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Protecting Investors in Financial Markets

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There are four broad views to the causes of the variations of investor protection witnessed today (Ayyagari et al., 2007). The law and finance view focusses on the distinctions between English common law and French civil law, in particular their differing approaches to protecting the interests of private investors against those of the state (which was greater under English law), to explain variations in present-day protection of investor rights (Beck et al., 2003). The endowment view states that the colonisation strategy has had a greater bearing on rights protection (Levine, 2005). The ethnic diversity view considers that as ethnic diversity of a country increases, groups in power create laws and administrative systems that are against the interest of rival ethnic groups, and thus erode the degree of independence from government interference afforded to investors (Alesina and Ferrara, 2004). According to the culture and religion view, the varying degrees of protection awarded to investors can be explained by the degree of authoritarianism of the primary religion, and its consequent impact on popular culture and perceived acceptability of government interference in private affairs (Callen et al., 2011).

As explained by Heston and Rouwenhorst (1994), returns from equity markets do not necessarily bear a correlation with market volatility. A part of the benefits of international diversification is generated by diversification across industries, because different industries experience different degrees of volatility. Ergungor (2003) has suggested that the legal environment has a significant effect on markets, for instance a market oriented system with a reliable judiciary is more conducive to safer transactions for external stakeholders. Allen and Gale (2000) have argued that banks and equity markets have similar functions, and therefore, an environment conducive to safe financial transactions will benefit either market, especially in developing countries.

Returns on international investments are also affected by country-specific factors such as monetary policies, fiscal policies, and institutional and legal factors across the regions (Heston and Rouwenhorst, 1994). To study the impact of industry-specific and country-specific factors on market returns, Heston and Rouwenhorst (1994) studied 829 firms across 12 countries and 7 industries, and measured returns on securities as a factor of the time period, industry, country and firm-specific variations. They found that for returns across countries, most variation could be attributed to country-specific, rather than industry-related factors, and that diversifying across industries within a country has a relatively weaker impact on investment returns. They concluded that country indices show greater volatility than industry indices because the impact of variations across countries is greater than that of variations across industries.

Zweigert and Kotz (1998) have characterised legal systems in terms of legal procedures, as well as the broader philosophy and ideologies followed. Accordingly, legal systems have been considered to have an impact beyond legal procedures, on seemingly unrelated matters such as creating a conducive climate for investment, protection to markets and investor protection. Legal systems have been broadly classified in terms of their origins in a colonial legacy, as the common law system, which originates in English law, and civil law, which is derived from Roman law – a prominent example being French law (Djankov et al., 2007). La Porta et al. (2002) created a system of measuring and coding rules for investor protection using country-specific financial laws across countries, and codified laws for the protection of external stakeholders. They also found that countries which have adopted variations of English law offer greater protection to external investors than those which use Roman law. According to research by Beck et al. (2003), legal origin also affects a country' adaptability to financial changes. The impact of legal systems on financial transactions goes beyond merely laws, as it also affects other factors such as implementation and enforcement of laws, social norms and so on (Djankov et al., 2003).

However, Stulz and Williamson (2003) argue that legal systems and the quality of contractual enforcement merely have a correlation, and not a causational relationship. It has been argued that the origins of legal systems have a relationship with the cultural beliefs of the region, as both have their roots in historical circumstances. According to this view, financial transactions are affected by cultural norms and values (Licht et al., 2005). Rajan and Zingales (2004) have argued that the origins of legal systems have a correlation with political choices, and that it is in fact the differences in political system and culture which lead to different levels of protection extended to investors in different countries. They argue that the correlation between the origins of legal systems and financial transaction systems is, in historical terms, a recent trend, and that in some developed countries, the adoption of a legal system has followed, not preceded the conventions adopted for financial contracts, and therefore, legal origins are irrelevant to the quality of enforcement of contractual agreements.

Chung (2006) has argued that weaker governments lead to a higher asymmetry of information between investors and liquidity providers. Siegel (2005) has shown that even ADR listing of a foreign firm on US exchanges are insufficient to enhance protection to stakeholders. Bacidore and Sofianos (2002) have found that non-US firms registered on American markets continue to have greater information asymmetry and therefore, lower depth and greater volatility. Chung (2006) therefore concludes that liquidity and availability of data are an outcome of native investor protection policies, despite cross-investments in other countries.

The reasons why some countries have greater protection of investor interests than others have been investigated by Ayyagari et al. (2007), who have used firm-level data from more than 7500 companies to categorise entrepreneurial perception of the protection extended to investor rights. They found that variations across companies such as size, ownership and industry category explain about 50% of the variation in investor rights protection across countries. They also found that a country's legal origin is a reasonably accurate indicator of protection to contractual guarantees, inasmuch as it affects the culture of the country and mitigates the impact of ethnic fractionalisation. However, they found that organisational variables such as size, ownership structure and organisational structure have a significant impact on the reliable implementation of financial contracts.

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