How Equity Capital Markets Can Promote FDI in LDCs[1]

by

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Introduction

The Doha Programme of Action (DPoA) for the Least Developed Countries (LDCs) was adopted by the United Nations (UN) General Assembly (GA) in April 2022.[3] The DPoA is a global compact that is primarily designed to support the attainment of the Sustainable Development Goals (SDGs) by the forty-six LDCs.

In the DPoA, the GA recognizes that the LDCs, which have about 14% of global population, account for only 1.3% of global gross domestic product and about 1.4% of global foreign direct investment (FDI).[4] Noting with concern that FDI flows to LDCs were already decreasing between 2015 and 2019, and observing that the COVID-19 pandemic exacerbated existing challenges, the GA asks the UN Secretary-General to "explore the feasibility of establishing an international investment support centre for least developed countries in the form of a one-stop shop to mobilize support for implementation of the investment promotion regime for least developed countries and graduated countries."[5] The center, work on which is underway, is expected to support the LDCs in attracting FDI.

FDI, according to the Organisation for Economic Co-operation and Development (OECD), "is a category of cross-border investment in which an investor resident in one economy establishes a lasting interest in and a significant degree of influence over an enterprise resident in another economy."[6] As evidence of cross-border interest and influence, the OECD requires ownership of 10% or more of "the voting power in an enterprise in one economy by an investor in another economy…."[7] Therefore, minority equity positions—positions between 10% and 50%—qualify as FDI.[8]

In general, minority equity positions expose shareholders to risks. In particular, minority private equity positions carry material risks. In LDCs, such material risks may prove binding constraints that limit FDI to majority private equity positions, with potential minority foreign investors either preferring debt to equity or electing not to participate at all. Binding constraints can be relaxed by switching from minority private equity positions to minority public equity positions, especially within predictable corporate law

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All opinions are the personal opinions of the author.
[3] https://digitallibrary.un.org/record/3968043?ln=en
[4] Ibid., p. 3
[5] Ibid., p. 54
[6] https://www.oecd-ilibrary.org/finance-and-investment/foreign-direct-investment-fdi/indicator-group/english_9a523b18-en
[7] Ibid.
[8] In the interest of simplicity, it is assumed that an X% ownership holding is associated with X% of voting power.

environments.[9] Thus, this document argues that, since they can foster investor participation, public equity capital markets (ECMs) are vital to the endeavors of LDCs to attract FDI.

The document has four sections. The first section discusses FDI in an LDC context. The second section examines obstacles faced by minority shareholders. The third section describes the advantages of public ECMs and proposes policy objectives. The last section summarizes and concludes.

FDI and LDCs

The OECD states that[10]

> *FDI is a key element in international economic integration because it creates stable and long-lasting links between economies. FDI is an important channel for the transfer of technology between countries, promotes international trade through access to foreign markets, and can be an important vehicle for economic development.*

Consequently, as the SDGs cannot be achieved without satisfactory progress in the LDCs, the GA's attention to FDI is justified. Having attracted around USD 48 billion during the first two years of the decade, LDCs are said to need over USD 853 billion until the end of the decade to reach the SDGs.[11]

Unfortunately, LDC realities present substantial hurdles to bankability. The UN defines LDCs as "low-income countries confronting severe structural impediments to sustainable development" that "are highly vulnerable to economic and environmental shocks and have low levels of human assets."[12] Due to legal uncertainty, underdeveloped markets, and unreliable data, it is exceptionally difficult to identify and finance viable private-sector LDC projects.[13] As a result, it is quite likely that viable projects remain unbanked.

Legal predictability, while sometimes ignored, is a crucial factor without which investments cannot be evaluated. For instance, investors, both foreign and domestic, ordinarily demand clarity on corporate forms and changes, shareholder rights and duties, creditor contracts and protections, and shareholder-manager and shareholder-debtholder relationships.[14] Motivated by financial performance and operational excellence, while safeguarding their reputations, investors choose their exposures to the company through participations in the company's capital structure.[15] Shareholders are owed legally

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[9] It is presumed that acquiring 10% of voting power is *prima facie* evidence of "lasting interest." So, an appreciation for the liquidity offered by public ECMs is not viewed as opposed to an *ex ante* long-term commitment.

[10] Ibid.

[11] https://www.un.org/ohrlls/events/international-investment-support-centre-support-ldcs-with-fdi-promotion

[12] https://www.un.org/development/desa/dpad/least-developed-country-category.html

[13] The focus is on institutional weakness: it is not on risks. Specifically, legal risk is understood to exist in an environment of legal predictability, while legal uncertainty is understood to derive from the absence of legal predictability.
A project is defined as "viable" if it has positive net present value.

[14] In this document, the capital structure is assumed to be comprised of equity and debt.

[15] In a capital structure comprised of equity and debt, there are four possibilities: equity; debt; equity and debt; and no participation.

imposed fiduciary duties by managers and officers, whereas debtholders enter into voluntary contracts with the company.

Minority Shareholders

Even if ownership and voting power are assumed to be in a one-to-one correspondence, in line with Footnote 8, control may necessitate further analysis. To illustrate, a majority shareholder usually owes fiduciary duties to the company and minority shareholders, while a minority shareholder typically owes fiduciary duties to the company and other shareholders only when found to exercise actual control over the company.[16] Each jurisdiction has its own character and quality. What matters is the protection on which investors, such as minority shareholders, can rationally rely.

Not surprisingly, the degree of investor protection—measured by the nature of legal rules and the rigor of law enforcement—is positively correlated with the breadth and depth of capital markets.[17] For example, stark differences have been found between French civil law countries and common law countries.[18] In fact, adequate shareholder protection has favorable effects both on domestic development and on cross-border flows:[19]

> *Firms are larger, more valuable, and more plentiful, dividends are higher (and diversion of profits lower), ownership concentration is lower, and stock markets are more developed in countries with better protection of shareholders.*
>
> *... entrepreneurs gain more (or lose less) from an improvement in investor protection when the country is open to world capital flows than when it is not. Entrepreneurs are more likely to use their political influence to improve investor protection when the country is open to capital flows.*

Conversely, the greater the opportunity for a controlling shareholder to dispossess minority shareholders, the costlier outside capital, with equity sold to outsiders only when internal resources are insufficient to finance viable projects. As a consequence, economic growth and market development are impaired.

Similar negative outcomes for equity occur under two other scenarios: when information is not shared intentionally with prospective shareholders and when information cannot be shared credibly with prospective shareholders. In the former scenario, in the presence of a majority shareholder, the prospective shareholder may struggle to obtain information.[20] Even if the information is eventually provided, it may be outdated. In the latter scenario, as shown by the Nobel Prize laureates George

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[16] Even in the United States, different jurisdictions take different approaches: https://www.afslaw.com/perspectives/alerts/minority-shareholders-and-their-fiduciary-duties-other-jurisdictions.

[17] La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. 1997. "Legal Determinants of External Finance." *Journal of Finance*, 52 (3): 1131-1150.

[18] Ibid.

[19] Shleifer, Andrei, and Daniel Wolfenzon. 2002. "Investor Protection and Equity Markets." *Journal of Financial Economics*, 66 (1): 3-27.

[20] A majority shareholder tends to have more information than a minority shareholder. Also, a majority shareholder tends to have control over management.

Akerlof[21] and Michael Spence,[22] if management knows more than outsiders know about the outlook for the company, the company may raise debt to signal quality.[23] Moreover, because of informational asymmetry, an attempt to raise equity may be perceived by outsiders as an attempt to sell a "lemon," increasing the cost of equity to the point of rejecting viable projects.[24]

Public ECMs and Policy Objectives

Compared to private ECMs, in addition to superior liquidity, public ECMs offer superior information. In public ECMs, one has the ability to increase or decrease one's holdings relatively quickly by trading on a stock market, and every stock exchange requires regular disclosures and exceptional notifications. In private ECMs, one is not able to increase or decrease holdings quickly, if at all, and a controlling shareholder may restrict access to information.[25] Therefore, to steer meaningful volumes of FDI toward LDCs, a coherent public ECMs strategy has to be crafted.

More than three decades ago, the Nobel Prize laureate Robert Lucas noted the connection between capital flows and policy choices:[26]

> *Only insofar as political risk is an important factor in limiting capital flows can we expect transfers of capital to speed the international equalization of factor prices. In a world of largely immobile labor, policies focused on affecting the accumulation of human capital surely have a much larger potential. So too, I think, do policies in which aid of any form is tied to the recipient's openness to foreign investment on competitive terms.*

Given its internal capacity, financial resources, and convening power, the UN is well-placed to lead a conversation about welfare-maximizing policy objectives on country and regional levels. Since a sound systematic way of ensuring that foreign investments are made on competitive terms is to harness the price discovery processes of public markets, capital market development and regional economic integration should be policy objectives.[27] To paraphrase Morck, Wolfenzon, and Yeung, the UN can help Member States pinpoint the adjustable factors that can make their political economies more robust, thereby producing preferable public policy outcomes:[28]

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[21] Akerlof, George. 1970. "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism." *Quarterly Journal of Economics*, 84 (3): 488–500.

[22] Spence, Michael. 1973. "Job Market Signaling." *The Quarterly Journal of Economics*, 87 (3): 355-374.

[23] Issuing debt means having no concern about bankruptcy, while issuing equity means selling "lemons."

[24] Myers, Stewart, and Nicholas Majluf. 1984. "Corporate financing and investment decisions when firms have information that investors do not have." *Journal of Financial Economics*, 13 (2): 187–221.

[25] Naturally, there are reasons for the existence of private companies. Some reasons are flexibility in company structure and actions, and in-depth knowledge of company decisions and operations.

[26] Lucas, Robert, Jr. 1990. "Why Doesn't Capital Flow from Rich to Poor Countries?" *American Economic Review*, 80 (2): 92-96.

[27] Of course, not every LDC needs a stock exchange or a central securities depository.

[28] Morck, Randall, Daniel Wolfenzon, and Bernard Yeung. 2005. "Corporate Governance, Economic Entrenchment, and Growth." *Journal of Economic Literature*, 43 (3): 655-720.

... public policy regarding important issues, like property rights, the development of financial markets and institutions, and economic openness, is usefully thought of as a political economy outcome. From this perspective, "public policy" in many countries cannot be considered a discretionary variable that can be "adjusted" to cure economic ills. We need to identify those factors that are "adjustable" and that might induce a transition of the political economy from a suboptimal to a better equilibrium.

Conclusion

The SDGs cannot be achieved without concrete advancements in the LDCs. The necessary advancements cannot be made without sufficient financial resources and appropriate knowledge sharing. Hence, FDI is an efficient, effective, and pertinent mechanism—a mechanism that holds enormous promise.

Cognizant of LDCs' urgent need for FDI, the GA has adopted the DPoA and asked the Secretary-General to explore a modality that can facilitate investment promotion for LDCs and graduated countries. The GA's request provides a valuable opportunity to deliver development impact at scale within a logical methodological framework.

Shareholders, both domestic and foreign, appreciate credible information and legal predictability. Minority shareholders favor jurisdictions that offer investor protection and holdings that are easily managed. Because they offer informational transparency, price discovery, and liquid securities, public ECMs are ideally placed to catalyze FDI. As it is not advisable for every LDC to have public ECMs and as mature public ECMs exist in sophisticated jurisdictions, the possibility of LDC companies listing their shares, perhaps only initially, on a few regional stock exchanges should be discussed.

Since the primary function of capital markets is to finance companies and projects, it is critical to acknowledge that the first step is the identification of viable investment opportunities. Thus, it is recommended that the one-stop shop "international investment support centre" have a market and project development hub (MPDH) similar to the InvestEU Advisory Hub.[29] MPDH can identify viable projects, guide viable projects to bankability, engineer financial solutions that connect project sponsors and project financiers, develop national capital markets and integrate national capital markets regionally, collaborate with governments to harmonize procedures and standardize documentation, and disseminate best practices.[30]

With welfare-maximizing policy objectives in mind, a coherent public ECMs strategy ought to be included in the discourse. Public ECMs are one part of the financial sector, which plays a leading role in poverty alleviation, economic empowerment, and systemic transformation. The UN can contribute to the creation of competitive and stable financial sectors that help reduce systematic risk and regional contagion.

[29] The InvestEU Advisory Hub was launched, in 2015, as the European Investment Advisory Hub.
[30] The founding of an LDC MPDH was proposed in August 2023.