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Impact of Legislation on the Iceland Stock Exchange

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Biography of the author

Professor Einarsson is the former dean of the Faculty of Economics and Business Administration at the University of Iceland. He obtained his PhD in Germany. He is the author of 6 books on microeconomics, business administration and cultural economics and over 50 journal articles and conference papers and over 400 shorter articles on economics, fisheries and politics in magazines, newspapers, and on websites. Professor Einarsson is a former Member of the Icelandic Parliament and Chairman of the Board of the Central Bank of Iceland and served as a delegate for Iceland at the General Assembly of the United Nations in New York.

Abstract

The paper describes the impact of legislation concerning securities exchanges on the volume of stock trading in Iceland and on stock prices. Organised trading in stocks in Iceland has only been going on for 12 years, but has been increasing rapidly in recent years. The first legislation exclusively concerned with trading of this kind entered into force in 1993, but extensive changes were made when Iceland became a party to the Agreement on the European Economic Area in 1994. The principal legislative acts on equity trading in Iceland date from 1993 and 1998. The paper addresses the impact of individual legislative reforms on trends in equity trading in connection with other influencing factors, such as general economic trends and the situation in the fisheries sector, which has traditionally accounted for a substantial part of the total volume of equity trading in the regulated stock market in Iceland. Specific attention is given to

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the impact of legislation on public control. Iceland became a NOREX partner in 2001, and comparison with other Nordic countries shows that, as a result of the significant growth in recent years, the Icelandic stock market has reached proportionally the same volume as the stock markets in other Nordic countries. Legislation has gradually reduced transaction costs, as formal rules have replaced informal rules, thereby reducing uncertainty and improving the quality of information in relations between buyers and sellers.

Keywords: Iceland stock exchange, stock exchange legislation, fisheries, equity trading

JEL: G12, G30, K22, K40

1. Introduction

The purpose of this article is to describe the development of trading on the equity market in the Iceland Stock Exchange (ICEX) in the course of only ten years since the beginning of regulated equity trading in Iceland. Over the past 20 years, legislation and procedures in Europe concerning equity trading have converged to become more and more similar in individual countries, although numerous differences remain in the governance of listed companies in individual countries.[2] As regards legislation for the protection of shareholders and creditors, however, legislation based on British tradition provides the strongest protection. Legislation based on French tradition provides the weakest protection, and German and Nordic legislation is generally regarded as falling somewhere between these two major traditions.[3] The description in this article primarily involves at Icelandic legislation on stock exchange trading, which is discussed in Section 2.

Section 3 describes the rapid development of equity trading in the Iceland Stock Exchange in the context of other economic indicators and foreign markets. The rush of companies to list themselves on regulated stock exchanges has been significant in Iceland, influenced by the need for capital for development and growth,

[2] Barca F. and Becht M. (2001). *The Control of Corporate Europe*. Oxford University Press. Oxford and Berglöf E. (1997). Reforming corporate governance: Redirecting the European agenda. *Economic Policy*, 12(24).
[3] La Porta et al. (1998). Law and Finance. *The Journal of Political Economy*, 106(6), 1113-1155.

and also by the attraction of the improved standing which is often awarded to formally listed companies.[4]

Section 4 describes certain areas of dispute, such as the position of the fisheries industry in equity trading, as fisheries are an extremely important part of the Icelandic economy.[5] An account is also given of the impact of the participation of the Iceland Stock Exchange in NOREX, an alliance of the stock exchanges of most of the Nordic countries.

2. Legislation on Stock Exchange Trading in Iceland

2.1 Legislation current in 1984-1997

In 1984, the Central Bank of Iceland took the initiative in introducing regulated securities trading in Iceland. The Central Bank Act included certain provisions relating to such activities. Rules were set by the Central Bank concerning trading activities in the securities market. At first, trading primarily involved Icelandic Treasury Bonds and later housing bonds, which are state guaranteed bonds. Stocks were first listed on the Iceland Stock Exchange in October 1990.

Before 1990, stock trading was relatively rare in Iceland and stocks were not generally regarded as an attractive investment option. It was quite rare, in fact, for individuals and companies to sell stocks. Many Icelandic enterprises were family companies, which were deliberately kept closed. Also, relations among the various companies and their directors were extremely close, e.g. in political lobbyism and protection of common interests. The period from 1970 to 1990 was also characterised by extreme instability and inflation, but this situation was reversed after 1990. From 1980 to 1990, the average annual inflation was 34%, but from 1991-2003, the corresponding average was 3%.

The first legislation concerning the Iceland Stock Exchange (ICEX) was enacted in 1993. In 1992, three legislative bills were introduced in the Althing, the Iceland Parliament, which passed into law in 1993. The first was a cabinet bill on a stock exchange[6], the second was a cabinet bill on securities transactions[7] and the third

[4] Fisher C. (2002*). Motive des Börsengangs am Neuen Markt: Die Publikumsfinanzierung von Innovation aus theoretisher und empirischer Sicht*. Duncker und Humblot. Berlin.
[5] In 2001, fish products accounted for 62% of the export of goods and 40% of foreign currency income in Iceland (*Statistical Yearbook of Iceland* (2002). Statistics Iceland. Reykjavik, p. 197).
[6] Cabinet bill on a stock exchange (1992-1993). Althingi. 116th legislative session. Document 13/13.

was a cabinet bill on undertakings for collective investment.[8] The Act on the Iceland Stock Exchange secured, for the first time, the basis for a secondary market for securities, as the structure of the market was now transparent and the trading regulated. The Central Bank of Iceland carried out the financial supervision at that time. In this Act of 1993, the rules current at that time on the Stock Exchange were codified as statutory law and the Iceland Stock Exchange was reformed as a private non-profit institution and ceased to be a department of the Central Bank.

The Agreement on the European Economic Area, which was finalised in 1992 and entered into force in 1994, provided for the free flow of capital, although the Agreement did not require the establishment of a securities exchange in all the member states. However, Community Directive 79/279, which forms a part of the Agreement, stipulated that the member states should appoint authorities qualified to authorise the public listing of securities. Also, numerous EU directives relating to securities trading, e.g. concerning listings, the obligation to notify of holdings in excess of specific limits, disclosure obligations and obligations concerning prospectuses, were incorporated into the first Icelandic legislation on the Iceland Stock Exchange.

In the first ICEX legislation of 1993 it was stipulated that the Iceland Stock Exchange should have a monopoly on stock exchange activities in Iceland. Such monopolies were also the norm in other Nordic countries at that time, although they were in the process of being lifted. The new legislation took account of the Central Bank rules on securities trading and of legislation in neighbouring states, as well as all provisions which were binding for Iceland as a result of the membership of the European Economic Area.[9] The Althing did not make extensive changes to the legislative bill on the Iceland

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[7] Cabinet bill on securities transactions (1992-1993). Althingi. 116th legislative session. Document 11/11.

[8] Cabinet bill on undertakings for collective investment (1992-1993). Althingi. 116th legislative session. Document 12/12.

[9] The Act on an Icelandic Stock Exchange, no. 11/1993, was divided into ten chapters. The first chapter contains a provision to the effect that the Iceland Stock Exchange is a private non-profit institution and that its role is to engage in general stock exchange activities and that the Exchange is granted exclusive rights to engage in such activities in Iceland. Chapter 2 contains provisions on the board of directors of the Exchange and Chapter 3 contains provisions on an Executive Director. Chapter 4 provides for membership of the Exchange, which may include the Central Bank of Iceland, securities brokers and securities firms licenced to engage in brokering activities pursuant to the Act on Securities Transactions. The same applies to securities brokers in the European Economic Area. Chapter 5 provides for the public listing of securities in trading systems, and Chapter 6 describes the trading system. Chapter 7 contains provisions on financial reporting which are similar to the provisions of the Limited Liability Companies Act. Chapter 8 provides for supervision, stipulating that the Stock Exchange is subject to the supervision of the Banking Inspectorate of the Central Bank of Iceland. Chapter 10 contains various provisions such as provisions banning lending and guarantees and

Stock Exchange in the course of its deliberations.[10] The exclusive rights of the Exchange were delimited more clearly and provisions added to the effect that the Bank Inspectorate of the Central Bank could not obtain information directly from issuers of listed securities but should obtain such information and access to data on such parties from the Stock Exchange.

With the enactment of a legislative bill for an Act on Securities Transactions, which was submitted to the Althing at the same time as the legislative bill on the Iceland Stock Exchange, i.e. in 1992, a comprehensive legal framework had been established for securities trading in Iceland. The legislative framework was based on the legislation current at the time and on the legislation in neighbouring countries, which had already been adapted to the rules of the European Union. Also, direct account had been taken of the legislation and regulations of the European Union. Among other things, this comprehensive legislative framework on securities trading addressed the definition of securities, identified the parties licensed to trade and procedures for obtaining such a license, as well as the rights and obligations of securities firms. Also, the legislation provided for supervision, annual accounts and sanctions. The Althing enacted the legislative bill on securities transactions and the legislation bill on undertakings for collective investment unanimously.

It was a common characteristic of the process of enacting these three legislative bills that there was no dispute between the government and opposition and the bills did not undergo any major changes in the course of parliamentary deliberation. The bills resulted in threefold legislation, i.e. an Act on Securities Transactions, an Act on Undertakings for Collective Investment, and an Act on the Iceland Stock Exchange. In addition to these three statutes, the framework for financial activities in Iceland is completed by an Act on the Supervision of Financial Operations, which, until 1999, was in the hands of the Central Bank, and several other acts on financial undertakings. Icelandic legislation on financial markets still rests on these five pillars.

In 1996, several minor amendments were made to the Act on the Iceland Stock Exchange, the Act on Undertakings for Collective Investments and the Act on Securities Transactions. The purpose of the amendments was to adapt the legislation to the legislative framework current in the European Economic Area following the entry into force of a

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provisions on confidentiality. Chapter 10 provides for sanctions in the event of violation. This is the traditional structure of legislation of this kind.

[10] Report of the Economic and Trade Committee (1992-1993). Althingi. 116th legislative session. Document 393/13.

community directive on investment services. The amendments made the rights of securities firms subject to compliance with the provisions of the community directive concerning equity position.

2.2 Legislation current in 1998-2003

In the course of the approval of a cabinet bill on the activities of stock exchanges and regulated OTC markets in 1998, provisions on the exclusive rights of the Iceland Stock Exchange were repealed, permitting the establishment of new securities markets in Iceland, although no such markets have in fact been established.[11] This bill was enacted as a comprehensive statutory law on the activities of stock exchanges. The provisions of law concerning ICEX were incorporated into the new act, which included general provisions on the activities of stock exchanges. At the same time, the legislation contained provisions on the activities of regulated securities markets involving unlisted securities. The enactment of the bill established the legislative framework for securities exchanges which is still current. Some changes were made in the course of parliamentary deliberations based on reasoned submissions from parties such as the Federation of Icelandic Employers, the Association of State Authorized Public Accountants in Iceland, the Central Bank of Iceland, the Icelandic Association of Commercial Banks, the Iceland Chamber of Commerce and the Iceland Stock Exchange. All the amendments had the purpose of clarifying the provisions of the bill.

The current Act on the Activities of Stock Exchanges and Regulated OTC Markets No. 34/1998, which took effect on 29 April 1998, has since been amended five times. The most important of these amendments relate to supervision of the financial market. The first amendment was made in 1999 (Act No. 16/1999), when the supervision of the financial market was transferred from the Central Bank with the establishment of the Financial Supervision Authority (FSA), ending the supervision by the Central Bank and the Insurance Supervision Authority. Another change occurred in 1999 (Act No. 16/1999), when the Euro replaced the European Currency Unit (ECU) with the establishment of the European Monetary Union on 1 January 1999. At the same time, the powers of the Minister of Commerce to establish further rules on the public listing of securities were increased. The third change was in the year 2000 (Act No. 11/2000), when the FSA was granted increased powers. This change extended to the entire financial market, and was not

[11] Cabinet bill on the activities of stock exchanges and regulated OTC markets (1997-1998). Althingi. 122th legislative session. Document 356/285.

modelled on provisions governing surveillance authorities in the neighbouring countries. Under the new law, the FSA was secured access to information relating to potential violations in take-overs and flagging. The fourth change was effected in 2002 (Act No. 76/2002) when a new Memorandum of Association was established for EFTA; the previous Memorandum had been in effect without change for 40 years. The amendments to the agreement had the primary purpose of adapting it formally to the provisions of the EEA Agreement. The fifth change took effect in 2003 (Act No. 33/2003), when the provisions governing take-over offers and flagging were transferred from the Stock Exchange Act to the Securities Transactions Act.

In 1998 a cabinet bill on public financial supervision was passed into law by the Althing.[12] Under the new law, supervision of the capital market was transferred from the Central Bank to a new and independent institution, the Financial Supervisory Authority (FSA). The new Financial Supervisory Authority took over all the supervisory tasks of the Central Bank and the Insurance Inspectorate. This was in line with arrangements in other Nordic Countries, where regulatory bodies in the financial markets have been combined. The principal substance of the bill, apart from the actual establishment of the new institution, was to provide for its board of directors and assert its independence. The institution was granted powers and recourses comparable to the regulatory bodies it replaced. No substantive changes were made to the supervision procedures themselves with the enactment of this new law.

In 2000, the Act on Securities Trading was amended by the addition of provisions on public offerings and detailed provisions on insider trading. The purpose of this change was to simplify the rules applicable to public offerings. The term “insider” was clearly defined and restraints increased in order to promote confidence in the financial markets.

In 2003, changes were effected in the legislation governing financial markets in order to incorporate into the domestic legal order the conditions of community directive 85/611 relating to disclosure, investment strategies and conditions for marketing in the European Economic Area. The point of this legal reform was to divide funds requiring market authorization into securities funds, on the one hand, and investment funds on the other hand

In the same year, new comprehensive legislation was enacted concerning securities trading. Among other things, the new legislation contains the provisions on rules of

[12] Cabinet bill on Public Financial Supervision (1997-1998). Althingi. 122th legislative session. Document 951/560.

conduct in the securities market which had previously been contained in legislation governing the activities of stock exchanges. In addition, the new law provides for the activation of a flagging obligation at the 5% control level, and, furthermore, new community directives with EEA relevance were incorporated into the new legislation.

Also in 2003, a new comprehensive Act on Financial Undertakings passed into law, whereby the Act on Commercial and Savings banks, the Act on Financial Institutions other than Commercial Banks and Savings Banks, the Act on Electronic Money Institutions and provisions on the activities of securities firms and securities brokerage were combined into a single act on financial institutions. Among the changes this entailed was that the FSA (Financial Supervisory Authority) now grants and revokes operating licenses instead of the Minister of Commerce. At the same time, numerous community directives governing financial enterprises were incorporated into the domestic legal order. Figure 1 shows the five pillars of legislation on financial activities in Iceland.

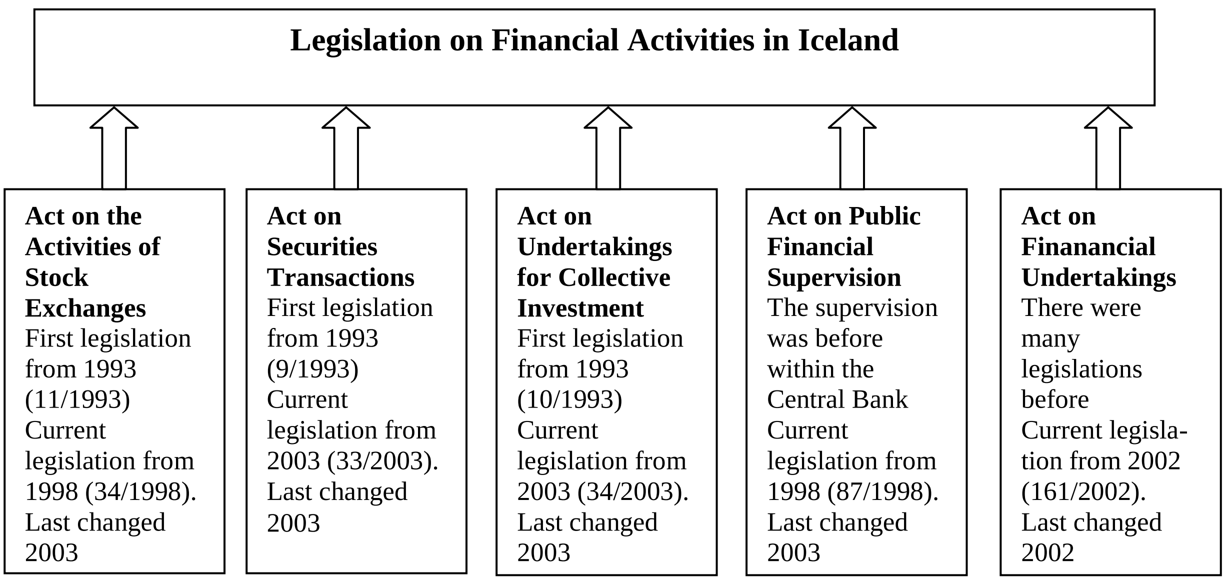

Fig. 1: Principal legislation on financial activities in Iceland

Other legislation of importance for the financial market includes the Act on Limited Liability Companies No. 2/1995, the Act on Electronic Recording of Securities No. 131/1997 and the Act on the Central Bank of Iceland No. 36/2001. In addition, government regulations grounded in these acts naturally form an important part of the regulatory framework of securities transactions.

Legislation in Iceland in the last decade concerning securities trading and securities exchanges, as well as legislation on supervision in the financial markets, investment funds and financial enterprises, has taken substantial account of the Agreement on the European Economic Area. The legislative framework has gradually been adapted to community directives owing to the fact that Iceland is under obligation to incorporate these acts of the European Union into the domestic legal order pursuant to the Agreement on the European Economic Area. At the same time, earlier legislation has been reviewed, clarified and simplified.

The EEA Agreement has had a profound and positive impact on the Icelandic economy, and has been a decisive factor in making the Icelandic stock market as healthy as it in fact is.

Provisions which are unique for Iceland are not prominent in this legislation; on the contrary, Icelandic legislation has been adapted to trends abroad, partly by reference to legislation in the other Nordic Countries and partly by fulfilling the provisions of the Agreement on the European Economic Area.

3. Stock Trading in the Iceland Stock Exchange 1991 to 2002

3.1 Number of listings and organisation of trading

The activities of ICEX have increased substantially over the last decade. Figure 2 shows the number of companies listed on the Iceland Stock Exchange in the past 12 years.[13]

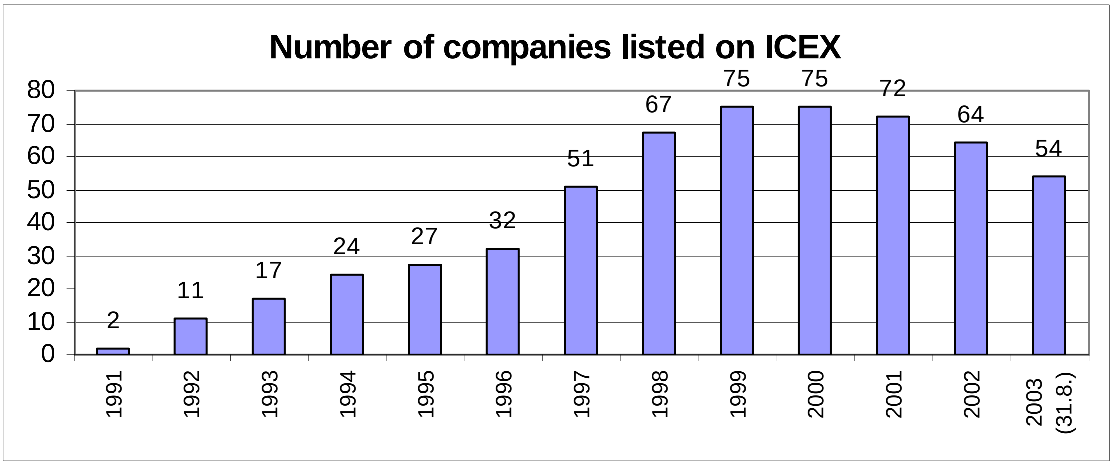

Fig. 2: Number of companies listed on the Iceland Stock Exchange 1991 to 2002

[13] *Annual Reports 1998* (1999) and *2002* (2003). The Central Bank of Iceland. Reykjavík.

The number of listed companies grew rapidly until 1997, from 2 companies in 1991 to 51 companies in 1997. At first, Icelandic companies were reluctant to obtain listing on the Stock Exchange. Among the reasons for this was that there was little experience in trading of this kind, the rules were unfamiliar at first, and there was fear that the disclosure requirements would undermine the competitive position of listed companies. This gradually changed, and large companies in important sectors were listed on the Exchange. This increased the available experience, and thereby the volume of trading, and this in turn encouraged other companies to apply for listing. The Stock Exchange opened access to capital by means of public offerings, which had not been a common feature of the Icelandic economy before that time, as companies had primarily been financed by loan capital. In addition, the extensive privatisation measures of government authorities strengthened the stock market, as numerous enterprises owned by the State were first incorporated as limited liability companies and subsequently privatised.

The number of listed companies peaked at 75 in 1999 and 2000. The number fell slightly in 2000 and 2001, and somewhat more in 2002. The drop in 2002 was principally a result of mergers of companies. The trend in 2003 has also been characterised by a fall in the number of listed companies, but this is not due only to mergers but also because the ownership of some companies has concentrated in the hands of much fewer shareholders, which meant that they no longer qualified for listing on the Stock Exchange. At the end of August 2003, only 54 companies were listed on the ICEX.[14]

Companies have complained that listing on the Stock Exchange has the effect of making sensitive information available to competitors, a particularly serious concern when few companies in a given sector are publicly listed. In addition to the reasons proposed above for the falling number of companies on the exchange, some companies have complained about the expense of listing on the Stock Exchange resulting from the onerous disclosure requirements.[15] However, Icelandic rules on disclosure are comparable to the rules applicable in the other Nordic countries owing to the membership of NOREX, an alliance of most of the stock exchanges in the Nordic Countries. Harmonised and detailed disclosure is extremely important for buyers and sellers of stock, so that the fact that some companies have complained of the cost of reporting is a matter of some concern as regards the further progress of stock trading on the listed market in Iceland.

[14] Listed companies. Iceland Stock Exchange. Located at www.icex.is
[15] Karlsdottir E.R. (2003). Hugleiðingar um framtíð Kauphallarinnar. *Hagur*, 25 (2).

As supervision in the financial market has increased with increasing experience and training among the employees of the Stock Exchange and the Financial Supervisory Authority, the directors of various listed companies do not appear to show the same support for the activities of the Stock Exchange as before. However, there is no indication that the provisions of Icelandic law are any more onerous for companies in Iceland than the provisions that comparable companies abroad have to submit to.

The process of trading in the Stock Exchange in Iceland is entirely electronic, as illustrated in Figure 3.[16]

[16] *Fact Book* (2003). Iceland Stock Exchange. Reykjavík, p. 44.

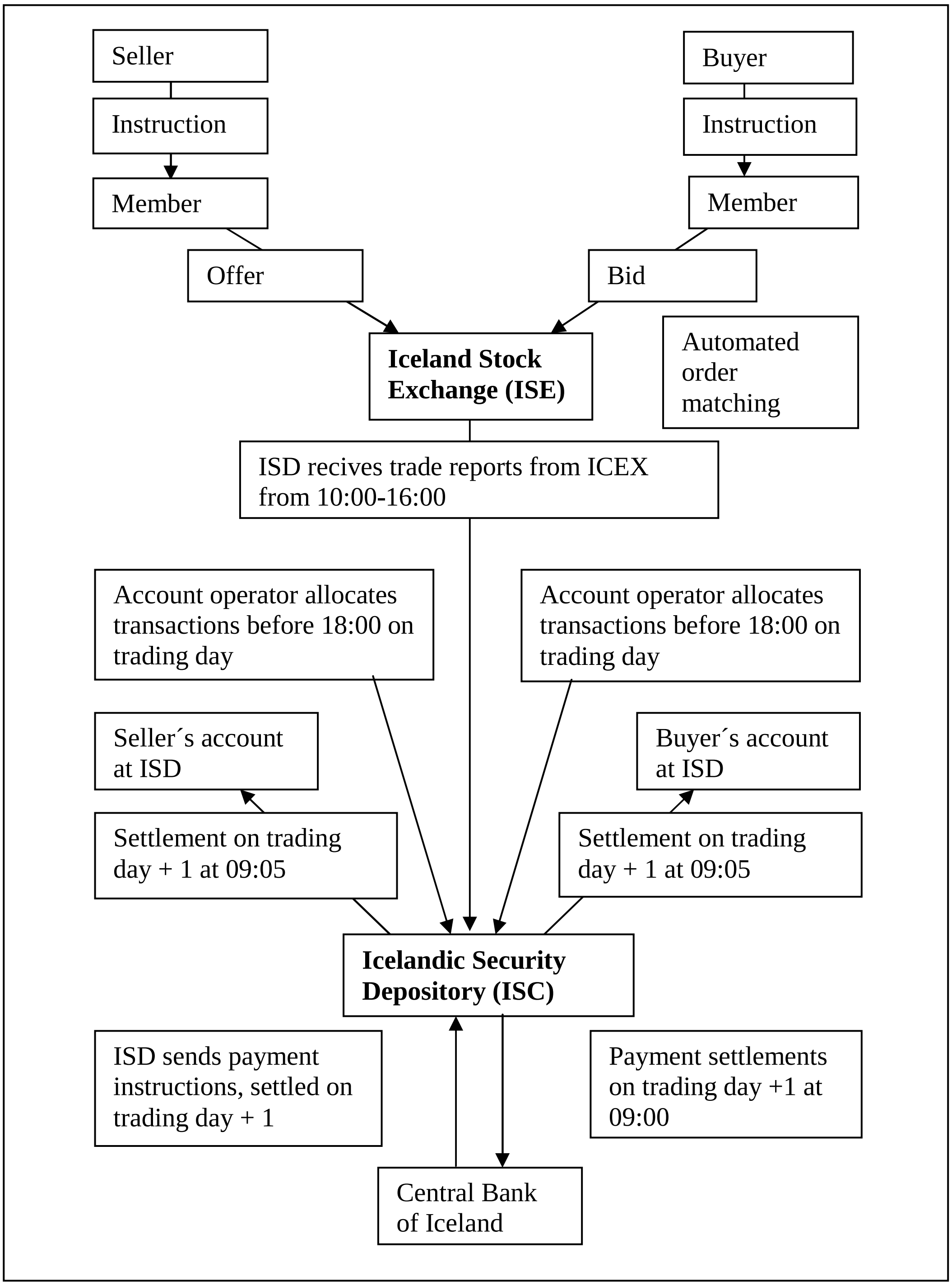

Fig. 3: Transaction process in the Iceland Stock Exchange

3.2 Market Value and Price Changes

The market value of stocks and volume of trading provide a good illustration of the activities of a stock exchange and their development over a longer period of time, as well as the ratio of market value and volume to gross domestic production, as shown in Figures

4 and Table 1.[17] Figure 4 shows the market value of stocks on the Iceland Stock Exchange and the volume of trading in listed stocks.

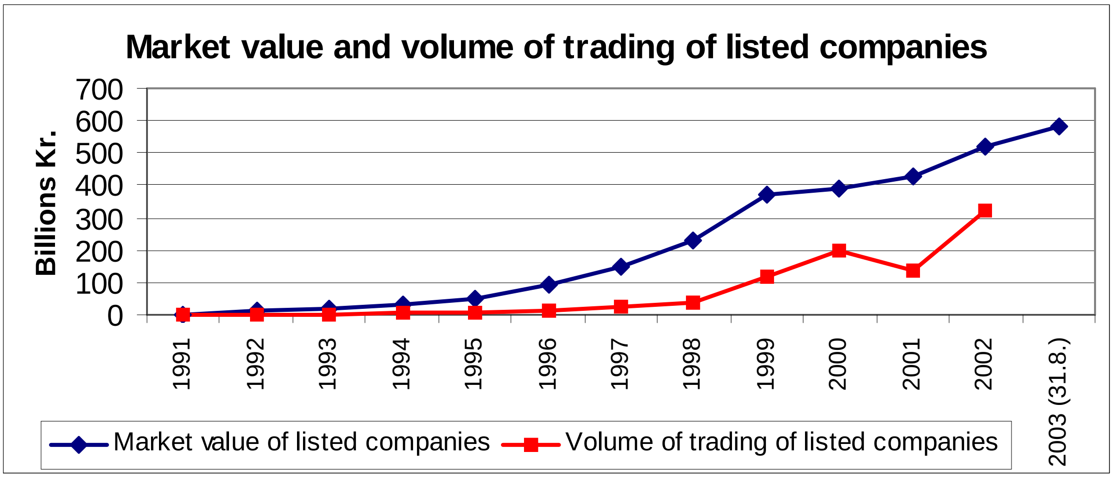

Fig. 4: Market value of stocks on the ICEX and volume of trading in stocks in listed companies inside and outside the Stock Exchange 1991-2002

The market value of stocks in listed companies has grown exponentially over the past 12 years, from ISK 2 billion in 1991 to ISK 580 billion in 2002. The volume of trading has also increased, from zero at the start to ISK 320 billion in 2002. All trading is included here, both trading within the Stock Exchange and trading between members of the Exchange outside the Exchange. Table 1 shows the market value of shares in the Stock Exchange and the volume of trading in stocks as a proportion of Gross Domestic Product (GDP) over the past 12 years.

[17] *Annual Reports 1998* (1999) and *2002* (2003).

Year	Market value of companies listed on the ICEX as a proportion of GDP	Volume of trading of companies listed on the IC as a proportion of GDP
1991	0.4	0.0
1992	3.3	0.2
1993	4.4	0.7
1994	7.2	0.9
1995	10.9	1.5
1996	19.4	2.2
1997	29.2	4.4
1998	40.6	7.0
1999	59.2	19.2
2000	58.8	29.8
2001	55.2	17.8
2002	66.2	40.7

Table 1: Market value of stocks on the ICEX and volume of trading in stocks in listed companies inside and outside the Stock Exchange as a proportion of Gross Domestic Product 1991-2002

In 1991, the market value of listed stocks corresponded to 0.4% of GDP, but by 2002 this ratio had reached 66.2%. In the last 4 years the ratio has been about 60%. The trading volume as a ratio of GDP rose to 40% in the course of a few years and doubled in 2002. Economic conditions in Iceland in the past 12 years have in many ways been favourable. Figure 5 shows the annual economic growth and inflation from 1991 to 2002.[18]

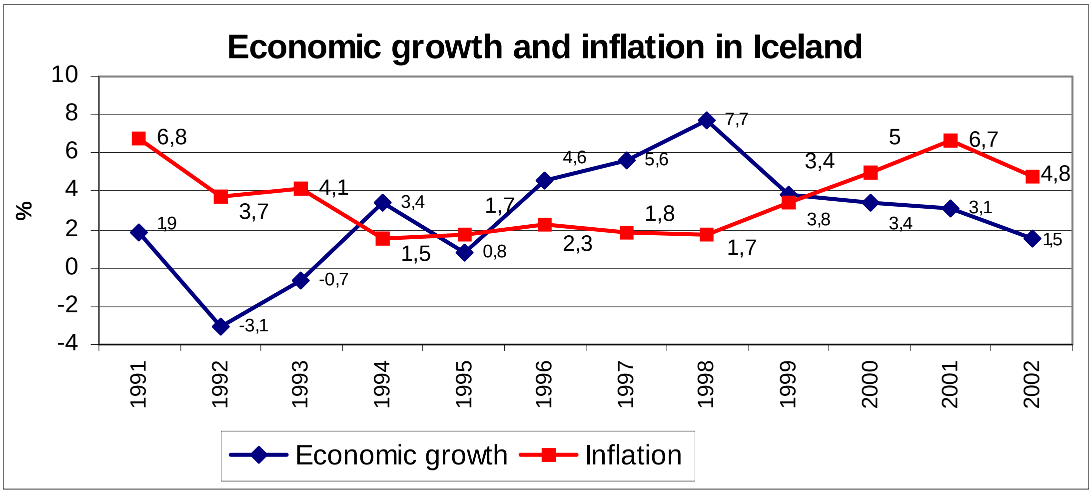

Fig 5: Yearly economic growth and inflation in Iceland 1991-2002

[18] *Peningamál 2003* (1999) and *2002* (2003).The Central Bank of Iceland. Reykjavík. and *Annual Report 2002* (2003).

Figure 5 shows that economic growth has fluctuated substantially, i.e. from a 3.1% recession in 1992 to a 7.7% growth in 1998. The annual economic growth in these twelve years was 2.6%. Annual inflation has also fluctuated substantially, reaching a low of 1.5% in 1994 and a high of 6.7% in 2001. Inflation used to be one of the principal problems faced by the Icelandic government, but since 1990 considerable success has been achieved in maintaining inflation at similar levels as in most neighbouring countries.

Stock prices have fluctuated extensively in the Stock Exchange in the course of these years. Figure 6 shows the fluctuations in the ICEX Main List Index and the ICEX-Fisheries Index over a 10 year period from 1993 to August 2003.[19]

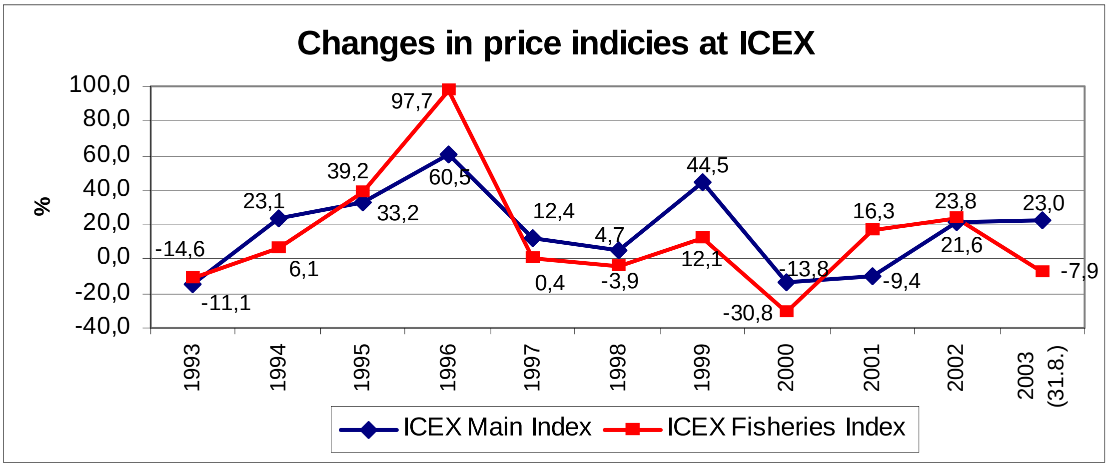

Fig. 6: Changes in the ICEX Main Index and ICEX Fisheries Index in the Stock Exchange in 1993-2002

In 1996, the ICEX Fisheries Index rose by 98%, but in 2000 the index fell by 31%. Slightly smaller fluctuations occurred in the ICEX Main list, which rose most steeply in 1996, by 61%, and recorded its greatest drop in 2000, when it fell by 14%. The average annual change in the ICEX Main Index was 13.8%, while the annual average change in the ICEX Fisheries Index in the same 10 years was 10.8%.

Table 2 shows a comparison of several stock exchanges in Iceland and elsewhere at year-end 2002.[20]

[19] *Fact book* (2003) and ICEX Indices. Iceland Stock Exchange. Located at www.icex.is
[20] Main Economic Indicators July 2003. OECD. Located at www.oecd.org and Market Statistics December 2002. Federation of European Securities Exchanges (FESE). Located at www.icex.is

Country of stock exchange	Market value of listed stocks as a percentage of GDP	Volume of stock trading as a percentage of GDP	Percentage of total volume of trading outside the stock exchange
Switzerland	205	16	22
Luxembourg	100	2	0
Britain	97	261	75
Finland	90	138	26
Iceland	**66**	**41**	**79**
Sweden	63	119	22
Spain	60	102	36
Ireland	43	28	91
Denmark	38	30	41
Norway	30	30	36
Germany	29	62	32
Austria	14	3	0

Table 2: Market value of listed stocks at year-end 2002 and the volume of stock trading in 2002 as a percentage of GDP and the ratio of trading outside stock exchanges in several countries in 2002

Table 2 reveals a number of interesting facts. The second column of the table shows the market value of listed stocks as a percentage of GDP, which is 66% for Iceland. Iceland is near the middle of the group of states, which is interesting in light of the short time that a regulated stock market has been in existence in Iceland. Some of the countries in Table 2 offer substantial international financial services, which in part have litle relation to the countries themselves. The United Kingdom (London), Luxembourg and Switzerland, which occupy the top three places, are examples of such international stock exchanges, and the assets listed in these stock exchanges are substantial as a ratio of the gross domestic production of these countries.

The third column of Table 2 shows the volume of listed stocks as a percentage of GDP. The volume of trading in the Icelandic stock market is large in comparison with many other countries. The ratio in Iceland is 41%. The volume of stock trading in Luxembourg and Austria are comparatively small. The table includes all stock trading, inside and outside the stock exchanges of the countries in question. The volume is greatest in the United Kingdom where it is almost three times GDP. It is interesting that Finland enjoys the strongest position of the Nordic countries with the greatest proportional value of listed stocks and the greatest volume of trading. The strong position of Finnish companies within the sector of information technology may be an explanation for this. Norway does not have a great value of listed companies, or a large volume of trading, and in fact Iceland is above Norway in this comparison. In spite of the substantial growth in stock trading in Iceland in recent years, which is partly based on foreign investments, Iceland still has a long way to go before foreign investment in Iceland reaches the same level as in other Nordic countries.[21]

Column 4 in Table 2 shows the ratio of total trading outside stock exchanges. This shows that in Iceland 79% of all trading involves stocks in listed companies outside the Stock Exchange. This trading is, of course, registered at the Icelandic Securities Depository, like other trading. Here, Iceland sets itself somewhat apart. Only Ireland has a higher proportion of trading outside stock exchanges. In Ireland, by far the most of the trading in listed shares takes place off the stock exchange, or 91%. Much of the trading in London is also off the stock exchange. Most commonly, about a third of the total trading takes place off the stock exchange. In the vast majority of cases, the price in the stock exchange is used in trading off the stock exchange, but of course it can be unfortunate in the long term if a large part of the total trading takes place off the stock exchange, as the trading on the exchange gives a good picture of the supply and demand. It is also important for the revenues of stock exchanges that most of the trading should take place there. Undeniably, however, the growth in Iceland has been extremely rapid and the Icelandic stock market has adapted itself quickly to the form and scope of activities which are most common in the neighbouring countries. All the countries in Table 2 have extensive experience of regulated stock trading, and most of them have decades of experience in the field.

It is interesting to compare the development of the Icelandic stock market with other relatively recent markets. Hungary was the first of the Eastern European countries to set up a traditional stock market along Western lines following the changes after the fall of the Berlin Wall in 1989.[22] A comparison of the first seven years of operation of the markets in Iceland and Hungary shows that the market value of listed company as a proportion of GDP was about twice as high in Iceland. The tempo of the privatization could be an explanation for this.

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[21] Gylfason T. (2003). Ferskir vindar. *Vísbending*, 21(18).

[22] Mitura-Zalewska A. and Hall S.G. (2000). Do Market Participants Learn? The Case of the Budapest Stock Exchange. *Economics and Planning*, 3 3(1-2).

4. Various Issues Relating to the Icelandic Stock Market

The supervision and governance of companies depends, among other things, on the concentration of their ownership. In many places, there are a few large shareholders with mutual ownership ties in numerous companies in the stock market. Ownership ties of this kind have a substantial impact on the governance of companies and they also has an impact on the stock market, e.g. as shown by research into the Spanish stock market.[23] Concentration of this kind is also common in companies in the Icelandic stock market and elsewhere. Even though the Icelandic stock market has grown comparatively large in comparison with other countries, as outlined above, there are relatively few companies in the market, i.e. 54 at the end of August 2003.

In many important sectors of the Icelandic economy, only a very few companies are operating. Thus, only three Icelandic companies are responsible for virtually all oil and gasoline sales, three companies are responsible for virtually all insurance, two companies are responsible for most of the shipping to and from Iceland and two companies are responsible for virtually all scheduled passenger flights to and from Iceland. The reason that there are so few companies in a market with such significant purchasing power[24] is that the market is small, with only 280,000 people and it is distant from other markets.[25] In the year 2003, the last oil company was delisted from the Stock Exchange, and the largest retail company, which was also the 3d largest company in Iceland in the year 2001,[26] was also removed from the stock exchange as the ownership had become so concentrated that it no longer qualified for listing on the Main Index of the Stock Exchange.[27]

[23] Leech D. and Manjón M.C. (2002). Corporate Governance in Spain (with an Application of the Power Indices Approach). *European Journal of Law and Economics*, 13(2).
[24] In 2001, Iceland's GDP in PPP in US $ per head was 30,400, which placed the country in 6th place in the world (*OECD in Figures* (2002). OECD. Paris)
[25] The average distance from Iceland to five other countries, Britain, France, Denmark, Germany and Italy, is 2,400 km. In comparison, the average distance between these countries, including Iceland, is 1,200 km measured from the capitals, Reykjavik, London, Paris, Copenhagen, Berlin and Rome.
[26] *300 biggest companies in Iceland* (2002). Frjáls verslun, 64(8).
[27] The competition authorities are currently in the process of investigating the activities of the three oil companies owing to suspicion of price fixing. A comparable investigation has been ongoing for six years with regard to the three insurance companies. Such investigations, although necessary, result in uncertainty in trading and can have a negative impact on the stock market if they are not brought to a conclusion in a relatively short time. It is interesting in this context that there is now a dispute in progress between the Competition Authority and the Financial Offences Department of the National Commissioner of the Icelandic Police concerning the proper conduct of investigations of this kind, which indicates a need for review of the current competition legislation.

Reforms in corporate governance in Finland in the years 1980 to 2000 have resulted in greater protection for shareholders and weaker protection for creditors.[28] It is an interesting viewpoint that insider trading regulation may involve more costs than benefits and that the resources now used for insider trading regulation might be put to better use elsewhere.[29]

Fisheries are very important for the Icelandic economy. The contribution of fisheries to domestic production was 12.5% in 2001,[30] and, in addition, fisheries account for 40% of foreign currency income as mentioned earlier. At the outset of stock trading in Iceland, trading in fisheries stocks was quite prominent. However, the share of fisheries in stock trading has fallen in recent years, as shown in Figure 7.

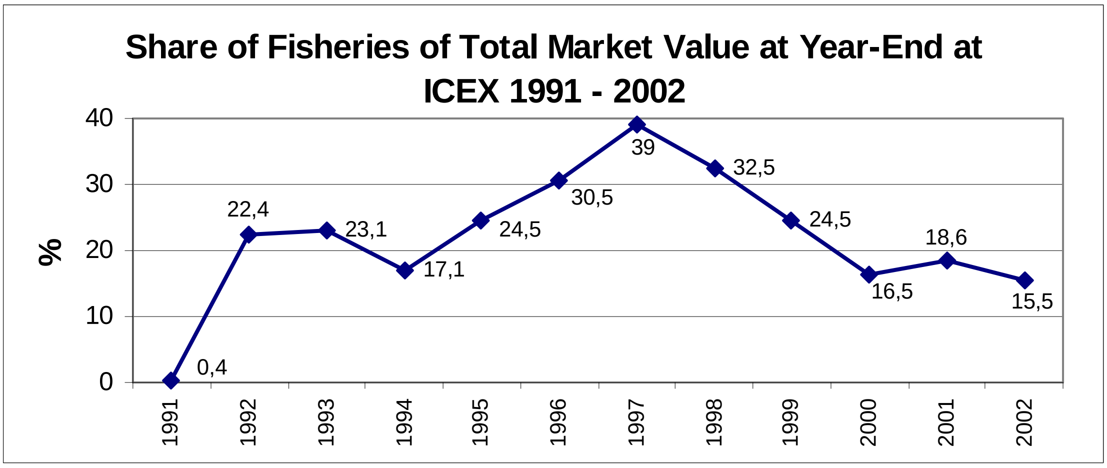

Fig.7: Share of Fisheries in Total Market Value at Year-End for 1991 to 2002.

The share of fisheries was 39% in 1997 but is currently 15.5% at the end of August 2003. But even though the weight of fisheries has fallen, the Icelandic stock market is prominent in this market in comparison with other countries. For this reason there has been discussion that the Iceland Stock Exchange should market itself internationally as a Fisheries Stock Exchange.[31] In February of 2003, 17 fisheries companies were listed in the Iceland Stock Exchange, as compared to 12 companies in the company coming closest in this respect, Japan. About 85 fisheries companies

[28] Hyytinen A., Kuosa I. and Takola T. (2003). Law or Finance: Evidence from Finland. *European Journal of Law and Economics*, 16(1).
[29] Marinor B.Z. (1998). Book Review. Essays in Law and Economics III. Financial Markets and Insurance. *European Journal of Law and Economics*, 6(2).
[30] *Statistical Yearbook of Iceland* (2002), p. 188.
[31] Einarsson A. and Egilsson V. (2002-2003). Bill to change the Act on Activities of Stock Exchanges and Regulated OTC Markets No. 34/1998. Althingi. 128th legislation period. Document 589/435.

are estimated to be listed on stock exchanges in the world, which means that 20% of them are listed in Iceland.[32] The market value of listed fisheries companies is highest in Japan, but Iceland comes second. The Iceland Stock Exchange is exploring the interest among foreign fisheries companies in listing themselves in the Iceland Stock Exchange, and there are indications that this may be a promising business opportunity.[33]

Iceland has every possibility of becoming an important fisheries trade centre, as there is extensive expert knowledge of fisheries in Iceland, which includes stock trading in this sector.[34] Thus, the analysis of annual accounts and future prospects of fisheries undertakings is a significant aspect of the work of Icelandic financial enterprises. There are numerous examples of companies obtaining a listing in stock exchanges which are centres of trading in their field of expertise. Thus, most large metal companies are listed in the stock exchange in London, and many international shipping companies are listed in the Norwegian Stock Exchange even though they may be based elsewhere. Icelanders are eleventh in the world when it comes to fisheries, and fisheries are the only sector where Icelanders have a strong economic position internationally.[35] It must be noted in this context, however, that foreign investors are banned from investing in companies operating in fisheries except to an insignificant extent. If Iceland becomes a member state of the European Union, it is most likely that it would not be permitted to maintain the ban, and in fact the ban is already an issue of dispute in the country. Even though the weight of fisheries companies has been reduced in the Iceland Stock Exchange, there have been profound changes in the Icelandic fisheries sector in recent years which have significantly strengthened the sector.[36]

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[32] Friðjonsson T. (2003). Alþjóðlegur sjávarútvegsmarkaður á Íslandi? *Vísbending*, 21(21).
[33] Friðjonsson T. (2003), p. 4.
[34] Einarsson A. and Egilsson V. (2002-2003), p. 1.
[35] The Iceland Stock Exchange is quite capable of taking the initiative in this matter. The Icelandic financial market is characterised by well educated people, many of whom have earned a good reputation outside Iceland. Many countries have concentrated their efforts on financial activities which bring substantial creation of value. A good example is Luxembourg. Icelanders have the capacity to become much more prominent in this area. The indirect impact of an initiative of this kind could be significant, and foreign enterprises would gain better knowledge of the Icelandic economy, which could promote greater foreign investment in various sectors in Iceland. Icelanders have a very good reputation in fisheries across the world and operate numerous fisheries companies outside Iceland. For this reason, many foreign fisheries companies might perceive an advantage in listing their companies in the Iceland Stock Exchange with its expertise and active market.
[36] Einarsson A. (2003). *Íslenskur sjávarútvegur – Breytingar síðustu áratugi og afkomumælingar*. Rannsóknir í félagsvísindum IV. Háskólaútgáfan. Reykjavík.

As mentioned earlier, the Iceland Stock Exchange joined NOREX, an alliance of the stock exchanges in Copenhagen, Oslo, Stockholm and Iceland, in 2001. The participation involves the use of the same trading system, and the rules of membership and trading are the same for all the stock exchanges. The alliance engages in joint marketing efforts outside the Nordic countries and works on education and technological and market development. The membership of the Iceland Stock Exchange of NOREX was an important step in the direction of enhancing the credibility of stock trading and the co-ordination of work procedures has also led to a reduction of transaction costs. The flow of information through NOREX is strong, as it is extremely important for traders to have good access to information. Limited information has a particularly inhibiting effect on the function of stock markets in their development phase.[37] Trading in the stock market is often a matter of finding the investment opportunities which yield sufficient returns to survive the transactions costs.[38]

The change in the situation of the Iceland Stock Exchange at this point in time is illustrated by comparing the fifteen largest companies (in terms of turnover) in recent years, i.e. at year-end, and observing whether they are listed in the Stock Exchange or not.[39] Table 3 shows this position.

[37] Flôres R.G. and Szafarz A. (1997). Testing the Information Structure of Eastern European Markets: The Warsaw Stock Exchange. *Economics of Planning*, 30(2-3).
[38] Jones S.L. (1999). Delayed Reaction in Stock with the Characteristics of Past Winners: Implication for Momentum, Value, and Institutional Following. *Quarterly Journal of Business and Economics*, 38(3).
[39] *300 biggest companies in Iceland* (2001), (2002), (2003). *Frjáls verslun*, 63(8), 64(8), 65(8).

		2003	2002	2001		2000	
Company	**Sector**	Listed	Listed	Rank	Listed	Rank	Listed
SIF	Fisheries	Yes	Yes	1	Yes	1	Yes
SH	Fisheries	Yes	Yes	2	Yes	2	Yes
Baugur	Services/commerce	No	Yes	3	Yes	5	Yes
Icelandair	Transport	Yes	Yes	4	Yes	3	Yes
Islandsbanki	Finance	Yes	Yes	5	Yes	4	Yes
Landsbankinn	Finance	Yes	Yes	6	Yes	6	Yes
Alcan	Manufacturing	No	No	7	No	7	No
Bunadarbankinn	Finance	Yes	Yes	8	Yes	13	Yes
Atlanta Air	Transport	No	No	9	No	11	No
Eimskip	Transport	Yes	Yes	10	Yes	8	Yes
Landsiminn	IT	No	No	11	No	9	No
Skeljungur	Oil distribution	No	Yes	12	Yes	12	Yes
Oliufelagid	Oil distribution	No	Yes	13	Yes	10	Yes
Pharmaco	Pharmaceuticals	Yes	Yes	14	Yes		Yes
Samskip	Transport	No	No	15	No		No
Kaupas	Services/commerce	No	No		No	14	No
Olis	Oil distribution	No	Yes		Yes	15	Yes

Table 3: The largest Icelandic companies of the years 2000 to 2003 and their position in the Stock Exchange

As Table 3 shows, 12 of 17 companies were listed on the Stock Exchange at year-end 2000, 2001 and 2002. By the end of August 2003, only 8 were left. There is not much change between years as regards the order of the companies.

The great growth in regulated stock trading, both inside and outside the Stock Exchange, indicates that transaction costs have fallen substantially as a result of this form of trading. Also, the supply of information has increased greatly, with the result that uncertainty has been reduced, as has the cost relating to the uncertainty. Since Icelandic legislation has gradually been adapted to trading practices which had already developed, it is clear that formal rules have replaced informal rules. It is extremely important in connection with the introduction of new business practices and new institutions to ensure that formal rules are consistent with the informal rules which may have been in effect for a long time.[40] There may be reason now to assess specifically whether the relatively concentrated ownership of many companies in Iceland will make further development of the market difficult. This could be offset by

[40] Eggertsson, T. (1996). A note on the economics of institutions. In Alston, L.J., Eggertsson, T. & North, D.C. (Eds.). *Empirical Studies in Institutional Change*. Cambridge University Press. Cambridge.

increased foreign participation in the Icelandic stock market, which could increase the volume of trading substantially, and it is worth noting that foreign investors have been prominent in the Icelandic state-guaranteed bond market recently.

5. Conclusion

A regulated stock market has only been in operation in Iceland for slightly more than 12 years. The Central Bank of Iceland took the initiative in trading of this kind and the first stocks were listed in 1990. The first comprehensive legislation on stock trading was enacted in 1993. The legislation of the ensuing years was modelled on trends in the other Nordic countries and Community legislation, and Iceland's membership of the European Economic Area resulted in profound changes in Icelandic financial activities. Legislation and practices in the European stock exchanges are similar from country to country. There was no political disagreement on legislation concerning stock trading in the development phase in Iceland. The current legislation on stock exchanges date from 1998, and there has been little amendment since.

Public supervision of the financial market was transferred from the Central Bank of Iceland in 1999 with the establishment of an independent official body, the Financial Supervisory Agency, which took over the supervisory tasks the Central Bank and the Insurance Inspectorate. This development was in line with trends in the other Nordic countries, in Britain, Canada, USA and elsewhere.

Icelandic legislation on financial activities rests on five pillars, i.e. the Act on the Activities of Stock Exchanges and Regulated OTC markets, the Act on Securities Transactions, the Act on Undertakings for Collective Investment in Transferable Securities and Investment Funds, the Act on Official Supervision of Financial Operations and Investment Funds, and the Act on Financial Undertakings.

The scope of activities of the Iceland Stock Exchange has grown extremely rapidly over the past twelve years. The number of companies in the market has grown substantially, the market value of listed companies and volume of trading has multiplied. Trading in the Stock Exchange is all electronic, and the growth in stock trading has grown significantly as a ratio of GDP. Stock prices have fluctuated tremendously in recent years, but there have also been considerable fluctuations in economic growth and inflation. The Iceland Stock Exchange has achieved a similar position as much older exchanges outside Iceland, but much of the stock trading is still conducted outside the stock market.

The Icelandic stock market is characterized by relatively few companies competing in important sectors, and investigations are in progress concerning suspicions of price fixing among many large companies.

Fisheries are an important factor in the Icelandic economy, and trading in fisheries stocks is relatively prominent. Work is in progress on the idea of developing the Iceland Stock Exchange into an international exchange in the world fisheries.

The amount of information available in the market has grown significantly, especially as a result of Iceland's participation in the NOREX alliance of Nordic stock exchanges. There has been some reduction in the number of listed companies in recent years.

Trends in the Icelandic stock market show that the concepts of the New Institutional Economics are extremely relevant, as transaction costs have fallen, information has increased and become more generally available, and formal rules have replaced informal rules. Increased participation by foreign investors in the Icelandic stock market is a feasible way of strengthening the market still further. This is in line with the fact that most of the trading in the Iceland Stock Exchange involves stocks in companies operating in the fields of finance and insurance.

At the outset of regulated stock trading in Iceland just over ten years ago there were few rules and the economy was extremely unstable. In the last decade of the last century, and the first years of the current century, the economy has been in an upswing at the same time as there has been extensive reform in legislation on stock trading. This upswing, together with the reformed legislation based on foreign models, is the principal reason for the success in the development of regulated equity trading in Iceland.

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