

Importance of Politics in the Reform of Capital Markets: Case Study of the Egyptian Capital Market

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INTRODUCTION

Financial development has proved to be a perfect indicator and reliable proxy for economic growth.¹ Capital Finance is one of the main vehicles of finance. Capital markets, as Thorsten Beck and Ross Levine showed empirically, can solely and independently lead to economic growth.² The consensus about the importance of financial markets and, particularly, the role that capital markets play in modern economies, did not coincide with similar development patterns in capital market regulations and institutions in developed countries and elsewhere. Some developed countries continue to have weak capital markets, and other developing countries are struggling to construct theirs. This fact propelled many to question why some developed countries continue to have weaker capital markets, why legal and extra-legal institutions are efficient in some countries but not in others, and why some countries do not reform these institutions. These are questions of institutional performance and evolution, and why institutions perform differently in different countries. Nonetheless, this paper is only

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I dedicate this work to the memory of my father, my teacher and my mentor Okasha Abdelaal. Of course all errors remain mine. The author can be reached at m.okasha@berkeley.edu or m.okasha.abdelaal@gmail.com.

¹ Ross Levine, *Finance and Growth: Theory and Evidence*, in 1 HANDBOOK OF ECONOMIC GROWTH 865, 868 (Philippe Aghion & Steven N. Durlauf eds., 2005).

² Thorsten Beck & Ross Levine, *Stock Markets, Banks, and Growth: Panel Evidence*, 28 J. BANKING & FIN. 423, 440 (2004).

concerned with the performance and evolution of legal institutions, focusing on capital market institutions.

Two main theories seek to explain the existence of different capital market models and the continuation of less efficient legal institutions in different countries. One theory relates to the legal origin of the country,³ and the other to political ideologies.⁴ Most importantly, all theories admit that legal institutions play a crucial role in capital markets' development.

Interestingly, development agencies such as the International Monetary Fund (IMF) and the World Bank often disregard this debate in the literature when advising or aiding developing countries. These development agencies usually promote the idea that institutions matter for development and some institutions are better than others because they reduce the transaction costs. Normally, these development agencies advise the developing countries to establish their financial markets and adopt legal institutions in ways similar to those that exist in the developed countries. The United States and the United Kingdom have deeper and more liquid capital markets, and their models are normally the ones propagandized to developing countries. This often takes place without a comprehensive study of the political reality in the aided country.

This paper establishes that the ultimate determinant of institutional efficiency is the country's political authorities and elite. Institutions affect the rents that different groups can obtain, and the political powers will always strive to maintain their rents and positions. Under pressure, political powers can support institutional change, but they will skew enforcement as much as possible in order to once again emerge as winners in the outcome. Turning a blind eye to the political reality in a country will only lead to ineffective institutions and power limitations. Not assessing a country's political reality will adversely affect the country and complicate future political and economical reforms.

Several studies discuss the determinants of the efficiency of legal institutions related to financial markets, and they mostly depend on cross-country regressions. These regressions are usually based on generalities that can

³ Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); Rafael La Porta, et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1152.

⁴ MARK J. ROE, *POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT* (Oxford University Press 2003).

sometimes dim the reality. Thus, this paper attempts to shed light on some new aspects while trying to fill the gaps. Empirically, the research herein shows that politics and political powers steer the success—or failure—of capital markets. This is established by the present case study of the Egyptian capital market from 1990 to 2010, focusing on capital market regulation and corporate governance rules as proxies for investor protection. The study of Egypt demonstrates how the former political regime misused the aid from the IMF and World Bank, and their recommendations for transforming to a market-based economy, by creating a system of crony capitalism. This was a result of the nexus of business and political elites with aligned interests. Thus, when it was time to privatize banks and build the institutional requirements for a strong capital market, the elites emerged again as the winners from these reformations. This paper, through the lens of Egypt, throws a light on the prevalent scenario in other like-developing countries. This paper is structured in the following order: Part I briefly reviews the debate around what controls the effectiveness of the institutions required for capital markets. First, the New Institutional Economics' assumptions about institutional changes are discussed; second, the legal origins theory is explained before adverting to a discussion on finance and politics literature; and finally, the distribution of power and its effect on institutional performance is introduced. Part II summarizes the most fundamental institutions required for developing a strong securities market, as they will be used as a yardstick for the changes in Egypt towards building a viable securities market. Part III assesses the history of Egypt and the reform programs of the period. The legal and institutional changes during this period are examined, focusing mostly on the Securities Market Law and Takeover Law. More importantly, while tracking the legal reforms, this study scrutinizes the politics behind these reforms and the role that political and business elites played. Finally, Part IV is an assessment of Egypt's achievements, shortfalls, and anticipations, and its relation with developing agencies.

I. WHAT DETERMINES CAPITAL MARKET INSTITUTIONS' EFFECTIVENESS?

Many papers accentuated the prominent role of legal and extra-legal institutions in financial development and economic growth.⁵ Why do some countries have less efficient institutions than others, and why do less efficient institutions persist?

New Institutional Economics (NIE) was the leading current in bringing legal institutions back to the economic development discourse and, thus, to the development agencies' agendas.⁶ Douglas North emphasized that institutions matter.⁷ He defined institutions as:

The rules of the game of a society, or, more formally . . . the humanly devised constraints that structure human interaction. They are composed of formal rules (statute law, common law, regulations), informal constraints (conventions, norms of behavior, and self-imposed codes of conduct), and the enforcement characteristics of both.⁸

North's main argument is that institutions can be wrongly designed due to transaction costs. For North, the explanation of why similar institutions have different results over time are the "following variables that would induce individuals to accede to and reinforce them: imperfect information, unequal bargaining power that allows powerful interests to design institutions to fit their ends at the expense of larger society, and "subjective models" that preclude

⁵ Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); Rafael La Porta, et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1152 (1998) [hereinafter *Law and Finance*]; see also Daron Acemoglu et al., *The Colonial Origins of Comparative Development: An Empirical Investigation*, 91 AM. ECON. REV. 1369 (2001) [hereinafter Acemoglu, *Colonial Origins*] (arguing that institutions in general are important, particularly through examining the effect of colonizers' policies in different places they conclude that institutions have direct effect on income per capita. However they do not share the Law and Finance, *supra*, argument that institutions are predetermined by colonial policies, in fact they see that they can be changed from time to time).

⁶ John K. M. Ohnesorge, *Developing Development Theory: Law and Development Orthodoxies and The Northeast Asian Experience*, 28 U. PA. J. INT'L ECON. L. 219, 244 (2007).

⁷ Brian Z. Tamanaha, *The Primacy of Society and the Failures of Law and Development*, 44 CORNELL INT'L L.J. 209, 227 (2011).

⁸ Douglass C. North, *The New Institutional Economics and Third World Development*, THE NEW INSTITUTIONAL ECONOMICS AND THIRD WORLD DEVELOPMENT 17, 23 (John Harriss et al. eds., 1995).

individuals from perceiving institutional inefficiencies.”⁹ However, recently North has given greater importance to differences in informal rules and enforcement characteristics.¹⁰

The NIE’s assumptions and arguments about the importance of legal institutions influenced different development agencies’ vision for economic reform. Institutions became an empirical measurement in the world development report.¹¹ Particularly, most policy interventions advocated by these agencies focused on legal reforms.¹²

The legal origins theory also influenced the development agencies’ reform strategy.¹³ A group of economists developed this theory in a series of empirical research studies, arguing that legal origins have a direct effect on the quality of laws a country has and are therefore pivotal in contributing to the development.¹⁴ Their seminal work shows that common law countries have a stronger securities market and a better developed financial sector because the laws in such systems afford greater protection to investors.¹⁵ Thus, these studies produced two important contributions: first, that certain institutions are better suited for developing strong financial markets,¹⁶ and second, that such institutions are more prominent in common law countries. Accordingly, this difference between common law and civil law countries explains the difference

⁹ Chantal Thomas, *The Future Of Legal Theory: Essay And Comment: Law And Neoclassical Economic Development In Theory And Practice: Toward An Institutional Critique Of Institutionalism*, 96 CORNELL L. REV. 967, 1020 (May 2011).

¹⁰ Douglass C. North, *Centennial Lecture: Why Some Countries Are Rich And Some Are Poor*, 77 CHI.-KENT L. REV. 319, 321 (2001); DOUGLASS C. NORTH, *UNDERSTANDING THE PROCESS OF ECONOMIC CHANGE* (Princeton University Press, 2005); *see also* Dan Danielsen, *Economic Approaches To Global Regulation: Expanding The International Law And Economics Paradigm*, 10 J. INT’L BUS. & L. 23, 72-75 (2011).

¹¹ Thomas, *supra* note 9, at 996-997.

¹² *See* Thomas Kelley, *Beyond the Washington Consensus and New Institutionalism: What is the Future of Law and Development?*, 35 N.C.J. INT’L L. & COM. REG. 539, 545 (2010).

¹³ Daniel Oto-Peralías & Diego Romero-Ávila, *The Distribution of Legal Traditions Around The World: A Contribution to the Legal-Origins Theory*, 57 J. LAW & ECON. 561, 615 (2014).

¹⁴ *Law and Finance*, 106 J. POL. ECON. 1152 (1998); Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON.3 (2000); *see also* Rafael La Porta et al., *The Economic Consequences of Legal Origins*, 46 J. ECON. LITERATURE 285 (2008), <http://dare.uva.nl/document/2/63538/>.

¹⁵ La Porta et al, *The Economic Consequences of Legal Origins*, *supra* note 14, at 286-90.8

¹⁶ *Id.*

in strength of financial markets today.¹⁷ In the common law system, law is organic and constantly evolving with judges' interpretation whereas the civil law system places greater emphasis on codification of clear laws that limit the judge's creativity in declaring law.¹⁸ In context of investor protection, the economists argue that certain characteristics of common law systems such as fiduciary duties, judges' flexibility, dependence on little regulation, and the wide role of private contracting foster capital markets' growth. These facets make common law countries better situated in protecting investors, as civil law countries depend on heavy regulation.¹⁹

The legal origins theory was contested on several grounds. Some criticized the economists' coding of the law,²⁰ while others criticized the qualitative link between origins and investor protection.²¹ Berkowitz, Pistor, and Richard argued that legal traditions did not influence the effectiveness of legal institutions;²² rather, they claim it is a country's reception to its own laws.²³

¹⁷ *Id.*

¹⁸ Thorsten Beck & Ross Levine, *Legal Institutions and Financial Development*, HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 251, 253-60 (Claude Menarde & Mary M. Shirley eds., 2005) (reviewing the history of both common law and civil law traditions, they argue that English lawyers and judges were the winners after the revolution, thus law was always placed above the king. In France, however, the revolution sought to curb the powers of the judges who were seen as against the French revolution, thus the theory behind the Napoleonic code was to draft clear and contradictory laws so that judges have no authorities.)

¹⁹ Mark J. Roe, *Legal Origins, Politics, And Modern Stock Markets*, 120 HARV. L.REV. 460, 464-65 (2006) [hereinafter Roe, *Legal Origins*].

²⁰ See generally ROGER M. BARKER, CORPORATE GOVERNANCE COMPETITION AND POLITICAL PARTIES: EXPLAINING CORPORATE GOVERNANCE CHANGE IN EUROPE, 110-15 (2010).

²¹ Roe, *supra* note 19, 466-467.

²² Daniel Berkowitz, Katharina Pistor & Jean-Francois Richard, *Transplant Effect*, 51 AM. J. COMP. L. 163, 165 (2003), <http://www.pitt.edu/~dmberk/AJCL.pdf>.

²³ See *id.* at 167. In fact, the transferability of laws and legal institutions from one country to another is a contestable matter with no consensus. For instance, Alan Watson the most prominent supporter of transplantation of laws argues that transplantation is the main source of legal development, whether recently or historically, that law is autonomous from the political, economic or cultural structure of a state and that it has a life of its own. Others like Kahn Freund state that the possibility of transplantation is variable but at a certain point a law can be deeply immersed within a state's cultural and political fabric that it cannot be transplanted. A stricter version of this view can be found in Montisquieu's opinion, where he claimed that in very few cases that a law of a state can benefit another. See, e.g., Alan Watson, *Legal Transplants and European Private Law*, Alan Watson Foundation (2006), http://www.alanwatson.org/legal_transplants.pdf (last visited May, 20, 2015); ALAN WATSON, LEGAL TRANSPLANTS: AN APPROACH TO COMPARATIVE LAW (2d ed. 1993). But see Otto Kahn-Freund, *On Uses and Misuses of Comparative Law*, 37

Nonetheless, the latter is related to another contestable issue – the transferability of laws from one country to another. Importantly, the debate about transferability of laws is greatly related to this paper’s research question. If the problem is in the transplantation process, then the context of the process is what really matters, and the reasons behind success or failure should be analyzed.²⁴

The most significant criticism of the legal origins theory came from the politics and finance literature, which represents the second main camp for explaining the disparity in capital markets’ strength and legal institutions in different countries.²⁵ Two particular lines of argument in this literature are directly related to this paper. Mark Roe presents the first line of argument, and avers that the political ideology of a country explains the variations in institutional differences and strength in capital markets between the developed countries.²⁶ He argued that the differences in investor protection between the United States and other developed countries in Europe are because the latter are more like social democracies.²⁷ In social democracies, governments favor employees over capital owners in conflicts that occur between them.²⁸ This inclination is against the shareholders’ interests, as risky expansions are not encouraged and hostile takeovers are not favored. This weakens many of the

MOD. L. REV. I (1974). John Gillespie, *Towards A Discursive Analysis Of Legal Transfers Into Developing East Asia*, 40 N.Y.U. J. INT'L L. & POL. 657 (2008). See generally Anthony C. Infanti, *The Ethics of Tax Cloning*, 6 FLA. TAX REV. 251, 320-38 (2003) for a review of this literature.

²⁴ John Armour et al., *How Do Legal Rules Evolve? Evidence from a Cross-Country Comparison of Shareholder, Creditor, and Worker Protection*, 57 AM. J. COMP. L. 579, 594 (2009).

²⁵ See PETER A. GOUREVITCH & JAMES SHINN, *POLITICAL POWER AND CORPORATE CONTROL: THE NEW GLOBAL POLITICS OF CORPORATE GOVERNANCE* 3 (Princeton University Press 2005) (“We believe that, like other decisions about authority, corporate governance structures are fundamentally the result of political decisions.”). See, e.g., Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in The Twentieth Century*, 69 J. FIN. ECON. 5 (2003); Roe, *Separating Ownership*, *infra* note 27, at 539; Mark J. Roe & Jordan I. Siegel, *Finance and Politics: A Review Essay Based On Kenneth Dam’s Analysis of Legal Traditions In The Law-Growth Nexus*, 47 J. ECON. LITERATURE 781 (2009).

²⁶ See Roe, *Legal Origins*, *supra* note 19, at 502-05.

²⁷ Mark J. Roe, *Political Preconditions to Separating Ownership From Corporate Control*, 53 STAN L. REV. 539, 543 (2000) [hereinafter Roe, *Separating Ownership*].

²⁸ *Id.*

institutions on which investor protection depend,²⁹ which raises the agency cost and leads to less active capital markets in such countries.

The second line of argument explaining the difference in institutions comes from Raghuram G. Rajan and Luigi Zingales, who criticized the legal origins theory to be “static . . . [and] apolitical”.³⁰ They presented data starting from 1913 from civil and common law countries showing that at that time, several civil law countries had stronger securities markets than the United Kingdom. They argue that the legal tradition argument of Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (hereinafter LLSV) failed to explain these shifts in the strength of the securities markets.³¹ Rajan and Zingales further argued that the legal origins theory was insensitive to political interest groups in different countries.³² The persistence of inefficient institutions in some countries can be explained not by the nature of common law compared to civil law, but by the fact that the quality of institutions in a country affects the rents that different groups can capture.³³ Consequently, those who benefit from inefficient regulation lobby against changes, and as long they are more powerful, underdevelopment of legal institutions and financial markets persist.³⁴

The main intuition behind the politics and finance literature was that “investor protection is a policy choice.”³⁵ This explanation, though not prominent in law and finance, is more plausible. In fact, it is unbelievable that legal origin

²⁹ *See id.* at 543-56.

³⁰ Andrew Kerner, *The Political Economy of Investor Protection*, EMORY UNIVERSITY Unpublished Ph.D. dissertation, 6-7, 17-18 (2009), available at <https://etd.library.emory.edu/view/record/pid/emory:1f5ks> (last visited Feb 27 2014); Rajan & Zingales, *supra* note 25, at 5, 7.

³¹ Rajan & Zingales, *supra* note 25; *see also* Thorsten Beck et al., *Law, Politics and Finance* 1, 20, WORLD BANK POLICY RESEARCH Working Paper No. 2585 (2001), available at <http://hdl.handle.net/10986/19682>.

³² Kerner, *supra* note 30, at 18.

³³ *See* Rajan & Zingales, *supra* note 25, at 18. They propose a theory of interest group in financial development in which their main argument is that financial development facilitates entry and increase competition. This hurts incumbents and lowers their profits because they originally rely on unequal access. Thus, they object to any changes to the regulation as a tool to limit competition.

³⁴ *See id.* at 21.

³⁵ Roe & Siegel, *Finance and Politics: A Review Essay Based On Kenneth Dam's Analysis of Legal Traditions In The Law-Growth Nexus*, 47 J. ECON. LITERATURE 781, 788-89 (2009).

continues to shape the difference in legal institutions and capital markets' strength today for numerous reasons. Civil law countries enforce contracts and property rights to an extent comparable to the United States of America and United Kingdom, and have a comparable quality of law and priority on the rule of law.³⁶ These countries could have easily built investor protections once there was a political will to do so, even if only a number of technical institutions were missing, because "their construction is not a rocket science."³⁷

Next, the argument that common law depends on judge-made laws which allow for more flexibility³⁸ is not precise for two reasons: (1) common law countries regulate extensively in the field of securities markets,³⁹ and (2) the adaptability argument proposed is a mere theoretical construct that needs to be empirically proven.⁴⁰ Moreover, one can argue that this adaptability in fact lowers predictability.⁴¹ A study that measured the indeterminacy (as a proxy or adaptability) in corporate fiduciary duties in Delaware, the United Kingdom, and Germany concluded that Germany had more indeterminate standards.⁴² This makes the argument that common law better protects investors because of its inherent adaptability and its less inclination to overregulation at least contestable.

Finally, LLSV argued that Roe's political economy theory is not warranted because his regression included only countries that were associated with World War II. They argued that there is no reason to selectively throw out

³⁶ See Roe, *Separating Ownership*, *supra* note 27, at 602.

³⁷ *Id.*

³⁸ Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 9-12 (2000) [hereinafter La Porta et al., *Investor Protection*].

³⁹ Mark J. Roe, *Legal Origins*, *supra* note 19, at 470-85 (Roe actually argues that common law and civil are coming closer to each other. As common law regulates more now and the judge in common law countries now is getting help from specialized agencies such as the SEC and from the exchanges, the role of the judge is not strong enough to lead to this difference. Roe further explains that on historical basis judges failed when there was no legislation to protect investors.).

⁴⁰ Andreas Engert & D. Gordon Smith, *Unpacking Adaptability*, 2009 B.Y.U. L. REV. 1553, 1561-70 (2009).

⁴¹ *Id.* at 1561-62 (The ability of legal institutions to respond to behavioral changes is indeed important, but is not without costs. As when a court changes an existing legal rule this means it is engaging in policy analysis; this implies rejecting the legal authority. Therefore, the more responsive the legal system becomes the less people can rely on the legal rules. This system can suffer from both little adaptability and excessive adaptability.).

⁴² *Id.* at 1570 (citing Jens Dammann, *Corporate Law and Legal Determinacy*, UNIV. OF TEX. SCH. OF LAW (2009), https://law.utexas.edu/wp-content/uploads/sites/25/dammann_corporate_law_and_legal.pdf).

data and stated, “[w]hen we use [the full available sample to run the Roe regression], the correlation reported by Roe disappears This may not be surprising: many developing countries stayed out of World War II, yet remained financially underdeveloped.”⁴³ This last argument is problematic for two reasons. Firstly, it reflects an important gap in the literature where no detailed case study exists about countries that can show neither the relation between politics and finance nor legal origins and financial development in developing countries. Most of the studies are based on cross-country studies with no detailed analysis of these countries.⁴⁴ In fact, many developing countries were not associated with World War II, but a detailed analysis would reveal that many, if not most, are underdeveloped due to political reasons. Secondly, the analysis does not make any distinction between developed and developing countries.

Despite this heated debate in the literature and the wide criticism that the legal origins theory has faced, development agencies adopted the argument that common law is better suited for economic growth.⁴⁵ This is critical as it can lead to a number of inefficiencies; by assuming common law tools are more powerful, efficient tools elsewhere can be overlooked. Further, failing to understand the political reality in the aided country can lead to futile changes and wasteful resources.⁴⁶

Central to this paper is the phenomena that politics affects legal rules and legal institutions differently in developing countries than it does in developed countries. Politically sensitive areas, such as corporate governance and financial regulation, are most critical, as these affect the rents that different political groups can capture.⁴⁷

⁴³ Rafael La Porta et al., *The Economic Consequences of Legal Origins*, 46 J. ECON. LITERATURE 285, 321 (2008), <http://dare.uva.nl/document/2/63538> [hereinafter La Porta et al., *Economic Consequences*].

⁴⁴ Mariana Pargendler, *Politics in the Origins: The Making of Corporate Law in Nineteenth Century Brazil*, 60 AM. J. COMP. L. 805, 808 (2012).

⁴⁵ Ralf Michaels, *Comparative Law by Numbers? Legal Origins Thesis, Doing Business Reports, and the Silence of Traditional Comparative Law*, 57 AM. J. COMP. L. 765, 771-72 (2009).

⁴⁶ Mark J. Roe, *Legal Origins*, *supra* note 19, at 464.

⁴⁷ See John W. Cioffi, *Legal Regimes and Political Particularism: An Assessment of the "Legal Families" Theory from the Perspectives of Comparative Law and Political Economy*, 2009 B.Y.U.L. REV. 1501, 1516-17 (2009), available at <http://digitalcommons.law.byu.edu/cgi/viewcontent.cgi?article=2468&context=lawreview>.

But how do political groups and rent seekers affect the performance and evolution of legal rules and institutions? The main argument here surfaces from the political settlement literature which expounds that an institution's design does not lead to a certain outcome. In fact, the underlying political settlement is the main determinant for the performance of these institutions and the economic or political outcome.⁴⁸

Professor Mushtaq Khan defines the concept of political settlement as “an interdependent combination of a structure of power and institutions at the level of a society that is mutually ‘compatible’ and also ‘sustainable’ in terms of economic and political viability.”⁴⁹ Khan also emphasizes that the political settlement in developing countries is different than that of developed countries. For Khan, developing countries' political settlement is “*Clientelist*,” i.e. characterized by the exercise of power through informal institutions.⁵⁰ According to Khan,

Once a political settlement based on a compatible combination of institutions and power emerges, both the institutions and the distribution of power become supportive of each other The performance of new institutions and the consequences of institutional evolution can therefore be analyzed in terms of how institutions or institutional changes are likely to be resisted in the context of this specific distribution of power. The political settlement can therefore help to explain the performance of *particular* institutions because of specific costs of enforcement and resistance [T]he enforcement of a particular institutional rule is likely to be more effective if the distribution of benefits under that institution is not contested by groups with holding power, and conversely its enforcement is likely to be weaker if powerful groups contest its enforcement.⁵¹

⁴⁸ Jonathan Di John & James Putzel, *Political Settlements* 6, GOVERNANCE AND SOCIAL DEVELOPMENT RESOURCE CENTER (2009), <http://www.gsdc.org/docs/open/eirs7.pdf>.

⁴⁹ Mushtaq Khan, *Political Settlements and The Governance of Growth-Enhancing Institutions* 20 (July 2010) (unpublished manuscript), http://eprints.soas.ac.uk/9968/1/Political_Settlements_internet.pdf (last visited Nov. 4, 2015).

⁵⁰ *Id.* at 5, 8, 48.

⁵¹ *Id.* at 5-6 (defining power distribution in terms of holding power of the parties which Khan measures according to their ability to inflict costs or ability to absorb costs).

Khan also states different types of arrangements between political and business elites affects the outcome and performance of different institutions.⁵² Thus, the political settlement concept establishes a framework to understand how politics affects institutions. It also provides a lens through which to comprehend the determinants of institutional performance and evolution.

Proceeding from this, the rest of this paper applies the political settlement framework on capital market regulations in Egypt. The paper investigates the evolution of investor protection laws and institutions in Egypt, and the politics behind these reformations, in order to comprehend what affected the performance and the quality of these institutions.

Egypt represents an interesting case study specifically for the finance literature because until 1952, Egypt had an active and strong capital market. After the 1952 Revolution, however, the country adopted socialist policies that made the capital market completely stagnant before it was revived by a political decision. Then, in the 1990s, Egypt adopted the IMF development program which required many legal and institutional changes, most of which were Anglo-Saxon rules. Curiously, Egypt passed through two waves of reformations. The first was futile because laws were introduced only on paper, but the second wave was more earnest. The following paragraphs focus on two main questions: first, was the first phase impeded because of the legal origins or the politics, and what induced the changes in the second one? Second, can real reformations be introduced without understanding the politics inside a country, and what can be concluded from this study?

Since the primary concentration of this paper will be the capital market, it is useful to glance through the conclusions of some influential papers about the necessary rules and institutions for developing a strong capital market. This will guide the study of changes in Egyptian laws. It will also help in understanding why certain institutions were built and others were not.

⁵² *See id.* at 64. (“An important set of variations in the type of clientelist [sic] political settlement can be related to the organization of the ruling coalition. . . First, we look at the power of factions excluded from the ruling coalition relative to the ruling coalition. Secondly, we look at the internal distribution of power within the factions that constitute the ruling coalition, in particular between higher and lower levels. These dimensions are important for understanding the likely time horizon of the ruling coalition and its implementation capacities.”).

II. INSTITUTIONAL FRAMEWORK FOR A STRONG CAPITAL MARKET

A strong securities market must have a network of legal and market institutions that ensure the existence of a transparent market where material information freely and adequately flow to investors guiding them in making informed investing decisions.⁵³ Such a market must also ensure investor protection from expropriation by insiders such as managers or controlling shareholders.⁵⁴ In other words, in order to build a strong securities market, a good minority shareholder protection must be afforded and policymakers must envision solutions for asymmetry of information and self-dealing. Failing to protect investors will make them either refrain from the securities market or from discounting the price,⁵⁵ which would naturally lead effective firms and issuers to avoiding capital markets because of the high price of capital.⁵⁶

Solving this issue is an uphill task: it involves developing sophisticated, experienced, and specialized courts and regulators who can police the capital market;⁵⁷ imposing extensive financial disclosures which can provide investors with reliable information;⁵⁸ and subjecting the financial reports to compulsory audition by independent accountants who are subject to appropriate risk of liability.⁵⁹ In short, a myriad of legal and extra-legal institutions should be introduced, ranging from reputational intermediaries such as accounting firms, analysts, incentivized lawyers,⁶⁰ investment banks, and a financial press that

⁵³ Ronald J. Gilson, *Transparency, Corporate Governance and Capital Markets*, ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (April 26, 2000), available at <http://www.oecd.org/corporate/ca/corporategovernanceprinciples/1921785.pdf> (last visited May 25 2015).

⁵⁴ Bernard S. Black, Reinier Kraakman, & Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?* 52 STAN. L. REV. 1731, 1784-86 (2000); see also La Porta et al., *Investor Protection*, *supra* note 38, at 4.

⁵⁵ Black, Kraakman, & Tarassova, *supra* note 54; see generally Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430 (2008).

⁵⁶ Djankov et al., *supra* note 55.

⁵⁷ See Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 789 (2001).

⁵⁸ See *id.* at 809.

⁵⁹ See *id.* at 792.

⁶⁰ See, e.g., Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 593-609, 618 (1984) [hereinafter Gilson & Kraakman Market Efficiency]; see also Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 36 COLUMBIA LAW SCH.

publicize any fraud acts,⁶¹ to adequate civil and criminal liability imposed on violators⁶² and a specialized court capable of applying these rules efficiently.

Therefore, a developing country, when deciding to adopt a market system, must understand that copying laws in books will lead to a complete failure unless doing so is accompanied by a comprehensive knowledge of the entire web and structure supporting the system. Developing such institutions is not impossible, but doing so will affect the rents that different groups can capture from capital markets. Thus, in addition to developing the aforementioned institutions and rules, a polity that supports such reformations must exist.

III. EGYPT'S STOCK EXCHANGE: AN OVERVIEW FROM 1990-2010

Recently, Egypt has been witnessing increasing efforts to develop and reform the financial sector, regulate markets and upgrade their organizational and legislative structures, strengthen capital structures of financial institutions, and protect investors' rights. These reformations were part of a larger privatization effort and a movement towards a free market. While it is true that these reformations led to the enhancement of the economic development of the country in the last few years, they did not survive Hosny Mubarak's regime due to the inequality of distribution of wealth and corruption.⁶³

A. Egyptian Stock Exchange: A Historical Glance

The Egyptian Stock Exchange⁶⁴ is one of the oldest exchanges in both the Arab region and the world. It is located in Cairo and in Alexandria. The Alexandria Stock Exchange was established in 1888 and the Cairo Stock

CENT. L. AND ECON. Working Paper No. 240 (2003), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=462786 [hereinafter Gilson & Kraakman, *Market Efficiency Twenty Years Later*].

⁶¹ Gilson & Kraakman, *Market Efficiency Twenty Years Later*, *supra* note 60, at 11.

⁶² See Black, *supra* note 57, at 787.

⁶³ To use Mushtaq Khan's Political settlement concept, the political settlement was unviable.

⁶⁴ The Egyptian stock exchange was previously called CASE (Cairo and Alexandria Stock Exchanges), but was renamed the Egyptian Exchange (EGX) in 2008.

Exchange followed in 1903.⁶⁵ The Egyptian Exchange is not only one of the oldest in the region and was one of the most active exchanges in the world until the 1940s;⁶⁶ it was ranked the fifth in the world.⁶⁷ However, due to the socialist policies adopted by the government after the 1952 Revolution and until the 1970s, and the wave of nationalization of firms, there was a concentration of ownership of the public sector and a near-complete paralysis of the capital market.⁶⁸ The capital market remained stagnant until the 1990s, when it was revived after the issuance of the Capital Market Law of 1992 and the privatization efforts launched in the country.⁶⁹ The state dominated the economic activity during this period, but was not able to sustain the economic growth that the country witnessed at the beginning, leading to the deterioration of the economy. The revolution established only the military. The existing business elites were all framed as anti-patriotic, which enabled the state to seize many of the privately owned enterprises and lands.⁷⁰ Therefore, there were no competing powers in this era to force the ruling elite to adopt certain institutions.

After President Sadat came into office in 1970, he adopted the “open door policy” to liberalize trade and transform the economy to a market-based economy.⁷¹ The open door policy made export related projects a priority.⁷² Additionally, foreign investments were greatly encouraged and allowed foreign investors to take majority interests in some firms that had been reserved for the public sector. Arab investments were granted special privileges, and large stakes

⁶⁵ Shahira Abdel Shahid, *Corporate Governance Is Becoming a Global Pursuit: What Could Be Done in Egypt?*, Cairo & Alexandria Stock Exchanges Working Paper No. 1, 42 (Sept. 2001), available at <http://papers.ssrn.com/abstract=286875>.

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ Radwa S. Elsaman & Ahmed A. Alshorbagy, *Doing Business in Egypt After the January Revolution: Capital Market and Investment Laws*, 11 RICH. J. GLOBAL L. & BUS. 43 (2011).

⁶⁹ Shahira Abdel Shahid, *The Impact of Globalization on Capital Markets: The Egyptian Case*, Cairo & Alexandria Stock Exchanges Unpublished Manuscript 9 (June 2002), available at http://www.egx.com.eg/pdf/the_0impact_of_globalization.pdf (last visited Nov. 7, 2015).

⁷⁰ See JOHN WATERBURY, *THE EGYPT OF NASSER AND SADAT: THE POLITICAL ECONOMY OF TWO REGIMES* 67-68 (Princeton University Press) (1983).

⁷¹ See Nazih N. M. Ayubi, *Organization for Development: The Politico-Administrative Framework of Economic Activity in Egypt under Sadat*, 2 PUB. ADMIN. DEV. 279, 281 (1982).

⁷² *Id.*

of public sector firms were to be put up for private subscription.⁷³ At the beginning of this era, there was a surge in the economy's growth rate; however this was not directly related to the reforms introduced, but rather to the increase in revenues from oil, the Suez Canal, and tourism. Once the oil price plummeted in 1985, fiscal deficits rose to about fifteen percent of GDP and the country again was not able to sustain economic growth.⁷⁴ Sadat's era was thus characterized by an authoritarian military ruling with very weak, if any, capitalists or private entrepreneurs to push for certain reforms.

B. The Revitalization Of The Stock Market, Legal And Institutional Developments, And The Politics Behind The Changes

In the 1990s, Egypt's deficit was rising to unprecedented levels, and its negotiation with the IMF led to Egypt adopting of the stabilization program.⁷⁵ This program directed the country's policy to the liberalization of the economy and privatization of state-owned enterprises.⁷⁶ Overall, the Stock Exchange can be said to have passed through two phases of developments in the legal and institutional structures since Egypt started its privatization program in the 1990s. During this period, the country transplanted a number of laws in order to shift to a market economy, increasing the role of the private sector and reforming its financial sector. For purposes of simplification and clarification, the studied period will be divided into two phases: 1990 to 2001 and 2001 to 2010. Each phase includes a discussion of the political effects on the transplanted legal institutions and their role in the development of the stock market. Thus, important changes in the legal and institutional structure are reviewed, followed by their political roles. Through a review of the entire process, this paper analyzes the real factors and determinants of the failure or success of the legal institutions necessary for developing the capital market.

⁷³ Lama Abu-Odeh, *On Law and the Transition to Market: The Case of Egypt*, 23 EMORY INT'L L. REV. 351, 381 (2009).

⁷⁴ Anton Dobronogov & Farrukh Iqbal, *Economic Growth in Egypt: Constraints and Determinants*, World Bank Working Paper No. 42, 2-3 (October 2005), http://siteresources.worldbank.org/INTPREMNET/Resources/489836-1123682017954/Egypt_growthpaper1.pdf (last visited May 25, 2015).

⁷⁵ Mokhlis Y. Zaki, *IMF-Supported Stabilization Programs and their Critics: Evidence from the Recent Experience of Egypt*, 29 WORLD DEV. 1867 (2001).

⁷⁶ *Id.*

1. *Phase (I): 1990 – 2001*

As previously indicated in section II, a prerequisite for efficient and healthy capital markets is addressing two main problems, asymmetry of information and self-dealing, in addition to a web of institutions that must exist to ensure the market's adequate performance.⁷⁷

At the beginning of this decade, Egypt was heavily indebted, forcing the government to accept the reform program the IMF and the World Bank introduced. This program aimed to transfer Egypt's economy to a market-based economy and replace the public sector in the market with a strong private sector.⁷⁸ At this time, the country's capital market was totally dormant, and it only came back to life in 1992. The program seemed successful from 1992 to 1998 as the economy continuously rose, many reforms were introduced (most importantly, the introduction of capital market law), the capital market was revitalized, the inflation rate was reduced to a single digit number,⁷⁹ about one third of the state owned enterprises were privatized, and foreign investments were encouraged with new laws granting tax exemptions and protection for such investments.⁸⁰ Egypt's capital market was revived after more than 40 years of stagnation.⁸¹ The capital market's capitalization increased from eight percent in 1992 to about twenty-five percent in 1997,⁸² and total traded volume during the period 1996-97 reached 579 million shares—three times the traded volume of 1992-95. Similarly, total traded value during 1996-97 recorded EGP 45 billion,

⁷⁷ *Supra* notes 53-62 and accompanying text.

⁷⁸ Egypt Economic Reform and Structural Adjustment Program: Performance Evaluation Report, AFRICAN DEV. BANK (May 15, 2000), http://www.afdb.org/fileadmin/uploads/afdb/Documents/Evaluation-Reports-_Shared-With-OPEV_/05092259-EN-EGYPT-ECONOMIC-REFORM-AND-SAP.PDF.

⁷⁹ *Id.* at 10-18.

⁸⁰ Karen Pfeifer, *How Tunisia, Morocco, Jordan and even Egypt became IMF "Success Stories" in the 1990s*, MIDDLE EAST REP. NO. 210 REFORM OR REACTION? DILEMMAS OF ECON. DEV. IN THE MIDDLE EAST 23 (1999).

⁸¹ Dobronogov & Iqbal, *supra* note 74.

⁸² Maged Shawky Sourial, *Monetary Policy and Its Impact On The Stock Market: The Egyptian Case*, MINISTRY OF ECONOMY AND FOREIGN Trade, http://www.egx.com.eg/pdf/Monetary_Policy_and_its_impact_on_Egyptian_market.pdf (last visited December 7, 2015).

six times the total traded value during the period 1992-95. In 1997, market activity reached its peak with a turnover ratio of thirty-four percent.⁸³

Despite this upsurge in the Egyptian economy, which was inflated by number of factors,⁸⁴ a number of exogenous negative incidents shocked the Egyptian economy and stock exchange by the end of 1997. These incidents—namely, the Luxor terrorist Attack, the financial crisis of 1998, and several internal financial scandals—resulted in a slack in the economy and, later, the stock market's collapse.⁸⁵ The financial scandals led banks to adopt tight lending regulations, which exerted more pressure on the stock market. Thus, the country strove to sustain the capital market by providing tax exemptions for those listed on the exchange.⁸⁶ These actions led to an expansion of the number of listed companies, reaching more than 1000 in 2001.⁸⁷

Notwithstanding these encouraging numbers, Egypt's attempt at building a strong and active securities market failed. Of the 1000 listed companies, the ten most actively traded represented seventy-five percent of the trading volume in 2001, with average free float around twenty-five percent in the 50 most actively traded companies.⁸⁸ Ownership was heavily concentrated and the public was discouraged to participate, which led to a slowdown in economic performance and a decline in average economic growth from five and three quarters percent to three percent as of 2002-2003.⁸⁹ Noticeably, the capital market was not available as a means of financing corporations.

What caused the boom and then this bust? Why did Egypt fail to build its securities market during this decade? Did the country's adherence to civil law tradition hinder the construction of the capital market, or do other reasons exist?

⁸³ *Id.*

⁸⁴ *See infra* note 123.

⁸⁵ Dobronogov & Iqbal, *supra* note 74 (the financial scandal known as "loan deputies" was a result of the number of defaults on bank loans that certain parliamentary members obtained by corruption).

⁸⁶ *Supra* note 65 at 42-45.

⁸⁷ *Id.*

⁸⁸ *Id.* (The free float in other listed companies is even less than twenty-five percent, since the turnover ratio was very weak).

⁸⁹ Ahmed Badreldin & Christian Kalhoefer, *The Effect of Mergers and Acquisitions on Bank Performance in Egypt*, GERMAN UNIVERSITY IN CAIRO Working Paper No. 18 (October 2009), http://mgt.guc.edu.eg/wpapers/018badreldin_kalhoefer2009.pdf.

To answer these questions, a review of the legal and institutional framework present at that time is required. After reviewing the legal framework, this section analyzes the reasons behind any shortages in the legal framework during this period and discusses the distribution of power at that time and its effects. The review of the legal framework is confined to shareholder protection, transparency and disclosure requirements, takeover regulation as a mechanism for disciplining management, regulation of financial intermediaries, and self-dealing during this era.

a. Shareholders' Rights

Shareholder protection is essential for securities markets in general, as investors generally face agency problems.⁹⁰ They might be expropriated by insiders, whether controlling shareholders or managers, which can hinder the development of any securities market.⁹¹ Thus, a starting point for building a strong, reliable stock market has to be providing adequate protection to shareholders. This protection can be furnished through a variety of tools, and the first of which is by giving shareholders the right to control and steer their corporations.

Shareholders' rights were among the areas that were adequately drafted from inception: the protections that shareholders enjoy under the Egyptian Law are emphasized in the powers of the General Assembly ("GA"). There are two types of GA: Ordinary General Assembly ("OGA") and Extraordinary General Assembly ("EGA").⁹² The OGA has the following rights: to elect and fire directors at will, to monitor the management, to decide board members' compensation, to review and approve financial statements, to decide dividend distribution, and to make any other decision that the directors or five percent of shareholders decide should be reviewed by the GA.⁹³

⁹⁰ La Porta et al., *Investor Protection*, *supra* note 38, at 1148-49.

⁹¹ *Id.* at 1147-49, 1169.

⁹² Law No. 159 of 1981 (Companies Law) art. 63 & 68, *Al-Jarida Al-Rasmiya*, (Sept. 17, 1981) (Egypt) [hereinafter CL]; *see also* Decree No. 96 of 1982 (Executive regulation for the Companies Law No. 159 of 1981) art. 200, *Al-Wakae Al Masriya*, (June 23, 198) (Egypt) [hereinafter ECL].

⁹³ CL, *supra* note 92, at art. 61 (among other things: the OGA has many other rights, including the right to decide on the dividends policy, to make and use reserves, to appoint or dismiss auditors, and to allow self-dealing transactions); *see also* ECL, *supra* note 92, at Art. 216 & 217 (detailing a complete list of the OGA's rights).

Before the GA meets, directors are required to make available all the financial statements and any comments on those in the 30 days prior the meeting, the full auditor's report, and the board of directors' report about any remuneration paid to any of the directors. Shares within any class must have equal rights,⁹⁴ and shareholders can easily obtain information about rights attached to their shares. Shareholders have the right to actively participate in the GA and address questions to directors and auditors,⁹⁵ and they have the right to include their proposals in the agenda. They have the right to vote through proxy,⁹⁶ yet there are certain limits, as the proxy has to be a shareholder, not a director, and cannot represent more than ten percent of the capital or twenty percent of the represented shares in the GA.⁹⁷ Further, the decisions of the OGA are passed by simple majority of shares represented in the meeting.⁹⁸

On the other hand, the EGA has the power to amend the charter of the corporation, decide on mergers, or increase or decrease the company's capital. The decisions of the EGA pass by two thirds of votes⁹⁹ unless the decision is related to mergers, increase or decrease of capital, or dissolution of the company. In any of these cases, the decision has to pass by three-fourths of the shares represented in the meeting.¹⁰⁰

Unlike aforementioned, the legal rules that alleviate asymmetry of information or protect shareholders from self-dealing were not adequately drafted.

b. Transparency

A securities market's transparency is an essential ingredient for its healthy functioning. Factually, transparency is even a prerequisite for shareholders to practice their rights. Transparency of a stock market can be upheld through different techniques, but the ones addressed in this section are the disclosure requirements that the law mandated.

⁹⁴ ECL, *supra* note 92, at art. 132 & 133.

⁹⁵ CL, *supra* note 92, at art. 72.

⁹⁶ *Id.* at art. 59.

⁹⁷ Law No. 95 of 1992 (Capital market law) art. 9, *Al-Jarida Al-Rasmiya* (June 22, 1992) (Egypt) [hereinafter CML].

⁹⁸ CL, *supra* note 92, at art. 67.

⁹⁹ *Id.* at art. 70.

¹⁰⁰ *Id.*

As previously stated, asymmetry of information between outside investors and insiders is a major stumbling block that the regulator has to solve in order to encourage investments. Unfortunately, in the intended decade, the rules ensuring transparency only required minimal disclosures: for instance, for a company to go public, it must issue a prospectus that must be accepted by the capital market authority (“CMA”), but the prospectus only requires basic information.¹⁰¹ Mandatory disclosure requirements of capital market law included balance sheets, income and cash flow statements, directors’ reports, changes in stockholder equity and board composition, and external auditor reports.¹⁰² The law did not require disclosing ownership structure, non-financial disclosure, or any rules that require disclosing foreseeable material risks, such as risks related to off balance transactions. Although CMA had the authority to examine compliance with disclosure requirements, it would do so only in case of non-compliance and publish its observations at the company’s expense.¹⁰³

The listing requirements did not mitigate this deficiency; they mainly allowed companies to list on one of three tiers: the “official schedule”, the “unofficial schedule 1,” or the “unofficial schedule 2.”¹⁰⁴ The official schedule had the most stringent requirements. Hence, most corporations did not list on it, which decreased any benefits from listing rules, as the other schedules do not force companies to disclose more than what is required by law. Further, they did not require a minimum number of shareholders or free float, which led many closed corporations to list, especially after the Income Tax Law No. 5/1998 granted tax holidays to companies that list on the stock exchange.¹⁰⁵ This led to the increase in market capitalization but no practical benefit or importance.

Moreover, financial statements had to be in compliance with the Egyptian Accounting Standards, which are generally similar to international

¹⁰¹ CML, *supra* note 97, at art. 4, 5 & 6.

¹⁰² *Id.*

¹⁰³ CML, *supra* note 97, at art. 6.

¹⁰⁴ Bassam I. Azab, *The Performance of the Egyptian Stock Market*, THE BIRMINGHAM BUSINESS SCHOOL 34 (Sept. 2002), available at http://egx.com.eg/pdf/the_performance_of_egyptian_stock_market.pdf.

¹⁰⁵ Ali A. Bolbol et al., *Financial development, structure, and economic growth: the case of Egypt, 1974–2002*, 19 RES. INT’L BUS. & FIN. 171 (2005).

standards.¹⁰⁶ Annual and semi-annual financial statements should be fully audited. The auditors have to be completely independent from the company and the board; accordingly, the auditor cannot be a founder, a board member, or an employee.¹⁰⁷ The auditor is liable for misrepresentation and errors and should compensate the company and/or shareholders for any resulting loss.¹⁰⁸ In spite of the previous, there was no obligation for companies to establish audit committees or other mechanisms to ensure oversight, nor was there a formal system in the country for monitoring auditors or a reviewing panel that had authority to discipline the practitioners. Therefore, in this period, the regulator overlooked, creating an incentivized and tightly regulated important reputational intermediary that is the accounting firms. Also during this period, the penalties inflicted on violators were weak, but the market had no tools to offset this weakness and punish the wrongdoers.

c. Related Party Transactions (Tunneling)

Likewise, the rules for related party transaction and self-dealing were weak. Though the Egyptian Accounting Standards requires directors and managers to disclose any material interest and the CL requires managers to disclose any conflict of interest to the board and abstain from voting in addition to notifying the GA,¹⁰⁹ no sufficient requirement exists regarding the movement of assets between subsidiaries of the same holding company. Further, there are no clear rules on the transfer of assets, and the shareholders do not vote on this issue, especially since the majority shareholder at the subsidiary level and the majority shareholder at the holding level are often the same.¹¹⁰ Insider trading was addressed in one article¹¹¹ that did not define non-public information, and the

¹⁰⁶ *Report on the Observance of Standards and Codes (ROSC) Corporate Governance Country Assessment Arab Republic Of Egypt*, THE WORLD BANK 11 (Sept. 1, 2001), available at http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2006/02/01/000012009_20060201093319/Rendered/PDF/350810EGT0REV0rosc02001.pdf [hereinafter *The World Bank, ROSC*]

¹⁰⁷ *Id.* at 12.

¹⁰⁸ CL, *supra* note 92, at art. 109.

¹⁰⁹ *Id.* at art. 97-99.

¹¹⁰ CL, *supra* note 108, at art. 67.

¹¹¹ CML, *supra* note 97, at art. 64 (“any person who divulges a secret . . . has benefited he, his spouse and his children, from insider information of his work, or who used

penalties of EGP 20,000-50,000 and/or prison terms of two years were not deterrent.¹¹² Furthermore, takeovers were not regulated except by one article, which was totally unsatisfactory and did not afford protection for minority shareholders.

d. Enforcement

Law without enforcement is toothless. Enforcement can be provided through market regulators, courts, and market participants. However, under this section, the concern is given to market regulators and courts only, as the market participants' ability to enforce the rules depends on the powers and incentives the law gives them.

The regulator, Capital Market Authority, was neither experienced nor effective. It employed only 250 personnel who were paid significantly less than their private sector and exchange personnel counterparts.¹¹³ For instance, CMA has wide administrative sanction powers, including warnings, delisting, and suspending and revoking licenses, but it did not effectively use these powers. Until 1999, only one tenth of all listed companies published their financial statements regularly, and not more than fifty percent sent their quarterly financial statements to CMA; nevertheless, CMA did not delist violators or revoke any licenses.¹¹⁴ Additionally, courts in Egypt usually take four to five years to decide cases. Thus, enforcement of the available inadequate protection was even further undermined.

It is clear that, during this decade, the legal regulation and institutional mixture required for developing a strong and deep capital market was far from being complete; therefore, the stock market crashed upon the first real pressure.

material misstatement, or omitted any material information in reports, submitted by him, to the extent that it affects the results contained in such reports”).

¹¹² *Id.* (before the change in 2008).

¹¹³ The World Bank, *ROSC*, *supra* note 106 at 3.

¹¹⁴ Nagwa A. Samak & Omneia A. Helmy, *Foreign Portfolio Equity Investment in Egypt: An Analytical Overview* CAIRO UNIVERSITY FACULTY OF ECONOMIC AND POLITICAL SCIENCE) 27 (unpublished manuscript), available at http://www.egx.com.eg/pdf/equity_portfolios_in_egypt.pdf (last visited December 7, 2015).

e. Why Did Egypt Fail?

As indicated above, the main factor that propelled the country to change its regulations was the unprecedented rise of deficit and inflation rates, which shook the legitimacy of the ruling regime. At the beginning of this period (1990), the market economy of the country was still in the cradle of transformation, and not enough major private business players existed to form a pressure group to lobby for certain reformations.¹¹⁵

In theory, liberalization of a country's economy can lead not only to economic development, but also to political liberalization and democratic progress in the country.¹¹⁶ Liberalization would diminish the state's power by ending its financial repression.¹¹⁷ In other words, before the economic reformations, the biggest banks, which were the only source of finance in Egypt at that time, were publicly owned.¹¹⁸ Therefore, the government easily controlled private sector development, and in return, business elites depended on their connections to obtain required finances.¹¹⁹ Theoretically, financial reformations can liberate business players from the state control of finance and thus be freed from state dependency. Consequently, this would revamp the political system and cause business elites to fund the opposition or themselves participating in the government.¹²⁰

The Egyptian government, anticipating the fast and complete liberalization of the economy, chose to proceed in this process in a slow, gradual

¹¹⁵ Larry P Goodson & Soha Radwan, *Democratization in Egypt in the 1990s: Stagnant, or Merely Stalled?*, 19 ARAB STUD. Q. 1, 14 (1997).

¹¹⁶ Ito Hiro, *Financial Development and Financial Liberalization in Asia: Thresholds, Institutions and the Sequence of Liberalization*, 17 N. AM. J. ECON. & FIN. 303, 304 (2006); see also Rajan & Zingales, *supra* note 25 at 7.

¹¹⁷ See Daron Acemoglu & James A. Robinson, *Political Losers as a Barrier to Economic Development*, 90 AM. ECON. REV. 126, 126 (2000) [hereinafter Acemoglu & Robinson, *Political Losers*] (arguing that "the effect of economic change on political power is a key factor in determining whether technological advances and beneficial economic changes will be blocked").

¹¹⁸ Mahmoud Mohieldin, *On Bank Market Structure and Competition in Egypt* 15 (May 2000) (unpublished manuscript), available at <http://www.mafhoum.com/press6/179E13.pdf>.

¹¹⁹ *Id.*

¹²⁰ Stephan Roll, 'Finance Matters!' *The Influence of Financial Sector Reforms on the Development of the Entrepreneurial Elite in Egypt*, 15 MEDITERRANEAN POL. 349, 350-52 (2010).

pace.¹²¹ The governing regime adopted a selective reformation technique that would allow them to embed themselves. Thus, they tried to establish strong relations with a select group of businessmen based on mutual benefits, which can be called creating a system of crony capitalism.¹²²

Since that time, the relations between the regime and the business players have been developing steadily. In realization of this system, and to ensure the continuance of the regime after the economic liberalization of the country, several steps were taken. First, the process started in a slow pace privatizing very few companies, then they were sold to select entrepreneurs that the government trusted by underpricing or without competitive bidding. Those privatizations were even done in non-transparent means and away from the eyes of the public to create unnatural profits for members of the business elites that the regime selected and favored. An example of this is reflected in World Bank economist John Sfakianakis's article:

The networks that elite businessmen put in place in the mid-1990s were not circumstantial. They were established as a result of the dwindling power of the public sector elite and the regime's intention to see businessmen replace the bosses of the state-owned enterprises (SOEs). The intention of elite businessmen to form networks was to perpetuate their monopoly power in the marketplace. It was not geared toward influencing the political landscape of Egypt whatsoever. These businessmen put in place conglomerates, which for the most part were neither vertically nor horizontally integrated, but were random collections of different business ventures, as a result of rent-seeking patterns rather than competitive attainments Certainly, the biggest privatization that Egypt experienced in the early stages of the privatization process was the sale of Coca Cola in 1993. It was a deal that involved most prominently, among other members of the political elite, the quintessential elite businessman of the 1990s, Mohamed Nosseir. He benefited from his relations with Atef Sidqi as well as Atef Ebeid to purchase with little competition the Coca Cola factory, which he resold two years later, at a price more than triple his cost.¹²³

¹²¹ Why did the government choose this path? This can be explained in terms of the ruling elite's realization that their term may be short lived, so they engaged in entrenching and rent seeking practices in order to obtain benefits.

¹²² Roll, *supra* note 120.

¹²³ JOHN SFAKIANAKIS, *The Whales of the Nile: Networks, Businessmen, and Bureaucrats During the Era of Privatization in Egypt*, in NETWORKS OF PRIVILEGE IN THE MIDDLE EAST: THE POLITICS OF ECON. REFORM REVISITED 77, 89 (Steven Heydemann ed., 2004).

Another of the regime's moves was to refrain from the privatization of public banks and use the financial resources available to fund the preferred network of business elites. Reports show that until 2000, a total of 343 businessmen had received around forty-two percent of available credit in Egypt.¹²⁴ Alarmingly, that credit was extended by phone calls and without sufficient collaterals.¹²⁵ Bank loans were even sometimes extended to those entrepreneurs to allow them to purchase privatized assets.¹²⁶ Finally, the regime helped a number of elite businessmen create monopolies that perpetuated the position of both political and business elites as dominant players in their respective fields.¹²⁷

Therefore, by returning to the question posited above—why did Egypt fail to develop a capital market?¹²⁸—it is clear that the dominant authority had failed to establish the required institutions. They did so to entrench themselves by creating a layer of business elites that cannot challenge the regime's legitimacy or authority¹²⁹ out of fear of massive reformations that could destabilize the regime.¹³⁰ In all cases, the reformations Egypt introduced, and those the country

¹²⁴ Amr I. Adly, *Politically-Embedded Cronyism: The Case of Post-Liberalization Egypt*, 11 BUS. & POL. 1, 11 (Jan. 2010).

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ Sfakianakis, *supra* note 123 at 80.

¹²⁸ The upsurge of stock markets until 1998 can be attributed to two phenomena that had no relation to the capital market's efficiency: first, the privatization program induced many to participate in the stock market; and second, the improvement in Egypt's creditworthiness after the Gulf War. Regarding the privatization program, in 1996, nineteen companies were sold, eighteen of which were through the stock exchange; in 1997, another thirteen companies were sold; and, finally, by the end of 1998, the government had sold controlling interests in 99 companies with a total value of LE 4.6 billion. Regarding Egypt's creditworthiness, the country received assistance from Arab countries in the form of \$7 billion in debt forgiveness and rescheduling of \$27 billion in other debts. Therefore, once the economy started to slow down, the capital market's deficiencies floated to the surface as it failed to attract investors or provide a means for financing companies.

¹²⁹ Alison Elizabeth Chase, *The Politics of Lending and Reform: The International Monetary Fund and the Nation of Egypt*, 42 STAN. J. INT'L L. 193, 223 (2006).

¹³⁰ *Id.* (Chase precisely described the politics at this period when she stated: "For a regime undergoing a crisis of legitimacy and paranoid of terrorism and social activism . . . [T]he Egyptian government was compelled to implement a certain degree of reform . . . but the government's assessment of the domestic political consequences of reform led it to adopt a strategy of delay and gradualism in implementing structural adjustment . . . economic policy in Egypt resulted from the relative balance of international pressure, the preferences of the governing elite, and the pressures of a volatile population, with the

abstained from interjecting, were not a matter of legal tradition but of political convenience and congruence.

The next phase will show that even if Egypt failed to adopt the required institutions when the political will existed and the distribution of power changed, this created a coalition that supported the existence of a well-functioning capital market, which negates the assumption that civil law impedes change.

f. Summary

The distribution of power at the beginning of the 1990s was characterized by a dominant ruling party supported by the military. At the same time, socialist policies adopted in the preceding years and nationalization and seizure of many of the privately owned properties led to existence of very weak business elites. Their ability to absorb costs or inflict costs on the ruling regime was nonexistent. However, due to a bad economic situation, this political settlement could not be sustained. With the existence of external pressure for reformations, the ruling regime had to introduce reforms. In addition, the ruling regime understood that such reforms could reduce its power. This was exacerbated by an absence of business elites that could demand certain reforms or put additional pressure on the ruling elite. The result was the creation of ostensible reforms and ties with connected business players to ensure their support in the future.

The transplanted capital market institutions were not complete and did not consider the whole web of necessary institutions out of fear of being a channel to fund opposition groups. The proposed institutions would have affected the rents that the powerful group extracted; thus, it resisted the changes by not introducing many necessary institutions and abstaining from enforcement of the ones they had to adopt. In short, the proposed institutions by the World Bank and the IMF were not supported by the existing polity, which led to futile changes.

2. Phase (2): 2002-2010

The economic crisis Egypt witnessed at the turn of the 1990s disturbed the legitimacy of the existing regime. The Asian financial crisis had a spillover

pressure of the international community or fiscal crisis at times capable of overwhelming the regime's fears of domestic political reprisal.”)

effect on the Egyptian economy, in addition to other indigenous incidents attributable to the bad loan scandals and the tourism problem at that time, which was affected by terrorist attacks.¹³¹ This made the government push for banking sector reforms, which, in turn, led to a credit scarcity for the private sector. The credit available was subject to tight conditions for obtaining it. The capital market, with the weak, thin legal and extra-legal institutions existing at that time, failed to balance the shortage of liquidity. At the end of 2001, the capital market collapsed, the value of trades fell sharply, and the country's economic growth in general slowed down. In other words, the excessive rents and accumulations that had to be granted at the preceding phase and the exogenous incidents made the political settlement unviable.

However, by the end of the 1990s, the distribution of power was not the same. The relation between political elites and business elites was taking an important turn. Specifically, the alliance between political elites and business elites was deepened by the rise of Gamal Mubarak, President Hosny Mubarak's son.¹³² Gamal Mubarak, who was being groomed to be his father's successor, had been an investment banker and worked for Bank of America in London for several years before he joined the National Democratic Party (NDP)¹³³ in 2000. Gamal Mubarak established the Egyptian Center for Economic Studies (ECES) in 1992 with other members of the elites on its board, such as Ahmed Ezz,¹³⁴ Mohamed Mansour,¹³⁵ Rashid Mohamed Rashid,¹³⁶ Ahmed El-Maghraby, and Nassef Sawiris, all of whom were owners of the biggest corporations in the Egyptian economy, and all of which have monopolies or quasi monopolies. The

¹³¹ *Supra* notes 85-88 and accompanying text.

¹³² Mohammed Zahid, *The Egyptian nexus: the rise of Gamal Mubarak, the politics of succession and the challenges of the Muslim Brotherhood*, 15 J. N. AFR. STUD. 217, 218-222 (2010).

¹³³ The National Democratic Party has been the Hegemony Party in Egypt since 1970. Former Egyptian president Hosni Mubarak was a member of the NDP.

¹³⁴ Ahmed Ezz owns EZZ steel and controls around 60% of steel production in Egypt. He is one of the closest persons to Gamal Mubarak and was the secretary for organizational affairs for the National Democratic Party (NDP), a member of the party's policies secretariat, and elected chairman of the People's Assembly's Budget and Planning Committee. Ezz is widely viewed as a symbol of the regime's corruption and cronyism.

¹³⁵ Mohamed Mansour controls a number of top companies in Egypt and served as a transportation minister from 2006 until 2009.

¹³⁶ Rashid Mohamed Rashid owns Fine Foods, one of the biggest companies in Egypt that later merged with Unilever. He was a minister of trade and industry from 2004 until 2011.

ECES became an important link between the business elites and the political elites.¹³⁷ It particularly became the main neo liberal think tank for the second wave of the reformations.¹³⁸

Gamal Mubarak, unlike his father, is not a member of the military and, therefore, had no support from the armed forces. Hence, he had to resort to the business elites for support and, naturally, they supported his ambitions for political leadership in return for him advancing their interests. Thus, it could be said that his relationship with them was a “partnership of convenience”¹³⁹.

The President’s son had the view of a liberal economic system within a strong state.¹⁴⁰ But, because he needed the business elites’ support, he had to take care of their interests. When Gamal formally joined the NDP, he took with him a number of the business elites, and they presented what Gamal called new thinking to revise the NDP economic program. He was also behind the 2005 cabinet shuffle, where six of the ministers were directly linked to him.¹⁴¹

The new cabinet launched a comprehensive financial sector reformation plan. Reformation of the securities market was at the heart of this plan. In fact, many of the reformations addressed the shortfalls of the preceding decade. The legal and institutional framework of the capital market developed steadily in the second phase, providing the required protection and transparency required by the investors. By focusing on the same framework developed in section II above, and contrasting the changes in this period to the period of phase 1, the following subsection reviews the legal and institutional changes that took place during this period. This paper will then analyze the reasons behind the changes and how political incentives were behind the reformations.

a. Shareholders’ Rights

¹³⁷ Stephan Roll, *Egypt’s Business Elite after Mubarak: A Powerful Player between Generals and Brotherhood* 9 (2013) (unpublished manuscript) (on file with the German Institute for International and Security Affairs), available at http://www.swp-berlin.org/fileadmin/contents/products/research_papers/2013_RP08_rll.pdf.

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ Heba Saleh, *Egypt’s Rulers Struggle with ‘New Thinking’*, BBC NEWS (Sept. 21, 2004), http://news.bbc.co.uk/2/hi/middle_east/3676256.stm.

The new reformations have addressed many of the flaws and shortfalls of the previous era, introducing comprehensive improvements in the legal and institutional framework. The new developments provided more protection to shareholders and investors. In 2001, the Central Depository Law No. 93 came into force. It required all public companies to register their shares as a condition for listing in the Exchange.¹⁴² Thus, settlement of transactions now takes one day for treasury bonds and same day for securities intermediaries licensed by the CMA to do same day trading.¹⁴³ This protects shareholders from the risks associated with material receipt and delivery of securities. Moreover, cumulative voting and class actions were introduced. Also, the new listing rules added to these safeguards by protecting shareholders from suffering illiquidity in case the corporation decided to delist, as it imposed an EGA decision with a three-fourths voting requirement granting the dissenting shareholders a withdrawal right and imposing on the company a duty to buy their shares according to the highest price in the last month,¹⁴⁴ thereby empowering minority shareholders and enhancing their protection.

b. Transparency

Similarly, the transparency and disclosure regulations witnessed a significant leap. The increased requirements were substantially added by the new listing rules, promulgated in 2002 and amended several times until 2010.¹⁴⁵ The listing rules cancelled the old unofficial schedules. The new rules required a minimum number of shareholders (not less than 100) who own at least five percent of outstanding shares.¹⁴⁶ Likewise, the listing rules required every listed company to disclose its ownership structure, to disclose any person holding more

¹⁴² Law No. 93 of 2000 (Central Securities Depository and Registry Law) art. 11, *al-Jarida al-Rasmiyya* (May 18, 2000) (Egypt).

¹⁴³ MISR FOR CENTRAL CLEARING, DEPOSITRY AND REGISTRY, <http://www.mcsd.com.eg/mcdr/english/showpage.aspx?pageid=22> (last visited NOV. 7, 2015).

¹⁴⁴ Chairman of the Capital Market Authority Decree No. 30 of 2002 (Securities Listing & De-Listing Rules of Cairo & Alexandra Stock Exchanges), *al-Jarida al-Rasmiyya*, 18 June 2002, art. 35 (this rule was added by virtue of the amending Decree No. 67 of 2010) (Egypt).

¹⁴⁵ *Id.* at art. 4, 17, 18. (listing rules were amended by Capital Market Authority (“CMA”) Decision No. 94 of 2008 and Egyptian Financial Supervisory Authority Decisions No. 50 of 2009, 64 of 2009, 67 of 2009, and 132 of 2010; EFSA has replaced the Capital Market Authority in 2008).

¹⁴⁶ *Id.* at art. 4.

than five percent of its shares, to disclose affiliated or controlled companies,¹⁴⁷ and to appoint investor relations personnel to answer investors' inquiries.¹⁴⁸ They also required the board of directors to issue an annual report that discloses any transaction between the company and any of its subsidiaries¹⁴⁹ and obliged companies to disclose any change in previously filed information or any proceedings initiated by regulatory bodies against the company.¹⁵⁰ Moreover, in order to limit fraud and ensure transparency and adequate disclosure of financial information, the listing rules required all companies to have an internal audit committee.¹⁵¹ A special corporation was affiliated with the stock exchange for the purpose of enhancing the dissemination of information.

Most importantly, sanctions in 2008 became deterrent as the law imposed EGP 2000 for every day of delay in submitting the financial reports.¹⁵² Further, it imposed five years of imprisonment and up to EGP 20 million in case of disseminating false information.¹⁵³ Moreover, enforcement of these rules had become aggressive and by the end of September 2003, 99 companies had been delisted for failing to observe the new listing rules. Since then, the Exchange has witnessed waves of delisting for noncompliance. This made the number of listed companies fall from more than 1000 in 2001 to 189 in 2010.¹⁵⁴

c. Reputational Intermediaries

Another considerable shift in legislative policy was noticeable in this decade, especially after 2004, as more consideration was given to financial intermediaries. Thus, creating quality disclosure and transparency rules in this era focused on both corporations and auditors. For instance, the Egyptian Accounting Standards were developed in 2006¹⁵⁵ to replace the old ones; further, in 2008, the Egyptian Auditing Standards were developed in accordance with the

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* at art. 15.

¹⁴⁹ *Id.* at art. 17.

¹⁵⁰ *Id.* at art. 18.

¹⁵¹ *Id.* at art. 7.

¹⁵² CML, *supra* note 97, at art. 65.

¹⁵³ *Id.* at art. 63.

¹⁵⁴ *Annual Report (2010)*, THE EGYPTIAN EXCHANGE (2010), http://www.egx.com.eg/get_pdf.aspx?ID=728&Lang=ENG (last visited Nov. 2, 2015).

¹⁵⁵ Decree No. 243 of 2006 (Egyptian Accounting Standards), *al-Wakae al-Masriya* (July 11, 2006) (Egypt).

international standards.¹⁵⁶ The CML was also amended to require the establishment of a record for auditors who are licensed to audit listed companies.¹⁵⁷ The Egyptian Financial Supervisory Authority (“EFSA”), which replaced the CMA,¹⁵⁸ accordingly created the Auditors Oversight Board. It also sets the conditions upon which auditors can be registered, imposes periodic examinations, and maintains records about auditors that are updated on a regular basis with the findings of the periodic examination and remarks of the quality of work of the registered auditors. Finally, it can suspend auditors for a specific time or remove them from the registry in cases of violations.¹⁵⁹ These records are publicly available on the EFSA website, and corporations are obliged to choose their auditors from the registered ones. Any violation is accessible by the public and potential employers.

Noticeably, the reformations were also concerned with market and economic stability during this period and after the partial growth of the market. Therefore, the first thing the law dealt with in this era was the financial soundness of the brokerage firms and other companies dealing in securities, requiring a minimum paid up capital of EGP 5 million. In addition, the EFSA promulgated comprehensive financial solvency standards to limit the risks associated with their activities, while the executive regulation of the CML laid the obligations and restrictions for such companies. The legislator thus imposed extensive disclosure requirements and set rules for conflict of interests. Further, intermediaries and all their employees were required to be registered with the exchange. The exchange, in turn, sets minimum educational requirements and requires such employees to pass a certain exam before they can be registered with the exchange.

¹⁵⁶ Decree No. 166 of 2008 (Egyptian Auditing Standards), *al-Wakae al-Masriya* (June 30, 2008) (Egypt).

¹⁵⁷ CML *supra* note 97, at art. 11.

¹⁵⁸ Law No. 10 of 2009 (Regulating Non-banking Financial Markets and Instruments), *al-Jarida al-Rasmiyya*, 25 (Feb. 2009) (The authority is mandated to supervise and regulate non-bank financial markets and instruments including the equity and derivatives markets).

¹⁵⁹ EFSA Decree No. 84 of 2008, *al-Wakae al-Masriya* (July 16, 2008); Decree No. 24 of 2009, *al-Wakae al-Masriya*, (Sept. 1 2009).

d. Related Party Transactions

Regulation of self-dealing and insider trading has been tightening the screws on insiders. For example, the listing rules required *ex ante* notification of GA to any transaction that any board member is party of and to seek the GA's approval in advance.¹⁶⁰ In the same sense, the listing requirements enjoined corporations to set mechanisms that prohibit insiders from dealing on information that is not publicly available and set a minimum black out period of 15 days prior to dissemination of information and three days after, during which insiders are totally banned from trading.¹⁶¹ It also required insiders and the corporation to inform the EGX whenever they trade in securities of the company, which in turn publishes such information.¹⁶² Moreover, the executive regulation for CML added a new chapter in 2006 for insider trading and price manipulation.¹⁶³ This chapter defined price manipulation and stipulated—as an example—what can be considered per se manipulations.¹⁶⁴ These include, inter alia, spreading incorrect information, wash trading, painting the tape, and spreading rumors.¹⁶⁵ It also defined who can be an insider and what can constitute inside information that is prohibited.¹⁶⁶ It widened the scope of prohibition and established a tipper-tippee liability.¹⁶⁷ Finally, the law has dramatically increased the penalties imposed on those committing such crimes, which became a minimum of two years of imprisonment and/or EGP 20 million.¹⁶⁸

e. Takeover Regulation

Takeover stayed unregulated, except by one article (which was totally unsatisfactory), until 2007, when the Ministerial Decree No. 12 for 2007 added a new chapter to the executive regulation of CML that furnishes a comprehensive

¹⁶⁰ Decree No. 30 of 2002, at art. 19 (as amended by Decision No. 50 of 2009).

¹⁶¹ *Id.*

¹⁶² *Id.*

¹⁶³ Minister of Economics and Foreign Trade Decree No. 135 of 1993 (Executive Regulations of the Capital Market Law) pt. 11, *al-Wakae al-Masriya* (April 8, 1993) (as amended by Decree No. 141 of 2006 adding a new chapter to the executive regulations) (Egypt).

¹⁶⁴ *Id.* at art. 319.

¹⁶⁵ *Id.* at art. 320-321.

¹⁶⁶ *Id.* at art. 319.

¹⁶⁷ *Id.* at art. 323.

¹⁶⁸ CML, *supra* note 97, at art. 64.

regulation for hostile takeovers.¹⁶⁹ The hostile takeover law is modeled on the French law: it imposes a mandatory tender offer to all outstanding shares upon crossing a certain threshold, and as per the non-interference rule on board of directors asserting that no action can be taken by the board that have detrimental effect on the offer.¹⁷⁰ Moreover, article 357 gives the EFSA the power to force the new controlling shareholder (upon existence of certain conditions) to buy the shares of minority shareholders.

f. Enforcement

Enforcement also improved significantly in this decade: starting from 2003, the Exchange started delisting noncompliant corporations. Further, the EFSA replaced the Capital Market Authority, Egyptian Insurance Supervisory Authority, and the Mortgage Finance Authority as it became the supervisor of all non-banking financial instruments and markets. The first aim stated in the byelaws is for the Authority to protect investors and work on the development of the financial markets.

Moreover, the law created an obligatory dispute resolution committee and it made it mandatory to file a complaint with the EFSA before filing a case.¹⁷¹ There was an attempt to solve disputes by compulsory arbitration in order to mitigate the inefficiencies of the court system and ensure access to justice, but this rule was declared unconstitutional.¹⁷² Therefore, in 2008, Egypt created economic courts to adjudicate commercial and financial matters, inter alia capital market disputes, allowing for first time mediation and putting a 12-month time frame on dispute resolution.¹⁷³ In addition, judges are obliged to take economic training before being able to sit in the economic court. In short, there has been a considerable progress in enforcement, whether from the regulator (where allocated budget has increased continuously since 2000) or the courts.

¹⁶⁹ Minister of Investment Decree No. 12 of 2007, *al-Wakae al-Masriya* (Feb. 4, 2007) (amending some provisions of the Executive Regulations of the Capital Market Law No. 95 of 1992 issued by Decree of the Minister of Economics and Foreign Trade No. 135 of 1993).

¹⁷⁰ *Id.* at art. 343-356.

¹⁷¹ CML, *supra* note 97, at art. 50 & 51.

¹⁷² Case no. 55/2002/Constitutional Court (Egypt).

¹⁷³ Law No. 120 of 2008 (Economic Courts Law), *Al-Jarida Al-Rasmiyya* (May 22, 2008) (Egypt).

Last but not least, the reformations also endeavored to deepen the capital market and increase its liquidity by introducing a number of techniques such as margin trading,¹⁷⁴ online trading,¹⁷⁵ intraday trading, enabling investors to benefit from same day price fluctuations, and introducing and regulating securitization.¹⁷⁶ An investor protection fund was also created to protect investors in case of insolvency of brokerage firms. Finally, the legislator incentivized corporations and the public to participate in the capital market through the new Income Tax Law No. 91 of year 2005 which set corporate tax at 20% of their net yearly profit¹⁷⁷ and removed any taxes on the gain of investors that resulted from investments in securities registered in the Egyptian Stock Exchange (whether profits are achieved through trading in them or through payment of dividends).¹⁷⁸

g. *Stock Market Reaction to the Second Wave of Changes, Political Incentives, and the Transplantation*

The market positively responded to the new wave of reforms. In 2005, Egypt was ranked first in economic reformations across the globe as a number of reforms were introduced.¹⁷⁹ This time, the reforms were not solely confined to legal rules but also targeted the institutions and enforcement mechanisms.

In brief, bigger steps were taken toward a more efficient capital market in the last few years. This is evident in the significant progress of the regulatory, legal, and institutional developments.¹⁸⁰ The improvements were followed by stricter measures in enforcing the law and corporate governance rules, which led to a wave of delisting companies that did not comply with the listing requirements.¹⁸¹ The number of listed firms fell from more than 1000 in 2001 to

¹⁷⁴ Decree No. 192 of 2005, *al-Wakae al-Masriya* (June 10, 2005) (Ministerial Decree amending Capital market Law executive regulations).

¹⁷⁵ Decree No. 50 of 2006, *al-Wakae al-Masriya* (May 14 2006) (Egypt).

¹⁷⁶ Ministerial Decree No. 46 of 2004, *al-Wakae al-Masriya* (Sept. 2, 2004) (Egypt).

¹⁷⁷ Law No. 91 of 2005 (Income Tax) art. 31, *al-Jarida al-Rasmiyya* (June 2005),(Egypt).

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ The World Bank, *ROSC*, *supra* note 106.

¹⁸¹ Radwa S. Elsamam & Ahmed A. Alshorbagy, *Doing Business in Egypt After the January Revolution: Capital Market and Investment Laws*, 11 RICH. J. GLOBAL L. & BUS. 43 (2011).

306 in 2009,¹⁸² and even more companies were delisted in 2010 due to failing to commit to the listing and new disclosure requirements.¹⁸³

The public float in the 50 most active companies increased from around twenty percent in 2001 to around average of forty-five percent in 2009.¹⁸⁴ Moreover, the turnover ratio increased to around seventy percent in 2008 before it goes down to around fifty percent in 2009.¹⁸⁵ Further, the volume and number of listed transactions increased significantly, and the companies listed on the Exchange included a diverse range of industries. This positive impact can be demonstrated by Table (1), which shows the ascent in value and volume of the traded securities from 2003 to 2008. Additionally, Table (2) shows that in 2008, the market capitalization reached about ninety percent of the GDP before the numbers dropped in 2009 as a consequence of the global crisis. Moreover, the positive effects of the reformations were also evident in the amount of foreign direct investments that increased from \$2.1 billion in 2002 to \$13.2 billion in 2008-2009 before it fell to \$6.8 billion as a result of the financial crisis in 2010. This indicated that the country was on the right track with the economic growth rates reaching seven point two percent in 2008.¹⁸⁶

¹⁸² *Annual Report*, THE EGYPTIAN EXCHANGE (2009), http://www.egx.com.eg/get_pdf.aspx?ID=727&Lang=ENG (last visited Nov. 2, 2015).

¹⁸³ OXFORD BUSINESS GROUP, THE REPORT: EGYPT 2010 at 84 (Interview with EGX CEO explaining the reasons for delisting the companies).

¹⁸⁴ Shahira Abdel Shahid, *Does Ownership Structure affect firm Value? Evidence from the Egyptian Stock Market* at 14 (Unpublished Manuscript), available at <http://papers.ssrn.com/sol3/papers.cfm?abstract-id=378580>. For 2009 market data see Mohammed Fawzy Omran, *Single and multiple risk factors in the Egyptian stock market*, 3 *Afro-Asian J. Fin & Accounting* 195, 199 (2013).

¹⁸⁵ has a *Annual Report (2011)*, THE EGYPTIAN EXCHANGE (2011), http://www.egx.com.eg/getdoc/aa66c418-dbe7-4447-a602-dcab01b12e84/AnnualReport-2011_en.aspx (last visited Dec. 15 2015)

¹⁸⁶ Central Bank of Egypt Annual Report 2008-2009, 82 available at http://www.cbe.org.eg/NR/rdonlyres/47D89D4E-C9E6-4BC7-A1B4-F7896577115A/1210/Annual_20082009.pdf

Table (1):
*Value and Volume of Traded Securities and Bonds (2003/ – 2008)*¹⁸⁷

Item	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Value Traded (LE million)	27,349	72,831	241,443	261,639	553,239	280,025
Monthly Average (LE million)	2,279	6,069	20,120	21,711	46,103	23,335
Volume Traded (million securities)	1,684	2,273	5,834	9,423	19,912	25,872
Monthly Average (million securities)	140	189	486	785	1,659	2,156

Table (2)
*Market Capitalization (2003 – 2008)*¹⁸⁸

Item	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Market Capitalization (LE billion)	172.92	337.22	376.97	602.00	813.34	463.34
Market Capitalization/GDP (%)	35.63	62.62	61.03	80.83	90.72	45.97

What explains these reformations? Again, political choices and incumbents' interests are the answer. Of course, the existing ruling coalition had an interest in introducing these reformations.¹⁸⁹ Gamal Mubarak, while being groomed to lead the regime after his father, was not a military person and needed the support of the business elite. Thus, Gamal was the architect of the new cabinet of 2005 as a number of members were directly linked to him and came to office pushing for financial sector reform.

In fact, the financial market's development was in this group's best interest.¹⁹⁰ The opening of the market for foreign banks would increase the availability of credit, instead of only depending on the credit provided by public

¹⁸⁷ *Annual Report (2008)*, THE EGYPTIAN EXCHANGE (2008),

¹⁸⁸ *Id.*

¹⁸⁹ Angela Joya, *The Egyptian revolution: crisis of neoliberalism and the potential for democratic politics*, 38 REV. AFR. POL. ECON. 367, 370-71 (2011).

¹⁹⁰ *Id.* (arguing that the new liberal path that the new government claimed created nothing but more powerful ties between business elite and ruling regime).

banks that were on the decline.¹⁹¹ The new banking entrants would not endanger the position of those players because they already had monopolistic positions in the market.¹⁹² Further, they are the only players that new entrants can extend credit to; since Egypt had no system of credit bureaus, the new entering foreign banks would have difficulty in assessing the creditworthiness of other medium or small size enterprises.¹⁹³

On one hand, capital market development represented a new opportunity for financing the elite's corporations, and, again, there was no fear of competition from other players. Hence, in as thin of a market as Egypt, where the cost of financing is high, only big and renowned corporations could benefit from such a financing tool.¹⁹⁴ Further, the capital market represented a very important vehicle for the business elite to transfer part of their ownership and profits abroad.¹⁹⁵ It also helped them grasp investments from abroad to their companies, thus increasing available financing options. Capital markets also represented a possibility for them to partner with foreign companies. As for the increased burdens that the development of the capital market would bring, this was not a problem for their corporations since most of them were already listed on foreign exchanges abroad and were subject to such high burdens.

On the other hand, the regime had a strong dual sided incentive in surveillance and development of strong institutions in this field: (1) building a reputable capital market to finance corporations would help economic growth of the country and consequently, send a positive message to the international community (especially, this would benefit Gamal Mubarak in his strive to

¹⁹¹ Sahar Nasr, *Access to Finance And Economic Growth In Egypt*, WORLD BANK, MIDDLE EAST AND NORTH AFRICAN REGION, 25 (2008).

¹⁹² Roll, *supra* note 120, at 362-63 (2010).

¹⁹³ *Id.*

¹⁹⁴ *Id.*

¹⁹⁵ This is usually done through creating firms abroad where they own stakes in it. Then, in an undisclosed way they benefit from their connections whether through dealing based on non-public information or through controlling corporations in Egypt which are engaged in embezzlement transactions, for instance buy lands for low prices then selling later for higher. *See, e.g.*, Patrick Kingsley, *Hosni Mubarak's Family Own Assets On British Territory*, The Guardian, March 27 2013; *see also* Nadin Marroushi, *Mubarak Sons Insider Trading Case Begins, But Is Justice Elusive*, EGYPT INDEPENDENT (July 9 2012) (describing the facts of the Mubarak's sons case and their foreign entities and the way they were able to deal on inside information).

presidential palace);¹⁹⁶ and (2) the corporations would be able to obtain finance in an arm's length from the government through the stock markets, and that the size of the funds available for the corporations could not be closely monitored or restricted by the government.¹⁹⁷ This endangers the government's control over the business and finance in the country. To minimize this effect, the government created the monitoring agencies directly appointed by the president and only answerable to him. Moreover, appointees did not have a maximum serving period. Consequently, the government ensured having full control over enforcement. Further, this trepidation from inability to control finance is clearly evident in the EFSA and EGX enforcement of disclosure rules. The more the stock market became active, the harsher the enforcement for the disclosure requirements became.¹⁹⁸ Further, the EGX has continuously updated its system to be able to monitor trades on a real time basis.

In short, there were incentives for both the business elites and political elites to have a reputable stock market at home. The government, particularly, had the incentives to control this market. So, it created the required institutions and continuously increased its budget to be able to cope with its expansion. Further, Gamal Mubarak's interests in the presidency and presenting and depicting himself to the outer world as a potential successor to his father made him strive to present himself as different from his father. He tried to represent himself as a neoliberal thinker and believer. He realized that the widening of the financial market was in the interest of the business elites.

This does not mean that reformations were perfect or that the enforcement was adequate. The above reformation does not make Egypt have a deep capital market that resembles those found in developed countries. The reason for this lag, again, is not legal tradition but political choice, since the

¹⁹⁶ Michelle Dunne, *Evaluating Egypt Reform*, CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE 5 (2006), <http://carnegieendowment.org/files/CP66.Dunne.FINAL.pdf> (last visited May 27, 2015) (he points how Gamal Mubarak has favored reformations that makes the NDP resemble western political parties).

¹⁹⁷ Sourafel Girma & Anja Shortland, *The Political Economy of Financial Development*, 60 OXFORD ECON. PAPERS 567, 575 (2008).

¹⁹⁸ See generally OXFORD BUSINESS GROUP, THE REPORT: EGYPT 2010, AMERICAN CHAMBER OF COMMERCE IN EGYPT (2010).

enforcement of the regulations was selective. The political authorities favored certain investors and connected elites to benefit from expropriation of other investors, thus willfully undermining the quality of the legislation and the protection afforded to investors. For instance, there was not one single insider trading case reported from 1992 until 2008.¹⁹⁹ Further, according to capital market law, the chairman of the EFSA (which is directly appointed by the president) can drop charges against violators, a process which is done away from the scrutiny of the public.²⁰⁰ It can be said that the government gave the businessmen the carrots that insured their loyalty in the shape of monopolies and cheap lands. At the same time, the government built institutions that could record the corruption of these businessmen as a stick that can be used any time by keeping the executive agencies under their direct control.

h. Summary

At the beginning of this phase, the distribution of power changed, and more power was channeled to emerging business elites. Thus, the ruling elite had to include them in the ruling coalition. This was evident by the 2005 cabinet reshuffle. When the business elite themselves became a part of the ruling coalition and had accumulated enough resources and rent during the preceding phase, introducing broad changes in capital market institutions did not present a danger that challenged either the ruling elites or the business elites. In fact, the changes presented a further chance for acquiring additional resources. Further, for the ruling elite to ensure that the relative power of the business elite does not supersede theirs, they had an interest in building the necessary institutions and enforce them when necessary. Of course, because the business elite now have enough power, they resisted the enforcement of many of the built institutions, and mostly those institutions were enforced against non-connected business players. As for the connected players, these institutions worked as a bargaining chip. It intentionally left leeway for the rent seekers to benefit to be able to ensure their allegiance. Thus, while the law was evolving during this period, business and political elites intervened in different times to manipulate the law for their interest. For instance, though there were no insider trading cases till

¹⁹⁹ *Id.* at 80.

²⁰⁰ CMI, *supra* note 97, at art. 69.

2008, after the 2011 Revolution, 23 businessmen, including Hosni Mubarak's sons, were charged for insider trading and price manipulations, which means that EFSA has recorded the faults, but actions were halted by the regime.²⁰¹

IV. CONCLUSIONS AND TAKEAWAYS FOR DEVELOPMENT AGENCIES

The decision to develop a country's financial market is clearly a policy choice. In its essence, it is a distributive choice.²⁰² As made clear from the literature review and the case study, the effectiveness of legal institutions, their enforcement, and their evolution are directly affected by the support of the existing polity and whether the power distribution in the country is supportive or antagonistic to these institutions. So, when development agencies give policy recommendations to such countries, ignoring the politics and distribution of power, the outcome is futile.²⁰³ There is a need to comprehend the division of power in the existing political settlements to implement viable reforms. As the case study shows, institutions that work perfectly in some contexts may not be functional and effective in others.

The main determinant of the effectiveness of the institutions is not the legal tradition, as conventional wisdom purports, but the political reality in the country introducing these institutions. More precisely, a greater attention should be given to the political settlement in the country and whether it can be supportive of the proposed institutions or not.

Importantly, development agencies should be attentive that "societies may choose the wrong policies and institutions, or even pursue disastrous courses

²⁰¹ Noha Moustafa, *Economy Caught In Crossfire Of Insider Trading Cases, Tax Disputes*, EGYPT INDEPENDENT (March 27, 2013), <http://www.egyptindependent.com/news/economy-caught-crossfire-insider-trading-cases-tax-disputes>; *EFG-Hermes Co-Chief Resigns*, AHARAM ONLINE (Oct. 8, 2013), <http://english.ahram.org.eg/NewsContent/3/12/83501/Business/Economy/EFGHermes-cochief-resigns.aspx>.

²⁰² See John W. Cioffi, *Legal Regimes and Political Particularism: An Assessment of the "Legal Families" Theory from the Perspectives of Comparative Law and Political Economy*, 2009 B.Y.U.L. REV. 1501, 1516-17 (2009).

²⁰³ Rajan & Zingales, *supra* note 25, at 33.

of action, because these choices are not made for the benefit of society as a whole, but for the benefit of those who control political power.”²⁰⁴

Daron Acemoglu and James Robinson raise another critical problem of policy advice without considering its political affect.²⁰⁵ They argue that policy choices taken at one point in time usually strengthen some groups and weaken others. This directly affects the political equilibrium at a later point in time.²⁰⁶ Therefore, the pursuit of economic reforms that change the distribution of rents in society should be done cautiously.²⁰⁷ Even if such reforms are well intentioned, they could tilt the balance of power even further toward the already powerful groups.²⁰⁸ Thus, when it comes to policies that affect distribution of income and rents, its ramifications on future political equilibria should be scrutinized.²⁰⁹

This negative effect that Acemoglu and Robinson described is exactly what happened in the case of Egypt. The IMF, involved in the reformations in Egypt, did not consider the political reality prevalent in the country. This led to policy recommendations that allowed the regime to manipulate the reformations for their gains. As discussed above, the country introduced reformations gradually until enough ties were created with business elites, resulting in a system of crony capitalism, where business elites were left to expropriate and create conglomerates and monopolies while protecting them from competition in return of their allegiance.

The introduced economic reformations had political consequences at the time of their adoption and have also had a reverberating effect to date. Even after the collapse of Mubarak's Regime, Egypt is left with powerful business elites that have large market shares and monopolies in different sectors of the economy. Furthermore, they will fight to retain the rents that they used to capture

²⁰⁴ Daron Acemoglu, *Why Not A Political Coase Theorem? Social Conflict, Commitment, And Politics*, 31 J. COMP. ECON. 620, 648 (2003) [hereinafter Acemoglu, *Political Coase Theorem*].

²⁰⁵ Daron Acemoglu, & James A. Robinson, *Economics Versus Politics: Pitfalls Of Policy Advice*, NAT'L BUREAU OF ECON. RESEARCH Working Paper No. 18921, 2013, at 4 [hereinafter Acemoglu & Robinson, *Economics Versus Politics*].

²⁰⁶ *Id.*

²⁰⁷ *Id.* at 21.

²⁰⁸ *Id.*

²⁰⁹ *Id.* at 22.

under Hosni Mubarak. To give an example of this fact, when president Morsi came to power in 2012, he tried to pass a tax on share profits. After issuing the law, tremendous pressure came from the financial sector leading to the repealing of the law only two weeks after its introduction.²¹⁰

This shows how the economic reforms that the IMF advocated at the beginning of the 1990s affected Egyptian politics both at that time and today, with no loss of momentum. In conclusion, “one size fits all” reforms are not functional and should be abandoned in favor of a more tailored policy that incorporates a study of power division and political realities.

²¹⁰ Stephan Roll, *Egypt's Business Elite after Mubarak: A Powerful Player between Generals and Brotherhood* 14 (2013) (unpublished manuscript) (on file with the German Institute for International and Security Affairs), available at http://www.swp-berlin.org/fileadmin/contents/products/research_papers/2013_RP08_rl1.pdf.