Global Business & Development Law Journal

Volume 9 | Issue 2 Article 4

1-1-1996

Nepal: The Emerging Security Market (Legal and Policy Aspects)

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This article represents the views of the authors and does not necessarily reflect the views of the institutions with which they are associated.

I. INTRODUCTION

In the present world economy the securities market has become increasingly important.[1] The knowledge of legislation, regulation and procedures relevant to the securities market is therefore also extremely important. This paper has, thus, a primary objective of giving a general idea about the legal regime and intricacies of securities market operations in Nepal.

From an economic viewpoint, Nepal is classified as one of the fifteen poorest countries.[2] Like many countries in a similar situation, Nepal, for over a decade, has been attempting to move away from this poverty. It is in need of generating capital and, as a prerequisite, in need of developing a legal and administrative framework which would permit the development of such a capital market.

Therefore, the general purpose of this paper will be to provide the minimum legal background to, and principal sources of information on, the emerging role of the securities market in promoting the economic development of Nepal. The principal focal point of discussions will be the laws that govern the securities market. However, this paper will also delve, in parallel, into specific government policies along with their gradual evolution and their effects on national development.

This paper will be divided into three main parts. The first part will lay the groundwork by discussing succinctly the importance of securities[3] in the national context, as well as the government's attitude regarding the market as a whole. In

1. Over the past ten years total capitalization of stock markets worldwide has grown from $4.7 trillion to $15.2 trillion; the share of the developing countries in this total has jumped from less than 4% to 13%. *See* Asli Demirguc-Kunt and Vojislav Maksimovic, *Stock Market Development & Corporate Finance Decisions, in* FINANCE & DEVELOPMENT 47 (World Bank, June 1996).

2. *See generally* WORLD BANK, WORLD DEVELOPMENT REPORT 188 (1996) (listing Nepal as 11 of 51 classified low income economies); *see also* Kishor Uprety & R.D. Alwis, *Legal and Policy Aspects of Private Foreign Investment in Nepal*, 7 TRANSNAT'L LAW. 103, 106-07 (1994).

3. For clarity, except when specifically stated, the term "securities" throughout this paper, shall be considered as including all individual and institutional securities and excluding government securities.

order to place the topic in its deserved context, this section shall also deal with policy aspects of the securities market along with its evolutionary history.[4]

The second part of this paper will focus on the economic aspects of the securities market,[5] in particular the demand, supply and price of securities,[6] as well as economic phenomena which affect capital market development as a whole.[7]

Finally, the third part will analyze the legal framework in which the securities market operates. In this context, the paper will not only discuss the provisions of the existing laws dealing with the securities market, but will also analyze the pros and cons of such laws as demonstrated by a series of practical examples. The approach will be to examine "what the laws ought to be" and not merely "what the laws actually are." In these discussions we will also take into account the obvious discrepancies between laws and practice which, in fact, have resulted in a situation of quasi-non-application of several provisions of the existing laws.[8]

Before proceeding further, a final remark is needed. In preparing this paper, the authors confronted two problems. First, the frequency with which the laws and policies changed in Nepal, particularly toward the end of the 1980s, complicated the analytical aspect of this study. It was difficult to make any confident evaluation of the system, especially since the findings were not sufficiently uniform. Second, the serious shortage of writings on the Nepalese securities market, as well as the dearth of case law, did not permit us to take a comparative approach. As a result, the article is predominantly descriptive in nature.

II. THE DEVELOPMENT OF THE NEPALESE SECURITIES MARKET

A securities market, when organized properly, provides marketability and price continuity for shares and assists in evaluating securities in terms of their intrinsic worth. It also helps the orderly flow and distribution of savings between different types of investments. It has a vital role to play in helping industries raise necessary capital.

Understanding the development of the Nepalese securities legislation requires some knowledge of the economic realities of the country and its marketplace. A capital market is an essential component of a free market economy as it enables the transfer of money from savers to producers.[9] Economic factors establish the

4. *See* discussion *infra* part II.
5. *See* discussion *infra* part IV.
6. *See* discussion *infra* part V.
7. *See* discussion *infra* part III.
8. *See* discussion *infra* part VI.
9. *See generally* Gerhard Pohl et al., *Creating Capital Markets in Central and Eastern Europe*, TECHNICAL PAPER (World Bank, 1995) at 1-2.

limits of the contemporary securities market as well as the material conditions upon which any legislation must be based.

The explanation as to why capital markets are still relatively unimportant in Nepal lies in a combination of historical circumstances, current economic and financial developments, and government policy.

A. Evolutionary History

At the outset, a preliminary remark would seem appropriate: generally, the Nepalese people, with few assets, are highly risk averse, placing a premium on liquidity. This creates either a demand for fixed-yield claims with high liquidity, such as saving deposits or other pegged bonds, or a demand for real assets.[10] Therefore, private individuals are investing their savings in tangible assets such as gold, silver, diamonds and real estate.[11]

In Nepal, except for a brief period starting from 1936 until the end of the Second World War, no significant attempt had been made to raise funds for industries through the floatation of securities, especially stocks in the market.[12] In the absence of development of corporate securities, the only securities generally floated in the market were government securities.[13]

As a matter of fact, the history of the securities market began in 1937 with the flotation of shares by two prominent companies, the Biratnagar Jute Mills Limited and the Nepal Bank Limited.[14] The first legislation governing companies was introduced in 1951[15] and the first government bond was issued in 1964. Nevertheless the securities market remained underdeveloped and fairly unimportant both in terms of listing with the stock exchange and capital mobilization. Information remained scarce, costs of obtaining accurate information remained immoderately high, regulation remained limited and manipulation by market participants remained substantial, especially in the case of private issues.[16]

Although the Central Bank of Nepal (NRB)[17] was, since its establishment, authorized to issue government securities and bonds, the concept of a corporate

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10. *See* Janardan Dev Pant, *Reinforcing Nepalese Stock Market*, KATHMANDU POST, May 1, 1996 (visited May 1, 1996) http:www.south-asia.com/ktmpost/1996/may1/may1ec.htm.

11. *Id.*

12. R. S. MAHAT, CAPITAL MARKET, FINANCIAL FLOWS AND INDUSTRIAL FINANCE IN NEPAL 25 (1981). *See generally* MEHAR MAN PAUDEL, AGRICULTURAL AND INDUSTRIAL FINANCE IN NEPAL 50, 50-63 (1986) (providing a brief account of financial institutions in Nepal).

13. MAHAT, *supra* note 12, at 25.

14. Pant, *supra* note 10.

15. The Company Act (Nepal, 1951). This Act was repealed and replaced by the Act of 1964 which was subjected to major amendments in 1968, 1970, 1981 and 1986. The Act is reprinted in Nepal Ain Sangraha Vol. 5.

16. Pant, *supra* note 10; *see also* PAUDEL, *supra note* 12, at 53 (noting the absence of a capital market and institutions hindered Nepal's early efforts to mobilize savings capital).

17. Established in 1956 pursuant to the Central Bank Act (Nepal, 1956).

securities market had not developed much. Further, the Nepal Industrial Development Corporation (NIDC) was established[18] as an industrial development bank with the objectives of establishing, developing, expanding and modernizing private sector industries. Besides providing direct loans to industries, the NIDC was also required to assist in selling, buying and underwriting their issued securities. Later, the establishment of the Provident Fund (PF),[19] the National Insurance Company (NIC)[20] and the Agricultural Development Bank (ADB)[21] also contributed to the development of a securities market in Nepal. These financial institutions are the major components of the current capital market. They have made, and continue to make, investments in the share capital of incorporated entities as well as in government securities and are thus involved in the development of the securities market. However, no significant development of the securities market could be noticed as the major activities of these institutions were not directly related to securities. Hence, an agency for channeling savings into productive investments was deemed necessary.

B. *Modern Times*

The capital market has, in recent years, been considered an important underpinning for the development of industry, commerce and the entire economy.[22] Indeed, capital markets include not only the infrastructure to buy and sell securities, but also provide the formal and informal rules by which market participants buy, sell and own such instruments and advise on corporate control transactions.[23] The role of the capital market was understood by the successive governments in Nepal and, through policy, sufficient emphasis was laid for its development. The present government has made major policy commitments for economic liberalization with a view to adapting to new global trends.[24] This is obvious from the eighth Five Year Plan 1992-1997 (the Eighth Plan) which states:

> "In order to develop capital markets during the plan period and to make capital available to industry, commerce and all other areas by mobilizing internal resources on an institutional footing, it will be essential to make appropriate institutional arrangements and to properly activate financial

18. Established in 1959 pursuant to the Nepal Industrial Development Corporation Act (Nepal, 1959).
19. Established in 1963 pursuant to the Provident Fund Act (Nepal, 1963).
20. Established in 1967 pursuant to the National Insurance Company Act (Nepal, 1967).
21. Established in 1967 pursuant to the Agricultural Development Bank Act (Nepal, 1967).
22. *See generally* National Planning Commission, Eighth Plan 1992-1997 (July, 1992) at 119 [hereinafter Eighth Plan].
23. Gerhard Pohl et al., *supra* note 9, at 3.
24. BISHWAMBHAR PYAKURYAL, IMPACT OF ECONOMIC LIBERALIZATION IN NEPAL 3 (1995).

institutions in capital markets as well as to set up a stock exchange and prepare a legal basis for its operations."[25]

The Eighth Plan is, thus far, relatively clear in spelling out the policies of the government for the development of capital markets.[26] It essentially emphasizes setting up a securities exchange board as a non-profit body; developing a Securities Exchange Center; investing available resources in shares, developing brokerages, involving employees provident fund, insurance companies, banks and other financial institutions in the capital market, including their engagement in the development and expansion of brokerages and financial services; undertaking savings programs; developing a practice of acquiring capital by issuing shares; reviewing laws related to the capital markets; reviewing institutional and legal structures of existing financial institutions; arranging for companies to deal in public deposits; and developing institutional credit ratings.[27]

To fill in the much needed institutional gap, with the objective of fundamentally facilitating and promoting the growth of capital markets, the Securities Exchange Center (SEC) was established in 1976.[28] Its establishment, *inter alia,* was primarily aimed at promoting public savings and mobilizing capital funds for investment, encouraging people's participation in ownership of business and industries, and providing marketing facilities for channeling securities exchange business. However, for more than a decade, the SEC could not achieve its stated objectives mainly because it failed to visualize the operational mechanism of securities exchange activities. On the contrary, it merely became the helping hand of the NRB in disposing of government securities comprised of treasury bills, development bonds or promissory notes, without substantial activities of buying and selling securities.[29] Furthermore the SEC was more interested in promoting public limited companies with the objective of drawing the attentions of investors to invest in shares and debentures of such companies. It was unable to establish and maintain linkage with existing unorganized brokers who could have made securities available. Moreover, the SEC could not visualize the positive implications of speculation in light of the rise and fall of securities prices that makes the purchase and sale of securities possible. As a consequence, for over a decade,

25. *See* Eighth Plan, *supra* note 22, at 119.

26. *Id.* at 119-20.

27. *Id.*

28. The SEC was established with an authorized capital of one million rupees (51% owned by the National Industrial Development Corporation and 49% owned by the Central Bank) and aimed at assisting public limited companies in raising capital through the issue of shares and debentures, and creating a market place where the purchase and sale of securities could take place through intermediaries operating on the floor of the exchange. *See* MAHAT, *supra* note 12, at 31; *see also* USAID, *The Nepal Stock Exchange*, 5 ECONEWS 13, 13 (1994) [hereinafter *Nepal Stock Exchange*].

29. M.K. Shrestha, *Securities Exchange Center: Problems and Prospects*, OCCASIONAL PAPER 2 (United Dynamic Research and Consultancy, 1986).

it continued to get involved in floating shares of new companies which did not necessarily project future prospects.

As stated above, since 1976, the SEC had operated on the basis of the sale of government securities and had not been involved in buying and selling securities.[30] However, a substantial part of its business increased with the infusion of a 13% national savings certificate in 1977, in addition to the already existing treasury bills and government development bonds, as well as the repurchasing of government securities on a commission basis.[31]

As a result of carrying out securities business without developing a floor for the securities exchange, the securities of existing companies that would have been otherwise managed by brokers through buying and selling could not come forth; specifically this was because the SEC's strategy to monopolize the business by strict legal and administrative measures were unfavorable to the unauthorized brokers dealing in securities. Thus, until the promulgation of the Securities Exchange Act of 1983 [hereinafter SEA],[32] the SEC confined its activities to managing government debentures and nothing concrete was done to present opportunities to small investors.

After the enactment of the new SEA, the SEC endeavored to create some securities exchange norms. As the only legally acknowledged stock exchange house in the country, it prepared itself to get involved as a merchant banker.[33] However, the SEC continued carrying out other activities which were not meaningfully relevant to the development of the stock exchange.

In the context of the Eighth Plan (1992-1997),[34] the government also formulated the first comprehensive plan for capital market development. Subsequently, the first amendment to the SEA was introduced in 1992 creating a legal basis for the implementation of the government's pronounced policies.[35] In 1993 the government privatized brokerage functions. The development of the securities market was strengthened by the establishment of the Securities Exchange Board under the new Securities Exchange Act of 1993 with the basic objectives of formulating policies and regulations, prescribing terms and conditions for stock exchange operations, as well as inspecting and registering securities.[36] Moreover, in 1994, the SEC was transformed and was renamed the

30. *See supra* note 12 and accompanying text (regarding the lack of effort made to raise funds through industry through the issue of securities).

31. Twenty paisa on every Rupees 100 was rediscounted. *See generally* SECURITIES MARKETING CENTER, INTERNAL RULES AND REGULATIONS 2 (1978). It should be noted that since early 1993 the Nepalese currency (Rupee) is fully convertible. As of September 1996, one United States Dollar is roughly equivalent to 56 Rupees.

32. The Securities Exchange Act (Nepal, 1983). It should be noted that numerous provisions of this original act have since been amended.

33. SECURITIES EXCHANGE CENTER: SEC LIMITED: AN INTRODUCTION (1984).

34. Eighth Plan, *supra* note 22.

35. SECURITIES BOARD, AN INTRODUCTION; SEBO/N (HMG/N, 1994).

36. *See Nepal Stock Exchange*, *supra* note 28, at 13.

Nepal Stock Exchange (NEPSE), which, on January 13, was formally opened for business, i.e. trading under NEPSE's roof began. Along with these changes trading has been generally and gradually increasing and is being carried out exclusively by private brokers.[37] Moreover, the development of a secondary trading market has encouraged foreign organizations to invest. Experience shows that shares of foreign joint venture companies, banks and financial institutions have remained, and continue to remain, greatly oversubscribed.

Notwithstanding the relative progress noted above, there is a great deal of apprehension about the pricing of stocks in Nepal which remain, by and large, inaccurate. The prices do not conform to the logic of the market and do not reflect the supply and demand in proper.

III. THE SOURCE OF STOCK PRICE INACCURACY

Market prices for securities generally represent what people think will be the total return on the stock over the coming years. There is no clear guide as to how a stock should be valued. The price of a stock in a company which is not doing well, but is perceived as having a good future, will be higher than a similar company that is perceived as having difficulties. Stock analysts often compare the market's assessment of value with the companies' "book value."[38] Accounting practices in Nepal, however, do not permit an accurate assessment of book value.[39]

In the securities market, the demand and supply of stocks plays an important role in price fixation. The price of a given stock is determined exclusively by the interacting forces of supply and demand converging on such stock at a given time. The price of the stock and the volume of its past transactions are meaningful indicators of the future supply and demand pressure the stock is likely to encounter in the market. This is the most important element in determining the probable direction of the price movement. The supply and demand may be influenced by rational as well as irrational factors and a single factor may elicit varied and conflicting reactions from different sectors.[40] In the sphere of developing economies, two major groups are influencing the securities market:

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37. USAID, *The Investment Climate in Nepal*, 5 ECONEWS, at 7-8 (1994). Compared to 1994, the daily trading value as well as the number of transactions has increased five times and twelve times respectively, in 1995.

38. The value according to its accounting records, which is computed by subtracting all debts from assets, the remainder being total book value. THE MCGRAW-HILL DICTIONARY OF MODERN ECONOMICS. A HANDBOOK OF TERMS AND ORGANIZATIONS 43 (3d ed. 1983).

39. Because of this, investors are wary about their money. The prices of shares for almost all publicly traded companies do not seem satisfactory. *See* Gopal Tiwari, *Wild Fluctuations in Share Market Spook Investors*, KATHMANDU POST, June 17, 1996 (visited June 17, 1996) http://www.south-asia.com/Ktmpost/1996/Jun17/jun17ec.htm.

40. *See generally* IRVING L. ACKERMAN, HOW TO INVEST IN THE PHILIPPINES STOCK MARKET 62, 62-67 (1980).

the land owning, trading and money lending group and the newly developed urban middle class and urban trading groups. Their desire for a high degree of safety results in inconsistency in the prices of securities. The small saving urban middle class group is primarily interested in safety. Since only a few securities are safe, and are often foreign-owned, the prices of these are bid-up, and the rates of return are low. The remainder of the market is speculative with great fluctuations in the prices of securities.[41]

Most research indicates that the profitability of a stock investment is decided by examining earnings per share (EPS), cash dividend[42] and bonus share.[43] These generally have an effect on stock price and thus the profitability or the rate of return of a stock investment. EPS is the ratio of total earnings divided by the total number of outstanding shares. A stock with a higher EPS usually has a higher expected rate of return than stock with a lower EPS, provided the rate of risk, financial leverage, dividend policy, timing of earnings and present value of future cash flows are the same for both stocks.[44]

The comparison of the price of the stock and earning per share of a company provides the price-earnings ratio (P/E) from which an estimated rate of return can be calculated. "Blue chip" companies[45] will have this approximate prime rate of borrowing. Companies which have a good future are likely to have a high price earning ratio, while companies with a poor future have a low P/E. Before the SEC began operating, many of these ratios were very low, reflecting the lack of trading. The SEC was generally illiquid,[46] investors seldom found it possible to either buy profitable shares or sell unprofitable. Generally, investors expect that in addition to dividends there will be capital appreciation. Most recent stocks, with limited earning history, like the Himalayan Bank, have a P/E ratio and a rate of return that does not make sense in light of its historical performance, but presumably reflects the stock holder's perceptions of likely future earnings. In 1994, the P/E for Nepal Lube grew dramatically high. This increase in price probably reflects its likely better performance once privatized. Stocks that are infrequently traded do not have sufficient turnover to establish accurate prices and hence do not reflect current reality about the financial situation of the company.

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41. George Rosen, *Capital Markets and the Industrialization of Underdeveloped Economies*, 6 INDIAN ECON. J. 172, 186 (1958).

42. Cash dividends are designed as declared dividends payable in cash. *See* JERRY M. ROSENBERG, DICTIONARY OF INVESTING 63 (1993).

43. Bonus shares are shares given without charge to existing shareholders in proportion to the shares already owned. GRAHAM BANNOK ET AL., DICTIONARY OF ECONOMICS 50 (1987).

44. ANUJA RAJBHANDARI, PROFILE OF NEPAL STOCK EXCHANGE INVESTORS 5 (1995).

45. Blue chip companies are those whose common stock earnings and dividend records have been stable or have been growing slowly but steadily. Because of this stability, which reduces the risk of loss, typical blue-chip stocks are high-priced in relation to that corporation's earnings. MCGRAW-HILL DICTIONARY, *supra* note 38, at 41.

46. It had a deficit in liquid assets, not having cash or assets readily convertible into cash. For a definition of the word illiquid, see ROSENBERG, *supra* note 42, at 157.

It is possible for a share to be overvalued. It is possible for a good company to have too high a price and thus not be a good investment. Thus, some shares that shot up early, have fallen back. Even the bluest of blue chips can be overvalued. Some stocks that shot up initially have been subject to corrections as investors determined that their values were too high. A number of financial stocks that benefitted from the general increase in share values are in this category.[47] In Nepal, as the stock market is relatively new, price hikes have been initially experienced. This is mainly due to a high demand. Most experts believe that stock prices in such cases are not driven by fundamentals.[48] Ultimately a market correction and fall in price is inevitable.

Studies have shown that the main reasons for stock price inaccuracy in Nepal are (i) lack of public information, (ii) speculative trading, and (iii) liquidity. They are briefly discussed in the following paragraphs.

A. *Lack of Public Information*

As the concept of the stock market is new to the Nepalese people, information regarding the sale and purchase of stocks plays a crucial role. This information has a dual impact on investors as it provides, on the one hand, basic knowledge to people who are unaware of such a market, while on the other hand providing the elements required for a better calculation of the price of a stock to those who are already involved in the market.

The share price of listed companies is a matter of continual change. Information regarding the financial position, future prospects of the company, and the past level of share prices are major determinants in the estimation of the value and hence, the demand for securities. As the interaction of demand and supply of securities is the basis for price determinations, information essential to estimate demand as well as supply should be made easily available.

An efficient market requires a complete flow of information. Without this, the major objective of the investor, i.e. to minimize risk and maximize return, on the basis of given information cannot be achieved. Mere distribution of the prospectus at the time of the floatation of new or old shares is not the right way to protect the interests of investors. To really protect investors what is needed is to make detailed company studies regarding the future prospects, earning possibilities, dividend payments, or intrinsic merits of the securities in question.[49]

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47. USAID, *NSEL's First Eight Weeks*, 5 ECONEWS 1, 9-10 (1994) [hereinafter *First Eight Weeks*].

48. Emerging markets as a group are commonly perceived as relatively volatile, with stock prices often driven by speculation rather than underlying fundamentals. *See* Soo J. Yim, *Government Intervention and Regulation in Emerging Stock Markets: A Case Study of the Korean Stock Exchange*, 8 ICSID REV.- FOREIGN INVESTMENT L.J. 53, 61 (1993).

49. Shrestha, *supra* note 29, at 16.

An investor normally purchases a share which has a higher expected rate of return. The rate of return on any asset is a sum of the risk-free rate of return and an additional return, known as the risk premium. Hence, the total risk level of a stock is the sum of systematic and unsystematic risk, and risk premium is an additional return for the additional rate of systematic risk involved in investing in that particular stock. Systematic risk[50] arises due to changes in the economy and the market, and unsystematic risk arises due to company or project specific factors. It is believed that by forming a portfolio of several stocks, one can reduce unsystematic risk. On this basis, a rational investor prefers a portfolio which has the highest rate of return for a given amount of risk, and the lowest risk for a given amount of return. In this context, an investor needs to obtain various types of information to determine the most efficient portfolio. In the absence of sufficient information the efficient portfolio hypothesis is not applicable. Thus, the only way to minimize risk and maximize return is to invest in blue-chip stocks or more protected stocks.[51] With the establishment of the NEPSE, a system to disseminate information has gradually been reinforced. For instance, stock-prices of listed companies are regularly provided. However, the information NEPSE has been providing is still insufficient and incomplete to estimate the price of the stock; a factor which accentuates price inaccuracies. The NEPSE needs to take a cautious approach in saving investors from foul play by informing and advising them of the desirability of investment in the securities of only such companies that show a promising future and prospects.[52]

Dissemination of information is considered to be one of the most important underpinnings of any securities market.[53] When information arrives infrequently or erratically, investors lose confidence, transparency disappears, and possibilities for manipulation multiply.[54] It is important, therefore, for the stock exchange to feed the market on a continuous basis with the latest material developments concerning listed companies.[55] Material developments are those that have an impact on share price in the market. In order to disseminate material information, the stock exchange must receive the information from the companies themselves."[56]

Information on the details of dividends, rights and bonus announcements released by the listed companies, and details of the daily share transactions and last traded price, help investors to arrive at a rational decision. In Nepal, however,

50. Systematic risk is the tendency of the asset price to move along with the market index. *See* ROSENBERG, *supra* note 42.

51. M. K. Shrestha, *Issues in Financial Management*, OCCASIONAL PAPER (Tribhuvan University, 1987) [hereinafter *Issues in Financial Management*].

52. Shrestha, *supra* note 29, at 16.

53. RAVI PEIRIS, THE NEPAL STOCK EXCHANGE: A REVIEW OF ITS CURRENT STRUCTURE AND RECOMMENDATION FOR THE FUTURE 23 (1993).

54. *Id.*

55. *Id.*

56. *Id.*

the major problem is the lack of information supplied by the listed companies to the NEPSE. The free flow of information from the listed companies to the NEPSE is a necessary pre-condition for maintaining meaningful trading floor operations. At present, the listed company personnel appear to be rather concerned about the erratic price movements of their shares at the stock exchange on the few occasions that they are transacted.[57] Nevertheless, the dissemination of information has helped significantly in improving the situation and reducing inaccuracy in stock price.

B. Speculative Trading

Speculation refers to the buying and selling of securities with a view to buying and selling later at a profit when prices change. Thus, speculative trading carried out by investors affects the price of stocks.[58]

Investments made in the stock market on the basis of random speculation are gambles. It is impossible for any share market to function properly based upon uninformed speculation; yet genuine speculation which is based on a reasoned forecast of the real value of the investment performs a vital function. In this connection, it may be noted, to much of the public securities market seems to be a "legalized gambling casino."[59]

No stock exchange, however, can operate purely on the basis of investment buying and selling. Speculation forms an integral part of any market mechanism. Genuine investors alone cannot provide the requisite volume or continuity of business, which would enable a large number of buyers and sellers to trade at all times in the exchanges so as to entail adjustment of the relative value of the securities in which they trade to its real worth. However, speculative activities should not be allowed to degenerate into gambling. To minimize unhealthy speculation overall improvement in public standards and codes of conduct in the realm of private enterprise seem essential. Added legislation alone cannot stop speculation. As previously mentioned, unhealthy speculation changes the stock market into a gambling casino where accuracy is rarely the rule.

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57. *Id.* at 23.

58. These speculators can be classified under various heading such as Bear, Bull, or Stag. Bear refers to a stock exchange speculator who sells stocks or shares that he may or may not possess because he expects a fall in prices and therefore, that he will be able to buy them (back) later on at a profit. MCGRAW-HILL *supra* note 38, at 35. Bull refers to a stock exchange speculator who purchases stocks and shares with the belief that prices will rise and that he will be able to sell them again later at a profit. The market is said to be bullish when it is generally anticipated that prices will rise. *Id.* at 49. Stag refers to a speculator who subscribes to new issues or who buys and sells shares for profit, having had no intention of retaining the securities for any length of time. ROSENBERG, *supra* note 42, at 312.

59. Irwin Friend, *The Economic Consequences of the Stock Market*, 62 AM. ECON. REV. 212, 212 (1972).

If stock market operations were confined to genuine investors[60] only, the volume of transactions would be much too small to ensure ready liquidity and daily price quotations, which constitute the market's greatest advantages. Therefore, the facilities that make speculative trading possible may be considered to be beneficial and even necessary, provided that there is sufficient control to ensure that the speculation does not get out of hand. A stock exchange is essentially speculative as people estimate the future earnings of a company.[61]

C. Liquidity

Investors want liquidity, i.e. the facility to convert their investment into cash at any given time. The stock exchange, to some extent, shifts the burden of financing industries from the shoulders of company management to the investors. There is always a conflict of motives between industries and the investors in stock. Industries require long-term finance with the end in view of investing in land, buildings, plant, machinery, materials, etc. Investors, on the other hand, have a liquidity preference, that is, they want to get back the money as and when they would need it. Alternatively, while industries require permanent finance, investors can commit their savings only temporarily, since they will want to be able to free up their investments in the event of unexpected future expenses. It is not merely the individual investors who suffer from the "liquidity preference" complex industrial investors also share this same preference.[62]

Experience shows that people do not buy securities if they are not assured of their marketability. In Nepal, before the establishment of the Securities Exchange Center, a "secondary market" to ensure liquidity did not exist.[63] At present, the trading floor of the securities market, including the open-out-cry system, has contributed to liquidity. It is found that banks, in general, buy and sell development bonds, shares and debentures according to their liquidity requirements. Hence, liquidity plays an important role in the price determination of a stock. For this, the NEPSE, by centralizing all trading in one location, has optimized the liquidity of the securities market as a whole. "Having all sellers and all buyers come to a central market improves the prospects of achieving trade. Given Nepal's small size, the likelihood is that the number of shares available for trading and the number of investors engaged in trading will never be very large. Accordingly, it is especially important to concentrate trading as to time and place in order to maximize the opportunities for liquidity in the market."[64]

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60. Genuine investors are those investors who invest after a detailed study.

61. *See First Eight Weeks*, *supra* note 47, at 7.

62. CALCUTTA STOCK EXCHANGE ASSOCIATION, THE STOCK EXCHANGE; A SYMPOSIUM 66 (1958).

63. Indeed, a secondary trading market serves the two important functions of providing liquidity and price discovery through resales among investors. *See* Yim, *supra* note 48, at 55.

64. ARIES GROUP LTD, CAPITAL MARKET DEVELOPMENT PROJECT IN NEPAL 9 (1993).

IV. PRINCIPAL ACTORS OF THE SECURITIES MARKET

The principle actors in the stock market are investors, brokers, market makers and dealers. The way they carry out their activities and the level of their knowledge affect the stock market.

A. *Investors*

Investors in Nepal have been investing in shares without any consideration of the investment portfolio. Since investing in stock is a new concept for the Nepalese, there is still no standard approach to the investment decision. Very few investors seem to have knowledge of the fundamental and technical analyses to be carried out prior to making an investment decision. In most investment decisions, fundamental and technical analyses are an integral part of the decision. Fundamental analysis helps investors decide what to buy or sell, and technical analysis helps investors decide when to buy or sell. Technical analysis saves investors from buying or selling the right share at the wrong time. Fundamental analysis saves the investor from buying or selling the wrong share at the right time.[65]

In addition to fundamental and technical analyses, an investor should also have a knowledge of industry analysis and company analysis. These analyses help investors determine the relative quality of securities and to decide whether a particular security is good at current market prices. An investor, besides understanding the above analytical concepts, should also take into account the following: whether shares are listed on the stock exchange; whether the share is actively traded; the size of the company; whether the company is diversified; whether the shares of the company are widely held; and whether the nature and reputation of the company's management is satisfactory. If an investor is not aware of these elements the investment pertaining to it cannot reflect the actual price of the market. Although investment in the Nepalese share market has increased more than was anticipated with the establishment of NEPSE, the return from such investments is not yet fully satisfactory as the investments were made without information about the necessary components. Hence, there exists a high level of price inaccuracy. In addition, most investors believe that the market is manipulated by a few market makers,[66] and that as a result, the market moves up and down according to the vested interest of these few active market makers. Such belief is mainly due to a lack of knowledge on the investor's side about the proper functioning of the different components of a share market.

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65. Parmeshwar B. Malla, *Capital Nepal*, 5 MONTHLY STOCK MARKET REV. 9 (1995).

66. Market makers are those who buy and sell securities on a continuous basis for one's own account by setting the prices at which the securities will be bought or sold. *See generally*, THOMAS LEE HAGEN, THE LAW OF SECURITIES REGULATIONS § 10.3 (3d ed. 1996).

B. Brokers

Brokers, as intermediaries between investors and the stock exchange, are the prime movers of the stock market. In Nepal, before the establishment of NEPSE, the Securities Exchange Center mobilized its own staff to intermediate and facilitate buying and selling of securities without any outside brokers. After its transformation into the NEPSE, broker licenses were granted to qualified individuals, firms and companies interested in acting as brokers. Initially twenty-five brokers were selected and trained before being inducted to the floor. Currently, there are thirty-two brokers.[67] This addition has helped to increase competition in the floor of the NEPSE, based on an open out cry system of trading.

It is worth mentioning that brokers are either individuals, firms or companies and make transactions only as an intermediary on the basis of a client's order. As such, brokers are unauthorized to buy or sell on their own account. They can only benefit when there is an increase in the volume of trading and the number of transactions. Hence, their activities significantly affect the price of stock.

C. Market Makers

Market makers are companies or corporate bodies which make commitments for completing transactions in securities issued by the government or issued with the guarantee of the government and other listed corporate bodies. The market makers' objective is to provide instant liquidity in the market. They also act as issuance managers and underwriters. Market makers are thus primarily introduced with the intention of providing liquidity to the market. In Nepal, presently five companies are working as market makers.[68] Generally market makers are legally required to hold stock in at least three different companies and/or in government bonds. They need to be willing, and able to, purchase stocks offered at their buy-rate and to sell stocks at their sell-rate.

The companies working as market makers sell and buy shares and bonds to brokers and quote both selling and buying prices for their stocks. Thus they help increase the liquidity of the market and reduce the problem of shortage of liquidity encountered by the securities market during the existence of the former Securities Exchange Center. However, market makers have not yet been completely successful in providing liquidity to the market. This is particularly so because they are unable to acquire a sufficient buffer stock of shares initially required by them for market making. In addition, due to the continued lack of

67. *See* Pant, *supra* note 10.

68. The five companies which presently function as market markets are the Share Market, the NIDC Capital Market, the National Finance and Leasing Cy, the National Commercial Bank, and the Citizen's Investment Trust. *See* RAJBHANDARI, *supra* note 44, at 12.

liquidity in the market, the market makers have not been able to create an impact on the share market. It has been noted that there is still a lack of necessary market pre-conditioning for the functioning of market makers. The liquidation of the NCM Mutual Fund, a fund operated by NIDC capital market, is a case in point which illustrates the collapse of price in the stock market due to a growing suspicion of the activities of market makers.[69] As a consequence of this pre-conditioning deficiency, only some equity market makers are active, others only interested in government bonds have not begun operations since the modalities for trading government securities at anything other than par and registering the new owners are not yet complete.[70]

It is also important to note that the concept and role of dealers has not yet been introduced, at least from a legal viewpoint, to Nepal's stock market. Dealers are companies or corporate bodies that buy all or partial securities directly from the issuer at the time of floatation with the objective of selling them through the stock exchange. Dealers are generally also involved in issuance management and make transactions at the stock exchange on their own account. It suffices to mention that in the case that dealers become part of the market operations, there will be an impact on supply of shares in the market and, consequently, on the price of the stock.

V. DEMAND-SUPPLY ASPECTS OF SECURITIES MARKET

The demand and supply of stocks plays an important role in the proper functioning of a stock market. As the balance of demand and supply factors helps determine the price as well as the liquidity essential for a security market operation, a broad and efficient stock market depends on the extent of the supply and demand.

As mentioned earlier, the two major groups demanding securities are the landowning, trading and money lending groups in the rural sectors and the more recently developed urban middle class and urban trading groups.[71] Often the interest of the second group may overlap with that of the first, but the major interests of both remain the same.

A recent research study on stock exchange investors in Nepal has shown that the majority of investors in stock are middle and lower income groups. The study

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69. The NCM Mutual Fund was established in 1993 with a 45% share of the NIDC capital market and the rest of the investment provided by 1,726 shareholders for a total capital of 525 million Rupees. It went out of business in 1995. *See NIDC to Re-Activate Mutual Fund*, KATHMANDU POST, June 5, 1996 [hereinafter *NIDC to Reactivate*]. The main reason was that after the opening of the open floor share market, people showed a great enthusiasm and there were significant trading transactions. But immediately after this initial burst of activity, further transactions failed to occur. *Id.*

70. *See First Eight Weeks*, *supra* note 47, at 7; *see also* Tiwari, *supra* note 39.

71. *See supra* note 40-42 and accompanying text.

defined the middle income group as those who have monthly incomes between 5000 and 10,000 Nepalese rupees, own one house, one vehicle, and less than one ropani of land.[72]

In Nepal, the demand for securities is increasing. The Securities Exchange Board estimates that there were 150,000 shareholders in 1994, up from 60,000 in 1993. Nearly all recent share offerings have been, by and large, oversubscribed. For example, the share offering by Nepal SBI Bank,[73] which remained open to the public for only eight days, was fourteen times oversubscribed with an estimated 90,000 Nepalese seeking to invest. Nearly a third of the applications were from people outside the capital city of Kathmandu. While the majority of the shares are held by the Indian joint venture partner (50%), the Employees Provident Fund (15%), and the Agricultural Development Bank (5%), the interest of the public in equity investments seems enormous (30%).[74]

For their investment, the investors look at companies with promising financial prospects. To most investors, a company with good financial prospects is one which provides accounting information in its annual report. Some others look at the market demand for the products or services of the company. Some investors appear to have preferred joint venture for investment because of their international reputation.[75] This means that the investors perceive the total risk in these stocks to be lower. Hence, the increasing demand for stock and a growing enthusiasm of small investors about this form of investment is encouraging. Moreover, the demand for investing in the securities market has also increased from a number of foreign organizations. However, until recently the exchange remained closed to foreign investors, although foreigners who were primary investors could disinvest through the market.[76] It was only in June of 1996 that the government opened the stock exchange to foreign investors.[77]

With the expansion of new financial institutions such as merchant banks, the supply of stock in the market has increased. Except for this, a large potential supply of stocks resides in private companies. All these possibilities of increasing

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72. RAJBHANDARI, *supra* note 44, at 4. One ropani comprises an area of 0.05 hectare or 5 acres.

73. Nepal SBI Banks was the first Indo-Nepal joint venture bank.

74. *Nepal SBI Bank posts Marked Profits*, KATHMANDU POST, May, 26 1996 (visited May 27, 1996) http://www.south-asia.com/Ktmpost/1996/May27/may27-ec.htm.

75. The Nepal Indosuez Bank, the Nepal Arab Bank and the Nepal SBI Bank are some of the examples of joint-venture companies.

76. *See First Eight Weeks*, *supra* note 47, at 17.

77. The decision of the government was to allow foreign institutional and individual investors to invest only up to 25% of the paid up capital of selected companies. The decision also allowed foreign security firms to tie up with local companies and stockbrokers in joint ventures which limits foreign equity participation. *See* Tiwari, *supra* note 39. It should be mentioned that based on the policy of welcoming foreign investment through the secondary market, the government has also specified that such foreign investment shall be on tourism, water resources, mines and mineral-related industries and goods production and processing sources. *See* MINISTRY OF FIN., ECON. SURV. FY 1995-1996, at 100 (HMG, 1996).

the volume of stocks can be materialized only if corporations become the popular form of business organization.[78]

Following the political changes of 1990, the number of joint ventures and public limited companies has grown in Nepal. This has increased the supply of securities to a considerable extent. However, the number of listed companies is still relatively low. The volume of stocks issued by the existing companies is not large either. As a result, the number of well performing industrial public limited companies has not increased significantly. Initially, the tendency of establishing a public limited company by the investment of capital was dominant. The supply of stock did not reflect the demand.

There are various types of obstacles on both the demand and supply side. On the one hand, with the supply side there is a tendency of ownership limitation and control of the enterprises within close circles. On the other hand, there are no fiscal or other incentives for the firms to become public. Strong barriers existing within the socioeconomic infrastructure, as well as historical reasons, have made successful floatation difficult. On the demand side, the vast majority of the population is illiterate and unaware of modern business principles making the floatation of new ventures, as well as the selling of their shares, difficult. Even relatively sophisticated and educated people with resources and knowledge tend to show market preference for investment in low-risk or zero-risk ventures such as real estate.[79]

Apart from this, the secondary market, the market makers and the brokers are not fulfilling their roles well. The lack of dealers and underwriters further limits the supply thereby affecting the efficiency of the market. Moreover, some large companies and promoters have issued shares solely for their own benefit. For example, the Nepal Lever Limited decided to sell only 15% of its total issued shares to the public.[80]

VI. LEGAL REGIME APPLICABLE TO SECURITIES EXCHANGE

A. *The Organic Source: Constitutional Provisions*

As mentioned earlier, the need for capital market development in Nepal has been, for a long time, an accepted reality. The newly enacted Constitution enshrines in its directive principles, provisions designed to promote private sector

78. MAHAT, *supra* note 12, at 31-32.
79. *Id.*
80. PARIYOJANA CHINARI, HIGHLIGHTS YEAR 2 n. 1, at 8 (1993).

growth.[81] The Nepalese Constitution[82] does not contain any particular provision regarding the securities market. However, its Chapter on the Directive Principles and Policies of the State contains some implicit references to economic activities. Indeed, Article 25 (1) of the Constitution states that the chief objective of the State is to promote conditions of welfare on the basis of the principles of an open society by establishing a just system in all aspects of national life, while at the same time protecting the lives, property and liberty of the people.[83] Further, Article 25 (2) of the Constitution adds that the fundamental objective of the State is to transform the national economy into an independent and self-reliant system. This is to be done by preventing the available resources and means of the country from being concentrated within a limited section of the society, by making arrangements for the equitable distribution of economic gains on the basis of social justice, by making such provisions as will prevent economic exploitation of any class or individual, and by giving preferential treatment and encouragement to national enterprises, both private and public.[84]

Albeit vague, Articles 25 (1) and (2) may indeed be considered the source for all legislation regarding securities in Nepal.

B. Securities Exchange Act

Bearing in mind the importance of the securities market in the development of capital markets in the country, in 1983 a law establishing a framework for securities transactions was promulgated: the Securities Exchange Act (SEA).[85] The objectives of the SEA are to "systematize and regularize the securities exchange in order to maintain the economic interest of the people and to contribute to the economic development of the country, to protect the interest of investors and to increase the people's participation in industrial enterprises."[86] The SEA is the first specific legislation enacted in Nepal to govern securities. The SEA, designed essentially to regulate the conduct of the securities market as well as protecting the investor, was amended in 1992 to adapt to the new policies of the government. Indeed, before the amendment of the SEA, Nepal had a rudimentary system for regulating securities. Although the SEA of 1983 permitted formation of stock companies and the issue of stocks, it had limited guidelines regarding the functioning and operation of the securities market. The SEA, as

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81. SECURITIES EXCHANGE CENTER LTD, SECURITIES MARKET IN NEPAL 5 (Plan. and Market Dev. Dept., 1991) [hereinafter SECURITIES MARKET].

82. NEPAL CONST. (1990) [hereinafter NEPAL CONSTITUTION]. (English translation available with the author).

83. *Id.* art. 25(1).

84. *Id.* art. 25(2).

85. SEA, *supra* note 32.

86. *See generally* SEA, *supra* note 32, at Preamble.

amended and presently in force, covers *inter alia*, matters regarding the establishment of stock markets, the conduct of security businesses, accounts and trading in securities.

The SEA is quite short in length and relatively uncomplicated in structure. It consists of a total of thirty-six articles. Article 1 defines several terms.[87] Article 2 deals with the establishment of the Securities Exchange Board (SEB).[88] Article 2(a) identifies the mechanisms for operation of the securities market[89] and Article 2(b) deals with the issue and registration of securities.[90] Similarly, Article 3 covers aspects related to the listing of securities,[91] Article 4 covers aspects related to the membership of the securities market[92] and Article 5 enumerates the prerogatives of the government.[93] The SEA deals with sanctions in Article 6[94] and concludes in Article 7 with final, miscellaneous provisions.[95]

1. Definition of Securities

Article 1 of the SEA defines securities to include shares, stocks, bonds, debenture, debenture-stocks issued by an incorporate entity, transferable certificates of deposits issued by a legal entity under the unit account savings or collective account savings programs, and bonds issued by the government, including stock-bonds issued against full governmental guarantee, as well as receipts and titles related to such bonds.[96]

This definition permits essentially two observations. First, a security is a document incorporating a private right. This means that a security creates a contract, property or other right.[97] Second, certain payment instruments, such as checks and bills, are excluded from the definition of security. Thus the SEA's definition of security may be considered overly restrictive.

Notwithstanding the difficulties encountered by the overly restrictive definition, the SEA may be read in light of its overall purposes of investor protection and regulation of the securities market to yield a workable definition. Traditional investment paper such as stocks, bonds and options are covered

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87. *Id.* §§ 1-2.
88. *Id.* §§ 3-7.
89. *Id.* §§ 7(a)-7(e).
90. *Id.* §§ 7(f)-7(i).
91. *Id.* §§ 8-16.
92. *Id.* §§ 17-20.
93. *Id.* §§ 21-23.
94. *Id.* § 24.
95. *Id.* §§ 26-36.
96. *See id.* § 2(a).
97. It may be inferred that the term "right" refers to right of contract, property or other rights, depending upon the conditions of the issue and the domestic law.

clearly by the definition. The definition also covers the financial products traded in the securities market, as well as devices such as investment contracts.

2. *Screening of Securities Business*

The screening process within the securities market is, as provided by the SEA, presently ensured through the Securities Exchange Board (SEB). Indeed, the SEA provides for the establishment of a SEB to administer and regulate the securities exchange market, in order to protect and promote the interests of the investors and to develop the securities market.[98] The Board supervises the public issue and trading of securities and the operation of the stock exchange. Although the law refers to a specific reporting system and thus formally places the SEB under the general supervision of the Ministry of Finance,[99] in practice the SEB indeed regulates the admission of securities to the market as well as the operation of the security exchange market and its members. The SEA gives the SEB extensive administrative authority to enforce the Act. However, violations of the SEA are generally handled through the criminal and civil codes in force.[100]

The SEB is constituted with a view to involve the most relevant partners of Nepalese society concerned with the operation of securities markets. It comprises representatives from the Ministries of Finance, Industry, Law and Justice, as well as representatives from the central bank. In addition, the presidents of the Federation of Industry and Commerce and the Chartered Accountants Association of Nepal are also members of the Board.[101] The government appoints the chairman of the Board.[102]

The SEB is expected to carry out a broad range of activities. According to Section 5 of the Act, it is vested with the responsibilities of, *inter alia*, (i) advising the government on the formulation of policies regarding the development of the securities market as well as the protection and promotion of investors, (ii) administering the functioning and regulation of the securities exchange, (iii) granting authorization for legal entities to operate a securities market, (iv) registering the securities issued by the different entities, and finally, (v) providing directives to the securities market for a proper functioning of the securities exchange.[103]

98. SEA, *supra* note 32, § 3.
99. *Id.* §§ 27, 32.
100. *See infra* notes 136-37 and accompanying text (regarding civil and criminal enforcement of securities regulations).
101. SEA, *supra* note 32, § 3(2).
102. *Id.* § 3(2).
103. *Id.* § 5.

3. *Access to the Security Market*

All persons, whether individual or a body corporate, should obtain membership in the securities market prior to becoming involved in securities trading.[104] They should apply for membership by submitting all relevant information in accordance with procedures prescribed by the law.[105] A membership-certificate is then granted to the applicant. While granting such certificates, the SEB, on the basis of the nature of the involvement of the individual or the body corporate, classifies the applicants as falling into one of the following categories: (i) securities issuer, (ii) intermediary broker (securities intermediary), (iii) security dealer, or (iv) market maker.[106]

The SEA also restrains the members from carrying out or initiating any activity aimed at negatively influencing a securities transaction or price of a security. According to its Section 20, the members cannot, (i) circulate incorrect or misleading information, (ii) refer to non-tradable securities as tradable securities, (iii) over-value or under-value the price of a security which in reality has remained constant, (iv) encourage security- transactions creating a misleading appearance of active trading or causing price increase or decrease, (v) present incorrect and misleading statistics about securities, or (vi) misuse of known information.[107]

4. *Issue and Registration of Securities*

Securities are, for a greater part, sold on the primary market where distribution periods may exceed one year; some securities registered under the SEA have a shorter distribution period. Therefore, investors generally redeem securities by making a redemption demand against their issuer. Alternatively, they may sell the securities to another investor so long as that sale is consistent with conditions set by the issuer. The manner and method of selling securities is direct and simple. The issuer either sells directly to an investor, or uses the services of an intermediary.

Disclosure of corporate information through the registration system is required when securities are to be sold to the public.[108] In fact, a company may not offer its shares or debentures to the public unless it is a public company. A public offering of securities is accomplished through the issuance of a prospectus, a copy of which must have been registered with the SEB. The Board reviews the

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104. *Id.* § 17.
105. *Id.* § 17(2).
106. *Id.* § 18(2).
107. *Id.* § 20.
108. *Id.* § 15(a).

prospectus and may issue comments or request additional information prior to accepting the prospectus for registration.

5. *Security Exchange Center*

As yet the secondary market for securities in Nepal is still relatively small. Nepal pursued its planned growth of the capital market with the establishment of Securities Exchange Center (SEC) in 1976.[109] The SEC has been a pioneering institution involved in the management of public issues made by corporate bodies. The SEC availed its services to its members in and about November of 1983, when the floor was opened for the secondary trading of stocks.[110] The operations of NEPSE are chiefly financed by commissions, investment income, listing and membership fees. Once the trading is handed over to professional brokers, the revenues from the commission also go to brokers.

In so far as the operations of the NEPSE are concerned, the SEA vests a strong authority in the government. The NEPSE should operate under the given regulations and by-laws approved by the government. The concerned authority, that is the government, can also appoint two members to the NEPSE Board.

6. *Listing of Securities*

A public limited company can make a public offering of shares by fulfilling provisions stipulated under the Nepal Company Act.[111] The initial share capital, as proposed in the memorandum of articles of a particular company, can also be raised through a public offering. Subsequent increases in share capital should be approved by a general meeting and the proposed changes in the memorandum and articles should be approved by the concerned agency or department of the government.[112] Existing shareholders and employees reserve the right of subscription in the increased share capital.[113] Rights are allotted in proportion to ownership of existing shares, and employees are entitled to the shares as set aside by the company. A premium issue requires prior approval from the concerned agency or department of the government. The allotment of shares is made so as to include all the applicants as far as possible.[114]

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109. In 1994, the SEC was officially transformed into the Nepal Stock Exchange. *See* SECURITIES MARKET, *supra* note 82, at 5.

110. *Id.* at 6.

111. The Company Act, *supra* note 15.

112. When seeking approval for an increase in share capital, the agency or department to which the request is made must have been identified previously by notice of the government.

113. The Company Act, *supra* note 15.

114. *Id.*

Thus corporate bodies are obliged to list their shares and debentures in the market in order to be qualified for exchange. However, government bonds issued under the National Debt Act[115] are exempted from such compulsory listing obligations. The listing of corporate shares and debentures is affected by an application from corporate bodies. The NEPSE examines the application so received under certain criteria.

To begin with the status and ownership structure of the company will be reviewed. In case of stocks, the share value must be above 100 rupees; the number of shareholders must be above 100; and at least fifteen percent of the subscribed value of shares should be owned by those shareowners who detain not less than 100 units of shares.[116] In case of debentures, on the other hand, the maximum permissible unit price is fixed at 1000 rupees, minimum number of debenture owners is fixed at twenty-five and the duration for maturity is fixed at not less than two years.[117]

Next, the transferability of securities will be considered.[118]

Finally, the economic and financial position of the enterprise will be appraised.[119]

On examination by the NEPSE, if the securities are found suitable for smooth trading, if they satisfy expectations under these three criteria, listing will be permitted.

Thus all corporate bodies intending to issue securities, prior to their trading, are required to list such securities.[120] The application filed with the SEB must include a prospectus in the form prescribed by law.[121] The prospectus generally contains information about the organizational structure of the company, its management, capitalization and business. In addition, it contains *inter alia*: (i) the latest audited consolidated financial statements, parent company financial statements and, if requested, information concerning important subsidiary companies, (ii) comparative balance sheet and profit and loss accounts (income statement) with summarized financial data, distribution of earnings, yield on the securities and other items, and (iii) statutes and regulations.[122]

To put it more clearly, the application for listing of securities should contain the following particulars:[123] (a) the company's name, address and head office, (b) objectives and functions of the company, (c) a description of the securities to be

115. National Debt Act (Nepal, 1983).
116. SECURITIES MARKET, *supra* note 82, at 11.
117. *Id.*; *see also* Securities Listing Regulations § 9 (Nepal, 1984).
118. SECURITIES MARKET, *supra* note 82, at 12.
119. *Id.*
120. SEA, *supra* note 32, ch.3, § 8.
121. *Id.* § 10(2)(a).
122. *Id.* § 10(2).
123. *See* Securities Listing Regulations, *supra* note 118, § 2, at ¶ 1.

listed (objective of issues, allotment procedures, types, numbers, unit price of securities), (d) procedures regarding transfer, renewal, consolidation, splitting of securities and fees charged thereon and procedures for issue of new securities in lieu of old or lost securities and fee charged thereon, (e) the Memorandum and Articles of Association in the case of companies established under the Company Act or a special act in the case of companies established under a special act, (f) a copy of the decision of the Board of Directors regarding the listing, (g) a detail of those on the share/debenture holders list (name, address and share/debentures held by each one of them), (h) an audited balance sheet, profit and loss account of the past three years and the latest auditor's report. In case these statements are already six months old, a statement of profit and loss account, production and sales covering the six months period must also be provided.[124]

In order to enable proper monitoring of the listed companies, the SEC also requires the corporate body, after it is listed, to provide the following information to the Securities Exchange Center on a regular basis: (a) financial statements, balance sheets, profit and loss accounts and trial balances in case the audit is not complete within six months of the end of the fiscal year, (b) detailed description of shareholders and the type of securities, (c) information on general meetings, issues of dividends and bonus shares, (d) information regarding mergers or takeovers, (e) any restriction to be imposed on transfer, consolidation and splitting of securities, (f) any stoppage or future stoppage of operation due to natural calamities, accidents, labor problems, or reconstruction, and (g) half yearly (mid-year) trial balance, production and sales information.[125]

In fact, as shown by practice, the SEB attaches great importance to the prospectus and may request modifications or additions before giving its approval. In addition to examining the application/request and the prospectus, the SEB commissions a detailed review of the company's statutory auditors or independent accounting firm. Financial statements should comply with the provisions of Nepalese accounting laws.

Companies with securities listed on the stock exchange must submit to their shareholders audited statutory financial statements for the parent company. The SEB strongly encourages all listed companies to publish consolidated financial statements with an opinion thereon from the statutory auditors.

In addition to annual financial statements, listed companies must file with the SEB all financial information made available to the public, including quarterly turnover (sales), the mid-year financial position, preliminary announcements of unaudited results for the year, annual reports and other data submitted at shareholders' meetings.

124. SECURITIES MARKET, *supra* note 82, at 12-13.

125. *See* Securities Listing Regulations, *supra* note 118, §§ 12-13.

Regarding registration of securities, a significant problem should be noted within the SEA. The status of privately placed securities and public offerings with small value remains unclear. The SEA does not provide any explicit exemptions from its registration requirements. This omission indeed constitutes a statutory defect. The SEA should exempt, in an explicit manner, privately placed securities and public offerings having a value that does not warrant application of the SEA. An exception for private placement should apply to sophisticated investors and institutional investors. However, this exception should not be so broad as to include unsophisticated investors. This is justified for three main reasons. First, registration facilitates secondary trading by providing a body of information about the issuer to the public. Second, the disclosure of information backed by government enforcement enhances investor confidence in the market. Third, most investors in Nepal are unsophisticated and need the protection of the securities law.

7. Rejection to Listing

Section 13 of the SEA provides for the rejection or suspension of the listing. According to it, the reasons permitting the security market to refuse or suspend the listing of a security are both of a technical and administrative nature. Indeed, from a technical standpoint, refusal or suspension may be invoked when: (a) based on the number of shares and the distribution of capital, the sustainability of the securities exchange does not appear to be feasible, (b) economic and efficient transfer or change of title of the securities does not appear to be feasible, or (c) the financial and monetary position of the company does not appear to be satisfactory.[126] Moreover, according to the Act, refusal or suspension may also be invoked for "any other acceptable reasons."[127] Indeed, because of the vagueness of this notion and lack of a proper definition of what is acceptable, this provision of the SEA remains quite subjective, leaving ample room for confusion and distrust vis-a-vis the state apparatus.

As soon as the decision to reject or suspend a listing is made, the applicant concerned should be notified and the SEB should be informed.[128]

It is worth mentioning that a major problem in Nepal is that most privately owned large firms do not want to go public. They most likely fear loss of control and loss of secrecy.[129] However, opening firms to partial public ownership does not necessarily reduce the power and wealth of those who still control the firm.[130] It might well enable them to expand their holdings and their economic power.

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126. *See* SEA, *supra* note 32, § 13.
127. *Id.*
128. *Id.* § 13(2).
129. Pant, *supra* note 10.
130. *Id.*

Listing enables a firm to become better known within the financial community.[131] This increased perceptibility, in turn, aids the expansion program, which hinges largely on mergers and acquisitions, by increasing contacts with potential joint venture or acquisition candidates. Listing also facilitates stock-for-stock swaps.

8. *Cancellation of Securities*

The SEA also provides for the possibility of cancellation of a security. According to the Act, the security market can proceed with the cancellation of the security when (a) a violation of the Act or its regulations is noticed, (b) any orders or directives issued by the security market have not been followed, (c) or the interest of the investors necessitates such a cancellation.[132]

9. *Government Interventionism*

The SEA states that, in consideration of the monetary and financial situation of the country, the government can, from time to time, give directives to the SEB. The Board has to abide by such directives.[133] Although the Board's authority is limited to the letter of the SEA, the SEA confers several significant powers on the Board. Most significantly, according to the SEA, the Board can give appropriate orders and directives to the securities market or its members, either individuals, firms or companies, in consideration of the governmental policy, directives, or the situation of the capital market. It shall be the duty of all the individuals, firms or companies to follow such directives or orders.[134] In this context, it should be added, the Board may also appoint up to two persons as members of the management council of the securities exchange market. Such appointees shall include one lawyer.[135] Moreover, for the purpose of regulating and administering securities exchange activities, the Board can require the legal entity, members, firm or companies to furnish statistical information or specifications in a form and substance that is acceptable to the Board.

It is appropriate to note that, unlike the Securities Exchange Commission in the United States of America, the SEB in Nepal lacks statutory authority to hold hearings and impose penalties.[136] However, whenever the Board deems it

131. *Id.*
132. SEA, *supra* note 32, § 14.
133. *Id.* § 21.
134. *Id.* § 22.
135. *Id.* § 22(2).
136. *See generally* US Securities Exchange Act of 1934, 15 U.S.C. (according to which the Securities and Exchange Commission (the Commission) is empowered to conduct investigation of possible violations of the securities laws. The Commission can also order an administrative hearing to determine if penalties are in order with respect to any security, person or firm registered with the Commission. In addition, the Com-

appropriate, it can commission an investigation of the securities operation and exchanges within the securities market or membership holders, individuals or body corporate. In so doing, it can appoint an individual or a unit/division/department to act as the investigating commission. All operators in the securities market shall be required to furnish all information requested by the investigation commission.[137]

10. Liabilities and Remedies

As already mentioned above, the SEA does not provide remedies for statutory violations. It relies on criminal, civil and administrative remedies outside of the SEA to enforce violations of its provisions. This reliance on other law to provide remedies for statutory violations has roots in the country's legal practices. However it is an unfortunate policy choice specifically with regard to the SEA. The decision to place the remedies for civil and criminal violations of the SEA in the appropriate sections of the civil and criminal codes requires a level of coordination among diverse statutes that is unlikely to occur in the immediate future. This is especially true in the context of a judicial system where massive reform appears to be highly justified. The failure to provide a coherent, rational and easily identifiable scheme of remedies within the SEA represents a missed opportunity and derives from blind adherence to tradition.

11. New Issues Management

The SEC, or NEPSE from its early days,[138] has been undertaking new issues and sales management of shares and debentures in order to augment the supply of securities in the market.[139]

A company willing to obtain the services of the NEPSE should file an application with the NEPSE[140] in accordance with the particulars prescribed in the

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mission can also review the hearing officer's decision and, if necessary, modify the sanctions originally levied. Besides administrative proceedings, the Commission can bring court actions to enjoin violations of securities laws based upon a "proper showing" of a reasonable likelihood of further violations). *See also* DANIEL V. DAVIDSON ET AL., BUSINESS LAW. PRINCIPLES AND CASES 648 (1984) (describing the SEC's power to conduct investigations and utilize enforcement powers).

137. SEA *supra* note 32, § 23.

138. *See supra* notes 104-06 and accompanying text (regarding §§ 17 and 17(2) of the SEA).

139. *See* SECURITIES MARKET, *supra* note 82, at 6.

140. The SEC, or NEPSE, an off-spring of the government's industrial policy, was initially placed under the Ministry of Industry. From April 1991, the government decided to shift it to the Ministry of Finance to integrate the securities market with the overall financial development of the country. The NEPSE owes its existence to the Company Act. The NEPSE is thus obliged to act accordingly in connection with the convening of general meetings, amendments of memorandum of articles of association and appointments and functioning of the Board of Directors. However, its operations are mainly guided by the SEA.

guidelines for new issues and sales management.[141] The information regarding capital, management, shareholding, partners, project reports, financial statements (both historical and projected), other operating results and an approved prospectus should be submitted with the application. The issuer should agree and declare that it will always make an effort to protect the interests of the general investors. Generally, the amount of the initial offering should not be less that twenty percent of the issued capital. However, this condition is not applicable to a public enterprise or companies with at least a fifteen percent holding with shareholders who possess less than 100 shares.[142]

Normally the issuer should pay a commission to the NEPSE for the management of new issues and sales services. The commission ranges from 1.35% to 2% of the revenues derived from the issue. Moreover, the issuer has to bear other costs such as stationeries, promotion, bank charges, postage and telephones costs. It is worth mentioning that the NEPSE also generally provides advisory services regarding allotment of shares, post-issue services like the collection of call money, distribution of share certificates, etc. as per the company's requests.[143]

C. Trading System

In selecting a trading system, there is often a tradeoff between the ability to trade promptly and price stability.[144] This tension is always given due consideration in all countries. In Nepal, in order to facilitate trading of securities, a separate room is designated by NEPSE for trading of shares, debentures and government bonds. Presently the brokerage functions are being fulfilled by the NEPSE itself. Bids and offers in written form are collected by the market supervisor of the NEPSE who maintains them in a confidential manner.

In the case of an offer for sale, the client deposits the scripts along with the selling order form. Whereas the buyer deposits ten percent of the bid price in the deposit account of the NEPSE, an initial offer for sale or purchase remains open for three days. It is renewable from time to time.

The blackboard hung on the wall of the trading room reflects the latest trading price together with the bid and offer price of the listed securities. Transactions are carried out by giving priority to the highest bid and lowest offer. Among bids/offers made at the same price, the earliest one has priority over others.

The procedures regarding clearing and settlement are relatively simple. Once a transaction is decided the buyers and sellers are notified. A buyer deposits the

141. Guidelines for New Issues and Sales Management 2043 (1986).
142. *See* SECURITIES MARKET, *supra* note 82, at 6.
143. *Id.* at 8.
144. Gerhard Pohl et al, *supra* note 9, at 13.

total amount of money less the advance deposit plus commission in the deposit account of the NEPSE. The seller contacts the market operations section of the NEPSE to complete the documentation work. The seller gets the payment for the sale immediately after completion of the documents. The documents are sent to the concerned company to effect share transfer accordingly. A share certificate in the name of the new shareholder is then handed over to the buyer.

It is worth mentioning that clearing and settlement of these shares must be closely integrated with the country's banking and payment system.[145] The development of capital markets suffers with a poorly developed payment system. For instance, making a rapid transfer of share ownership would not be efficient unless the rules regarding payment are improved.

As of May 1996, there are eighty-five listed companies in Nepal and market capitalization is at 11,970 million Nepalese Rupees (roughly equivalent to 213,750,000 United States dollars). There are thirty-two member brokers and five market makers.[146] Transactions of securities on the floor of the NEPSE are conducted on the open auction axiom.[147]

According to the NEPSE's classification, all listed companies are divided into six groups: banking, finance and insurance, manufacturing and processing, trading, hotels and others. The majority of the investors are interested in owning shares from the banking groups, and in the finance and insurance companies. These are considered to be blue chip stocks. In the present context, some market makers are less effective and others are creating a monopoly over certain stock, through brokers, who divert these stocks from the general public eager to invest. Due to this, investors ordering shares from their individual brokers are not always in a position to be satisfied.

Lack of transparency in floor activities, inefficient administrative procedures and lack of confidence has rendered the stock market vulnerable. Initially, to operate a Mutual Fund, the promoters, with high-sounding advertisement, created high expectations among investors. With the closing down of the Mutual Fund, people lost confidence in the share market, which consequently contributed to the decline of the stock market and further diminished the re-purchase value of shares.

With the establishment of the NEPSE, it should be noted, for an initial period, there was a rapid increase in both stock purchasing and selling activities as the NEPSE provided a trading venue. Similarly, the formation of the SEB is a major step to fill the gap and provide a policy making body to prescribe terms and

145. For a brief account of the clearing and settlement system, *see generally*, Jeff Stehm, *Clearance and Settlement Systems for Securities*, TECH. PAPER (World Bank, 1996); *see also* EDWARD L. RUBIN AND ROBERT COOTER, THE PAYMENT SYSTEM: CASES, MATERIALS AND ISSUES (1989) (providing a detailed study on the payment system.)

146. *See* Pant, *supra* note 10.

147. *Id.*

conditions for operating the stock exchange and to inspect the activities and to register the securities.

The massive increase in stock exchange activities notwithstanding, most investors involved in the market seemed to lack knowledge about securities. It was often observed that they were not even aware of the risks involved in the share market. This situation created the possibility of market manipulation by a few investors.

As an emerging stock market, NEPSE has experienced various ups and downs. However, with privatization and growing experience amongst business groups, it maintains the potentiality to play an important catalytic role in raising capital from both domestic and foreign investors and thus, enhance business development in general.

D. Information Dissemination

The NEPSE has given due place to providing an information system in order to strengthen the securities market. The NEPSE analyzes and publishes a financial and managerial performance review of listed companies on a regular basis. The NEPSE also publishes monthly reviews incorporating information on the government's relevant policy matters, corporate sector news, securities market news and special studies. Despite the above, it is worth mentioning that the dissemination of information has for long been handled inadequately by the NEPSE, affecting transactions in securities.[148]

VII. Evaluation Of The SEA And The Securities Market Operations

The securities market operations in Nepal suffer from a variety of problems. Whilst most of these problems are due to an incomplete legal and regulatory environment within the country, dominated by the flaw of vagueness, some are also due to the particularity of the market structure itself as well as the lack of an adequate infrastructure. Some notable problems are discussed briefly in the following paragraphs.

The SEA fails to define security professionals, investors and issuers. Moreover, Securities Regulations have made provisions to admit securities dealers and market makers as members of the Stock Exchange, but have failed to clearly distinguish the functions that these two types of members are expected to perform. The confusion becomes worse given the overly restrictive nature of the definition of security provided by the SEA, resulting in the exclusion of certain payment instruments that are common to most developed and mature securities

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148. *See* SEA, *supra* note 32, § 2(a).

markets.[149] Similarly, the SEA has also failed to define a private placement. The absence of a clear definition has resulted in an unclear status for private placements especially in terms of restriction, and a lack of any explicit exemption from registration requirements.[150]

The lack of a prescribed waiting period during and after registration remains another noteworthy problem. The SEA does not deal with the waiting period, which indeed may vary considerably. No doubt this variance discourages the different players within the securities market and certainly contributes to the slow development of the securities market in the country. In addition, failure to prohibit insider trading and to address the issues regarding manipulation, stabilization and foreign securities, the introduction of which remains difficult, engendered frustration amongst operators and has consequently lowered the possible growth of securities market operations.

The legal regime governing securities market operations in Nepal does not contain comprehensive and satisfactory liability provisions, lacks rules regarding conflict of interest, and lacks a customer protection scheme. Moreover, when problems pertaining to the above occur, the only possible recourse remains the ordinary courts which, as mentioned earlier, are ill-equipped to address the problem as they are unfamiliar with the securities market. As a consequence, the potential players become more risk-averse. They are, no doubt, concerned about legal and judicial uncertainty.[151] These kinds of apprehensions only increase the risk of jeopardizing the success of the securities market in general, since most operators tend to loose confidence.

The lack of an adequate regime governing liabilities becomes a more serious problem as there is also a lack of self-regulatory mechanisms amongst organizations operating within the market. Stock exchanges all over the world engage in substantial self regulation. The features of a self-regulatory environment include a policy making body within the organization composed of practitioners, in which both users of the market and market intermediaries are represented. Market self-regulatory organizations are usually financed by revenues that they themselves generate rather than public funds from the treasury. Self regulation is desired essentially to ensure direct accountability to the members and the stability and effectiveness of the exchange. In a self-regulating environment there is a

149. *See* SEA, *supra* note 32, §§ 17-20; *see also supra* note 92 and accompanying text (noting the restrictive definition in the SEA of "security").

150. *See supra* notes 111-25 and accompanying text (specifically noting the absence of a private placement exemption from registration with the SEA).

151. In economic terms, since the judiciary has a monopoly on the supply of justice, it consequently also has incentives to act inefficiently. *See* Maria Dakolias, *The Judicial Sector in Latin America and the Caribbean; Elements of Reform*, TECH. PAPER 5 (World Bank, 1996). It is indeed believed that an effective government requires functioning legal and judicial institutions to accomplish the inter-related goals of promoting private sector development, encouraging development of all other societal institutions, alleviating poverty and consolidating democracy. *Id.* at 1.

general willingness of members to accept regulations as they are formulated by their own professional peers. When self-regulation is technically adequate, market practitioners are often able to identify and comprehend a business problem before the crisis actually occurs. There is business sensitivity in a self regulatory environment created by the need to know the workability of a regulation and its benefits to the investors and the market.[152] As a result of this comprehension and sensitivity, in carrying out their business the different actors tend to automatically feel more responsible and liable vis-a-vis other fellow members and investors.

It should be mentioned that financial assets are pieces of paper evidencing a claim on the issuer. Marketable securities are financial assets that are easily and cheaply tradable in organized markets. In Nepal warrants, options (puts and calls) and financial futures do not exist. The only marketable securities the country has are treasury bills (a short term money market instrument sold at discount by the government), treasury bonds (long term bonds sold by the government), corporate bonds and common stocks. The leading source of financial claims in Nepal is from the development of commercial banking.[153]

In this context therefore, in order to reinforce the capital market the government should issue stocks and bonds of government-owned companies to the public through a listing at the stock exchange. The government should also thoroughly impose the rule of disclosure and reporting requirements on both privately owned and public companies, and encourage trust funds, including insurance companies, to invest fixed portions of their resources in the securities market. This could be accomplished either directly or through an investment company. For instance, the government could issue bonds to finance much needed hydro power that would be momentous in the development of capital markets.[154] In order to attract investors, the country can protect these types of bonds against inflation by fixing their redemption value, and interest payments, on a stable foreign currency such as the US dollar.[155]

Transactions in securities in Nepal also remain vulnerable because of lack of information. *Inter alia*, the available material information about the listed com-

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152. *See* Gerhard Pohl et al., *supra* note 9, at 20, 22-23 (providing a brief account on the specific features of self-regulatory organizations); *see also* Anand Chandavarkar, Presentation at the World Bank's Seminar on Promoting Capital Markets in Developing Countries (Dec. 7-8, 1993) (transcript available from the author); Robert Pardy, Presentation at the World Bank's Seminar on Promoting Capital Markets in Developing Countries (Dec. 7-8, 1993) (background notes available from the author).

153. *See* Pant, *supra* note 10.

154. *See* ECONOMIC INTELLIGENCE UNIT COUNTRY REPORT: INDIA, NEPAL, 42-3 (2nd Q. 1996) (offering detail on opportunities in hydropower investment).

155. *See* Pant, *supra* note 10. In this context, it should be noted that on April 29, 1996, the government announced that stock market has been opened for foreign investors since the fiscal year 1996. It also revealed that the government was drafting necessary legislation to allow foreign investors in the stock market which indisputably plays a significant role. However, a policy that would tax foreign investors with the rate similar to those imposed on domestic investors and the provision of guarantees on remittances of dividends and repatriation of investment would be necessary. *Id. See also supra* note 73 and accompanying text.

panies is incomplete, the companies' annual reports are often submitted late, and the pricing of stocks by brokers is not controlled. These factors often damage the image of the NEPSE and discourage investors. Indeed, when the information arrives infrequently or erratically, investors lose confidence, transparency disappears and the possibilities for manipulation multiply. Information gives the investor an idea regarding the material development of companies which, in turn, impacts on share prices in the market.[156] The dissemination of information is, indeed, a pre-condition for meaningful trading floor operations.

The stock market in Nepal is relatively thin and illiquid and public participation is limited. Consequently the market for stock brokering is quite limited and a large percentage of the functions are still fulfilled by the NEPSE. In this context, the selection and admission of a stockbroker should be done with a great degree of care, caution and foresight. The selection procedure should be transparent, and above board, and should not be exclusively family-oriented. The authorities should endeavor to pick the correct people with the necessary qualifications and the right temperament. In spite of the thinness and illiquidity of the stock market, regulations limit the number of brokers. Indeed, capital and other requirements the brokers have to *de facto* meet limit the number of brokers. The minimum capital requirements only increase possible loss that brokers could incur through their agency transactions, since they themselves are not expected to act as principals in a securities transaction. Also such capital requirements go a long way to ensure that even when brokers decide to leave the market because of losses, they will still have the resources to cover their obligations. This creates noncompetitive conditions and unnecessarily restricts the growth of the NEPSE and securities trading.[157]

To solve the problem faced due to a limited number of brokers, Nepal's securities regulations should contemplate the appointment of individual firms as brokers. In fact, the investors' perception of a market where individuals operate as brokers is relatively vague. Individuals acting as brokers are viewed as creating a greater risk than other forms of brokers. This is particularly due to the absence of a "perceptual succession," meaning that when an individual acting as a broker dies the business he conducted loses its legal identity. Although, as a matter of law, individual debts are not extinguished upon the death of the individual, a perception that individual brokers are less secure prevails within the market.

To remedy this two possible solutions may be sought. First, the securities regulations could stipulate a minimum capital requirement for the individual,

156. *See* Tiwari, *supra* note 39.

157. It is believed that in an environment of open competition, business norms tend to evolve toward efficiency. *See* Robert D. Cooter, The Rule of State Law Versus the Rule of Law State: Economic Analysis of the Foundations of Development, Presentation before the Annual Bank Conference on Development Economics (Apr. 25-26, 1996), in Washington D.C. (World Bank) (transcript available with the author).

similar to that of a broker. Second, the regulations could limit broker membership only to corporate entities registered under the Company Act.

Lack of liquidity within the NEPSE is another noteworthy problem. It prevents the market makers from acquiring a buffer stock of shares initially required by them for market making. The capital requirements laid down by the exchange are stringent and the operations of market makers are closely monitored by an exchange surveillance unit. However, at present, neither the Securities Board nor the Stock Exchange appears to be geared to operate such a surveillance system. Market makers in the current Nepalese system suffer from a severe lack of information about the listed companies. The inconsistent publishing of their own annual reports is partly to blame for this situation. The function of the NEPSE is securities trading,[158] while the SEB is supposed to regulate the capital market.[159] However, in practice, the demarcation of functions of the NEPSE and the SEB is not so clear. Apprehension prevails amongst public investors when issues are priced as premium. To overcome this problem, disclosure requirements should be drawn in more detail so that the issuers have to justify their pricing decisions. Presently, this has, by default, been the responsibility of either the SEB or the NEPSE. This should be the responsibility of only one body.

Amidst this confusion, market makers in Nepal tend to remain relatively passive. There should be provisions, in the Securities Regulations, to encourage them to be more pro-active. In those securities for which market makers are used, the exchange should allow the market makers to fix their own margins, specifically because it is difficult for the NEPSE to determine the appropriate spread. The NEPSE has not stipulated the minimum spread, for a very valid reason. It cannot, itself, estimate an appropriate margin due to the nascent state of market development. In general, low volume stocks require a higher margin and high volume stocks necessitate a lower margin. In competitive markets, one control present over the market makers' spread is that agency trading between brokers can replace transactions with market makers if a market maker's margins become excessive. If volumes are too low for this competition to operate effectively, the NEPSE may then consider limiting margins.

Presently, the securities regulations stipulate 500,000 rupees (roughly 89,000 United States dollars) as minimum capital for corporate entities to be licensed as stock brokers. In addition to a minimum capital, it may be important to stipulate some additional mechanism of client protection to guard against the financial failure of a broker/member of the NEPSE. The absence of a protective mechanism erodes the confidence of the investor.

There is a lack of transparency in the present system of trading in the NEPSE which does not help to improve the public's perception of the NEPSE. After

158. SEA, *supra* note 32, § 7(c).
159. *Id.* § 5.

recruitment of a broker the NEPSE should introduce public trading on listed securities where they can achieve a greater degree of transparency in their trading operation. To ensure that trading is conducted in a fair and efficient manner the NEPSE should adopt a clear set of rules outlining the basic principles to govern floor trading.

The level of trading activity in the secondary market depends upon the extent of a primary market. In this context, the NEPSE should introduce mechanisms to ensure that all companies admitted to the NEPSE are of a certain minimum size and that a stipulated percentage is held by the public prior to generating a quotation. The listing procedures also need some improvement. First, the procedure of obtaining a listing should be changed by requiring that companies wishing to obtain a listing submit an application to the NEPSE. This should be done prior to allowing the public issue of shares in order to permit the NEPSE to ensure that listed firms have allowed proper public participation in the offering. Second, the recapitalization rules should be changed. The listing of partly paid shares in the existing listing process of the NEPSE has created confusion and inefficiency because partly paid shares represent those funds that the company cannot use immediately. In this context, allowing the companies to only issue a bulk of shares necessary to raise the capital immediately required could be useful. Also, the revival of mutual funds[160] seems appropriate to increase the level of confidence of the investors in the share market.

Finally, it is essential to formulate guidelines regarding new issues. Such guidelines should cover the opening and closing of a share issue, the printing and distribution of applications and documents, processing of applications and banking of proceeds, the time period of allotments, returning of excess fund, issue of certificates and commencement of secondary share trading.

VIII. Conclusion

Whether Nepal can sustain an independent securities market will be determined by future economic and political development. Regulations regarding securities markets pose a difficult problem because the various aims of such regulations often seem contradictory. Indeed, no legislation in any part of the world has achieved a perfect balance between reliance on market forces and government guidance of the market place. However, emphasis should be laid on creating a certain equilibrium between the two. In Nepal, the future will however depend on three main factors: the privatization of property, the negotiability of these privatized securities, and government policy.

160. The mutual funds are particularly good for small and medium investors. *See NIDC to Reactivate*, *supra* note 68.

First, privatization is a necessary condition for the creation of the securities market. Companies must be privatized so that ownership may be transferred to the public. Privatization should result in the issue of equity and debt securities. The privatization process also must include the development of legislation to allow lenders to secure loans against real and personal property. This is necessary since the lack of securities leads to credit losses and consequently to an unwillingness to lend.

Second, privatization will increase the volume of product on the securities market and permit the average Nepalese investor to buy shares in private companies. Privatization would allow market participants to set prices and to trade securities in substantial volume once the state has authorized their negotiability.

Third, the policy of the government should remain clear and, for a continuous period, stable and consistent with the spirit of a liberalized market. Indeed, the sustainability of a security's market cannot be evaluated in a short period of time. It is important for the government to promote an enabling environment and provide a reasonable time frame for the different components of the securities market to firmly settle as operators on a sustained basis. Frequent changes in policies will discourage such operators to establish trust with the market and consequently will affect the development of the capital market in the country.

The share market is considered to be very sensitive. Political instability, natural calamities, terrorist activities, corruption and so forth can easily affect the share market. For instance, noticeable fluctuations on the demand for share in the world market were apparent in the aftermath of the earthquake in Kobe, Japan, the bombing of the World Trade Center in the US, and the Hawala Scandal in India. The share market in Nepal also cannot remain unaffected by political change.[161] Hence, the success of the securities market does not only depend on its operators and the legal framework therefor, but also on the political and institutional stability the country can provide on a continual basis.

161. Indeed, investors seem to be scared of wild fluctuations in the share market. Share traders complain that due to unsystematic management and inactivity of market makers, it [the share market] has gradually been losing investors' faith. *See* Tiwari, *supra* note 39.