market.

This concept brings us to the market efficiency goal that is backed by stability of the market, removal of unnecessary barriers and investors' confidence in the market. Capital market stability is an essential goal for the State economy. It is possible only if all market participants will benefit rather than incur cost in investment transactions, if their interests will be protected and balanced and if the participants will be confident about the market. Confidence in the market, according to EU directives evaluates market efficiency from the investor's perspective. Its sub-goal is to protect against the undisclosed information usage in the market. The concern with undisclosed information is closely related to the need for full disclosure of information in the sense that each address the problems created by the

²⁸ LR Civilinis Kodeksas (Civil Code), Žin. (2000, No. 74-2262), Art. 1.2.

²⁹ Vertybiniu popieriu rinkos istatymo projektas (Securities market law project), (*proposed by Lithuanian Securities Commission*)// <www.lsc.lt>, visited 2001.05.10.

³⁰ For the purposes of this paper the following EU Council Directives are analyzed: 79/279/EEC, 80/390/EEC, 82/121/EEC, 88/627/EEC, 89/298/EEC, 89/592/EEC, 93/6/EEC and 93/22/EEC.

asymmetry, or lack of balance, of information.³¹ The goal here is to eliminate or at least reduce information asymmetry, because clear information circulation provides the necessary basis for market efficiency and enables investor self-protection.

Also necessary and consistent with one of the general attributes of EU regulations for market efficiency is removal of unnecessary barriers. Despite this attribute, the EU directive³² applies it only for securities issuers. The removal of barriers for the issuer and development of uniform listing requirements brings us to the final major goal – the development of one single market. Integration, cooperation and equal protection among various markets are the obvious sub-goals for single market development. This overview of the goals that are indicated in the Council Directives shows that there are many goals a legislator faces with and usually the sub-goals are interconnected.

The Lithuanian national securities law has similar objectives. The current Securities Public Trade Law was replaced by the new Securities Market Law that will be necessary, when the new Civil Code entered into force on July 1st, 2001. The goals and objectives of current law and the new law are almost identical. They are primarily concerned with "a secure, open and efficient market",³³ maximum security for investors and fair competition³⁴ among market participants. Although the goals are similar to the European Council Directives, there is a difference in investor security protection. The Lithuanian law sets the goal for maximum security of investor. The maximum investor protection goal is clearly implemented in the rules and instructions issued by Lithuanian Securities Commission. The need for investor protection is not questionable, but such a high protection level may imbalance the market and does not comply with the primary reasonableness requirement – the core for regulation efficiency.

The goals that legislator has to comply with in making market regulation laws are not unidirectional. Usually there are competition, contradictions, conflicts and even inconsistency of goals. The easy situation is when the goals are similar and by realizing one goal the legislator improves the fulfillment of another. In this situation there is no legal efficiency problem. The efficiency dispute arises when there is incompatibility of goals. Legal theory solves the conflicts of law by looking at the hierarchy of the law. No law can conflict with the State Constitution, and the specific prevails over the general.

This approach can hardly be adopted when dealing with the goals of regulation. Conflicts in goals cannot be resolved by simply taking one goal and ignoring the other. The efficient solution is to find the equilibrium point where every goal is fulfilled to the maximum scope possible without major intervention in the fulfillment of other goals.

The economic perception of efficiency is the best allocation of resources in order to achieve the maximum amount of utility for the society.³⁵ As we are dealing with regulation on vital sector of economy, consideration must be given to this interpretation also. In the legal sphere given goals are the resources in accordance with which a legislator has to build efficient regulation. If all goals were of an equal importance, improvement in fulfillment of one goal would not create more benefit to society if this caused equal damage on another.

³¹ Information asymmetry is the characteristic of inefficient market when different market participants have unlike information about the market and the securities traded. Information inadequacy leads to the unsound investment decisions.

³² European Council Directive 79/279/EEB coordinating the conditions for the admission of securities to official stock exchange listing, Official Journal L 066, 16/03/1976, p. 21-32.

³³ Vertybinio popieriu viešosios apyvartos įstatymas (Securities Public Circulation Law), Žin. (1996, No. 16-412), Art. 1.

³⁴ Lithuanian Broker Association suggests replacing this goal with "restriction of systemic risk"// <www.nfma.lt>, visited 2001.05.10.

³⁵ See WONNACOTT, *supra* note 2, p. 37.

Since importance of goals is not constant, a legislator should consider the highest hierarchical goals only. While this is the solution for conflicts of law it contravenes another economical concept – the theory of microeconomics of diminishing marginal rate of utility.³⁶ If all available resources are allocated only to the fulfillment of the highest goals, we could not reach an optimal benefit level. The most important goals should get the major part of available resources, but not all. In comparison, small amounts or resources redistributed for other goals could create more overall benefit. The resource distribution and balance theory seems reasonable, but raises doubts why it has not been adopted in resolving conflicts of law. The allocation efficiency theory could be used only if resources are divisible. In conflict of law case the decision could not be based partially on several conflicting laws, but in resolving goals conflict resources could be distributed proportionally.

2. Semantic dependencies system

The first problem in evaluating efficiency of the legal regulations is the construction of the database necessary for this process. The private sector's analysis does not provide analogy for this information, because it has clear quantitative measures, *i.e.*, profitability, income, cash flows, etc. that are not helpful in determining efficiency of regulations. The legal regulation area is rather troublesome in regard to measurement efficiency. A possible alternative is to employ Semantic Dependencies Systems by building a tree of general and specific goals and tasks as well as policy issues that are attained in the given regulations regime.

There are goals and policies that are primary input variables. The given result is the regulation set that will accomplish as much as possible of the given goals.³⁷ It should not be a difficult task if these goals, objectives and policies are not contradictory. The main issue becomes mitigation the conflicts of incompatible objectives. Another question to be decided is the settlement of priorities that helps to regulate the intervening forces. The most obvious and very general example of goals that are incompatible in part is the goal of protecting investor's security. But, on the other hand, we want to attract more companies to trade their shares publicly. If we shift a heavy burden of massive disclosure requirements on a company, the investor need for the information and the demand for security will be satisfied. But on the other hand the company's interests are infringed by reporting requirements that may damage its ability to compete in the market. This will lead to the decreasing number of securities traded in the market. Companies will tend to register their shares in the other markets to meet their capital raising needs, where the requirements are not so burdensome. Finally it will affect the investor back again, as there will be not much choice to invest in. It will reduce the possibilities to construct the optimal investment portfolio, as there will be not enough securities listed in the market. So this is a simple example of how the misbalance of policies leads to overall inefficiency. This shows that by

³⁶ This means that amount of utility society receives from allocating resources is increasing at high speed when the first theoretical unit of resource is allocated and but velocity is diminishing. Therefore the additional benefit from allocating next unit of resource is smaller every time. Bearing in mind this phenomenon the efficient recourse allocation procedure requires testing the utility society receives from each portion of resource. *Id.*, p. 44.

³⁷ Philip R. Lochner, Jr. states that "an economic regulation can fail because it does not accomplish its stated purpose. A second type of failure occurs if the adoption of an economic regulation does not take into account all of the economic effects that regulation may have. Thus, an economic regulation may accomplish its stated purpose, but may have so many reasonably foreseeable and material adverse side effects that, on balance, it may legitimately be seen as a failure" (PHILIP R. LOCHNER, JR., "Economic Regulation and Democratic Government", *Journal of Corporation Law*, Vol. 25 Issue 4, p831, 11p.).

meeting one goal completely and ignoring another one the final result reached will not be optimal. Better situation could be created if there was partial fulfillment of both goals. But such a simple analysis cannot demonstrate the point where there is an optimal point of meeting two goals. Which one is more important and should be preferred? The given discursive analysis cannot establish the priorities of the goals, their consistency levels and the scope of fulfillment. Therefore there is a need to make a qualitative step further in this analysis. After identification of the goals in a previous section we need to determine the possible scope of fulfillment. Studies on semantic conflicts³⁸ between goal descriptions in similarity analysis assume the following four cases between two given pragmatic objects:

- 1) the goals are identical;
- 2) the goals are similar;
- 3) the goal is in decomposition with the other;
- 4) the goal is conflicting with the other.

Those cases are ranked according to levels of their compatibility. The first two groups - identical and similar goals - could never cause a problem. They are so closely related that by fulfilling one another one will be fulfilled or at least improved as well. Decomposition level occurs if by executing one goal there is no significant overall effect to the fulfillment of another. Although it could have an impact on realization of some sub-goals, the overall effect is minimal because some of them have positive and some negative impact.

As talking about conflicting goals it should be noted that there are two possible types of conflicts – compatible and incompatible. Compatible conflicts are seen as such where by executing one goal we deteriorate the achievement level of another. This is the case that was given in disclosure requirement situation. If we want to improve investors' situation we can do it only by making corporation situation worse. Such a situation calls for an economic reasoning when there is some level of efficiency achieved, but it is impossible to improve situation for one side without at least minimal damage to another. Finally, incompatible conflicts shall be interpreted as a situation where fulfillment of one goal completely extinguishes possibilities of another goal's realization. Such a situation is an example of goals' indivisibility, thus it is necessary to adopt the conflict of law solution method. Developing the hierarchy of goals helps solving this inconsistent situation. Therefore we need to know what results we get by executing one goal and ignoring another one and vice versa. The positive result gained by realizing the top priority goal shall be greater than the loss deriving from disregard of the low priority goal.

The hierarchy of the goals may be constructed by building up the interconnected goals on various levels of abstraction. The goals are ranged from the top priority strategic policies and go down to the low-level procedural issues, which are decomposition of the strategic policies. The downward direction in the hierarchical goal tree describes how the various top-level policies can be achieved by executing the lower ones.

On adjacent levels of decomposition in the hierarchy structure, goals are connected by a specialization link. It can also link a specific goal to a more general one. Goals related by a specialization links are similar. There is also possibility of mutual specialization dependency that means that the goals are identical. Goals are independent if they have no common constrains and have neither positive nor negative effect on each other.

The negative influence from one goal to another points that first one hinders the achievement of the second and vice versa. This is the most usual point where the problematic situations arise. Goals' conflicts may be compatible and incompatible. Compatible conflicts are permissible because there is at least one sub-goal between the two

³⁸ REMIGIJUS GUSTAS, *Semantic and Pragmatic Dependencies of Information Systems*. (Kaunas: Technologija, 1997), p. 91.

conflicting goals which could be achieved and satisfy both goals in part. Incompatible conflicts shall be regarded as inconsistent situation.³⁹

If sub-goals are conflicting then a global goal is contradictory. Any contradictory goal has at least two sub-goals that are conflicting. A contradictory goal is consistent if conflicting sub-goal satisfies a more general goal, otherwise it is inconsistent.

The presented set of dependencies and rules is the core of analysis within policies and goals modeling. It serves as a tool to discover various conflicts, contradictions and inconsistencies among policies and goals. It also enables to build up a hierarchical policy tree and allows solving the problems concerning goal priorities.

The given discussion on legal regulation goals in the previous section and the semantic dependencies model allow constructing the goals' tree (fig. 1). Here all goals and principles are analyzed joined together in one single scheme, which in addition demonstrates how after implementing one goal other goals are affected.

After this analysis we may arrive to the *definition* of a *legal obstacle*. This is the regulation that deals with several conflicting sub-goals and does not take into account its effect on every interconnected goal in order to determine the balancing point where the society could benefit most.

3. Capital market problems and legal regulations

This section will analyze separate pieces of legislation, examines how they meet the goals that are set forward and also evaluates what overall effect legislation has – market development promotion or hindrance and depression. Capital market faces many restrictions and hindrances. They are not indiscrete and could be grouped into external and internal issues. External issues cover the problems arising outside the capital market, however, substantially influencing the market. Internal issues arise from burdens on issuers, intermediaries and investors.

3.1. External issues

Securities Commissions are seen as indispensable institution for efficient market performance. However, their rights and authority varies from state to state. In US SEC is the supreme market regulator. But there is an ongoing discussion whether this is the best system. The alternatives proposed are self-regulation by the exchange or the regulation by state. EU has no single supreme security regulation body yet⁴⁰. Lithuanian model, which follows French example, has separation of powers among various institutions dealing in the market. The regulatory model is not much in question as the regulations itself.

3.1.1. State Fiscal Policy

According to recommendation of International Organization of Securities Commissions the security market regulator should have "adequate powers, proper resources and the capacity to perform its functions and exercise its powers".⁴¹ The Parliament cannot delegate to the agency powers far exceeding market boundaries. However, there are important obstacles that affect capital market.

³⁹ *Id.*, p. 105-106.

⁴⁰ An article in *Economist* states that Europe lacks not just a powerful supervisor with the remit to maintain transparent markets, but any consistent code of securities regulation ("Europe's regulatory muddles", *Economist*, Vol. 355 Issue 8174, p. 18. (2000.10.06.)).

⁴¹ See Objectives and Principles of Securities Regulation, *supra* note 9.

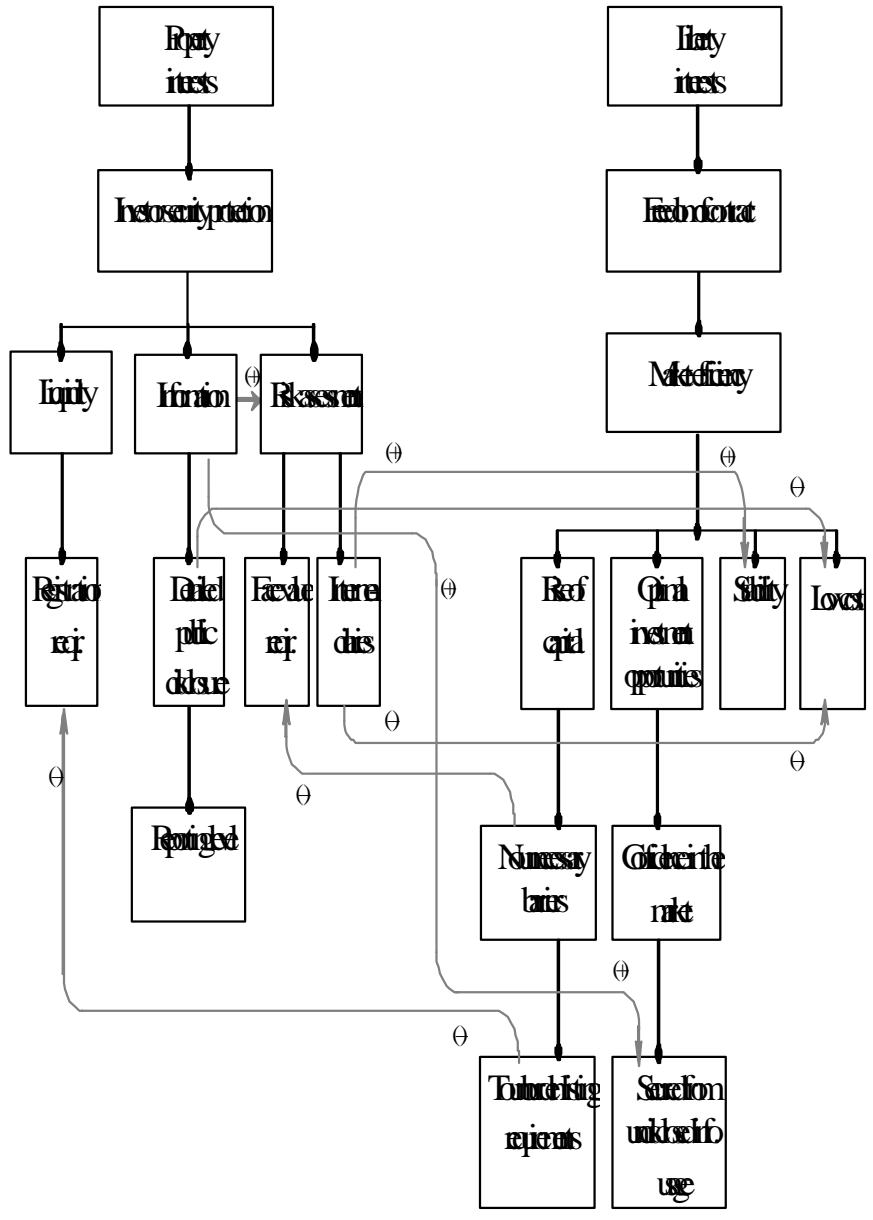


Fig.1. Semantic System of Legal Concepts and Meddling

Fiscal policy of Lithuania is based on flawed principles of budget formation, revenue and expenditure imbalance, and State financial system segmentation into separate monetary funds. These features make national fiscal policy less transparent, encourage tax increase and boost State borrowing needs.

The State budget imbalance is influenced not by a single goal but by a set of factors. The conflicting goal of capital market efficiency does not come alone as well: national product growth, economic efficiency of State administration structure and many other goals clearly outweighs State need to finance its expenditures. Despite the notion of wrong monetary policy formation criteria, changes for a better are tardy due to a large set of goals that have to be balanced by making decisions in this area. It is clear that Lithuanian law regulating State budget formation⁴² is too liberal and does not discover the optimal fulfillment of goals, therefore it fall within the scope of legal obstacles.

The existing fiscal policy increases the risk of capital market investments, makes the country less investment attractive. Because the treasuries market is so appealing due to its profitability and safety, it absorbs investor capital, essentially diverting funds away from the private investment.

There are two parts of a capital market - shares and bonds segments. Currently only State bonds occupy the bonds segment. There are no private corporations bonds traded in Lithuanian market yet. It means that State bonds enjoy "monopoly" in the bonds segment and only they attract funds from the private investment. The investment resources are scarce, and exaggerated government need to borrow infringes with funds allocative efficiency⁴³ and this affects market efficiency negatively.

Comprehensive reform of the national financial system would help to create more favorable conditions for the development of the capital market and the national economy as a whole. It is essential to eliminate flaws in budget formation, consolidate the state monetary funds into a single fund approved through legislation, and adopt laws setting limits on the rate and volume of borrowing in proportion to Gross Domestic Product.

Another closely related problem is the International State credit rating issue. Government need to borrow could be financed externally if Lithuania had a higher credit rate. Standard & Poors (S&P) currently rates Lithuania in the low investment grade, at "BBB-".⁴⁴ Moreover, Lithuania has been warned about the growing fiscal gap that would result in downward pressures on Lithuania's ratings.⁴⁵ The current credit rate evaluates Government bonds as high risk and speculative. One-step superior rating could open external financing possibility for the government. For example, US pension funds are important financing source, but they are restricted in their investment scope. They are banned to invest in risky and speculative securities. The improvement in fiscal policy would upgrade Lithuania credit rating and enable to access overseas funds and redirect national funds back to the private investment. Low State credit rating hinders Private corporations rating as well. Corporation simply cannot get a better rating than the State where it is located has. Better ratings would attract more investors in the private investment sector as well and it would increase market liquidity that serves for the investor security protection goal.

⁴² See *id.*, p. 984.

⁴³ "Allocative efficiency" refers to the increase in social welfare that comes from allocating society's scarce resources to those who value them most highly, and costs to those who find them least burdensome (RICHARD A. POSNER "Economic analysis of law" 569 12-13. 5th ed. Boston etc. Little, Brown, 1998).

⁴⁴ Report on Lithuania, Standard and Poors, May, 2001// <www.standardpoor.com>, visited 2001.05.15.

⁴⁵ *Id.*

3.1.2. State property privatization

There are several methods of privatizing the shares of state-owned companies: public offerings on the stock exchange, public auctions, public tenders or direct negotiations. Usually small and less attractive companies are sold on the bourse, and this privatization method is seen as superior. The bourse system ensures transparent privatization, a wider circle of potential investors (both Lithuanian and foreign) are involved, and investors are free from any additional requirements. This privatization method ensures the best results possible and at the same time encourages capital market development. This method serves for the goals of minimization of barriers, market efficiency and liquidity. However, it is difficult to determine what reasonable goals are considered by selecting other privatization methods⁴⁶ – this obstacle has a clear negative economical effect on the market. It is expedient to privatize state-held shares exclusively through the Stock Exchange, applying other methods only in exceptional, clearly regulated cases.

3.1.3. Direct and portfolio investment

Generally, foreign direct investment has been defined as investment where an investor based in one country acquires an asset in another country with the intention to manage the asset.⁴⁷ International law used to support the position that nations were always free to keep foreigners out. Now, however, treaties have begun to regulate countries' approaches to entry and operations of foreign direct investment.⁴⁸ Portfolio investment on the contrary does not intend the management of the asset and therefore is usually preferred by the legislator. Lithuanian law does not limit any investment and does create a conflict with the economic goal of retaining management power in the company. Despite the fact that retention of managerial power in the company would favor the capital market, it would create an incompatible conflict (*see section 2, p. 11*) with liberty protection interest. Lithuania has also assumed its obligations under the treaty with EU not to infringe free movement of capital.⁴⁹ Applying the formal definition of legal obstacle we find a positive output, but given type of goals conflict and the economic evaluation of overall benefit to the society we find it outweighing the capital market hindrance. Therefore direct investment shall not be limited.

3.2. Internal issues

Internal issues cover direct capital market regulation that affects market participants - securities issuers, financial intermediaries and investors.

3.2.1. Securities issuers

Some legal scholars arguing for narrow interpretation of securities law goals note that they all are about nothing but disclosure.

A primary mean of accomplishing disclosure goal is encouragement of financial

⁴⁶ LR valstybes ir savivaldybiu turto privatizavimo istatymas (Law on privatization), Žin. (1997, No. 107-2688).

⁴⁷ DON WALLACE, JR, AND DAVID B. BAILEY, "The Inevitability of National Treatment of Foreign Direct Investment With Increasingly Few and Narrow Exceptions", 31 *Cornell International Law Journal*. 615 (1998).

⁴⁸ *Id.*

⁴⁹ Europos sutartis, steigianti asociacija tarp Europos Bendriju bei ju Šaliu Nariu ir Lietuvos Respublikos (Treaty of association with EU), Žin. (1998, No. 11-266).

information circulation through the registration of securities. This information enables investors (not the government), to make informed judgments about whether to purchase a company's securities. While the Securities Commission requires the information provided to be accurate, it does not guarantee it. Investors, who purchase securities and suffer losses, have important recovery rights if they can prove that there was incomplete or inaccurate disclosure of important information.

3.2.1.1. Reporting companies

The first question concerning issuers' regulation is the moment when the company becomes a reporting corporation. Under Lithuanian Securities Market Law⁵⁰ the company must register its shares and become a reporting corporation if it is a public limited company or the number of shareholders exceeds 100 or intend to issue publicly trades securities. Lithuanian Law on Corporations also indicates that a private limited liability company cannot have more than 100 shareholders.⁵¹ Many companies exceeded this limit in the initial stages of privatization and as a result had to reorganize themselves into reporting corporations. The mandatory reporting requirement for the company that does not intend to go public serves for the investor protection goal by fulfilling liquidity requirement. On the other hand, it conflicts with unnecessary barriers goal by voiding easy exit from the market. This conflict of goals needs to be resolved by determining the optimal fulfillment point. The increase in maximum shareholder head count does not eliminate this obstacle. There are companies that do not benefit from the market, as they do not intend to issue new emission of securities; however, they incur additional cost⁵² by being public. It would be appropriate to replace shareholder limit with the monetary limit.⁵³ Also it is necessary to create a mechanism to protect small shareholders when a PLC decides to reorganize into private limited company by applying a tender offer in this case.⁵⁴ The given proposals could diminish the negative effect of the mandatory registration requirement obstacle.

3.2.1.2. Disclosure scope

A registration statement continues to be the regulatory cornerstone for public offerings by any issuer. However, the disclosure requirements for registration shall not be considered as covering all the information the investor needs in order to make reasonable investment decision. Mandatory disclosure should focus upon those items of information uniquely known to the issuer.⁵⁵

⁵⁰ See Vertybiniu popieriu rinkos istatymo projektas, *supra* note 29, Art. 5.

⁵¹ This is a recent modification of Law on Corporations. For the last five years this shareholder limit has been 50 (LR Akciniu bendroviu istatymas (Law on Corporations), Žin. (1994, No. 55-1046), Art. 2).

⁵² They have to make regular reports, announce essential events and provide other information to market watchdogs and also they are subject to mandatory audit.

⁵³ Monetary limit is more accepted internationally, e.g. company has to public in US if its capital exceeds \$10mln. *or* if number of shareholders hits 500 (US Securities and Exchange Act of 1934). EU directives tend to measure corporations in the Council Directives by corporation capital as well.

⁵⁴ Tender offer is considered a proper instrument to protect the rights of small shareholders. There is a project of EU Council Directive prepared that will require for investor acquiring 1/3 of shares in the company to announce a tender offer for the remaining shares. The current regulator regime in Lithuania requires tender offer when one acquires half of the outstanding shares and it is proposed to lower it down to 40%.

⁵⁵ JAMES D. COX and EDWARD F. GREENE, "Summary of roundtable Discussions Regarding the Future Content of the U.S. Securities Laws" 63 *Law and Contemporary Problems* 3, 4. 2000.

Securities Market Law and Regulations on the Registration requires the operating company to publish a prospectus or memorandum in order to sell new securities issue⁵⁶. Along with basic information about the company and its new issue, the prospectus or memorandum must also provide information about the company's sales markets, competition, real estate, suppliers, staff, their salaries, etc. Much of the information required is the same as in the regular reports and essential event announcements published in the media. This requirement is pegged to investor security protection and market efficiency goals. Disclosure is usually defended as key to the "accuracy enhancement" of stock prices.⁵⁷ However, accurate securities prices may not provide as much economic benefit⁵⁸ as is commonly assumed.⁵⁹

These requirements do not improve the quality of information provided to investors, but they do make documentation drafting more money and time consuming. Balancing information and efficiency goals should solve the conflict of goals causing an obstacle with serious economic restraint. In issuing securities, it should be enough to disclose basic information about the company and its issue, as well as presenting a summary of essential events that have taken place since the last regular report. While preserving the same level of security for investors, this would enable companies to reduce issue costs and accelerate fund-raising.

3.2.1.3. Face value of shares

Law on Corporations⁶⁰ and some EU directives require that the issue price of shares should not be lower than their face value. At present market price of 29 out of the 39 issues listed on the Official and Current lists of the National Stock Exchange are lower than their face value.⁶¹

The current face value of company shares was determined largely by the compulsory revaluation of capital issued in the past. But this in itself did not increase the companies' equity. Various financial crises and the situation on the domestic and export markets have also affected the market value of shares. Presently, a company can reduce the face value of its equities and to restore the balance between their face and market value only by the amount of sustained losses. As a result, it is not possible for the company to reduce the face value of its shares in order to match the market value, or to release an equity issue if the market price of the company's shares has dropped below the face value due to factors beyond the company's control.

⁵⁶ See Vertybiniu popieriu rinkos istatymo projektas, *supra note 29*, Art. 5; also Del vertybiniu popieriu registravimo ir platinimo taisykliu (Securities Registration Instruction), LR VPK nutarimas, Žin. (1999, No. 76-2298).

⁵⁷ EDMUND W. KITCH, "The Theory and Practice of Securities Disclosure", *61 Brooklyn Law Review* (763, 764-65. 1995); also *SEC v. Ralston Purina Co.* 346 U.S. 119. (1953), explaining why registration with disclosure are necessary for public placement.

⁵⁸ LYNN A. STOUT, "An Economic Analysis of Stock Market Pricing and Securities Regulation", *87 Michigan Law Review*, 613, 692-95. 1988.

⁵⁹ Information is often scarce and expensive. As a result, even most rational individuals often act on incomplete information. Moreover, different individuals may have ready access to, and rely on, different subsets of incomplete information. Alternatively, two traders who acquire the same information might reach different conclusions because they interpret the data differently in the light of their own past experiences. This is much the same thing, as traders with different experiences are effectively relying upon different subsets of information (LYNN A. STOUT, "Why the Law Hates Speculators" 48 *Duke Law Journal*. vol. 48, (1999), p. 701).

⁶⁰ See Akciniu bendroviu istatymas, *supra note 51*, Art. 32 Clause 2.

⁶¹ See web page of National Stock Exchange// <www.nse.lt>, visited on 2001.05.17.

The original goal of banning trading share trade below its face value on issue was to protect investor and the market from high-risk securities. This goal conflicts with the goals to provide the device for the corporations to raise capital. Current situation where many companies have improper face value of shares has to be corrected by restoring balance between the face value of shares and their market price. To remove this obstacle it needs to enable companies to adjust the value of their equity to match the market. Thus, Law on Corporations should be amended to allow shareholders to decide lower authorized capital by the difference between the book value of the company's equity and its market price as established by independent valuers. However, it would create risk for market manipulation by multiple re-valuations; therefore this procedure shall be limited and permitted one-off before new issue of shares.

Another obstacle arising from the same conflict of goals is disallowance of shares with no face value. This prohibition may have been reasonable when the law was passed and possible speculation was seen as very dangerous activity for the whole economy, but it turns to be an obstacle when the market development proceeds. Shares with no face value would enable companies to sell their shares at market prices without any additional effort and would simplify securities accounting in view of the growing use of such shares in the world.

3.2.2. Intermediaries

Financial intermediaries' activities are regulated by the Securities Market Law⁶² and a series of rules set by the Securities Commission. The regulations aim to ensure that the market functions correctly (*market efficiency* goal) and that investors' interests are protected. However, they are stringent and detailed, requiring great accounting expenditures and restricting the freedom of transactions between financial intermediaries and their clients. The most problematic are the petty regulations regarding order receipt and execution, and unreasonably high requirements on initial brokerage equity.

3.2.2.1. Receipts and execution of orders

According to the Regulation of the receipt and execution of client orders approved by the Securities Commission, an investor must first conclude a contract with a financial intermediary before he is able to carry out securities transactions.⁶³ In order to carry out multiple transactions with the same issue, the investor must send a written order to the financial intermediary, who must register the order and return a copy to the client. This must be done every time the investor wishes to complete a transaction. If the client is unable to submit an order in writing, the rules allow him to do it in some other form. But in this case, the contract must identify the individual trader who will be working with the client.

These requirements are intended to protect investors' interests, but in fact, rather than provide protection, they restrict the operations of the investor and the financial intermediary, prolong transactions, increase transaction costs and may prevent orders from being executed on time. Securities Commission has an authority as an agency to regulate the capital market. However, this authority should not extend to the outside the market regulation. Market participants have their freedom of contracting right. Civil regulation goal is not to restrict it. The order transmission to the broker does not fall within the administrative authority of Securities Commission and moreover this regulation does not

⁶² See Vertybinu popieriu rinkos istatymo projektas, *supra* note 29, Art. 14-32.

⁶³ Del klientu pavedimu priemimo ir vykdymo taisykliu (Regulations of the Receipt and Execution of Client Orders), LR VPK nutarimas, Žin. (2001, No. 74-2622), Art. 3 and 8.

serve the specified investor security goal properly. The needless formalities are making foreign investors refuse the services of Lithuanian intermediaries and turn to foreign brokerages⁶⁴ instead. To achieve the market efficiency goal the formalization of contracts could be carried out in keeping with the Civil Code.

3.2.2.2. Capital requirements

Financial intermediaries in order to protect the interests of investors and to comply with EU directives⁶⁵ are required to meet initial equity requirements.⁶⁶ The owners' equity requirements in the EU were established in light of the capitalization and turnover of the Union securities market as well as the ability of EU traders to operate throughout the Union. The capitalization and turnover of the Lithuanian securities market are significantly lower; therefore the early application of the same requirements is unduly costly.

Owner's equity is seen as a fund necessary to protect investor. In case of fraudulent manipulation and tort by broker, investor could lay damages at financial intermediary. However, considering the liquidity of Lithuanian market, most of brokers do not have not open position but even the overall turnover reaching that numbers. Thus the high requirement for owner's equity serves as the unnecessary barrier to enter the market straining competition and hindering to achieve market efficiency. The existing owner's equity requirements should be reduced and it should start complying with EU directives only after the Lithuanian securities market has become part of the EU market.

3.2.3. Investors

3.2.3.1. Short selling

Short selling⁶⁷ is regarded as a useful mechanism⁶⁸ in some jurisdictions as an aid to liquidity. Where short selling is permitted, regulation must guard against manipulative practices, including those associated with a significant short position. In some jurisdictions this involves a combination of permitting securities lending and restricting short sales to liquid stocks.

Current Lithuanian Securities Law does not allow short sales, but the proposed project⁶⁹ does. However, the permission for short sales does not come together with the increased measures for investor security protection. Short sales permission is a very progressive step for a market development, but it creates additional risk for market manipulation and fair price distortion. Investor security goal is not regarded sufficiently in the proposed Securities Market Law and this creates irrational increase of risk. Disclosure of short sales and securities lending positions (or, at least, their reporting to the regulator) is a tool for the further reduction of risk.

⁶⁴ Under the contract of Baltic States Securities Exchanges, any brokers can execute their orders at any exchange in Baltic States. However, Estonian law has no such rigid regulations and brokers may act more flexibly.

⁶⁵ Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions. Official Journal L141, 11/06/1993 p.1-26.

⁶⁶ According to the rules approved by the Securities Commission (Rules of initial equity requirements for brokerages), the initial owners' equity of brokerages of the A, B and C categories should be not lower than 730,000, 125,000 and 50,000 ECU, respectively. Finansu maklerio imonių kapitalo pakankamumo skaičiavimo instrukcijos, LR VPK nutarimas, Žin. (1997, No. 108-2754).

⁶⁷ "Short selling" - is a sale of borrowed stock. It associated with speculation because a short seller can profit only if he can sell the borrowed stock at a higher price than he must pay when the time comes to repurchase it and return to the lender (STEVE THEL, "The Original Conception of section 10(b) of the Securities Exchange Act", 42 STAN. L. REV. 410, 432. 1990).

⁶⁸ Short selling is a necessary component of exchange traded futures and options markets.

⁶⁹ See Vertybinių popierių viešosios apyvartos istatymas, *supra* note 11.

3.2.3.2. Capital gains taxing efficiency

The main purpose of the capital gains tax is to equalize the conditions of taxing dividends and capital gains in order to ensure the principle of tax neutrality. However, tax neutrality is impossible to achieve when numerous tax exemptions, different tax rates, etc. are in place. Another objective of the tax is to expand the tax base. Effort to boost budget revenues through a tax that could be avoided and entails great expenditure is irrational.

The capital gains tax not only fails to achieve its objective, it also reduces incentives to invest in securities because the procedure of calculating and filing income tax returns places high demands on market participants in terms of money and time. This is an obvious conflict with market efficiency goal. It is likely that abolition of this tax would be more beneficial for both investors and the state because tax with high administrative cost and quite small revenue to the state simply can not be regarded as consistent situation.

3.2.3.3. Income declarations

Current legal regime⁷⁰ prohibits sale of securities when their value is higher than the minimum property value⁷¹ that must be declared unless the buyer has filed an income declaration.

This provision of the law is impossible to adhere to when transactions take place on the stock exchange, as the parties are not known beforehand when trading is done on the central market. In cases when income earned from the sale of securities is reinvested or securities are swapped, income used for the acquisition of securities has already been declared, making the requirement to declare income each time is unreasonable.

The requirement for the seller to examine whether the buyer has filled the income declaration properly serves for the prevention of money laundering. However, it has an incompatible conflict with the market efficiency goal. Income declaration supervision burden cannot be placed on the securities seller. In addition income should be declared once a year and only when the sum of income exceeds the minimum value of property, it should be subject to income declaration.

3.2.3.4. Inherited securities

Calculation of capital gains⁷² defines capital gains as income earned from the sale of securities less the price of their acquisition, the commission, and any acquisition-related taxes. Meanwhile, the acquisition price of inherited securities is only defined as the sum of the commission and taxes related to the assignment of ownership rights. As a result, an heir who sells inherited securities will be subject to a higher tax rate on capital gains than the former owner would have been.

Such regulation creates more favorable conditions for a short-term investment and speculations, while long term investment, that is core for corporation funding, is harmed. Consequently, the procedure of taxing capital gains makes securities investment less attractive as a long-term saving. Looking at the goals of regulation it is obvious that there is a conflict with constitutional equal protection principle and investor protection goal.

⁷⁰ Del Lietuvos Respublikos gyventoju pajamu brangiam turtui isigyti arba kitu isigytu bei perleidžiamu lešu deklaravimo (Law on the Declaration of Income for the Acquisition of Expensive Property and Other Acquired or Transferred Funds of the Residents of the Republic of Lithuania), LR Vyriausybės nutarimas, Žin. (1993, No. 70-1304), Art. 8.

⁷¹ Currently the minimum property value subject to declaration is 30 000 Lt (USD 7 500). Despite there is a proposal to triple the minimal amount subject to declaration, it creates burdensome requirement on market participants (*Id.*, Art. 3 Clause 2).

⁷² Vertybinių popierių vertės padidėjimo pajamų apskaiciavimo, nuostolių apskaiciavimo ir perkėlimo tvarka (Regulations of the calculation of capital gains income, calculation and carrying forward of losses), LR Vyriausybės nutarimas, Žin. (1999, No. 10-221), Clause 2.

3.2.3.5. Reinvestment

Calculation of capital gains income⁷³ requires that capital gains or a portion of them reinvested in other securities should be subtracted from taxable income. However, reinvestment has to take place in the same year that income is derived. This limits investors' opportunities, because the best time to sell securities may fall, for example, on December⁷⁴ of the current year, while the best time for reinvestment may be, for example, February the following year. Such limitation does not have any directly associated goal, except easement of accounting for the taxation authorities. Looking at the capital market regulation goals it is contradictory with the optimal investment opportunities and therefore conflicts with market efficiency goal.

3.2.3.5. Value Added Tax

Brokerage services in Lithuanian capital market could be provided not only by the brokerage firms but also by special departments of other financial intermediaries. The financial services provided by financial institutions operating under the laws On Public Circulation of Securities, On Pension Funds and On Investment Companies are subject to Value-Added Tax. According to the Law on VAT⁷⁵, financial services provided by insurance, banking and other credit institutions, including operations involving securities, are exempt from VAT. As a result, unequal tax conditions have been created for financial intermediaries. This is contradictory with equal protection principal and creates unnecessary indirect barriers for one group of financial institutions.

Under the Law on VAT⁷⁶, the circulation of securities is not subject to the tax. When calculating the tax, the turnover of securities is consequently attributed to the goods and services that are exempt from VAT. If a company's turnover consists only of goods and services subject to VAT, then the VAT payable to the budget is calculated by subtracting the purchase VAT from the sale VAT. However, if the company's turnover also includes items exempt from VAT, then not all of the purchase VAT can be subtracted from the sale VAT, but only a part of it, proportional to the share of the VAT sales in the total revenue. As a result of the flawed proportional approach in the calculation of VAT, companies have to pay higher taxes that may exceed their return on investment. This situation illustrates unequal treatment also. The State power to tax should not be executed irrespectively to the effect it creates on the economy. If a State benefit from the tax is smaller than the loss incurred by the corporation taxed, there is no overall benefit for the society and the unbalanced taxation is deleterious.

3.2.3.5. Restrictions on insurance companies

Law on Insurance⁷⁷ sets guidelines for the investment of insurance companies' authorized capital and reserves, while the finance minister decrees the amount of investments. Insurance companies are only permitted to invest their authorized capital in government and municipal bonds, real estate and timebank deposits. Reserves can be invested in company securities and mortgage loans. The chosen policy hardly reduces investment risk. Investments in treasury bills or real estate aren't risky in a well development economy, but in the emerging market that has not high credit rating it could

⁷³ *Id.*, Clause 8.

⁷⁴ There is a Capital Market Cycle theory claiming that Securities prices are highest on Friday at closing and lowest on Monday at opening during the week. It is called *week effect*. The same could be said about share price movements during the day (*day effect*) or even the whole year. Day and week effect are easy identifiable, while *annual effect* usually is shaded by other events.

⁷⁵ Pridetines vertes mokescio istatymas (Law on VAT), Žin. (1994, No. 3-40), Art. 4, Clause 5.

⁷⁶ *Id.*

⁷⁷ Draudimo istatymas (Law on Insurance), Žin. (1996, No. 73-1742), Art. 54 and 55.

hardly achieve risk reduction goal. This goal is an adaptation of investor security protection and could be fulfilled better by the requirement of a diversified investment portfolio. The current policy goal to create market for government bonds should not be considered more important than investor security protection.

3.2.3.6. Holdings

The Law on Investment Companies regulates the activities of public holding companies.⁷⁸ The law imposes an array of restrictions on holding companies: company directors must have a qualification certificate recognized by the Securities Commission, as well as work experience in banks or financial institutions. Also, shareholders have no privileged subscription rights to new equity issues. The law regulates the types of securities holding companies can invest in, as well as the amount they may invest. Also, restrictions on the establishment of holding companies are imposed. The main purpose of holding companies is to earn a profit from the operation of the subsidiary companies rather than from trade and speculation in securities.

The Qualified Institutional Buyers (QIB) regulation is based on the security protection goal. Every sort of QIBs has different rules imposed where they are permitted to invest. Generally the legislator should be concerned about the risk and liquidity of QIBs. The liquidity issue is most important considering banks investment portfolio regulation. If banks are allowed to invest in illiquid assets it increases the risk for the whole financial system stability.⁷⁹ However, the liquidity issue is not so important for the holdings and pension funds. They can predict their cash outflows more precisely. The remaining risk reduction goal cannot justify such regulation on holdings investment scope. Therefore, the requirements set out in the Law on Investment Companies merely restrict the operations of holding companies and burden market regulators.

3.2.3.7. Restrictions on pension fund risks

Law on Pension Funds⁸⁰ contains risk-limiting requirements for pension funds: capital adequacy, liquidity and a maximum open position in foreign currency.

These requirements were originally designed for commercial banks as their operations and risks differ from other types of legal entities. Pension funds are designed to accumulate retirement income for fund participants by investing their premiums in securities. Unlike commercial banks, pension funds can make precise estimates of the time and amount of future disbursements. They do not re-lend funds but invest them, which eliminates the need for any liquidity or capital adequacy requirements. The maximum open foreign currency position limits investments abroad even though investments in Lithuania may be more risky. The security and liquidity of pension funds' investments is also guarded by the diversified investment portfolio requirement contained in the law.

All the existing requirements except the diversified investment portfolio should be lifted, especially in view of the fact that insurance companies operating under a similar model are free from such restrictions. While still ensuring the same level of security for pension funds, this would reduce regulatory paperwork, make pension funds more flexible and free their assets. Meanwhile, the participants of pension plans would enjoy the benefit of greater retirement incomes.

⁷⁸ LR investiciniu bendroviu istatymas (Law on Investment Companies), Žin. (1995, No. 63-1581).

⁷⁹ This is the risk of "run on the bank" when depositors lose confidence in the banking system and want to withdraw their deposits immediately. If a bank has illiquid assets it may fail to meet such demand.

⁸⁰ Pensiju fondu istatymas (Law on Pension Funds), Žin. (1999, No. 55-1765), Art. 6, Clause 1.

3.2.3.8. Restrictions on pension fund investments

Law on Pension Funds⁸¹ provides that the Securities Commission can restrict pension funds' investments in deposits and securities of commercial banks. In keeping with this provision, the Securities Commission has issued a decision on restrictions on the investment of pension plan assets. It imposes limits on the amount of investments in securities depending on their type, issuer and country of origin.

The subjectively introduced restrictions on investment volumes do not increase pension funds' investment security, which is the main goal of regulation, but limit their ability to invest in risk-free securities irrespective of their type, issuer or country of origin. The requirement of a diversified investment portfolio is enough to boost investment security, and any additional requirements are not justifiable from the regulation goals' perspective.

Under the Law on Pensions⁸², pension funds must undertake a commitment to a certain annual rate of return on each type of pension plan. The rate is fixed by the funds themselves. This requirement burdens pension funds with a liability that is difficult to predict in advance and increases risks. During the period of economy recession the fund simply can not meet the requirement of flat rate of return without involvement in speculative investment. Speculative investment increases the risk of failure especially during recession period. That leads to the risk escalation. Obviously it was not the goal of legislator. The adaptation of flexible or semi-flexible rate of return could minimize the risk for the fund and promote fair competition in the market.

Conclusions

The capital market, being a significant part of the democratic state economy, has the task to achieve equilibrium in its money and capital markets and match the corporate investment with household savings. The efficient performance of the capital market can only be achieved if there is prudent and efficient regulation.

From the research guided by these goals, the following conclusions can be made:

1. The capital market, being in the center of state economy is affected by its goals, rules and regulations. It is affecting the direct capital market regulation not only by the securities market law, but also many other related legal rules and instructions.
2. Capital market regulation efficiency seeks to accomplish the given goals, and to comply with legal principles. The most difficult task is to find the balance among conflicting goals when embodying one goal or legal principle in its full scope harms another one. If the balance is determined improperly, the regulation becomes an obstacle for development and growth of capital market.
3. Adaptation of the semantic dependencies system and the examination of goals and conflicts in securities regulation make it possible to define legal obstacles in the capital market. A regulation becomes a legal obstacle when it intends to address one goal that conflicts with another and does not take into account its effect on every interconnected goal in order to determine the balancing point where the society could benefit most. Only by considering the interconnection between regulatory goals can regulations be written to achieve the optimal balance between these goals, thus benefiting society most.
4. Most of the legal obstacles arise from the conflict between investor security protection and market efficiency goals or their sub-goals. In most instances reviewed here capital market growth is hindered, thus the primary hypothesis of this paper is supported. Among most important hindrances there are the State fiscal policy, the State property

⁸¹ *Id.*, Art. 35, Clause 3.

⁸² *Id.*, Art. 32, Clause 2.

privatization, disclosure scope requirements, requirements on the face value of shares, capital gains taxing efficiency and limitations for Qualified Institutional Buyers investment scope.

5. Despite the fact that there are some legal obstacles for capital market efficiency, there may be other external goals that may justify their existence. Limitations should not be applied without reasonable consideration to goals that are outside of the regulatory scope. Several examples were presented here where the regulation satisfied the definition of a legal obstacle (*e.g.*, direct investment) but had supporting outside the market regulation goal, which justified its existence for its benefit to society.

The hindrance concept proved not to be the narrow interpretation of preventing growth. The short sale regulation analysis showed that it also takes into account faulty development directions and indicated the areas of development for the effective development of capital market.

Abstract in Lithuanian

Justas Babarskas

AR TEISINIAI TRIKDŽIAI STABDO LIETUVOS KAPITALO RINKOS AUGIMA?

Santrauka

Teisininkai ir ekonomistai nuolat diskutuoja apie laisvos rinkos naudą, tačiau realybeje laisva rinka su joje veikiančia tobula konkurencija yra tikrai idealus teorinis modelis, kuriame nėra dirbtinio reguliavimo, nėra mokescių bei jokių apribojimų asmenu, prekių ir paslaugų jūdejimui, kuriam vykstant visuomene nepatiria kaštų. Suvokiant, kad toks ekonominis modelis realybeje yra beveik nepasiekiamas, teisininkai laisvos rinkos samprata susiaurino iki pusiausvyros ekonomikos modelio, kuriame nėra kainos ir kiekio apribojimų.

Kapitalo rinka, budama svarbia demokratines valstybes ekonomikos dalimi atlieka pusiausvyros balansavimo funkcija pinigų ir kapitalo rinkose, suderindama gyventojų polinkį taupyti su verslo subjektų investicijų poreikiu.

Trumpu laikotarpiu nereguliuojama rinka gali pasiekti geresniu efektyvumo rezultatu, tačiau ji nėra stabili ir negali laiduoti ilgalaikio stabilaus valstybes ekonomikos augimo, todėl teisingas, subalansuotas ir efektyvus rinkos reguliavimas yra būtina efektyvaus kapitalo rinkos veikimo prielaida. Privataus sektoriaus efektyvumo samprata yra negincytina - tai resursų paskirstymo efektyvumas. Tuo tarpu teisinio reguliavimo efektyvumas yra diskutuojamas, kadangi kiekybiniu matu stoka ap sunkina objektyvaus ivertinimo galimybes. Vienas iš siulomu problemos sprendimo metodu - reguliavimo tikslu bei teisiniu principu analize. Pagrindiniai kapitalo rinkos reguliavimo tikslai - investuotojų apsauga, rinkos efektyvumas bei rizikos minimizavimas, turi būti derinami su bendraisiais teisiniais principais. Sudetingiausia užduotis istatymų leidejui yra konfliktuojanciu tikslu bei principu suderinimas siekiant pasiekti didžiausia imanoma naudą visuomenei. Reguliavimas, kuris siekia vieno tikslo igyvandinimo, tačiau tuo pat metu pažeidžia kito tikslo igyvandinimo galimybes tampa teisiniu trikdžiu.

Autorius darbe kelia hipoteze, kad tokie teisiniai trikdžiai stabdo Lietuvos kapitalo rinkos augimą. Išsamioje istatymų tikslu analizeje, nesigilinant i teisinio reguliavimo tikslus, kurie formuoja kapitalo rinka reguliuojancias normas, ivertintas šiu tikslu balanso teisingumas siekiant didžiausios ekonomines naudos visuomenei bei identifikuoti tikslu bei principu konfliktai galintys tapti vystymosi kliutimis. Darbo pradžioje suformuota hipoteze pasitvirtina - nesuradus optimalaus balanso tarp reguliavimo tikslu bei jų potikslu, formuojant teisinio reguliavimo režimą, teisiniai trikdžiai dažniausiai tampa kapitalo rinkos vystymosi stabdžiais.