Legal and Institutional Preconditions for the Efficient Functioning of Securities Markets

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Abstract

In order to make security markets function effectively, it is necessary among other things to insure market imperfections are minimal. It is necessary to consider the state functions for creating the fundamental legal and institutional preconditions which will achieve the abovementioned goal. Because of this, the present study analyzes alongside various forms of market imperfections the fundamental legal and institutional preconditions which are most important for the efficient functioning of securities markets. This study will also portray the situation according to the abovementioned existing preconditions in B&H. The main legal and institutional preconditions are: a regulatory body and public prosecutor, rules of procedure, mandatory disclosure of information, accounting and regulatory rules, institutions that formulate accounting rules, civil and criminal liability of accountants and financial auditors for cases of approved deceitful reports, sophisticated investment banks, sophisticated and specialized lawyers and legal experts, stock markets, civil and criminal liability of issuers and investors in cases involving the issuing of false information, criminal liability of insiders for intentional fraud, market transparency, prohibition of price manipulation, an established culture and other informal institutions.

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1. Introduction

As a way of financing and investing in most developed economies there is an investing-disinvesting mechanism in the securities market. The majority of authors take this mechanism as the center of the financial system, the generator of all economic activity. Within the hierarchy of objectives for transitional countries and less developed countries highest priority must be given to building a financial system that will drive all economic activities, and generate economic growth. The efficient functioning of a financial system in market economies depends on the efficient functioning of its securities market. The efficient functioning of securities markets depends on existing scale market imperfections like information asymmetry and negative selection. Because of this, a very important assignment for any country is the building of adequate mechanisms to prevent market imperfections which have a negative influence on investors’ confidence in the financial system.

The main objective of this work, using the experiences of more developed countries, is to present which legal and institutional preconditions are most important for the efficient functioning of a securities market and to portray the situation according to the abovementioned preconditions in B&H. The main intention of this study is, by examining legal and institutional preconditions for the efficient functioning of a securities market without special statistical analysis, to show a correlation between the legal protection of investors and the efficient functioning of a securities market and economic growth. The study consists of three parts. The first part represents a preliminary introduction to the main theoretical observations on fundamental principles for the efficient functioning of a securities market.

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and barriers (information asymmetry and market abuse) which have a negative influence on investor honesty and the efficient functioning of a securities market. The theoretical perspective is maintained by evidence that the most economically developed countries have the most developed securities markets and the most developed mechanisms for the protection of investor rights. The second part is a concise portrait of the fundamental legal and institutional preconditions for the efficient functioning of a securities market. The legal and institutional preconditions which exist as part of a mechanism for the protection of investor rights in those countries with the most developed securities markets serve as the basis for this section. The third part of the work presents an analysis of the situation in B&H according to the existence and future development of legal and institutional preconditions for the efficient functioning of a securities market in B&H.

2. The Fundamental Principles of the Efficient Functioning of Securities Markets

In order to function well, a securities market necessarily has to connect the supply and demand of securities in the shortest period of time with minimal cost. In other words, an efficient securities market is a market which undisturbed and with minimal cost transfers savings into investments on the basis of price signals. Price signals are correlated to the course of information which investors receive from issuers. Honesty and the quality of information received by participants are widely considered the basic preconditions for the functioning of a price signals mechanism within a securities market. Therefore, any disturbance of price signals (caused by e.g. price manipulation or by the spread of false information) can cause a disturbance in the efficient functioning of a securities market. An efficient, stable securities market generates economic development, and hence is the aim of every country. However, the creation of an efficient securities market is an extremely difficult task in the face of economic politics. On the other side, stability and effectiveness of a securities market are preconditions for the trust of investors ready to invest free financial assets for completely "abstract rights." The "value" of securities depends, among other things, on the quality and on the validity of the information about the issuer received by the investor. Indirectly, the value or price of a security depends on the respect and application of financial ethical principles by brokers and dealers.

The validity and quality of information from the issuer have a dual effect on a securities market. The first is direct, because it determines the effective impact on price signals, and the second indirect, because it supports an investor’s trust in a securities market. Many authors consider the "blind" trust of investors in securities markets "magical," an essential basis that still eludes models for sustainability.

Securities markets, which as an alternative model of financing have been inherited for over two centuries by the most developed market economies, play an important role in financial systems. The importance and role of securities markets have in the most developed countries influenced their recognition as major priorities for transitional economies from the end of the previous century. However, fast and large-scale privatization in centrally planned countries which had concentrated private ownership in public companies established securities markets overnight. The consequences of privatization "at any cost" showed that this activity demands a great deal of study and cost-benefit analysis before the best model of implementation and regulation is chosen. Securities markets that were established "overnight" in the process of transition were created more as institutional instruments for the implementation of privatization than mechanisms and initiators of economic development.

In the search for an answer to the question of what would be the best model for the formation of an efficient and stable securities market that would accelerate the economic activity of a given country, it is necessary to start from a non-economic institution that nonetheless strongly influences financial systems. This is the institution of "trust" among potential investors who are ready to cede their financial assets to profit carriers. The potential investor has to know that his invested assets won't be the object of market manipulation in order to have a trust in the financial system and securities market. He must also trust that he is in the same starting position in the competition as other participants in a transparent market. In other words, the investor believes in the securities market only when he knows that his rights are protected by law and that information rel-

3 Financial ethics represents the application of ethical principles in which financial, moral, and business interests, correctness and good behavior are realized, as opposed to immoral frauds and lies. The domination of ethical values in financial-market trade at the same time means the elimination of criminalization of the share market trade. More ethics in financial trade means less business immorality, frauds, robbery, bribes, corruption and most importantly less legal and administratively judicial regulation.

4 The terminological subject "same starting position" reflects the state of market symmetry from the availability of information relevant to decision making.
Legal and Institutional Preconditions for Efficient Functioning of Securities Market

Information asymmetry (which very frequently results in insider trading) and negative selection are the manifestations of the imperfection of a securities market. Negative selection appears as one of the consequences of information asymmetry, and both invite certain models of conscious intervention in a securities market. From the perspective of a free financial assets holder or potential investor, a securities market, as one of the alternative models of financing, is not perfect. In information asymmetry one or more participants has knowledge of privileged information about an issuer having a certain advantage over other participants. Information asymmetry is connected to a problem of mediation in the information transfer from issuer to investors. There are two courses between issuers and investors in securities: one of information from the issuer to the investors and one of capital from the investors to the issuers. In this process the second course is conditioned by the first. In other words, the placing of free capital into the securities of a concrete issuer depends on the quality of the information about the issuer received by investors. The course of information from the issuer to the investors can be direct or indirect through an authorized intermediary. However, certain persons, who are in the frame of issuers or who are by their function connected to the issuer, and who are named as insiders, have a certain advantage because they are at the source of privileged information and depending on its value can use it for personal benefit. The value or price of the securities of issuers depends on the issuer’s future business projections. The current position of an issuer is represented by profit and state balance, which are often signs of the future projections of the issuer. Insiders are among the first to find out about the future results? Specifically which laws and institutions are relevant to an efficient and respectable securities market? And what is the most appropriate rate with which to implement the chosen model? In order to answer these questions, it is necessary to present one theoretical approach that will concisely explain the complex net of relations between legal and market institutions representing support for an effective, stable and respectable securities market such as those in the United States of America and Great Britain. The text that follows, having in mind the positive legal solutions of the abovementioned countries, will give a short review of the main legal and institutional preconditions that must be ensured within a social context in order to provide a well-functioning securities market.

2.1. The Main Forms of Securities Market Imperfection

Information asymmetry, as the imperfection of the market, represents unequal availability to information relevant to the decision making of a participant in the securities market. Privileged information is all information about an issuer or his securities, which, if issued, would have an influence on the price of securities. Information asymmetry, which is the result of insider trading, negatively affects the securities market. The abovementioned claim was proven by Laura N. Benny through the formation of an index for measuring the effect of Insider Trading Laws on a securities market. During the creation of a securities market for a given country many questions arise. Among the most frequent are: which model of securities market regulation gives the best results? Specifically which laws and institutions are relevant to an efficient and respectable securities market? And what is the most appropriate rate with which to implement the chosen model? In order to answer these questions, it is necessary to present one theoretical approach that will concisely explain the complex net of relations between legal and market institutions representing support for an effective, stable and respectable securities market such as those in the United States of America and Great Britain. The text that follows, having in mind the positive legal solutions of the abovementioned countries, will give a short review of the main legal and institutional preconditions that must be ensured within a social context in order to provide a well-functioning securities market.

It was proven during theoretical and practical research that market imperfections in the form of securities market abuse (inside trading) decrease allocational, operational, and informational efficiency. Allocational and informational efficiency are connected with erroneous price signals and because of this «erroneously» directs free money resources. Operational efficiency is connected with evidence that the existence of insider trading increases the cost of transactions because dealers, taking this into consideration, enhance the bid-ask span which in turn increases costs for investors. See: Laura N. Benny, “Do Insider Trading Laws Matter? Some Preliminary Comparative Evidence,” William Davidson Institute, Working Paper Number 741, 2005.

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business performance of the issuer. To eliminate information asymmetry, insiders should issue all mentioned information without hesitation, in this way making it possible for investors to estimate the value of the issuer and his securities.

The introduction of a legal obligation to the issue of privileged information in addition to regular information about the solvency of the issuer decreases information asymmetry. The procedure of information disclosure, in the sense of the fulfillment of the legal form and procedure, poses no problem. Because of their position and interests, when informing the public, insiders often incorrectly represent the performance of an issuer, and are in turn trusted by investors. The interests of an insider can be such that he does not promptly disclose (or disclose at all) correct information regarding e.g. poor business performance, the dismissal of workers, or bankruptcy. He can take part in insider trading⁹ and make a profit until the correct information is made known to the public. False information, which is given to the public by the insider, is part of a price mechanism of the securities market, and creates a false perception of the real state of a certain issuer. This problem acquires importance within new legal entities, which are small corporations issuing securities for the first time. In their case there is no previous rating to base judgment on the security of the issuer and the quality of their securities. Investors are forced to rely on information given in the prospectus¹⁰ and to accept them as valid for decisions on securities purchase.

To simplify the situation, one can compare the process with that of a computer sale. The potential purchaser can see and test the computer before deciding to buy it. Furthermore, the potential purchaser can ask for a professional opinion about the condition and performance of the computer. At the potential purchaser’s disposal is the possibility of consulting a person who owned or used a computer of the same producer. The securities of a company that issues by public announcement for the first time are comparable to the first model produced by an unknown computer manufacturer. Investors can observe only “dry” information written on paper that they directly verify. The consequence of information asymmetry is a situation in which investors, because of a lack of trust and because of an ignorance of who issues relatively correct information, are offered a discount price for all securities. Discounting presents a kind of insurance that issuers will receive an acceptable price for the issued securities and motivation for further use of this model. However, although discounting is insurance from the potential damage caused by investing in the securities of a new issuer without an established rating, the discounting of prices will not discourage issuers from actions contrary to the principles of financial ethics. Circumstances in which the behavior of issuers is contrary to the principles of financial ethics result in potential damage to investors and decrease their trust in the financial system. There then appears a tendency in securities markets for high rated issuers to disappear because of the lack of acceptable and fair prices for their securities. At the same time, issuers with less respectable ratings remain on the market and worsen the problem of negative selection combined with lower quality information provided to investors. This situation reflects a condition in which high rated issuers leave the securities market in order to protect themselves from the risk of investing in the securities of unknown issuers, investors react with more discounting of prices which in turn intensifies negative selection and weakens the functions of the securities market (Black, 2001, p. 786). Because of the existence of insiders, information asymmetry and distrust in the correctness of information issued about the issuer and his securities, issuers intentionally discount the prices of securities, diverting issuers from this kind of financing.

Price manipulation¹¹ is another market imperfection, in certain cases connected to information asymmetry, and should be eliminated. If a participant knows correct information relevant to an investor’s decision yet gives false information, or spreads rumors about securities or their issuers with the aim of manipulating the market, he places himself in a better position than other participants. Dissemination of false information about a security through the media, including the internet or any other means, exists if two conditions are fulfilled. The first condition is that the information gives, or possibly gives, false or misleading indicators. The second condition is that the per-

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⁹ Although the term insider trading is generally understood as trading with privileged information, this term has a wider meaning. Most of what the comparative laws term insider trading, besides securities buying and selling, implies any usage of privilege during securities trading by knowing price sensitive information concerning the securities or their issuer. This practically means that the definition of insider trading includes elements of mediation in trading, investor consulting or revealing privileged information before their public disclosure.

¹⁰ The prospectus is a legal document containing information about financial and material facts connected to the issuer that are relevant for decisions about investing.

¹¹ Manipulation of the securities market is any activity, transaction or trade warrant, which can give false or deceptive signals about prices or about the offered or demanded amount of certain market materials, which are used for trading on the securities market and as a consequence the artificial formation of prices used in trading.
In the following text, the basic legal and institutional pre-

In order to prevent the appearance of negative selection as well as the damage caused by insider trading, including information asymmetry and false information dissemination, countries have to create an adequate mechanism for information disclosure which would sanction the disclosure and dissemination of false information and protect the rights of investors. Some countries partly solved the problem of negative selection and false information disclosure by a mechanism composed of a complex set of laws, private and public institutions authorized to implement the laws, and a guarantee of correct information. The basis for this mechanism, according to some authors (Black, 2001), are respectable institutions, i.e. intermediaries, such as investment banks, accounting companies, law firms and stock markets. The function or task of the abovementioned group of intermediaries is to control the quality and correctness of the disclosed information of every issuer. During this process they eliminate participants whose reputation is suspicious because of false information disclosed in a prospectus or financial reports. Institutions of intermediaries have their legitimacy because of their responsibility to investors in case of the approval of a false information disclosure. The responsibility of intermediaries is confirmed in civil or criminal procedures for cases of intentional deception and depends on an accepted, institutional model of financial market regulation. As a second possible solution, and one that has been introduced into practice, a governmental or public-law body may be formed authorized to regulate and control disclosure, the trading of securities and the sanctioning of violators.

In order to prevent a false picture, it should be mentioned that even in countries with developed securities markets and developed legal systems with adequate protection of investors, “fraud” on a securities market is far from rare. Therefore it cannot be said even for countries with the most developed securities markets that they have a defined mechanism of legal protection for investors, or a regulatory frame for the securities market. On the contrary, the institutional and legal frame for the securities markets functioning even in the most developed countries is being constantly developed and rebuilt with only one goal – strengthening the trust of participants in the securities market. As an example one can use the USA, where the falsification of documents and statements needed for the fulfillment of mandatory information disclosure presents a large problem, especially in cases of the violation of small investors’ rights who are not skilful enough for activities on the securities market.

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3. Legal and Institutional Preconditions for the Efficient Functioning of Securities Markets

States with efficient and respectable securities markets have developed mechanisms for the sanctioning of market abuse, information asymmetry and negative selection. Such mechanisms that contribute to the increase of securities market efficiency is constructed from a series of institutions that have been established for that purpose. These mechanisms aim to eliminate market imperfections while encouraging the investor’s general good faith in the financial system. In spite of the differences that arise from the characteristics specific to the economic system of a single country, the basis of an information asymmetry sanctioning mechanism and the increase of securities market efficiency lies in the following institutions and laws

a) Institutions:

1. A regulatory body and public prosecutor (in cases of activities classified as criminal acts that have been prosecuted ex officio) are the institutions or bodies which are independent, “scrupulous” and “moral,” and invested with legal authority. Regulatory bodies, in many states, exist as the Commission for Securities or self-regulating organizations. The specific concentration of regulatory authority depends on the accepted institutional model of regulation of the given financial system. However, there are two general approaches. The first is supported by proponents of regulation and implies that relations in financial matters are regulated by law and other legal instruments of the state. The second, supported by proponents...
of deregulation, involves an approach to the restrictive legal regulation of financial matters with the use of self-regulating organizations. Public-legal bodies appear as regulatory bodies, most often as the Commission for Securities, while self-regulating bodies appear as associations of brokers and dealers. A regulatory body and public prosecutor should have qualified personnel and an adequate budget to reveal and resolve complex cases connected to violations of rules on information issuing, insider trading and price manipulation. “Scrupulousness” and “morality” are qualities which transcend the domains of the law and the economy and the possession of these by persons that work in a regulatory body or in public prosecution is a precondition for the efficient sanctioning of information asymmetry and securities market abuse. “Independence” is often an important issue in the financing of a regulatory body. Their budgets are often restricted, with restrictive rules on salaries and awards which prevent the use of certain benefits, to ensure both the hiring and retaining of qualified personnel who are “scrupulous and honest.” Specialization of personnel for activities tied to the discovery of market abuses or the violation of rules concerning information disclosure, insider trading and market manipulation is an important condition. Namely, even in the most developed countries, there are a small number of public prosecutors who have the qualifications or interest to reveal and prosecute criminal acts and perpetrators in the field of securities law. Some violations within securities law include extremely complex and complicated frauds, e.g. a company who falsifies its financial reports. An unqualified and less professional public prosecutor may raise this kind of case, but would always prefer to investigate and prosecute perpetrators of a murder or other forms of severe criminal acts of which he has more knowledge and experience. The lack of sophisticated and specialized personnel in regulatory bodies and public prosecution is especially emphasized in transitional countries engaged in the establishment of securities markets for the first time and which must simultaneously educate their personnel. Furthermore, many cases require a careful analysis of the financial results of a company in order to prove insider abuse of privileged information and fraud. This financial analysis demands expert knowledge and skills from a prosecutor to prove fraud before a court.

2. A judicial system that is efficient, independent, based on ethical and moral principles and sophisticated enough to solve cases from the field of securities law is necessary. A precondition for the efficient functioning of a securities market is a fast, decisive judicial system capable of efficient intervention when sanctioning and preventing the illegal appropriation (theft) of financial assets. The ethics and morality of judges are especially important in the establishment of the rule of law on one side and a legal consciousness on the other; they must be certain of their role in the resolution of securities market manipulation cases. Independence and regular application of ethical and moral principles can be ensured only through the material independence and high salaries of judges. Judicial ethics and professionalism in the implementation of law are the main pillars against corruption. Complex cases of fraud in securities markets require sophisticated public prosecutors as well as qualified judges who will make decisions about the legitimacy of prosecution of the violation (this can be ensured by legal experience in securities law). The promptness and efficiency of court procedure, execution and decision-making are the second important condition. In cases where, e.g., an insider engages in fraudulent activity, some financial funds can be restored, unless the public prosecutor demands the suspension of the insider’s financial assets until the procedure is completed if the court accepts this as justified. However, if a public prosecutor doesn’t react in time, there is the possibility of the permanent loss of these assets.

3. Institutions which create accounting rules have to be competent in terms of professionalism and knowledge, and independent in initiatives to change and adopt existing rules according to newly created and changed circumstances. In the legal systems of many countries, as was previously stated, accounting rules are created in order to make the procedure of company taxation easier, while informing and attracting potential investors in the securities of the company; the issuer is of relatively less relevance. Regarding the primary aim of such rules and the demands of tax principles for rare tax law changes, it can be concluded that the abovementioned rules are inflexible when it comes to changes that have often been brought by contemporary business conditions. Accordingly, the creation of accounting standards and rules should not be exclusively the responsibility of Ministries of Finance as is most often the case, but rather that of some other organ or body such as the Commission for Securities. The creation of accounting standards and rules implies knowledge of a company’s business, an understanding of technical expressions used daily in the business of the company, knowledge of the basic principles of its activities connected to the securities market and the category apparatus which has been adopted in other legal norms that regulate its activity in the securities market. Creators of accounting rules must possess the ability to understand changes in the daily practice of the company caused by either internal or external factors. Inventiveness in the creators is necessary in
order to create new rules that will respond to the challenges of contemporary economic activities, as well as the ability to interpret these if need be. Experts from the field of accounting, e.g. auditors, are the most suitable for the implementation and interpretation of accounting standards and rules.

4. Sophisticated investment banks that control and analyze the issuers are an important institutional precondition for the efficient functioning of the securities market. The essence of their role concerns their reputation, which depends on the fact that issuers, their clients, do not sell overvalued securities. Investment banks are, besides auditing agencies and financial experts, the second key mediator, and seek to find a balance between the offering and selling of securities. Their role includes so-called “due diligence” investigation of the issuer, the documents offered, the presentation of the issuer’s prospectus, information disclosure about the main risks and creation of a list of the “unscrupulous” managers of the issuer. Furthermore, investment banks routinely check the biographies of insiders to determine if they engaged in activities that violated the basic principles of financial ethics. Any behavior of investment banks contrary to financial ethics negatively influences their reputation. An example of this is a purchaser of securities who, bearing in mind that an investment bank earlier sold unprofitable securities, avoids its future offers. Investment banks research the market performance of the issuer, in addition to the market performance and weaknesses of their competitors and in this way increase the quality of their service.16

5. Sophisticated lawyers and solicitors, who are securities professionals and who will ensure that the procedure of public disclosure will proceed legally. Lawyers and solicitors specializing in securities are the third link in the chain of reputable mediators, even if they are, compared to investment banks and accountants, less “visible” to the investors. Lawyers and solicitors have the task of finding a balance between acceptable financial reports required by issuers while hiding the risks and problems of the issuers.17

6. The stock market as a public-law or private-law legal body establishes standards for the behavior of its members. Its responsibilities include monitoring disclosure and deleting the quoted securities of issuers that have violated laws on the obligation of information disclosure. The investors use stock market lists to evaluate securities and their issuers. One of the basic effects of listing issuers who have disclosed the false information is injury to their reputation and all other issuers whose securities are quoted on the concrete stock market.

7. Directors and managers of issuers who are independent and ethical. Investment banks, accountants, auditors, and solicitors specializing in the field of securities are the main outer “reviewers” and underwriters of information disclosure documents. Those documents are signed by a director or another similarly invested individual. During the control and signing of a document, the director who is scrupulous and responsible notices mistakes and failures and corrects them. Efforts by the director to analyze reports “with special attention” are strengthened by establishing his responsibility to investors.

8. Investment funds and connected institutions established to protect small and insufficiently sophisticated investors from

14 Investment banks are those specializing in activities with securities.

15 “Due diligence” has many meanings; in a financial category apparatus it represents a certain investigation or analysis whose aim is the confirmation of the correctness of information relevant to the sale of securities. Generally, “due diligence” implies the concern of a rational person with the intention of making certain investments who wishes to avoid potential damages caused by a “wrong” estimation of securities.

16 One of the worst sources of business inconvenience, and one that will not be forgotten among investors or competitors, occurs when a bank as a guarantee sells the securities of fraudulent companies, whose prices decrease because of revealed fraud.

17 Bernard S. Black in the quoted work emphasizes that the role of lawyers and solicitors in information disclosure is determined by how ready issuers, insiders and investment bankers are to face the risk of responsibility to their investors. If the issuers and investment bankers do not want to take the risk of responsibility, they will make an effort to protect themselves by hiring lawyers and solicitors with the abovementioned characteristics to collect and analyze the most important documents used in the information disclosure process. The caution of the solicitor during his work on entrusted activities in the process of information disclosure, deriving from the protection of clients from liability, will help in ensuring the quality of information disclosure even in cases facing a small risk of responsibility. On the other hand, if issuers are ready to take the risk of responsibility, they will not hire a solicitor and the quality of disclosure will diminish.
risk through its dispersion in stock portfolios also support significance increase in securities markets. Investment funds that tend both to their ratings and their investor's interests carefully analyze the securities in which they investing. To this purpose they often engage specialized financial analysts who check the reliability and relevance of information received from the mandatory disclosure of financial reports.

9. “Venture funds.” Investors in the securities of well-known “high-tech” companies are faced with information asymmetry problems. This problem is connected to the fact that these companies often have a short history, make special products and take part in “fast changing” industries. Venture funds analyze and research “high tech” companies that need capital and issue securities. After the so-called “repacking” of assets received by the issuing of proper securities into the securities of a “checked” issuer from the industry, they observe growth and changes to their capital on the securities market. These kinds of funds play a double role on the market, ensuring financial capital and monitoring the securities market.

10. Agencies for the Estimation of Bonds. The basic function of these agencies is the quality estimation of bonds for potential investors. They are especially important for less developed markets, where they estimate the risk of a company and the state as well if the estimation cannot be made otherwise. In order to realize its function, an agency should have professional and sophisticated personnel and adequate financial assets necessary for the benefit analysis of investing in various issuers’ bonds.

11. Agencies for the Estimation of Manager Quality in investment or pension-funds. These agencies appear in the form of verified institutions for performance control of managers who administer investment or pension-funds on the basis of special quality measurement indexes.

b) Laws:

1. Procedural rules, given in the form of e.g. laws on civil or criminal procedure, should ensure a wide scope of evidence-collecting or the establishment of conditions for filing a suit especially regarding the small value requests of a large number of investors. It is useful to mention two statements regarding the creation of procedural rules:

- evidence of fraud activities connected to information disclosure often requires the collection of information

- individual investors often do not want to accept the high costs of complex suits for low-value damage compensation, especially when it is known that insiders have strong arguments in their defense. In these cases “class suits” could be used or some other method of including a great number of claims of low value, e.g. joinder (class) of procedures.

2. Widespread mandatory disclosure of information in the form of financial reports is a precondition for the efficient functioning of a market and basis for mechanisms that reduce information asymmetry. The development and stability of a securities market are conditioned by the trust of investors in the validity of the information they receive from the securities market and from the issuer. The trust of the investors is strengthened through the establishment of legal obligations for listed issuers to provide investors new and correct information about the financial results of their business activities through periodical mandatory disclosure. Mandatory disclosure is not only connected to information about the business of issuer, but disclosure of all other privileged information in the shortest period of time (ad hoc disclosure). During the mandatory disclosure of financial reports there is the possibility of fraud through the falsification of documents or the issuing of false information; this requires special checking. Regardless, these demands must be prescribed and established by law, especially when the issuer of securities is a public company. There is no homogeneous approach to the form, manner and rules by which information disclosure is prescribed. The basic dilemma is over whether the obligation of information disclosure should be prescribed by law or the rules of a stock exchange or self-regulating organization. Keeping in mind the pragmatic accommodation

18 It should be said that a certain group of authors considers this kind of securities market participants unimportant for the development of an efficient securities market.

19 Venture funds represent a special kind of intermediary agent specialising in investment in “high tech” companies securities.

20 Bernard S. Black states that in some legal systems, such as in South Korea, special arrangements for the investigation and opening of procedures with supplemental compensation are allowed. However, it was shown that the lack of a joint institutional procedure had a negative effect on information disclosure.
of laws to existing circumstances, and the necessity of their effective execution and deterrence, proponents of regulation believe that laws focused on accounting practices present a more efficient mechanism for eliminating information asymmetry among brokers than self regulating organizations.

3. Rules for accounting and supervision, in order to improve the efficiency of the functioning of the securities market, should be created as follows:

- Accounting and supervision rules should be made according to the needs of investors for relevant information; specifically their implementation should ensure useful information for investors. This request is especially important because of the fact that in many countries, accounting rules have been designed in order to simplify and streamline taxation, and not to enable investors to examine the solvency of the issuer.

- Accounting rules and standards should enable the comparison of financial indicators of different issuers in both domestic and international securities markets. At the same time they should not limit administrative organs in their choice of different models of accounting practice.

- Accounting rules should represent a balance between the wishes of investors for information and the costs of information insurance and concerns of companies over the disclosure of “sensitive” information that could be provided to competitors. Extremely flexible rules can reduce comparability and create a space for fraudulent activities by increasing information asymmetry between the issuer and investor. Standards of supervision have to be rigorous to discourage any attempt at fraudulent activity.

4. Laws for Securities Regulation or any law that will impose on accountants and financial auditors the risk of civil or criminal liability to investors in the case of the approval of falsified or deceptive financial reports. In this way the “resistance” of financial auditors and accountants to the pressure of clients for relaxed supervision or standards of information disclosure is ensured. Experts from the field of accounting and finances are, through the approval of financial reports, important mediators in the process of information transfer to investors. When they control or approve financial reports they can recognize fraudulent intentions and prevent them. With the establishment of a liability to investors, cases of the approval of falsified or fraudulent reports by accounting and auditing companies risk a loss in reputation. On the other side, the existence of liability for accountants and auditors requires accounting and auditing companies to include certain internal procedures and bodies for the control of the standards of approved reports.

5. For investment banks and other mediators the introduction of legal responsibility and possible damage to their reputations are very important legal preconditions for the efficient functioning of securities markets. The abovementioned responsibility is introduced in cases of guarantied securities which are sold through the disclosure of falsified or false information. The introduction of responsibility for investment banks has the same effect as that on accountants and auditors. Banks then refuse the efforts and pressures of clients for a relaxed treatment of disclosure. The additional effect of establishing responsibility towards investors is reflected in a greater effort on the part of investment banks to sustain and invest in their reputations. Investing in reputation improves the quality of financial services offered by banks. Furthermore, with the aim of sustaining their reputation, investment banks form internal procedures and organs for quality control, and standards which issuers of securities must satisfy. The best conditions for the existence of such responsibility, specifically its legal implementation, depend on factors in the economic system of the country. It is necessary to pay attention and avoid causing unnecessary and frequent disputes and court proceedings.

6. The institution of civil and criminal procedures, and the establishment of sanctions for all issuers and insiders who falsify, disclose or spread false information as well as those who use privileged information in an illegal manner. Investment banks, auditors and solicitors serve as a secondary means of preventing fraudulent activities in the issuing and trading of securities. The primary way is the sanctioning of issuers and insiders proven to be engaged in fraudulent activities.

Criminal liability for insiders who deliberately “deceive” investors. For insiders, according to some authors, unlike mediators, civil penalties and fines are insufficiently intimidating, making it necessary to introduce criminal liability and possible imprisonment for those convicted of the most serious forms of fraud. Here one should mention that in theories regarding the sanctioning of violators of the law, which forbids market abu-

21 The economic system as a totality of legal rules, which regulate economic courses, is determined by: the dominant form of ownership, institutional bases of business, the functional frame of economic courses, motives of business and the character of the economic role of the state.

22 Especially those connected to mandatory information disclosure.
es on the securities market, a dilemma arises over the justification of criminal sanctions implementation. The use of criminal sanctions for perpetrators of market abuses on the securities market has certain financial and social limitations. According to Becker (1976) the social costs of criminal sanctions involve those caused by the illegal behavior, those from the prosecution and punishment of the accused, who serves a sentence of imprisonment and loses his benefits because of potential separation from so-called “social calculus,” and administrative costs from court proceedings. Therefore, when defining the criminal liability of insiders, one should adhere to the principles of “Cost-benefit analysis,” and determine which application of the law is the most efficient given the total cost of the creation, respect and execution of laws is lower than the costs arising from fraudulent financial activity.

Rules that forbid insider trading activities and which effectively decrease the insider’s interest in concealing correct or disclosing incorrect information. If the law prescribes sanctioning for insider trading, the insider will calculate the level of risk from the sanctioning and the potential benefits which he would obtain from fraudulent activity. It is necessary that insiders, beside liability for false information disclosure, face an additional law stating their potential liability for insider trading.

7. Rules that ensure “market transparency”23 in the sense that the time, place, circulation and price of securities must be promptly disclosed to investors24. To establish these it is necessary to have one important source that will offer all investors equally full insight into the securities market. Full insight in a securities market enables investors, according to market signals, to create optimal portfolios and decrease information asymmetry. This includes the introduction of a legal obligation to regularly provide updates on the state of stock markets and disclose transactions of large investors, who often prefer to conceal their transactions in order to reduce the influence of prices on their trades. Furthermore, according to Bernard S. Black, transparency increases investor trust, increasing market efficiency. Stock markets should obligate brokers and dealers to submit regular reports about their transactions. Governments should establish an obligation to promptly report and request all participants in the stock market to report to a simple, consolidated source.

8. Rules that forbid market manipulation on the securities market and their implementation.25 The manipulator can undertake such actions to create values of securities that can be overvalued or undervalued, in order to make a transaction which brings him a greater profit. By creating a false image of securities other investors are misled, which negatively reflects on their portfolio and causes them damage. There is a great deal of proof both from theory and practice that the existence of strong laws that prohibit price manipulation of securities and prescribe strict sanctions for perpetrators increases the efficiency of a securities market (K. Aggrawal, Guojun Wu, 2002).  

9. Introducing legal obligations and liability for licensing intermediaries with good reputations. This depends on the mechanism for realizing the goals of the accepted model of regulation.26 Licensing is introduced first to investment banks

23 Transparency is considered a public good, and should be established and ensured by state law.

24 In other words, a transparent market is a market which has the following characteristics: constant circulation of specific information about issuers and issued securities, disclosure of material benefits based on legal activities with securities, and securities information disclosure before and after trade.

25 If the abovementioned definition of price manipulation is considered, the various forms of price manipulation in practice can be grouped into three types:

1. legal affairs or conditioned prescription:
   a) to create, or the possibility to create, misleading perceptions of supply, demand or the price of securities
   b) to direct, on an artificial level, a price maintaining one or more financial instruments regardless if the activities are the result of one or more individual’s operations, except in the following cases:
      - if a person negotiates some legal affair or prescribes trading which has elements of legally defined manipulation;
      - in cases where operations are accorded with a customary practice on a regulated securities market;

2. fictive transactions or fictive prescription for trading including others forms of fraud or dummy operations;

3. broadcasting rumors about securities through instruments for public information, including the internet, or through other instruments if the two next conditions are both fulfilled:
   a) if the information, rumors or news create an untrue sense about securities, or either give or potentially give misleading indicators,
   b) if the person who broadcasts the abovementioned information, rumors or news knows that the information was untrue. This brings up the interesting issue of journalists’ responsibilities within their own professions, where the liability for the broadcast of such information depends on their receiving a certain benefit by the broadcast
and auditing agencies.

10. A more flexible and stimulating tax system. Confiscatory tax systems, such as that in Russia, exclude honest reporting and profit registration, and hinder quality information disclosure. It has been generally observed that in matters of tax evasion private companies have a stronger interest than the public. For a strong and efficient securities market the tax rate is important; if it is high, public companies will not use the securities market as a model of financing. It is especially important if a high tax rate on securities transactions negatively affects the size of the market; this distorts offers and requests for securities according to different designations for taxpayers.

It is important to emphasize that some authors consider liabilities for licensing, directors and managers who are independent and ethical, flexibility and incentives agencies for securities rating and investment and pension-fund manager quality control less formal and important preconditions for the efficient functioning of a securities market. The abovementioned authors in their groupings of non-formal institutions also include:

1. Active informative politics, used for informing the public of fraudulent activities and false information disclosure by issuers through falsified financial reports and false prospectuses. Public criticism of persons who have committed fraud is a part of active informative politics. The effects of such active informative politics are strengthened with the regular disclosure of a so-called “black list” of issuers who have been proven to have previously committed or had the intention to commit fraud. This would provide the securities market with an objective, additional mechanism for information dissemination of the characteristics and solvency of issuers, specifically companies, insiders and mediators. One of the models that allows for continuous reporting to the public on the activities of financial markets— including fraudulent activities— are a financial press and academic journals. However, an “institution of slander” according to many authors represents a potential danger when this type of information dissemination is used. Insiders can accuse such institutions of “slander” and bring legal action against the editors of these magazines, which can decrease the initiative for publishing accounts of fraudulent activities of insiders. In spite of this, “institutions of slander” should be taken as a guarantee of the validity and the control of disclosed information. 27

2. Developed cultures28 of information disclosure. These include auditing agencies, investment banks, solicitors and managers who know that the concealment of negative information is damaging for them individually as well as for the wider public. Such entities gradually develop a culture of information disclosure. This group of securities market participants makes an effort to represent itself as professional and this greatly determines their behavior. Managers who avoid illegal activities can be mentioned as an example. False information disclosure and falsification of reports represent violations of norms that result in court proceedings and damage to reputation. Led by the principles of “bona fides” and good business practice in the knowledge and experience transfer to younger colleagues, a

26 The most general classifications of the institutional models of regulation would be made according to the basic mechanism of reaching the goals and instruments which are they based on, so that we differentiate between:

a) “regulation in the form of control and command” implies statutory rules that most often define obligations, specifically duties and the nature of the standard of behavior for participants on the market.

b) “regulation based on standards and initiative” essentially is based on general statutory and regulatory prohibitions of certain behaviors ensuring fines for violators. Standards function in such a way that regulatory activity is undertaken only in cases where a violation has been noticed.

c) “licensing” represents a regulatory technique which is based on the legal determination of obligation of license possession, which is issued by a defined state or regulatory entity for a natural person or legal entity conducting certain businesses. The starting point of this model is a “paternalistic” understanding that the social community or state has a general attitude towards every economic activity and therefore it has better knowledge than direct participants about what minimal requests should be fulfilled regarding certain economic activity. In this context justification for licensing arises in the case of social costs caused by the undertaking of certain economic activity by an unlicensed person that are higher than the individual costs are created by licensing.

27 Disclosure of information violations refer to fraudulent activities, specifically activities that violated securities laws through media. An especially interesting fact is that in countries with a less independent judicial system and less efficient public prosecution, journalists are often the object of attacks.

28 Culture and other informal institutions are the institutions which should be developed within one financial system, and which are important for supporting the development of an efficient securities market. Culture is related to the entire social heritage, in which the practice of a securities market should be used as an instrument for investment - disinvestment processes, and for behavior according to financial ethics.
manager will point out the possible negative consequences of false information disclosure. The existence of informal institutions that strengthen the securities market proves that formal rules, although important, are not enough for the efficient functioning of a securities market.

The listed institutions are not only necessary as preconditions for the efficient functioning of a securities market functioning but for the valid respect and realization of mandatory information disclosure as well. The main aim of creators of economic policy that recognize the importance of a securities market for the economic development of their country is the determination of which institutions are more or less important. Taking the experiences of the USA and Great Britain into account as countries which have the most developed securities markets it is noticeable that some of the abovementioned institutions developed alongside the securities market. In the USA for example, the securities market existed long before its state regulatory body was formed. In Great Britain, until the middle of the twentieth century, only a small number of promoters of securities invested in their reputation. Therefore it is important to mention those institutions whose formation and development will be initiated and observed by the state with regard to other institutions; this especially for transitional states which presently develop their financial systems around securities markets and will be spontaneously developing their regulatory institutions alongside them. The creation and formation of preconditions for the efficient functioning of securities markets is a long-term process, which does not depend solely on prioritizing certain institutions, but on the tradition of the given securities market as a potential model for investing as well. This means that the creation of legal preconditions for an efficient securities market in states whose financial system is oriented toward banking requires the additional creation of tendencies to use securities as instruments of investment. In those circumstances special significance lies in the education of the public about the benefits of financing and investing on a securities market.

4. Analysis of the Situation in B&H

Contemporary economic courses that focus on global economic movements and the relations of these to specific countries present many difficulties and challenges. One of these difficulties - and one which many transitional countries face - is the reform of a financial system so that it will respond to global trends and initiate economic development. Reform of a financial system means the establishment of a respectable, efficient and stable securities market. Only a stable and efficient securities market can be respectable. Therefore, the task of the economic policy makers of not only those states seeking to transform their economic systems into market-oriented economies, but all states seeking to improve the general course of their economic development is the creation of legal and institutional preconditions for an efficient securities market. Within this context they can use the experiences of other states which have built respectable securities markets by adapting institutions to the conditions of their own financial-legal system and heritage.

Bosnia and Herzegovina is an example of a transitional state that must undertake a total transformation of its economic system and while doing so create preconditions for the positive impacts of its integral market and economic course. With regard to legal and institutional preconditions for the efficient functioning of its securities market, Bosnia and Herzegovina, which is experiencing an upturn in its development, must first recognize that it lacks an integral securities market at a state level. This essentially means that the creation of laws on incurring debts, the debts and guaranties of Bosnia and Herzegovina, which would create the basic legal preconditions for the formation of a securities market, will be made within each separate entity's stock-market. In other words, the most important laws regulating the matter of securities and stock-markets were enacted at an entity level. It is important to add that in a sense the securities markets of the B&H entities have different regulation models; the B&H Federation applies Anglo-Saxon principles while the RS applies Eurocontinental principles of regulation. Furthermore, rules on participants' behavior, control and supervision over the trading of securities are the responsibility of Commissions for Securities, while the registration of securities is done through entity agencies (registers). In both entities the Commissions for Securities are independent entity institutions, whose roles are determined by law and which are financed with assets and taxes ensured by the total activity. The question that arises is

According to the presumptions, it would be possible to trade securities in B&H on both stock-markets.
whether, with regard to the financial, economic and general potential of Bosnia and Herzegovina, Bosnia and Herzegovina needs two stock-markets under the regulation of two different financial-legal systems. In other words, can Bosnia and Herzegovina, with its current non-integrated financial system, be included in regional and international financial courses?

With regard to the legal and institutional preconditions for the efficient functioning of securities markets, the following can be concluded:

Establishing a legal system and reform of the judicial system in Bosnia and Herzegovina towards an “independent judicature” will, in the long-term, after the consolidation of the total financial system, have an effect on the securities market’s efficiency. Efforts to establish a rule of law in B&H would increase legal culture and awareness on a higher level, and facilitate judicial system reform towards European standards incorporated in the ACQUIS. The reform of judicature started after the Court of B&H, Prosecution and Ministry of Justice of B&H were established. Institutional preconditions for the implementation of thorough judicature reform of B&H were established with these three state bodies. Reform of the judicature is the long-term process and it is expected that its result will be more efficient functioning, which means possible education of judges and prosecutors on market abuses on the securities market. This way it would be possible to fulfill this institutional precondition for an efficiently functioning securities market.

1. Proving the responsibility and sanctioning violators of information disclosure regulations on the securities market is done at the entity level. The criminal code of Federation of Bosnia and Herzegovina (F B&H) defines the falsification of securities as a criminal act. The Law of Securities Regulation of F B&H sets the sentence of imprisonment between three months and five years for persons, who, in order to gain material benefit for themselves or for others, specifically in order to cause damage, use privileged information contrary to the ordinances of the abovementioned law. Sanctioning with a fine or sentence of imprisonment is set by the same law (Article 130) for members of an issuer’s supervisory or administrative board in cases where the distribution of a prospectus is done in a way contrary to the new law and for the sake of false information disclosure. The Law of Securities Regulation defines the obligation of information disclosure for issuers, stock-markets, self-regulating organizations and mediators (brokers-dealers agencies). The enactment of a legal obligation to submit reports containing all relevant information about the issuer ensures the legal protection of investors. These same entity laws on securities regulation also set fines; for example, in the Law of Securities Regulation of F B&H, the fines range from 10,000,00 KM up to 70,000,00 KM for failure to disclose reports of the relevant information on the issuer. The same sanction according to the Law of Securities Regulation of F B&H, official gazette- “Sluzbene novine F B&H” no.39/98, will be applied for any person who violates the prohibition on price manipulation.

2. The initiation, creation and enactment of accounting standards and regulations in B&H are the responsibility of the Ministry of Finance (a consequence of fiscal federalism). The adoption of the Law on Accounting and Auditing of B&H created the legal preconditions for the introduction of mandatory standards of accounting and auditing, which will be applied over the entire territory of B&H. The same law defines standards regarding the qualifications, certification and licensing of professional accountants and auditors that are identical across all of B&H. The law stipulates the establishment of a special body, the Commission for Accounting and Auditing, which will control and supervise the implementation of these standards. The Law on Accounting and Auditing will serve as an instrument for standardization of regulations from the sphere of accounting and auditing, which is one of the most important steps towards the integration of the financial system of B&H. The second effect of the enactment of this law is an increase in the quality and level of professionalism in accounting, which will be reflected in their role in the securities market.

4. The strengthening of the principle of transparency in Bosnia and Herzegovina is discernible in the number of daily reports on trade in both stock-markets; these can be found on web pages and in the daily press.

5. When it comes to culture and other informal institutions as preconditions for an efficient securities market in B&H little improvement has been made. This is expectable considering that B&H has no tradition with securities markets as an investing-disinvesting mechanism. However, active informative politics is present, as the activities of issuers contrary to the law and sanctions undertaken by the Commission for Securities and public prosecutor are published on the Commission’s web page. Disclosure of so-called “black lists” of issuers, who have falsified documents, is not yet a practice, but it is possible that it will become one with the further development of the market.

6. Other institutions which are relevant to the efficient functioning of the securities market include:

a) In the Federation of B&H, at the end of 2005, the Self-regulating Organization of Professional Mediators in the Securities Trade was formed. The organization, based on the Law on Associations and Foundations, is formed as a voluntary,
the state. Due to the relatively short history of formal secondary securities estimation or securities estimation in general. This is e) There are no agencies in B&H capable of handling bonds estimation or securities estimation in general. This is due to the relatively short history of formal secondary securities markets supporting the solvency of the financial system of the state.

b) There are 11 registered investments funds in the F B&H with a basic capital of 3,623,507,271, 00 KM. There are 13 PIFs in the Republic of Srpska, which collected 1,6 million in certificates. Shares of these investment funds are included on a quoting list of stock market lists in Sarajevo and Banja Luka and with this conditions for the trading of shares of funds are fulfilled. Taking into the consideration the nature of PIFs and their share in privatized companies, it was unrealistic to expect their significant role in the acceleration of economic growth. This not only because of unfulfilled, unrealistic expectations, but because of prejudices and skepticism present at the inception of PIFs. However, PIFs have done little to counteract their negative publicity. Both of these facts resulted in citizens refraining from investing their certificates in PIFs. There is a tendency for investment funds to change and reemerge, which should be the basic model of investing and risk protection for small investors in B&H.

c) Pension-funds in B&H, because of their nature as public pension-funds funded by state or other levels of government, and serving to ensure at least a minimum of social and economic security, are not included in securities markets in B&H.

d) Pension-funds in B&H, because of their nature as public pension-funds funded by state or other levels of government, and serving to ensure at least a minimum of social and economic security, are not included in securities markets in B&H.

e) There are no agencies in B&H capable of handling bonds estimation or securities estimation in general. This is due to the relatively short history of formal secondary securities markets supporting the solvency of the financial system of the state.

f) For the same reasons there are no agencies for the quality estimation of managers who control investment funds. The formation of such agencies would strengthen trust in the securities of investment funds.

While essentially positive steps toward the legal and institutional preconditions for an efficiently functioning securities market have been made at the entity level, much remains to be done before B&H has a developed, adequate mechanism for the promotion and insurance of an efficient securities market. At the same time it is necessary to integrate the securities market at the state level. Integration of the securities market in B&H is the one condition without which further development of the financial system is impossible. This will involve the formation of special, integral state institutions and investing them with authority that presently exists only at the entity level. In addition, by following the second level of integration path tied to EU membership, B&H must accept regional and international financial trends and continue to develop its own financial system. This means that in order to accelerate its process of integration into European community, it will be necessary for B&H to harmonize its development of legal and institutional preconditions for a securities market with the guidelines and standards of new European stock market law.

5. Conclusion

The efficient functioning of a securities market, as an investing-disinvesting mechanism, has as its precondition the existence of an efficient state financial system. An efficient financial system accelerates economic activity, resulting in rapid economic growth. This is a very important correlation with special significance for transitional and less developed countries that are capable of creating an adequate social atmosphere for efficient economic progress. The essential principle for a securities market is investor confidence in the financial system; this confidence can only be achieved creating an adequate legal protection mechanism for investors. Institutional mechanisms that protect investor rights decrease market imperfections and improve the efficiency of a securities market. These consist of a very complex set of laws and sub laws and both private and public institutions authorized to implement and enforce them. Building these legal and institutional components, the main mechanisms for investor protection, is crucial in creating an efficient financial system centered on a securities market.

This study, aside from a brief theoretical glance at the elements essential to an efficient securities market, provided a concise elaboration of the legal and institutional precondi-
tions for the efficient functioning of a securities market with no intention of detailed analysis. This study presents as well a specific analysis of the situation in B&H with regard to the abovementioned preconditions, and with no intention of proving statistical correlations. These should be the subject of additional research. It would be very interesting to make a comparative analysis of the development of legal and institutional preconditions for securities markets across transitional countries. In this way, it would be possible to infer a correlation between the extent of legal protection of investors, securities market development, and economic growth. It would also be of great value- given the intention of B&H to join the EU- to define the best steps for harmonizing the laws, prescriptions and institutions of B&H with those of the EU.
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