Development of Financial Markets 5

A supply of bonds and equities is necessary for the development of a wide range of savings and investment opportunities. Bonds issued by governments generally provide risk-free investment and thus establish a benchmark for yield versus risk. Government bonds also provide long-term investment opportunities that are essential for the development of life insurance and pension funds. Long-term risk-free debt enables the suppliers of these products to match maturities with investments. A supply of equities provides risk investments that should enable the investor to enjoy capital growth in line with economic growth.

MONEY AND BOND MARKETS

In the early stages of development, central banks usually use direct instruments of monetary policy to control the balance sheets of commercial banks, generally interest rate and credit controls. When countries move to a market-based system, central banks rely on indirect instruments to influence the level of bank reserves through financial markets. The main indirect instruments are reserve requirements, lending facilities such as rediscount facilities, and open market operations.

PDMCs have made considerable progress in the 1990s in moving from direct to indirect instruments of monetary policy. First, all PDMCs have liberalized interest rates. Second, since the late 1980s, all PDMCs have at different times introduced

open market-type operations: in most cases, central bank securities are used for auctions, while some central banks also auction Treasury bills and bonds.[4] These operations have been supplemented by liquid asset or statutory reserve requirements (Table 4.1).

However, illiquid interbank markets and insufficient central bank earnings have hindered the full development of money markets in PDMCs. Although indirect instruments have been partly successful in restraining growth in monetary aggregates, some PDMCs (Fiji Islands and Solomon Islands) have had to increase liquid asset reserve requirements to high levels in order to prevent rapid declines in foreign reserves. Others, for example Tonga, have had to use moral suasion and resort to credit ceilings from time to time, because funds were lacking to pay the interest bill on securities. Because of the high excess liquidity in some banking systems, there has been little use of discount windows and lending facilities for banks.

In most PDMCs, there is a shortage of instruments and markets for them have not developed; most do not have much commercial paper or negotiable certificates of deposit in their money markets. The combination of high levels of liquidity and provident funds that hold onto both short-term central bank instruments and short- and long-term government instruments has led to a lack of secondary trading in these instruments, and has prevented the development of proper yield curves through the issuance of primary instruments and secondary market trading.

The lack of active secondary markets in either bonds or money market instruments in any of the PDMCs can generally be attributed to

(i) lack of a critical mass of fungible paper with different maturities;

[4] Bonds are defined as instruments with an initial maturity of more than one year. Money market instruments (central bank bills and treasury bills) may have a maturity that ranges from one day to one year. Money market instruments are generally issued on a discount basis, whereas bonds are normally issued at par value, with interest paid annually, semiannually, or quarterly.

(ii) excess liquidity in the banking sector, which means that banks do not need to minimize their asset ratios;
(iii) excess demand, particularly in the Fiji Islands from the FNPF, but also in other PDMCs[5]; and
(iv) interest rates that do not properly reflect the repayment risk.

Interest rates in the PDMCs (other than PNG) are very low compared with those in developed markets; investment in these bonds is thus unattractive to organizations that have other investment options. There is no cross border cooperation, although in general there are no restrictions on foreign buyers of bonds.

In developed markets, the commercial banks normally own a clearinghouse that provides an automated system for recording and clearing checks. They may also operate a high value interbank payment system. Central banks in many developed countries have also developed or are developing real time gross settlement systems that enable banks to settle with each other, across their accounts at the central bank, on an immediate basis. This system is frequently linked with bond settlement systems, normally operated by the central bank, and in some cases with the equity settlement system.

None of the PDMCs has implemented any automation in the payments process. Checks are cleared manually (listed and lodged at the clearing bank) and balances are reported physically to the relevant central bank. No PDMC has a high value payments network (although some banks will provide special clearance at a bank for a fee) or any real time gross settlement across accounts at the central bank. ATMs are being introduced into the PDMCs, but they generally operate on different systems and are not compatible.

[5] In Fiji Islands, bonds and bills are listed on the Suva Stock Exchange, but not actively traded.

Table 5.1

Issues of Bonds, Treasury Bills, and Central Bank Bills

	Bonds		Money Market Instruments		Other
	Government Bonds	Other Bonds Guaranteed by Government	Treasury Bills	Central Bank Bills	
Fiji Islands	Reserve Bank of Fiji (RBF) auctions bonds on a monthly basis.	Government-guaranteed Bonds are issued by Fiji Broadcasting Commission, FDB, Fiji Electricity Authority, Fiji Pine Limited, Housing Authority.	No Treasury bills are issued. However, the Government does issue some 14-day Treasury bonds.	The RBF auctions Reserve Bank Notes, with maturities up to six months, on a weekly basis.	FDB and the Credit Corporation issue promissory notes.
Papua New Guinea	There is some Government debt in issue, but no new bonds have been issued since 1993/4.	RDBPNG issued one bond in the late 1980s; this will mature in 2001.	Treasury bills with maturities of 28, 91, and 182 days are auctioned on a weekly basis. Kina notes with a maturity of 7 days are also issued.	BPNG does not issue its own bills.	Some companies issue bonds to pension funds.
Samoa	None	None	None	The Central Bank of Samoa (CBS) issues 91- and 182-day bills on a weekly basis.	

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Table 5.1 (cont.)

Issues of Bonds, Treasury Bills, and Central Bank Bills

	Bonds	Money Market Instruments			Other
	Government Bonds	**Other Bonds Guaranteed by Government**	**Treasury Bills**	**Central Bank Bills**	
Solomon Islands	In 1995, the Government defaulted on its bonds. The outstanding bonds were restructured in 1998. These bonds are being rolled over as they fall due.	None	Treasury bills, with maturities up to 182 days, are auctioned on a weekly basis.	CBSI issues such bills on an irregular basis to absorb excess bank liquidity.	
Tonga	Medium-term bonds are issued on an "as needed"' basis.	TBD issues bonds when it needs funds and when it can obtain Government approval.	None	Short-term notes (mainly 30 days) are auctioned on a weekly basis.	TDB issues short-term notes every two or three months.
Vanuatu	The bonds currently in issue (Vt30 million) are being rolled over.	None	None	Reserve Bank of Vanuatu issues notes with maturities of 28 and 92 days.	

Source: Central banks.

Box 5.1
Best Practice for Money and Bond Markets

Governments of PDMCs should attempt to issue medium- to long-term domestic currency bonds to deepen capital markets; such longer-term instruments could provide a viable alternative to short-term capital flows and minimize the currency and maturity mismatch. Central banks should attempt to ensure that there is a regular supply of fungible debt instruments of varying maturities to facilitate the development of a lengthening yield curve.

EQUITY AND DEBT FUNDING

An assessment of the financing needs of small and medium-sized businesses in PDMCs concluded that there were some unmet financing needs above US$100,000, and considerable unmet need for equity and debt financing between US$10,000 and US$100,000 (Admiralty Group Partnership 1998). However, the assessment did not make the important distinction between the need for development financing and the opportunity for venture capital funds to make profitable investments. Many development projects need to be funded through soft loans, grants, and technical assistance, with the objective of creating infrastructure and, probably, employment. These projects do not anticipate a substantial financial return within a five- to seven-year timeframe. On the other hand, venture capital should only be provided on the basis that within a five- to seven-year period the investments, as a whole, will provide a good return; in developed markets, that would normally be defined as a return above 25–30 percent compound growth per year.

In most PDMCs, few investments will be capable of meeting this criterion for return. The reasons for a difficult investment climate include

(i) sluggish economic growth;
(ii) the land tenure issue;
(iii) cultural issues that inhibit entrepreneurial drive, make it difficult to recruit and retain good staff, and, through dissipation of the assets, often lead to the failure of businesses run by indigenous peoples;
(iv) small, scattered populations, which make import substitution difficult;
(v) the remoteness of the PDMCs, which makes production for export expensive;
(vi) governance and management issues, which have subverted some of the more promising ventures;
(vii) social and security problems, particularly in Solomon Islands and PNG, which add to costs and make investment by overseas organizations unattractive; and
(viii) a lack of management expertise among many of the indigenous peoples, allied with difficulties in bringing in foreign capital and management.

The above constraints and issues make the provision of venture capital a highly risky operation. In many cases, it will be impossible to justify investment, and it may be better to recognize that the development of infrastructure in PDMCs is better achieved by the provision of well-administered grants and technical assistance. The experiences of the South Pacific Project Facility (SPPF) and the Kula Fund[6] are instructive in this respect. Both receive many requests for assistance/funding, of which only a very small number turn into feasible investment opportunities.

Sources of equity and debt finance

Sources of equity and debt finance for organizations that are starting or expanding productive enterprises in PDMCs are (i) family and friends; (ii) commercial banks; (iii) development banks; (iv) other domestic providers; (v) the

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[6] For more on these two institutions, see *vii./viii. Regional/International Funding Agencies* below.

general public who have bought securities made available through a public offering; (vi) foreign direct investment; (vii) regional sources; and (viii) various international funding agencies.

Family and Friends. In PDMCs many urban businesses are family-run by people who may be long-term residents or even second- or third-generation citizens, but who are not generally one of the indigenous peoples. In Fiji Islands, the industrial and commercial businesses are frequently run by Indians, and in most of the other places they are run by Chinese or Malays. These businesses have often grown through financing from family, friends, remittances from overseas members of the extended family, and retained earnings; they tend to be highly secretive. The Kula Fund has tried to invest in some of these businesses, as they are good quality, but discussions have not reached a satisfactory conclusion, because the owners/managers did not want outside interference or to have to provide information to third parties. With these businesses, when the original sponsor becomes too old to run the business, unless there is a family member to take over, the family would rather close the business down than bring in either outside management or outside investors. Banks and accountants confirm that external investment in these businesses would be difficult: their financial records are often poor or nonexistent, and the businesses keep multiple sets of accounts.

In Vanuatu, there is no income or corporation tax, because of the wish to develop an offshore financial center. There are thus virtually no incentives for owners of enterprises to incorporate. In other PDMCs, most enterprises are operated as private companies. The companies acts require all companies to make annual returns and generally to file audited accounts. However, in many PDMCs, private companies can opt out of this requirement with the authority of their shareholders; in general, minimum filing requirements have not been enforced.

The reliance on finance from family and friends and the reluctance to bring in outside management means that the growth of productive companies is limited by their internal resources, in both money and management expertise. It would

be better if successful companies could be encouraged to be both more professional and more dynamic. The development of domestic capital markets and a regional stock exchange are clearly key parts of this process.

Commercial Banks. In most PDMCs, the commercial banks are highly liquid and have funds to lend, but cannot lend them all due to a lack of bankable propositions. Sometimes they are also unable to lend because of the need to maintain a portfolio that is not unduly weighted by one industry. There is therefore a limit on the number of investments that can be made in, for example, tourist projects. In general, when lending to businesses, commercial banks will require a combination of the following:

a) security, in the form of land, capital goods, or perhaps a government guarantee;
b) a company track record with good financial accounts;
c) a management track record by the principals; and
d) a relatively low risk, which means they will tend to avoid investments in agriculture, fisheries, and other industries that are viewed as inherently risky, and will rarely be involved in "start-ups".

In most cases, the commercial banks are governed by country, industry, and project risk criteria laid down in Australia or the USA. Their lending policies are thus similar to those of commercial banks in developed markets: they lend to long-term company management, are extremely risk averse, and try to take collateral whenever possible. In PDMCs, the lack of freehold or leasehold land that can be used as security for loans makes the taking of collateral more difficult and thus restricts banks' lending opportunities. Commercial banks have specific problems in lending because local companies and potential borrowers lack management experience and knowledge of how to develop business plans. Commercial banks lend to projects funded by SPPF, which often provides crucial input into the business plan. At present, none of the commercial banks makes equity investments in the PDMCs.

Development Banks. As discussed in the previous chapter, development banks have been important sources of finance for development projects, but have not always been successful in using their funds for the development of sustainable businesses. It is important to reiterate that if the development banks become more commercially oriented, there will be a financing gap in rural development. If governments are to use funds to facilitate rural development, they will need to channel those funds through an organization with good corporate governance, clear objectives, and professional management. Without these attributes, the desired infrastructure development in the rural areas will not take place.

Other Domestic Providers. NPFs do not provide venture capital for domestic industries, nor should they be expected to do so. They are, in most cases, lenders of last resort to governments, but not providers of significant investment funds to the private sector. Tonga has a trust fund, but it is largely invested overseas and does not provide funds for domestic private sector development (although it has been a source of funds for public investment projects).

Some NBFIs in the Fiji Islands provide funds for private sector development. These include Colonial Life Fiji Ltd and Colonial First State Investments, Fijian Holdings Limited, and Unit Trust of Fiji.

Colonial Life Fiji Ltd. This branch of a local conglomerate has investments in all the companies listed on the Suva Stock Exchange (SSE) and in some unlisted securities. Colonial First State Investments has a minimum investment of F$250,000 (approximately US$125,000) in companies listed on the SSE; it takes a seat on the boards of companies it invests in, and in this way can add management expertise. It has recently established three unit trusts. These are open-ended funds, which will invest in liquid assets. Colonial First State Investments also invests in blue chip long-term investments; however, it is not a venture capital fund, and will therefore generally invest only in companies with a good record of profitable trading.

Fijian Holdings Limited. This is an investment company, established in November 1994 to enhance the participation of

indigenous Fijians in the economy. Ownership of shares is limited to indigenous Fijians and an individual's holding is limited to 100,000 shares. Its investment policy is generally risk averse, and focuses on companies with records of profits and dividend payments. Fijian Holdings has a window for green-field projects, but this is capped at F$2 million (less than 3 percent of 1999 net assets of F$73 million) and is fully utilized. Its main responsibility is to its shareholders and it proactively seeks to make investments in successful companies. As a known source of finance, they are often a first stop for companies seeking investments, and are often viewed as the natural partner for overseas investors. In general, an investment by Fijian Holdings is seen as a good indicator of investment potential by other investors.

Unit Trust of Fiji. Established 21 years ago by FDB, the Unit Trust of Fiji separated from FDB in 1997, although it is still Government-owned. The trust is open-ended and aimed primarily at retail investors. Its investment policy is risk averse, with considerable emphasis on liquidity; and it invests primarily in listed securities. Few investment opportunities meet the trust's requirements; however, if more listed securities were available, it would adopt a higher profile in trying to attract investors. No other PDMC in the study had institutional providers of funds for private sector development.

General Public. In all the PDMCs in the study, some companies had obtained funds through a public offering. In all cases, except Tonga, companies making a public offering are required to register a prospectus. In Samoa, the Solomon Islands, and Vanuatu, the prospectus must be registered with the Registrar of Companies. In PNG, the prospectus must now be registered with the Securities Commission of PNG (SCPNG), which has indicated that, in the future, it would be unlikely to register a prospectus unless the company planned to list on the Port Moresby Stock Exchange (POMSoX). In the Fiji Islands, the prospectus requires the prior approval of the Capital Market Development Authority (CMDA) before a company can make a public offer.

Without a stock exchange, investors would find themselves locked into their investments and are thus unwilling, except

in special cases, to provide funds. Public issuance has therefore been a little-used source of finance.

Foreign Direct Investment. All the PDMCs in the study except Samoa have an ambivalent attitude to foreign investment. PDMCs follow universal practice in requiring organizations wishing to do business to obtain a license, but draw distinctions between wholly domestic companies and companies with some foreign investment. The imposition of requirements for domestic control of companies in certain industries, such as Tonga's requirement that funds put in by foreign partners must be matched by domestic investors, leads to the companies' having small equity bases relative to the size of business undertaken. This can lead to very high gearing and lack of working capital for firms in the affected industries. Political uncertainly in the event of a change of ruling party is also a discouragement for foreign investment in PDMCs. One government may welcome foreign investment, whereas the next may take a very different view. There are also other restrictions on foreign investments in the PDMCs (Table 5.2).

Regional/International Funding Agencies. In almost all PDMCs, governments are looking to reduce their involvement in the economy by disposing of loss-making state-owned enterprises. They will, in most cases, need foreign partners, as there is insufficient capital and expertise within most PDMCs to buy and manage these enterprises. This will be difficult to achieve, and governments will not get value for any concessions, if the general attitude to foreign investment is restrictive and ambivalent. Restrictions increase the perceived risk of doing business in a particular country and lead to a lack of investors for the ailing industries.

There have been a number of attempts by international aid agencies to provide finance for private sector development through government or quasi-government organizations, such as development banks or small business centers. These attempts generally have been unsuccessful: either the business has failed totally or the fund providers have not received the level of return that was anticipated. Organizations structured as banks or lending institutions are not the best equipped to

identify or manage opportunities for equity investment; in addition, a mixture of equity and debt lent through one monitoring agency can easily lead to conflicts of interest. Once a business begins to go wrong, the agency has the problem of either trying to force repayment of the debt, by providing more equity, or calling in the debt and losing the equity. This route is not recommended for the provision of equity venture capital.

SPPF. SPPF was founded in 1990 by the International Finance Corporation (IFC) and is funded by IFC and the governments of Japan, Australia, New Zealand, Fiji Islands, Samoa, and Kiribati. Its role is to provide business advice to private sector companies in the Pacific, including help with market research, developing business plans, and the sourcing of finance. It has access to funds from IFC for debt or equity investment in some cases. These activities generally lead to some participation in the formulation of the project and product development. The target clientele are sound domestic sponsors who have a track record but lack the experience to put together a business plan. SPPF originally provided services free of charge, but now charges a US$100 application fee and then a completion fee of 1–2 percent of the funds raised. The funds received partly meet their costs but are also regarded as a commitment test of the sponsors.

Once a business plan is completed, SPPF assists the sponsor with finding financing. The preferred approach is to find it in the market in which the company is operating. SPPF, with the company, approaches the local development bank and commercial banks, and in nine out of ten cases, these approaches are successful. The unsuccessful approaches are normally the result of the banks' taking policy decisions about not investing in certain industries or because the banks' risk management criteria will not permit further investment in that industry. The banks and NBFIs in the region are all enthusiastic about the contribution being made by SPPF. This is the case in all markets, but the less sophisticated the national environment, the more significant the assistance is seen to be.

Pacific Islands Investment Facility. Where it is not possible to find domestic finance, SPPF will approach the Pacific Islands Investment Facility (PIIF). This is a venture capital facility provided by the IFC. The facility started at US$2 million and

Table 5.2

Current State of Restrictions on Foreign Investment

	Foreign Investors
Fiji Islands	Fiji Trade and Investment Board must vet all incoming investment. The new Government is reportedly very wary about foreign investment and has indicated to some companies that expatriate management should be replaced. Renewal of work permits has, in some cases, proved difficult and the period of renewal has been reduced.
Papua New Guinea	The Investment Promotion Authority is responsible for promoting foreign investment in PNG. Companies that are more than 50-percent owned by foreigners need approval from the authority. Certain activities are reserved for citizens, and either limited or zero foreign investment is permitted in specified industries: e.g., companies that operate service stations and fast-food outlets may have no foreign investors, whereas companies that operate supermarkets may have no more than 49% foreign investment. The Companies Act differentiates between domestic and foreign (or joint venture) companies in terms of fees. The registration fee for a purely domestic company is K115, for a company with one or more foreign investors it is K515. Foreign personnel require work permits, and businesses that employ foreign personnel must submit training and localization plans to demonstrate their commitment to local employment. Some occupations are reserved for citizens.
Samoa	In most industries except fishing, the Government encourages foreign investment. A new Foreign Investment Act is planned; it has been drafted in conjunction with the private sector to ensure that time for approvals is reduced as far as possible and that the opportunities for conflicts of interest between ministries are minimized.
Solomon Islands	The Foreign Investment Board screens foreign investments in accordance with the Foreign Investment Act. Any foreign entity wishing to do business must obtain prior approval from the Board.

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has subsequently been topped up to US$6 million. The terms on which this finance is provided are very flexible, in that both equity and debt are possible. There is neither an official minimum investment level nor a maximum percentage

Table 5.2 (cont.)

Current State of Restrictions on Foreign Investment

	Foreign Investors
	In addition, any significant transfers of ownership must be approved. The screening is more concerned with control than promotion. Some people in the Government are reported as being very nervous about foreign involvement, but others are starting to recognize that foreign investment is needed.
Tonga	Foreign ownership is not encouraged, although the Ministry of Labour, Commerce and Industry is currently reviewing the Foreign Investment Act. Distinctions between domestic and foreign (joint venture) companies have been removed from the new Companies Act, which has made it easier to register a company with some foreign ownership. However, obtaining a license to do business is much more difficult, as Government policy does not permit foreign ownership of businesses concerned with agriculture, fisheries, import/export, retail/wholesale, or "anything that can be done by Tongans". On the other hand, the regulations are administered with some flexibility, so it is not possible to determine which businesses will and which will not receive a license. Work permits for expatriates are also reported to be very difficult to obtain.
Vanuatu	The Ministry of Trade, Tourism and Business Development screens foreign companies and joint ventures that apply for licenses to do business. Domestic companies apply to the Ni-Vanuatu Development Agency. About two years ago, a swing against foreign investment was noted and some foreign investors tried to sell their interests. However, some changes have been made to the act and the economy is becoming more open, although the following criteria must be met before a foreign company can obtain a license: i) more than Vt5 million must be put up by the foreign investor; ii) some local employment must be created; iii) the company must not operate in a restricted industry, for example, telecoms. Obtaining work permits for expatriates is apparently quite difficult.

investment. Any decision depends on the nature of the investment. In practice, the projects generally have a value of around US$500,000; the maximum investment is around 25 percent of the total required, and is made mainly in the form of

debt. The decision as to whether or not to approve an investment lies with IFC rather than SPPF.

Debt rather than equity funding is usually provided, because it is easier to administer remotely. Specific reporting obligations and required ratios, for example to prevent excessive dividend distribution, can be built into a lending agreement, and ultimately the loan can be foreclosed if these are not met. With equity investments, there is no way to impose such restrictions, and even if a minority shareholder holds a seat on the board, the ability to force the production of meaningful financial statements, or to control or even influence events, could be very limited. There is also the cost and time factor of attending board meetings and undertaking site visits. Many sponsors prefer debt financing, as they do not wish to share the ownership of assets. To date, PIIF has had no problems with bad debts. However, the lengthy procedures apparently necessary to obtain funds from PIIF are seen, in many places, as a disincentive to trying to obtain them. The investment decisions are made in Washington, and are thus subject to the normal IFC scrutiny.

The availability of finance is not the major problem experienced by the companies assisted by SPPF. However, the existence of a regional venture capital fund would be useful for smaller investments; and additional funding on basically the same terms as PIIF, but with faster, regional decision making, would be a welcome addition to the range of funding options available to SPPF clients.

The Kula Fund. The Kula Fund is a regional venture capital fund operated by the Commonwealth Development Corporation, ADB, IFC, FNPF, EIB, regional governments, and Societe de Promotion et de Participation pour la Cooperation Economique/Proparco. It has offices in the Fiji Islands and PNG and is able to provide both equity investments and loans, but tends to concentrate on the former. It has a minimum investment level of US$200,000 and looks for an annual return of 25–30 percent. The Kula Fund will take only a minority stake but is an active board member, has a regional scope, and has investments in the Fiji Islands and PNG. The main problems for the Kula Fund are that potential investments in the smaller PDMCs either fall below the Kula minimum or do not offer the necessary level of return.

The Kontiki Fund. The Kontiki Fund Limited is an investment company, incorporated in 1998 in the Cook Islands, whose purpose is to invest in companies and businesses located in, or connected with, the Pacific islands. The principal objective of the fund is to achieve above-average, long-term capital growth for its investors. This is the only fund of this type that has been identified.

There are many international sources of investment that might seem available to the private sector within the PDMCs, as they are to other developing countries. However, these sources of finance are often tied to joint ventures with nationals from specific countries, have minimum levels of investment in dollar terms and maximum levels in percentage terms, and have funding terms that may be difficult and lengthy to negotiate. In general, these funds are not readily available.

LEGAL AND REGULATORY FRAMEWORK

Company law establishes the responsibilities of directors and the basic registration and filing requirements for companies. Each of the PDMCs has a companies act, under which their companies are incorporated. These acts set out the basic responsibilities of directors. In addition, each PDMC has a Registrar of Companies, who is responsible for registering companies and monitoring their compliance with the requirements of the companies act. The status of these measures in the six PDMCs in the study (not Kiribati) is shown in table 5.3.

A securities regulator, in addition to overseeing public issues by companies, is responsible for overseeing intermediaries and exchanges. Oversight involves licensing, which allows the organization to operate; monitoring, on an ongoing basis, to ensure that intermediaries have sufficient capital to meet their current and potential obligations; and monitoring, on an ongoing basis, to ensure that the investor is being protected from illegal or unfair practices, and that intermediaries are placing the interests of investors before their own interests.

Table 5.3
Current Status of Companies Acts and Registrars of Companies

	Companies Act	Registrar of Companies
Fiji Islands	Companies Act The Companies Act is being reviewed under the auspices of the Law Reform Commission.	Registrar of Companies The current status is not known. However, it was not possible for the registrar to provide a list of public companies for the SSE, when such a list was requested in 1998.
Papua New Guinea	A new Companies Act has recently been passed. It is based on the New Zealand act.	A system for recording the registration of companies is in place, and the Registrar is beginning to chase outstanding returns. The situation is improving.
Samoa	A new Companies Bill 2000 was approved by Cabinet in mid-2001.	The Companies Act requires the filing of annual accounts. There is a register of domestic and overseas companies operating in Samoa.
Solomon Islands	The Companies Act dates from 1961 and at present is under review by a representative committee.	The Registrar of Companies does not have an automated system and is understaffed; staff lack training and experience.
Tonga	A new Companies Act has recently been passed, modeled on the New Zealand act. However, practitioners have some problems with some provisions of the act; the Government is considering changes to it.	Compliance with the new act, which requires all companies to reregister, will be monitored by the Ministry of Labour, Commerce and Industry. The New Zealand Government is assisting by providing software and training for the team of inspectors.
Vanuatu	There is a Companies Act 1988, which was amended in 1990, 1992, 1993, 1997, and 2000.	Organizations wishing to do business in Vanuatu must register with the Financial Services Commission either as a business name or as a public or private company. All companies must make an annual return and companies with a turnover of more than Vt20 million must file audited accounts.

In the Fiji Islands, the Capital Market Development Act 1996 established the CMDA. It is fully funded by the Government, but the board includes representatives of the private sector. The broad purpose of the authority is “to develop an efficient and thriving capital market in Fiji and to develop and regulate the activities of the various market participants”. CMDA has issued a wide range of regulations and rules, as permitted and required by the act. The operation of the act and the regulations were subject to review in 2000 and some major changes were proposed. These included

(i) separation between the owners of the exchange and organizations using the exchange, in line with modern international practice;
(ii) the granting to CMDA of the power to approve all public offers and companies that list their shares;
(iii) the introduction of new regulations relating to prospectus requirements, takeovers, and mergers; and
(iv) introduction of a new Managed Investments Act and associated regulations.

In PNG, the Securities Act of 1997 established the SCPNG, with responsibility for licensing stockbrokers and stock exchanges, regulating the public issue of securities, and regulating takeovers and mergers. Under the act, the chairman of the SCPNG board reports to the Minister of Commerce and Industry. At present, however, the commission forms part of the Investment Promotion Authority, and has neither an independent source of funding nor an independent board; commission staff members also have departmental responsibilities within the authority. This is not in accordance with sound practice; SCPNG should have an independent board, independent budget, and full-time staff.

There is an urgent need for training and institutional strengthening within the SCPNG. The relationship between regulators and self-regulatory bodies is a complex one and needs well-trained and experienced people on both sides. At present, POMSoX has an experienced chief executive and a board that is very concerned about the maintenance of standards and independence, but there is no guarantee that this situation

will continue indefinitely. The SCPNG needs to use this period for training and for gaining knowledge and experience.

In Vanuatu, the Prevention of Fraud Act requires dealers in securities to apply for a license to the Ministry of Finance through the Financial Services Commission. There is no securities regulation in Samoa, the Solomon Islands, or Tonga.

Box 5.2
Best Practice for the Development of Capital Markets

PDMCs should ensure that they have modern, simple companies acts and efficient mechanisms for registering companies and monitoring their compliance with their ongoing filing obligations.

Regulators should ensure that securities firms have strong internal controls and compliance procedures in place. Investor protection should be provided through effective surveillance systems established in stock exchanges, and through independent surveillance by regulators.

PDMCs should promote the development of fair, orderly, and efficient capital markets, governed by strict standards of operational safety and efficiency, in which securities can be bought and sold by foreign as well as domestic investors at fair transaction costs. Economies need to develop clearance and settlement systems, with centralized securities depositories or registries and guaranteed settlement.

STOCK EXCHANGES

Companies and investors in PDMCs need access to a capital market for a number of reasons. First, in the absence of capital markets, companies are using bank finance for expansion purposes, which is likely to cost more than financing through the issuance of equity. Second, successful domestic

businesses could raise capital for expansion through such a market, and could realize some of the value they have built up through listing. Third, without a capital market, foreign investors do not have an exit method available to them, which makes them less willing to invest. A company's ability to make a public offering associated with a listing on a stock exchange or to sell its shares in the secondary market would enable foreign investors to realize some of the value they have built up. Fourth, there is a lack of domestic investment opportunities, high net worth individuals are investing in government bonds and on overseas markets, and PDMCs are missing out on using this capital productively within the domestic economy. Fifth, companies that raise capital domestically are required to pay high dividend rates to compensate investors for the illiquidity of their investment.

The two stock exchanges currently in operation in the PDMCs—SSE and POMSoX—are established in the most developed market and the largest market, respectively. Their operations are summarized in Table 5.4. There seems little likelihood of developing a domestic stock exchange in another PDMC: first, there are few public companies and most of these would be reluctant to list, as they are essentially family companies; changing this attitude will be a slow process. Second, there is no habit of equity investment, and it would take a considerable marketing effort to convince the general public that it is a good thing. Third, there are no indigenous intermediaries, and to try to develop them in the absence of any investors and products would be all but impossible.

It has been suggested that companies in the PDMCs do not need access to a national or regional exchange, as they can list on an existing international exchange. Most developed markets permit foreign companies to list on their exchanges, provided they meet the same listing requirements as the domestic companies. In general, many companies have taken advantage of this. For example, many technology-related companies have listed on Nasdaq; many companies that operate internationally have listings on a number of exchanges, for example the New York Stock Exchange, the London Stock Exchange, and the Tokyo Stock Exchange; and many mining companies are listed on the London, Australian, and South African stock exchanges.

Table 5.4

Ownership, Funding, Listing, Trading, Settlement, and Payments Systems in Stock Exchanges in the Fiji Islands and Papua New Guinea

	POMSoX	SSE
Ownership	Two brokers and the Central Bank. There are only two brokers, who are both owners. POMSoX would like to attract overseas brokers to use the exchange facilities. The relationship between ownership of the exchange company and access to the exchange facilities is not clear.	A combination of private sector and State enterprises. The Act originally envisaged that all owners would be members and all members would be owners. Proposed changes will remove that requirement and provide a separate status for owners and members.
Funding	Original funding by owners plus fees.	A grant from the Government (through the CMDA) plus fees.
Listing	Rules based on the rules of the Australian Stock Exchange (ASX), with minor changes to reflect the smaller size of companies in PNG. The rules envisage the secondary listing of companies that have a primary listing on an overseas exchange, but do not preclude other overseas listed companies. There are nine listed companies. Eight have primary listings on the ASX. The ninth is a Canadian company.	New listing rules were drafted last autumn to integrate with the revised CMD Act and Regulations. These rules will come into effect when the new law is passed. The rules are aimed at listing domestic Fiji companies, although they do not preclude listing companies incorporated overseas. There are nine listed companies. SSE also lists Government bonds and other debt instruments. None of these is listed on any other exchange.
Trading	Trading takes place through an automated trading system. POMSoX has adopted the ASX Business Rules to the extent that they are appropriate to PNG. Detailed volumes were unavailable but they are understood to be similar to those of SSE.	Trading takes place by open outcry during trading sessions that are held three times per week. New business rules were drafted last autumn. These are in process of being brought into effect. Trades are currently averaging about 70 per month.
Settlement	Physical settlement through exchange of share certificates. At present a single registrar is used for all listed companies, but this is not a requirement.	Physical settlement through exchange of share certificates. Companies continue to maintain their own registers.
Payment	Payment is by check.	Payment is by check.

However, such a company listing on an overseas exchange is rarely successful. The cost of compliance with overseas listing requirements is usually high, and it is difficult to raise the interest of investors in the overseas company. In almost all cases, once the initial listing publicity has died down, the volume of trading is very small. In the case of securities issued by companies incorporated in the PDMCs, there is nothing in the rules of the overseas stock exchanges to prevent them from seeking a listing. But the nature of the companies and the ownership restrictions in the PDMCs themselves make this difficult, and it is unlikely to prove a viable route for many companies in the near future: the companies are generally too small to meet the minimum size criteria for listing; the quality of their accounts is often inadequate; the lack of an audit history will generally make the securities ineligible; the number of shares the company is prepared to offer for public ownership is likely to be below the required minimum; the governments of the PDMCs place restrictions on foreign ownership, which will mean that the companies' shares are not freely transferable; and investors in the listing country are unlikely to be aware of, or particularly interested in, the shares of PDMC companies.

Many PDMC investors already take advantage of foreign exchange permissions to invest abroad.[7] This is likely to be an advantage to investors, as they can at present obtain better returns abroad than in the PDMCs. While investors should be encouraged to spread their investments, the overseas investments mean that, first, such funds are not available to support the expansion of business in the PDMCs; and, second, the investor is exposed to exchange rate risk and cannot match investments with obligations.

An alternative to the development of national or regional markets would be to persuade either the Australian Stock Exchange or the New Zealand Stock Exchange to emulate the relationship between the Hong Kong Exchange and the

[7] It is also very likely that some citizens receive funds abroad and leave them and invest them abroad without the permission of the PDMC authorities. This is invariably the case where there are restrictions on acquiring and holding funds in foreign currencies, but the extent of this practice in the PDMCs is not known.

People's Republic of China (PRC) by establishing a Pacific Board. The Hong Kong Exchange developed special listing rules to permit the listing of shares issued by PRC companies; these are known as "H" shares. These rules recognized not only that the country of incorporation of the shares was not Hong Kong, but also that the accounting and corporate governance standards of PRC companies were different from (and inferior to) those of Hong Kong companies. It was nevertheless felt that, on balance, investors should be able to invest in PRC companies, and that the companies would benefit from exposure to the standards prevailing in an established market. However, it should also be noted that, first, Hong Kong investors are familiar with Chinese companies and the Chinese way of doing business; and second, that the "H" share market operated alongside the domestic PRC markets in Shanghai and Shenzhen, which list shares that do not meet the more rigorous "H" share standards.

This proposal is unlikely to be attractive to either of the Australasian exchanges, which are moving toward more of a profit focus and away from the "club" environment. A Pacific Board would likely prove expensive to establish and is unlikely to produce significant profits in the short to medium term. Such a proposal is also unlikely to be welcomed by the Fiji Islands or PNG, both of which have spent monies in developing a national facility. The development of a Pacific Board in Australia or New Zealand would be aimed at the same companies that SSE and POMSoX are trying to attract.

A regional facility could be established either as a single development with a head office and regional offices, with SSE and POMSoX incorporated into this development; or as a network that links the existing exchanges to companies and investors in all the PDMCs. These alternatives can be compared to the development of a central mainframe computer system versus the development of a system that relies on distributed processing. A distributed, networked regional facility could be established that uses Internet technology to link the SSE and POMSoX to companies and investors in all the PDMCs, and that makes provision for other domestic exchanges to be added to the network as they are developed. The advantage of this approach is that no PDMC would need to enact extensive

legal changes in order to bring the system into operation: joining the service would not prevent any PDMC from enacting legislation to govern public issues or to offer investment services to the public, or from developing a domestic stock exchange if and when the time came. The development of the trading mechanism would be relatively inexpensive.

An Internet-based trading mechanism would permit the service to be offered through licensed intermediaries in the countries that have enacted the relevant legislation, but it could also be offered directly to investors in the others. An Internet-based trading mechanism would also enable the service to be offered to investors in remote locations, without the need for a physical presence in that location. The front end of the Internet service could be customized and presented as a regional facility to potential investors.

As part of the development of a regional exchange, companies would list on SSE, POMSoX, or other exchanges as they develop. The choice of exchange would depend on the type of company and the requirements of the listing rules. Investors would trade in these companies through an Internet trading mechanism that would allow them to access the relevant market for prices and order execution.

Ultimately, the prospects for successful development of capital markets and stock exchanges in PDMCs depend on the existence of sufficient effective demand for equity. Given the constraints of small economy size and the structure and performance of PDMC economies, such development must be seen as long-term.