

Fixing Iran's Financial Markets: From Corruption to Transparency

By Siamak Javadi, PhD

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INTRODUCTION

Iran's financial market is plagued with structural issues, including insider trading, systemic corruption in the stock market, continuous government intervention and price controls, and outdated accounting standards that increase the prevalence of corruption.

Iran's financial market urgently requires structural and fundamental reforms. The fall of the Islamic Republic presents a significant opportunity to implement these necessary changes. However, this transition will also bring various risks and challenges that must be carefully addressed. All policies aimed at reviving the financial market should be grounded in established economic and banking research and aligned with global best practices to ensure the stability and predictability of Iran's economy. It is crucial to avoid any complex, untested policies, as the Iranian economy cannot withstand another major shock.

In the short run, the immediate risks following the collapse of the Islamic Republic include:

- **MARKET CRASH AND RISK OF DEPRESSION:** Academic research shows a strong negative relationship between political uncertainty and asset prices, as well as corporate investment, across both stock and bond markets. In the immediate aftermath of the Islamic Republic's collapse, there is a high risk of a sharp drop in asset values, bank runs, currency depreciation, a marked reduction in corporate capital investment, rising unemployment, and a panic-driven selloff by investors. This scenario constitutes a full-blown economic crisis, leading to economic contraction, reduced output, and the potential for the country to enter a deep recession or even a depression. We recommend that the transition government halt all trading for at least three months—and possibly extend this to six months if necessary—while communicating these measures transparently to the public and market participants. The reasons for this are threefold:
 - To prevent a panic-induced selloff immediately after the IR's collapse, which could drive prices significantly below their fundamental values and result in massive capital loss.
 - To stop CEOs, corporate insiders, and IRGC affiliates from selling their holdings and transferring proceeds abroad, thus reducing pressure on the Rial and mitigating corruption and capital flight.
 - To allow external auditors sufficient time to assess the financial health of listed companies and their balance sheets, thereby addressing systemic corruption and outdated accounting standards in Iran's financial market.
- **ATTRACT FOREIGN INVESTORS:** Iran's lack of foreign investment stems from economic mismanagement, corruption, ill-conceived financial policies, and a hostile foreign policy, resulting in sanctions, FATF blacklisting, and deepening economic isolation. For over two decades, Iran has recorded the lowest net inflow-to-GDP ratio in the region, highlighting an urgent need for foreign capital. A key short-term objective for the transition government should be to signal credible investment opportunities by reopening the Tehran Stock Exchange (TSE). To foster confidence, trading should resume only after a thorough balance-sheet examination of listed companies, when risks of capital flight and economic uncertainty are brought under control immediately following the fall of the Islamic Republic, and in collaboration with experienced global exchange operators such as ICE (NYSE), Nasdaq, or LSEG (LSE).
- **CAPITAL FLIGHT:** Given the inevitable increase in uncertainty and risk immediately following the collapse of the Islamic Republic, there is a serious short-term risk of substantial capital outflow. Former officials of the Islamic Republic, along with other wealthy investors, households, and CEOs—primarily affiliated with the IRGC—may attempt to transfer their assets abroad. This could cause the Rial to depreciate rapidly, triggering a vicious cycle of currency depreciation and rising inflation, potentially culminating in a severe recession. Consequently, the transition government must impose and enforce restrictions on bank withdrawals; foreign currency transactions by individuals and firms; transactions within bank networks, including their foreign branches; and any (fire)

sales of company assets or ownership. Halting all trades in the stock market will also mitigate this risk, but will also temporarily detract from foreign investors as mentioned above.

- **ELEVATED CORRUPTION:** Following the collapse of the regime, corruption poses a significant short-term threat, closely tied to market crashes and capital flight. Iran's financial market already suffers from systemic corruption, and this risk could escalate if CEOs, insiders, and IRGC affiliates rapidly liquidate assets for private gain. The root of this problem lies in managerial agency issues and conflicts of interest between management and external stakeholders, such as shareholders and creditors. Unlike developed economies with robust mechanisms to prevent such self-dealing, Iran lacks these protections. As uncertainty rises following the regime's collapse, CEOs and insiders have a greater incentive to liquidate assets and transfer proceeds abroad, increasing the risk of capital flight, market crashes, and further destabilization of the financial market. Halting all trades in the stock market, banning the sale of companies' assets, and restricting capital movement as described above can mitigate this risk.
- Other recommended short-term measures include talks with the FATF to remove Iran from its blacklist, discontinuing mandatory adherence to Islamic Finance, and hiring external auditors to examine the balance sheets of all publicly traded companies while the market remains shut down and trading is temporarily halted.

In the long term, following the collapse of the Islamic Republic, the primary risk lies in mismanaging financial liberalization, which could undermine the country's economic growth and trigger a severe financial crisis. This risk arises from a weak credit culture, institutional deficiencies, and inadequate monitoring and oversight within Iran's banking sector, potentially leading to excessive risk-taking and cycles of lending booms and busts. To mitigate these risks, we recommend strengthening the banking system's credit culture, implementing robust credit checks, securing collateral for large or risky loans, adopting and adhering to the Basel framework, actively supervising banks, ensuring properly priced deposit insurance, introducing a free-floating exchange rate system, and modernizing accounting standards for transparent financial reporting.

Finally, we offer a framework and other long-term policies for reforming Iran's financial market in the post-Islamic Republic era. Our reform framework consists of:

- Updating Iran's outdated accounting standards and incorporating key provisions of the Sarbanes-Oxley (SOX) Act (2002).
- Strengthening Iran's legal system, emphasizing its critical role in fostering a robust financial sector.
- Implementing elements of Common Law legal framework to enhance investor protection, improve corporate governance, and stimulate economic development.

1. BACKGROUND

1.1. Pre-Islamic Revolution (1967-1978)

The Tehran Stock Exchange (TSE) commenced operations in 1967 as part of the government's efforts to modernize the Iranian economy during the 1960s. Initially, fewer than a dozen companies were listed, and during its early years, the TSE was overseen by the Central Bank of Iran. Market oversight, disclosure requirements, and investor protections were rudimentary compared to modern standards in developed capital markets, and no formal listing requirements existed for public companies.

Over the late 1960s and the mid-1970s, the TSE grew in size as more companies went public. By 1978, 105 companies were listed, with a total market capitalization of 240 billion rials—approximately \$3.4 billion (at an exchange rate of 1 USD = 70 Rials). Despite this expansion, the TSE still represented a small portion of the Iranian economy; according to World Bank data, the market capitalization of

these listed companies amounted to only 4.7% of Iran's GDP.¹ However, this positive growth trajectory was disrupted in the late 1970s by the political and social upheaval of the Islamic Revolution, leading to a sharp decline in both trading activity and stock prices as unrest grew and capital fled the country.

1.2. Post-Revolution

1.2.1 Iran-Iraq War Era (1979-1987)

The TSE experienced a prolonged period of stagnation and limited activity in the years immediately following the 1979 Islamic Revolution. The nationalization of many listed companies—including banks, insurance providers, and industrial manufacturing firms—along with the exodus of high net-worth individuals led to a sharp decline in market participation and activity. The TSE remained largely stagnant during the Iran-Iraq War (1980-1987) as the country diverted its resources to the war effort and faced economic sanctions.

1.2.2 Post-War Era

It was only in the late 1980s that the government initiated a series of economic reforms aimed at liberalizing and diversifying the economy beyond oil. These efforts included revitalizing the stock market to attract investment and privatizing state-owned enterprises. During the first eight years after the Iran-Iraq War—often referred to as the reconstruction period—Rafsanjani's administration introduced structural reforms such as price liberalization, exchange-rate unification, and industrial privatization. As a result, the TSE experienced a revival, marked by a broader range of market participants, an expansion of the market's scope—which previously had been dominated by a few major players—and an increase in the number of listed companies to about 250.

The presidency of Mohammad Khatami (1997–2005) marked a period of reform and relative economic openness for Iran, which significantly influenced the TSE. Khatami's administration pursued political and economic liberalization to foster a more inclusive and robust financial environment, focusing on enhancing market transparency, improving corporate governance, and safeguarding investor rights. In 2005, the Securities and Exchange Organization (SEO) was established as a regulatory body to oversee market activities and enforce regulations, representing a pivotal step towards a more structured and reliable market environment. Later, in 2012, new legislation was passed which paved the way for the creation of financial entities, such as investment funds and asset management firms, clearly delineating the roles and responsibilities of each institution under the SEO's oversight. The SEO remains responsible for drafting regulations that govern all institutions operating in Iran's financial markets.

1.2.3 Current State of Iran's Stock Market

The TSE has experienced tremendous growth since 2005, particularly over the past decade, as depicted in Figure 1. In the early 2010s, the TSE benefited from a combination of domestic economic reforms and global factors. High oil prices and economic policies encouraging private investment fueled a stock market boom. The nominal market capitalization of the TSE saw substantial increases, buoyed by the listing of new companies and the privatization of state-owned enterprises. By 2015, the TSE had grown to one of the largest exchanges in the Middle East in terms of both the number of listed companies and nominal market value.

¹https://data.worldbank.org/indicator/CM.MKTLCAPGD.ZS?end=1977&name_desc=false&start=1975&view=map



FIGURE 1: TSE historical performance since March 2015

However, when translated into dollar terms, this growth presents a more complex picture, largely due to the significant depreciation of the rial. This depreciation is the result of years of economic mismanagement, chronic fiscal deficits, ballooning money supply, lack of central bank independence, ineffective monetary policy, and the Islamic Republic’s malign foreign policy that has resulted in sanctions and Iran’s isolation from the global capital market.² As illustrated in Figure 2, although the nominal value of market capitalization in rials has surged, the dollar-equivalent market cap has been declining over the past four years, in tandem with the rial’s free fall. From its peak in August 2020—when the TSE’s market capitalization reached \$357 billion—it lost about 68% of its dollar value (approximately \$241 billion) by July 2024. At the time of this writing, the TSE’s dollar market capitalization stands at approximately \$115 billion, marking a five-year low. The gap between TSE’s market capitalization in rials versus dollars began widening substantially in March 2022, when the effects of President Raisi’s disastrous economic and foreign policies started to take hold. As a result, the TSE now ranks eighth among Middle Eastern stock exchanges by dollar valuation, marking a one-step drop from its 2023 ranking (see Figure 3).

² This issue is discussed extensively in the Banking chapter.

Rial vs. Dollar Market Capitalization of TSE

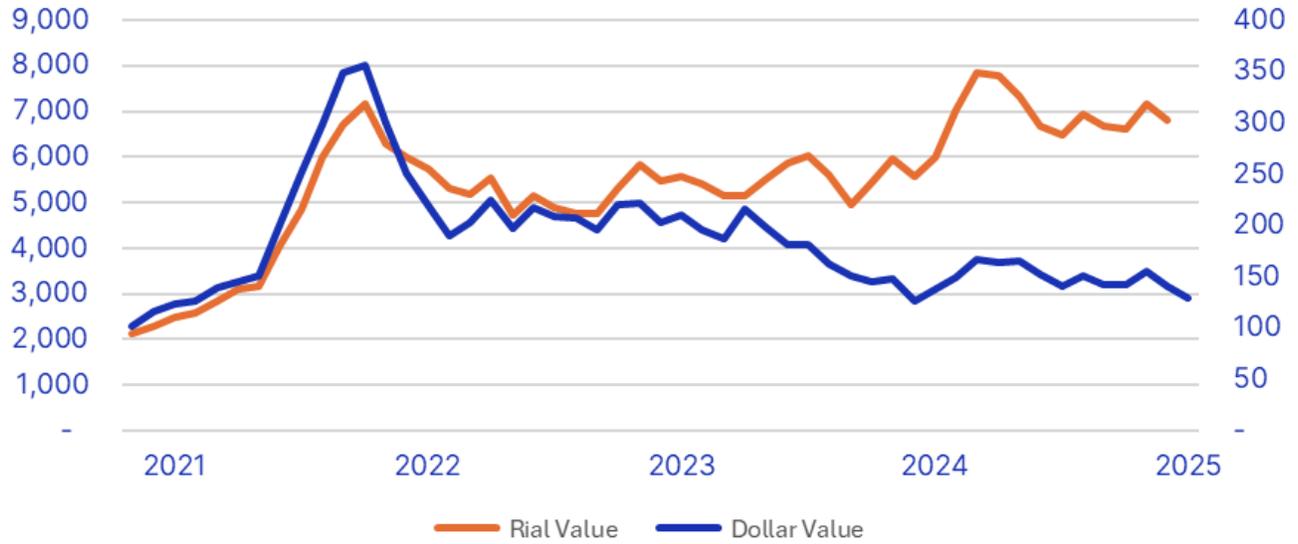


FIGURE 2: TSE Market cap in Rial vs. US Dollars

Dollar Valuation of Middle East Capital Markets

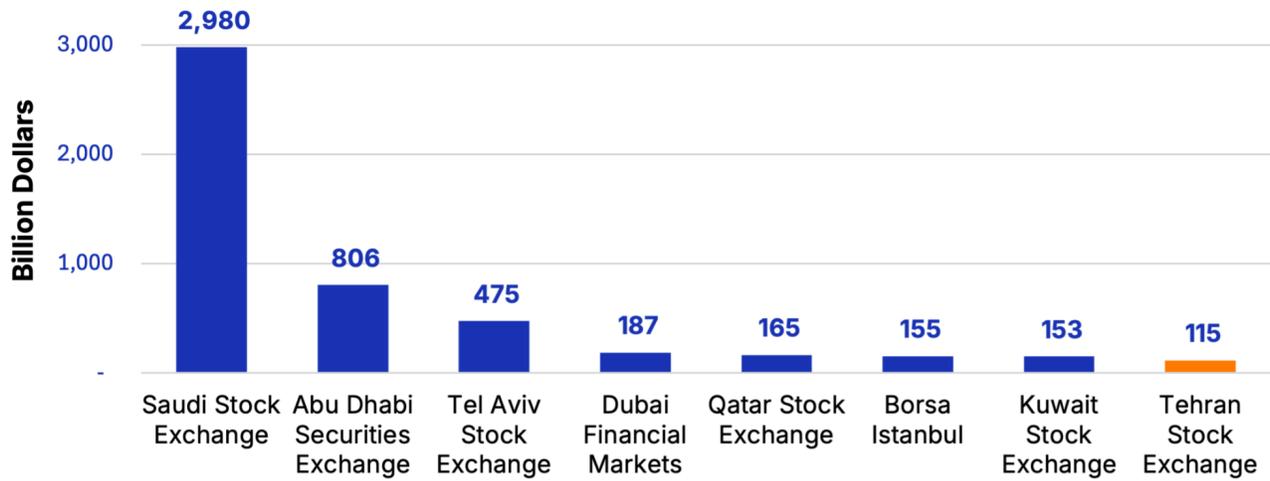


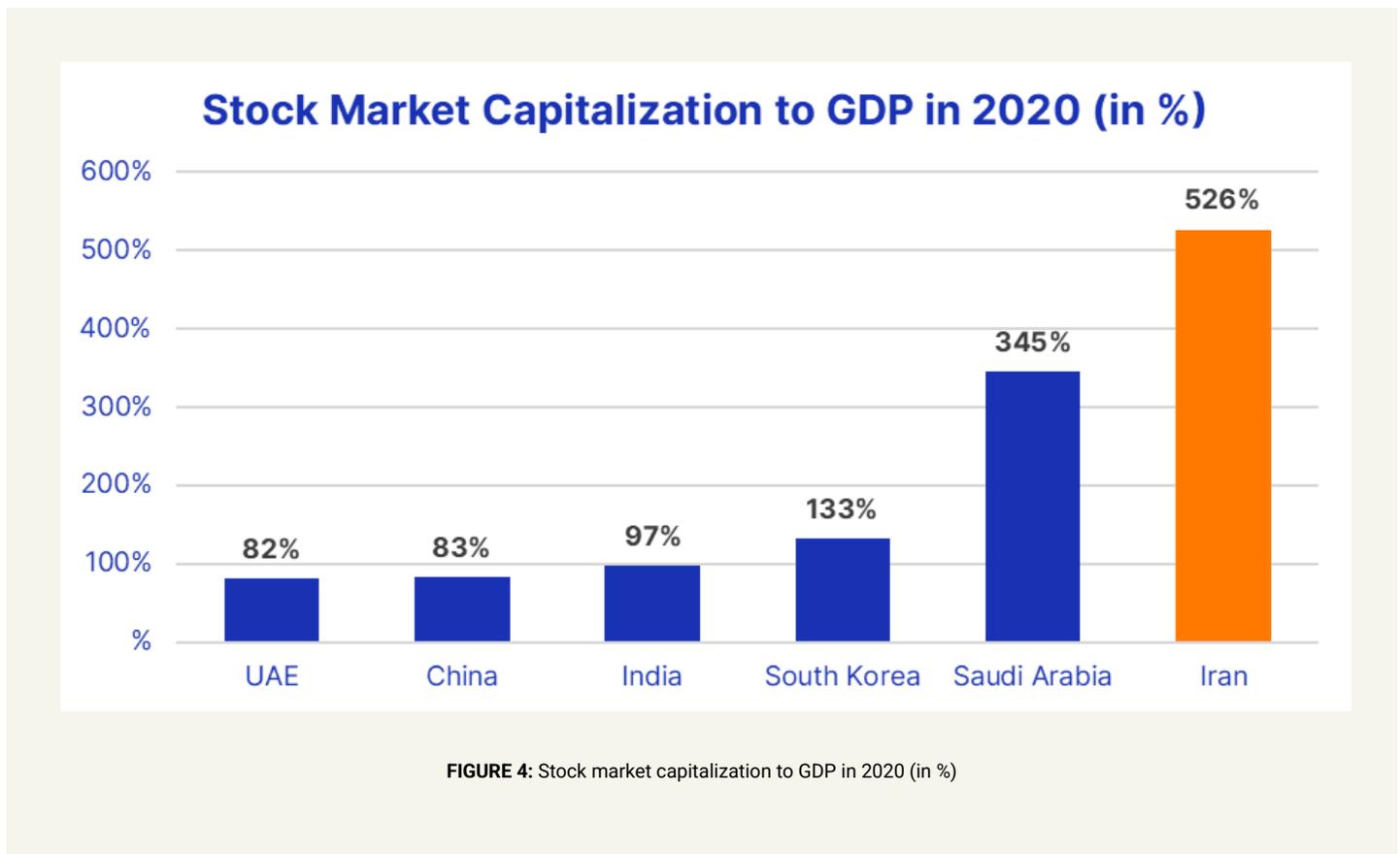
Figure 3: TSE Ranking in dollar value across the Middle East capital markets

Moreover, using the latest available World Bank data (2020), Figure 4 shows that Iran’s stock market capitalization-to-GDP ratio is about 526%, substantially larger than that of countries such as South Korea, China, and Saudi Arabia. As depicted in Figure 5, this ratio was historically stable averaging around 13% until 2018. However, given Iran’s well-documented economic stagnation, lack of investment, persistent inflation, and abysmal economic growth, the sharp spike in this ratio after 2018 strongly signals overvaluation or a bubble. This conclusion is consistent with the now-known “pump and dump” strategy employed by the Islamic Republic during the Rouhani Administration (discussed later in Section 2.2).

2. DIAGNOSTIC OF FUNDAMENTAL ISSUES

2.1. Asymmetric Information, Insider Trading, and Corruption

The foundation of the stock market is built on information. Access to accurate, timely information about a company's future performance and risk position are crucial metrics for investors. For this very reason, most advanced economies have enacted a multitude of laws to ensure that companies provide their financial information accurately, transparently, and promptly. These regulations ensure the proper and timely dissemination of information. In developed economies, manipulating financial reports or trading on private information constitutes a serious crime.



Stock Market Capitalization to GDP (in %)

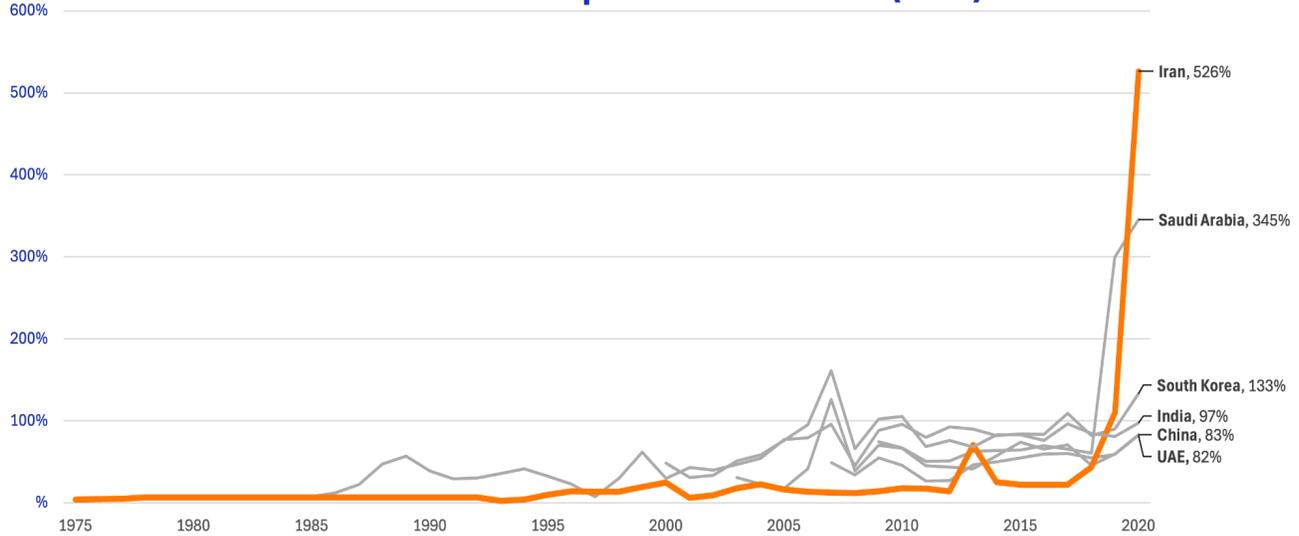


FIGURE 5: Historical variation in stock market capitalization to GDP

However, these laws alone are insufficient to prevent corruption and ensure equal access to information. An inherent information asymmetry exists between the public (outside investors) and firms' insiders. Managers invariably possess more accurate, timely insights into their firms' operations, giving them a decisive advantage. Consequently, if insiders (and the people in their network) buy or sell shares based on this inside information, they will undoubtedly profit, and the other party will inevitably lose. It is imperative to remember that stock market trading is a zero-sum game: the guaranteed profits earned by insiders who trade based on their private information must be equal to the loss to others on the other side of the transaction who do not have access to that private information.

To illustrate, consider a pharmaceutical company discovering that the FDA will not grant it the license to produce and release a new multiple sclerosis (MS) drug because it failed its clinical trials. Company managers are the first to learn of this development. As soon as this news reaches the market, this pharmaceutical company's share price will undoubtedly decline. However, if managers and other insiders—those who somehow learn about the trial failure before the rest of the public—sell their shares beforehand, they will practically succeed in selling the shares at a high price, to those unaware of the drug's failure and the imminent decline in the share's value. In this trade, the managers and others with informational advantages make a profit at the expense of unaware buyers. This example illustrates financial corruption.

Without effective laws and strict enforcement to deter such profiteering, the stock market would devolve into a platform of fraud, money laundering, theft, rent-seeking, and would essentially become a Ponzi scheme. For this reason, numerous laws exist in advanced economies requiring regulators to closely monitor all trades by managers and other influential individuals in the stock market. Despite strict laws to prevent the corruption mentioned above, insider trading and financial misconduct scandals occasionally surface even in developed economies. The pharmaceutical company scenario above is a real case involving an Australian firm; Chris Collins, a U.S.

Congressman from New York, was sentenced to 26 months in prison for selling shares in this company before the market learned about the MS drug's failure in clinical trials.³

Unfortunately, the TSE is rife with insider trading, and a lack of proper oversight and law enforcement by the SEO and the judiciary has substantially exacerbated this issue. This pervasive corruption is recognized and covered by the financial press inside Iran, where it is referred to as “institutional and systemic corruption” in the TSE. Although many of the TSE’s companies are nominally “privatized,” most remain under the control of the Islamic Revolutionary Guard Corps (IRGC) or are led by IRGC-affiliated CEOs, underscoring the prevalence of corruption and rent-seeking in the stock market. On August 20, 2022, Donya-e-Eqtasad—a leading financial daily—published an analytical article highlighting how the spread of structural corruption, legal loopholes, and individual-centric governance contribute to price manipulation in the TSE.⁴ More generally, various international institutions that measure global corruption have consistently ranked Iran one of the most corrupt economies in the world. According to the World Bank Corruption Index (Figure 6), corruption is far more pervasive in Iran than in most other countries in the region. Similarly, Transparency International’s Corruption Perception Index (CPI) has consistently placed Iran at 149th out of 180 countries and territories (Figure 7).

There is ample evidence documenting widespread corruption in Iran's stock market. Even in the United States—where laws are more stringent and enforcement is robust—financial misconduct and corruption still occurs. It is therefore logical to conclude that in a country like Iran, which lacks separation of powers and is rife with corruption, lawlessness, rent-seeking, and embezzlement, the stock market (controlled by the IRGC) suffers from entrenched corruption and insider trading. A recent example involves trading in Iran Khodro’s stock, Iran’s largest manufacturing company, in early May 2023. On May 29, 2023, news broke that Iran Khodro would halt production because the government would not provide the necessary U.S. dollars at the preferential exchange rate it had previously been offering. However, a letter confirming this decision was found dated May 7, showing that insiders had this information for more than three weeks before it became public. Iran Khodro’s share price reached an all-time high on May 6 and May 7, then steadily declined until May 29, losing about 26.5% of its value. Although the stock recovered some of its losses, it never again reached its May 6 and May 7 peak; as of May 2024, it remains about 45% lower than that high. This pattern clearly demonstrates that Iran Khodro insiders traded based on their knowledge of nonpublic information, offloading their overpriced shares while uninformed buyers suffered certain losses.

³ <https://www.justice.gov/usao-sdny/pr/former-congressman-christopher-collins-sentenced-insider-trading-scheme-and-lying>

⁴ <https://donya-e-eqtasad.com/بخش-بورس-6/3892176-بني-اعتمادی-بمبورس-نتیجه-گسترش-فساد/>

World Bank Corruption Index

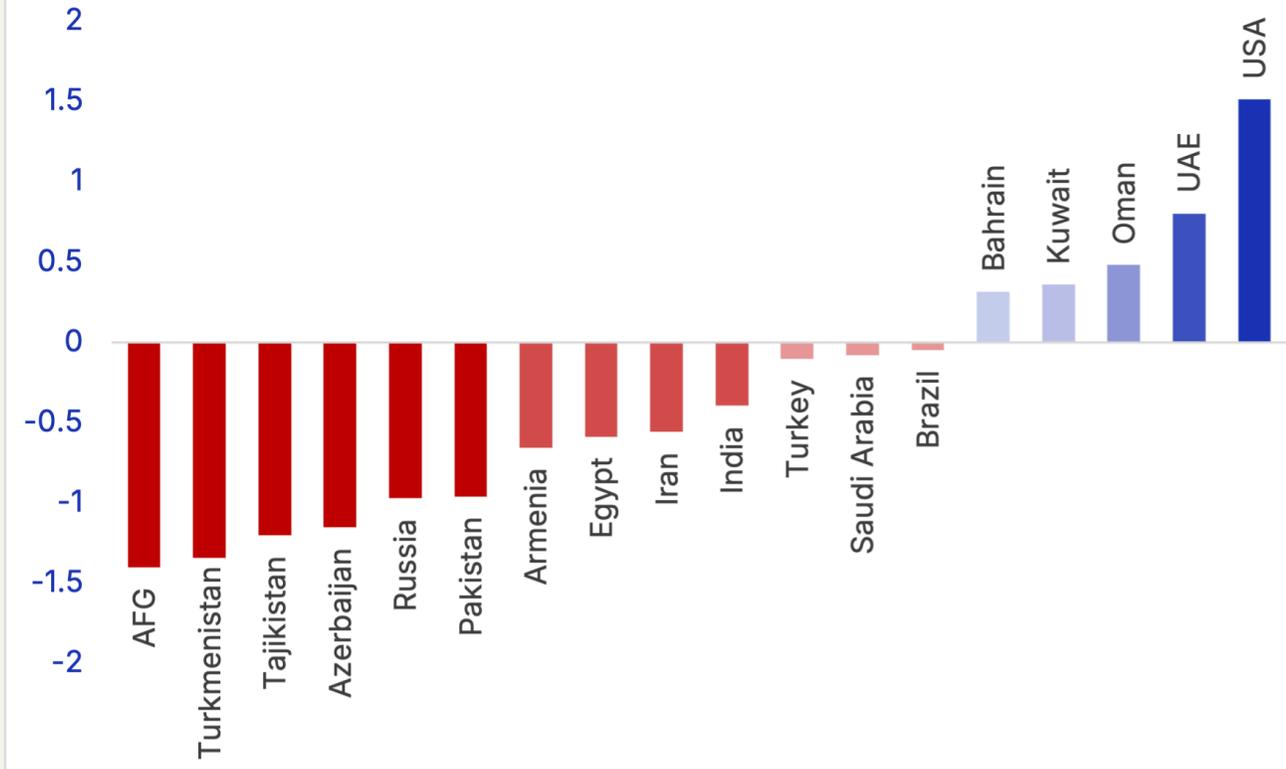


FIGURE 6: The World Bank Corruption Index

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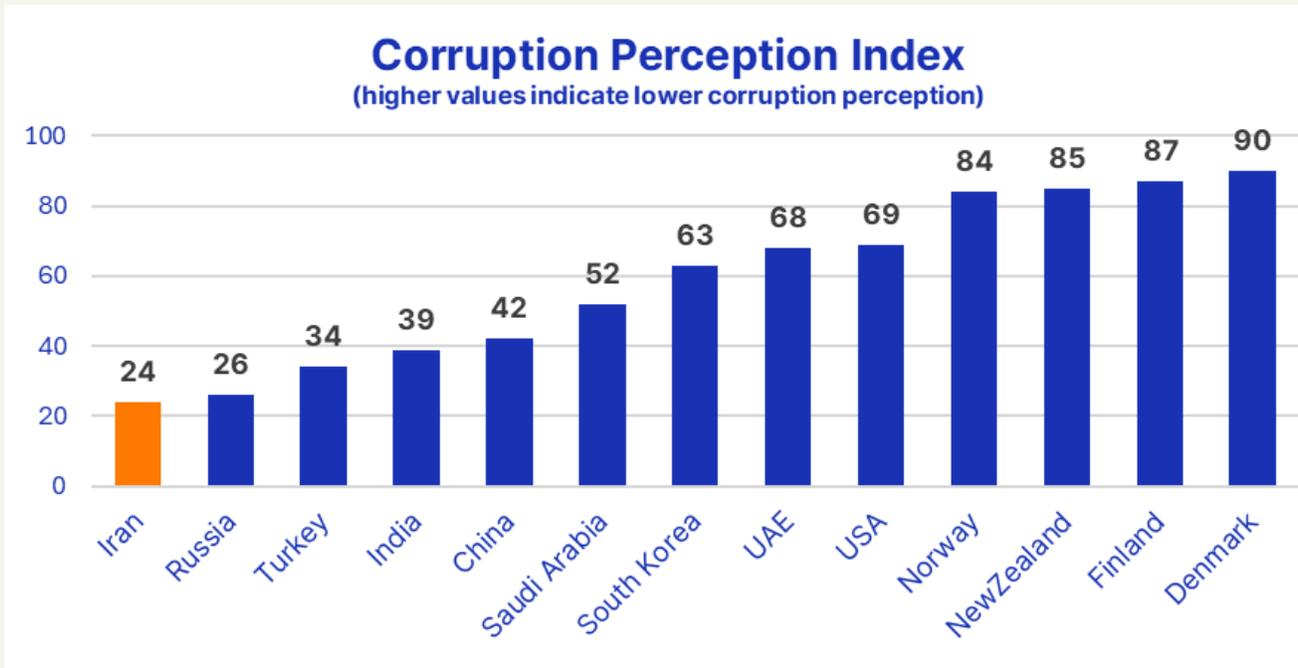


FIGURE 7: Corruption Perception Index by Transparency International

2.2. Government Price Control and Intervention

The Islamic Republic (IR) rose to power using anti-capitalist slogans and sentiments. In fact, Article 44 of the IR’s Constitution specifies that all major industries shall be owned by the government. Even after Article 44’s amendment in 2004, government and quasi-government entities still control roughly 60 to 80 percent of the Iranian economy. As a result, one of the hallmarks of the IR has been its continuous price controls and market interventions. Financial markets are no exception to this government intervention.

The SEO exercises comprehensive supervision over all national exchanges by imposing price ranges and fluctuation limits across all markets, including the TSE. In the TSE, government interventions affect the base volume and daily fluctuation range to prevent price manipulation due to low trading volumes. Typically, stock fluctuations are limited to a range of -5% to +5%, though the SEO recently expanded this range to -7% to +7% for stocks in the TSE’s first market. Similarly, in the Iran Mercantile Exchange (IME), the SEO has fixed the exchange rate to an official preferential rate called NIMA.⁵ Given the significant fluctuations in the exchange rate, those who purchase goods in the IME using this NIMA rate—or have privileged access to it—effectively receive a lucrative rent from the government and can gain undue advantage, creating market inefficiency and a high risk of corruption.

The adverse impact of the IR’s continuous price controls can be observed in all markets, ranging from the foreign exchange market to the energy market to the stock market. For instance, as discussed in the Banking chapter, maintaining several exchange rate systems is

⁵ NIMA is a currency exchange platform regulated by Iran’s central bank. It was established following the second round of oil embargoes imposed on Iran during President Trump’s administration in 2018. The NIMA exchange rate is fixed, requiring exporters to sell their foreign currency within this predetermined range to importers.

a key driver of corruption and rent-seeking. In fact, the IR regime has exploited its dominance and price-control abilities in the stock market to finance its own budget deficits. The shining example of this approach is the market crash of 2020. Most analysts and economists following Iran agree that the Rouhani Administration pursued a “pump and dump” strategy in the stock market to finance its budget deficit. Leveraging insider information, price manipulation, and aggressive marketing, the administration inflated the stock market, channeling liquidity into it. The resulting bubble peaked on August 10, 2020, before undergoing one of the worst crashes in TSE history. By October, the TSE tanked by more than 25%, with many stocks losing more than 70% of their value.

2.3. Outdated Accounting Standards

Another important issue of Iran’s financial market is its outdated accounting standards. As discussed in the Banking chapter, the banking system conceals rollover losses on its balance sheets by exploiting loopholes in these outdated standards, which deviate substantially from International Financial Reporting Standards (IFRS). During asset revaluations, banks inflate the value of their real estate holdings—relying solely on inflation—thereby masking the true extent of their losses and financial instability. Similarly, Iran’s outdated accounting standards have allowed Iranian corporations, often led by IRGC-affiliated CEOs, to hide or underreport their losses, fueling widespread corruption and embezzlement. A notable example of such corruption is the \$3 billion embezzlement case involving Foolad-e-Mobarake, the infamous steel company. Another example is the auto sector: the cumulative rollover losses of the two largest auto manufacturing companies, Iran Khodro and Saipa, is currently more than the annual budget of the IRGC, yet the banking system continues to provide large loans to these firms that are essentially bankrupt. This issue is also partly related to price control and government intervention (Section 2.2), as banks are obliged by the IR to offer (mandated) loan facilities to these auto manufacturers. The fact that the auto industry carries such enormous rollover losses despite having virtually no foreign competition underscores the destructive impact of continuous price controls and market intervention by the regime.

The well-known example of Enron’s collapse underscores the critical importance of reliable accounting standards. One of the devastating consequences of Enron’s collapse was the erosion of trust in the financial statement—and by extension, the entire financial system. Investors rely on financial statements to bridge the inherent information gap between themselves and company insiders; once the credibility of those statements is undermined, the entire financial system suffers. This is why the U.S. Congress enacted the Sarbanes–Oxley Act of 2002, aiming to improve the reliability, transparency, and accountability of financial statements and thereby deter corruption. By contrast, Iran’s outdated accounting standards exacerbate the existing information asymmetry that naturally occurs in the market and have made corruption more pervasive, systemic, and structural. Combined with constant government price controls and intervention, these practices have led the World Bank to rank Iran’s financial market among the most corrupt in the region.

2.4. Adherence to Islamic Finance and Risk Management

Adherence to Islamic finance principles has presented distinct challenges to Iran’s financial markets. As discussed extensively in the Banking chapter, Islamic finance forbids predetermined payments, such as interest (*riba*), thus limiting fund utilization exclusively to profit-and-loss-sharing agreements. Iran is the only country whose entire financial market follows Islamic finance, accounting for 34.4% of global Islamic banking assets—followed by Saudi Arabia at 20.4%. This framework significantly influences both risk management and the development of financial instruments. The Banking chapter discusses in detail how Islamic finance affects banking and central banking, including its impact on monetary policy. However, the challenges associated with Islamic finance extend well beyond the banking system.

One example of the challenges posed by Islamic finance is related to risk management. Financial derivatives are widely used in developed economies to manage different risk exposures, ranging from energy to foreign currency. For instance, in the early to mid-2000s, Southwest Airlines significantly reduced its jet fuel price risk by utilizing futures contracts, thereby gaining a significant competitive advantage. In Iran, however, such derivative instruments—employed in most developed capital markets—are not allowed by

the SEO for Islamic finance principles. As a result, Iranian firms lack the necessary tools to manage different types of risk exposure. This is particularly problematic given the notorious volatility and uncertainty of Iran's capital market, exemplified by the high fluctuations of the foreign exchange rate. Because companies cannot hedge against these risks, they inevitably pass them on to the end consumer in the form of price fluctuations. This dynamic, in turn, affects household consumption and expenditure, spilling over into the broader real economy. In other words, the inability of Iranian firms to hedge and manage risk ultimately burdens households with large price swings, amplifying the impact of economic cycles.

3. POST-ISLAMIC REPUBLIC: RISKS AND A FRAMEWORK FOR REFORM

3.1. Short-Term Risks and Policies

In this section, we examine the immediate risks facing the country's financial markets following the collapse of the Islamic Republic and propose potential remedies. These risk mitigation strategies are intended for short-term implementation during the initial transition period and should be revised after three to six months to avoid hindering economic growth and causing additional systemic shocks.

The primary goal of short-term economic policies in the post-collapse environment is to stabilize the financial market, prevent or contain panic, and avert further unintended damage. The immediate aftermath will likely bring unprecedented instability due to political and economic policy uncertainties. If not managed carefully, this uncertainty could have severe, long-lasting negative impacts on the economy. Therefore, the transition government should focus on economic stabilization and mitigating the effects of the unavoidable initial shock. Key to this stabilization effort is clear communication and the timely issuance of credible signals by decision-makers, which can prevent the financial system from descending into chaos.

3.1.1. Market Crash, and the Risk of a Depression

Academic research, both theoretical and empirical, has consistently demonstrated a negative association between political uncertainty and both asset prices and corporate investment. Early foundational work by Bernanke (1983) and Dixit and Pindyck (1994) laid the groundwork, and more recent evidence corroborates these findings. For instance, Pastor and Veronesi (2013) show that political uncertainty commands a premium in the stock market and increases volatility and correlations among stocks, especially in weak economic conditions. The underlying mechanism is that uncertainty reduces the value of the government's implicit guarantee. Kaviani, Kryzanowski, Maleki, and Savor (2020) document a similar pattern in the bond market, noting that credit spreads widen, indicating that corporate debt value decreases as government policy uncertainty rises. Gulen and Ion (2016) also show that corporate capital investment declines significantly when policy uncertainty increases. These studies' findings hold true regardless of whether the source of uncertainty is political, related to government economic policies, or even rooted in broader geopolitical risks.

The insights from this body of research hold significant implications for the Iranian financial markets in the immediate aftermath of the IR's collapse, as political uncertainty will undoubtedly escalate. Importantly, this event cannot be characterized as a routine political uncertainty, such as what occurs during election cycles, nor can it be viewed purely as policy uncertainty in the sense of Baker, Bloom, and Davis (2016). Instead, the collapse of the IR would be a major political and geopolitical shock with far-reaching ripple effects for decades, likely reshaping the political and economic landscape of the Middle East. Thus, given the frailty of Iran's financial markets and the issues discussed earlier, it would be reasonable to expect a substantial decline in asset prices across all markets.

The uncertainty shock immediately following the collapse of the IR will most probably trigger a panic among market participants, leading to a massive selloff. If not addressed swiftly and prudently, the selloff can quickly accelerate, creating a vicious cycle that would exacerbate the market's downward spiral. As panic spreads throughout society, more stocks will be listed for sale, causing prices to further drop. Companies may reduce investment, lay off workers, and sell their assets at fire sale price. Fire-sale of assets would

aggravate the market's downward spiral and laying off workers would decrease household consumption and increase indebtedness, which would result in lower creditworthiness and higher likelihood of default. When combined with the risk of a bank run and currency depreciation (as outlined in the Banking chapter), an increasingly dire image emerges. That is, in the short-run following the collapse of the IR, there is a significant risk of substantial decline in asset values, accompanied by bank runs, currency depreciation, a sizable decline in corporate capital investment, a rise in unemployment, and panic-driven selloff by investors. This scenario is the very description of a full-fledged economic crisis, leading to contraction of the economy, loss of output, and potentially a deep recession or depression if left unchecked.

3.1.2. Capital Flight

Intimately related to the risk of market crash discussed in the previous section is the risk of capital flight in the short-run following the collapse of the IR. The risk of capital flight, also recognized and discussed in the Banking chapter, generally rises as a country's investment risk or uncertainty increases. Capital flight is not a phenomenon that would appear for the first time post-collapse; Iran has already been experiencing and dealing with the consequences of substantial capital flight over the past decade. The available data provided by the Central Bank of Iran indicates that the cumulative amount of capital flight has reached approximately \$98.5 billion over the past nine years, and \$170.6 billion over the past 16 years. The most recent statistics of Iran's central bank suggest that during the first nine months of the Iranian year 1402 (March 2023 to December 2023), the outflow of capital from the country was over \$20 billion, reflecting a complete and total erosion of trust in the stability of Iran's financial system. The IR's malicious foreign policy, nuclear tensions, and anti-West ideology have led to international isolation and stringent sanctions, fueling economic uncertainty. Together with political instability, systemic corruption, and the IR's poor governance, these factors have significantly heightened the risk associated with investing in the country. Given these conditions, continuous capital outflows are not surprising. Indeed, mistrust among market participants becomes more evident during periods of heightened uncertainty. For instance, during the Woman-Life-Freedom uprising the rate of capital flight from the TSE doubled.

It must be emphasized that the capital flight discussed here is not limited to outflow of funds from the TSE alone. Like the discussion in the Banking chapter, this concept applies broadly to any departure of capital from the country. Context is essential to understanding this risk: the collapse of the Islamic Republic would generate a substantial uncertainty shock, sharply heightening both political and geopolitical risks, as well as overall economic uncertainty. Given the risk of bank run and currency depreciation in the immediate post-collapse period (see Sections 3.2.1 and 3.2.3 of the Banking chapter), it is implausible that TSE investors would withdraw their capital from the stock market only to deposit it in a potentially failing banking system or hold them in cash that could quickly devalue. Therefore, most capital will likely leave the country.

3.1.3. Elevated Corruption

Another short-term risk, also connected to market crash and capital flight, is the risk of corruption. As discussed earlier in Section 2.1, Iran's financial market is already characterized by systemic and institutionalized corruption. In the immediate aftermath of the collapse of the regime, this risk can escalate dramatically as CEOs, people in their network, and other corporate insiders that are mostly affiliated with the IRGC, hastily liquidate their firm's assets and extract private benefit. Such self-dealing or extraction of private benefits is a corporate governance issue stemming from managerial agency problems, in which management's interests conflict with those of external stakeholders—namely shareholders and creditors. Developed economies have extensively studied and addressed this issue, implementing measures to not only prevent or at least minimize CEO's self-dealing, but also to constrain the ability of blockholders and other majority shareholders to extract the firm's value as their private benefit of control.

Amid the uncertainty sparked by the collapse of the Islamic Republic, CEOs and other corporate insiders have a greater incentive to extract private benefits. They may not only dump the stocks they own in the market, but also liquidate the assets of companies they are managing, convert the proceeds to a foreign currency, and transfer it outside of the country. Historically, mechanisms to prevent or minimize such self-dealing have been either largely absent or unenforced, leaving firms even more vulnerable after the collapse. Their incentive to liquidate their stock and firms' assets would certainly amplify the capital flight risk, increase the likelihood of a market crash, and exacerbate the downward spiral of the entire financial market.

3.1.4. Recommended Short-Term Policies

MARKET CRASH MITIGATION POLICY

As previously discussed, the collapse of the Islamic Republic would not resemble an ordinary rise in political uncertainty—such as one that might accompany election cycles—nor would it simply be an increase in economic uncertainty related to government monetary or fiscal policies. Instead, it would constitute a major political and geopolitical shock, rendering conventional price-volatility measures largely ineffective. Most stock exchanges implement a form of circuit breaker that would be triggered and halt trading for a certain period when the price movement is deemed to be too volatile. While circuit breakers can temporarily slow down the market decline, they cannot prevent a crash driven by fundamental changes in the market. Indeed, circuit breakers failed to prevent the crash of 2008 in the United States.

To address the risk of a market crash, we suggest that the transition government halt all trading for at least 3 months (potentially extending to six months if necessary). This needs to be done transparently through clear and effective communication with the public and all market participants. There are several reasons for halting trades:

1. The expected massive selloff immediately after the collapse is at least partly due to panic. Without halting the trades and given the magnitude of the uncertainty following the IR's collapse, the decline in prices would become a self-fulfilling prophecy as the panic spreads throughout society. This vicious cycle could drive prices significantly below their fundamental values and wipe out large sums of capital.
2. It prevents CEOs, corporate insiders, and people in their network (mostly affiliated with the IRGC) from dumping stock holdings in the market and moving the proceeds outside of the country. It will also reduce the supply of rial in the foreign exchange rate market and reduce some of the pressure on the rial to depreciate. In other words, halting trade can mitigate corruption to some extent and will help slow down capital flight and currency depreciation.
3. Given the existing systemic corruption in Iran's financial market, and its outdated accounting standards, the 3-month trading halt would give the transition government some time to examine the financial health of all the listed companies and their balance sheets through external audits. This process would provide a clearer understanding of each firm's balance sheet before trading resumes.

CAPITAL FLIGHT MITIGATION POLICY

Although halting trades can prevent outflows from the stock market, capital flight remains a significant concern even after suspending trading on the TSE. In the immediate post-collapse period—likely marked by political and economic turbulence—CEOs may attempt to withdraw their firms' bank deposits, convert the proceeds into foreign currency, and transfer them offshore.

As emphasized earlier in Section 3.1.3, they may also try to find ways to liquidate the assets of their firms at fire-sale prices to extract private benefit. Other powerful people with substantial amounts of cash deposited in the bank may also attempt to do the same thing.

Section 3.2.2 of the Banking chapter discusses in detail the policies that the transition government needs to implement to mitigate the risk of capital flight. Here, we provide the key points:

1. Halt trading for three to six months.
2. Swiftly place a maximum limit on deposit withdrawal from banks.
3. Freeze conversion of investment accounts to checking accounts.
4. There must be a halt on (fire) sale of company assets or any major change of ownership in a firm. This policy is particularly important for alleviating corruption as it safeguards the assets of Iranian firms against the attempt of the CEOs and other insiders to tunnel out their firms to extract private benefit.
5. Enforce a maximum foreign currency limit for every person leaving the country with robust border enforcement.
6. Impose a maximum allowable amount of money that banks, financial institutions, and exchange companies could transfer daily from their foreign-based accounts to other foreign accounts, or within their international banking network.

FATF COMPLIANCE

It is crucial to end the isolation of Iran's financial markets and banking system as soon as possible once the IR collapses. Iran's financial market must begin to interact with and integrate into the global capital market. For this to happen it is necessary for the country to be removed from the Financial Action Task Force (FATF) blacklist. The transition government must initiate talks with the FATF and submit all required documentation to demonstrate their strong commitment to fulfilling the necessary steps outlined by the FATF, aiming for the country's removal from the blacklist. It is essential to start these talks promptly, as it would signal to the international community that the country's economy is on the path to reintegration. This move would provide a positive boost to Iran's financial market, its banking system, and thus the economy.

DISMANTLING ADHERENCE TO ISLAMIC FINANCE

In the short run after the IR collapse, the transition government must completely dismantle adherence to Islamic finance principles. This framework has had negative implications for the banking system and conduct of the monetary policy as discussed in Section 2.1.6 in the Banking chapter. It also limits the access of firms to financial derivatives and undermines their ability to hedge or manage different types of risk exposure. Removing Islamic finance regulations will enable the development of a derivatives market for more effective risk management. Moreover, it will improve the regulatory and governance structure of Iran's financial market. As discussed earlier, the SEO is currently responsible for drafting regulations that govern Iran's financial markets. However, the SEO itself is regulated by the Securities and Exchange High Council of Iran (SEHC). The SEHC uses its authority to implement the ideological policies of the IR in different exchanges. After the collapse, the SEHC must be dissolved, and the SEO should be the main authority overseeing and governing Iran's stock exchanges—comparable to the Securities and Exchange Commission (SEC) in the United States.

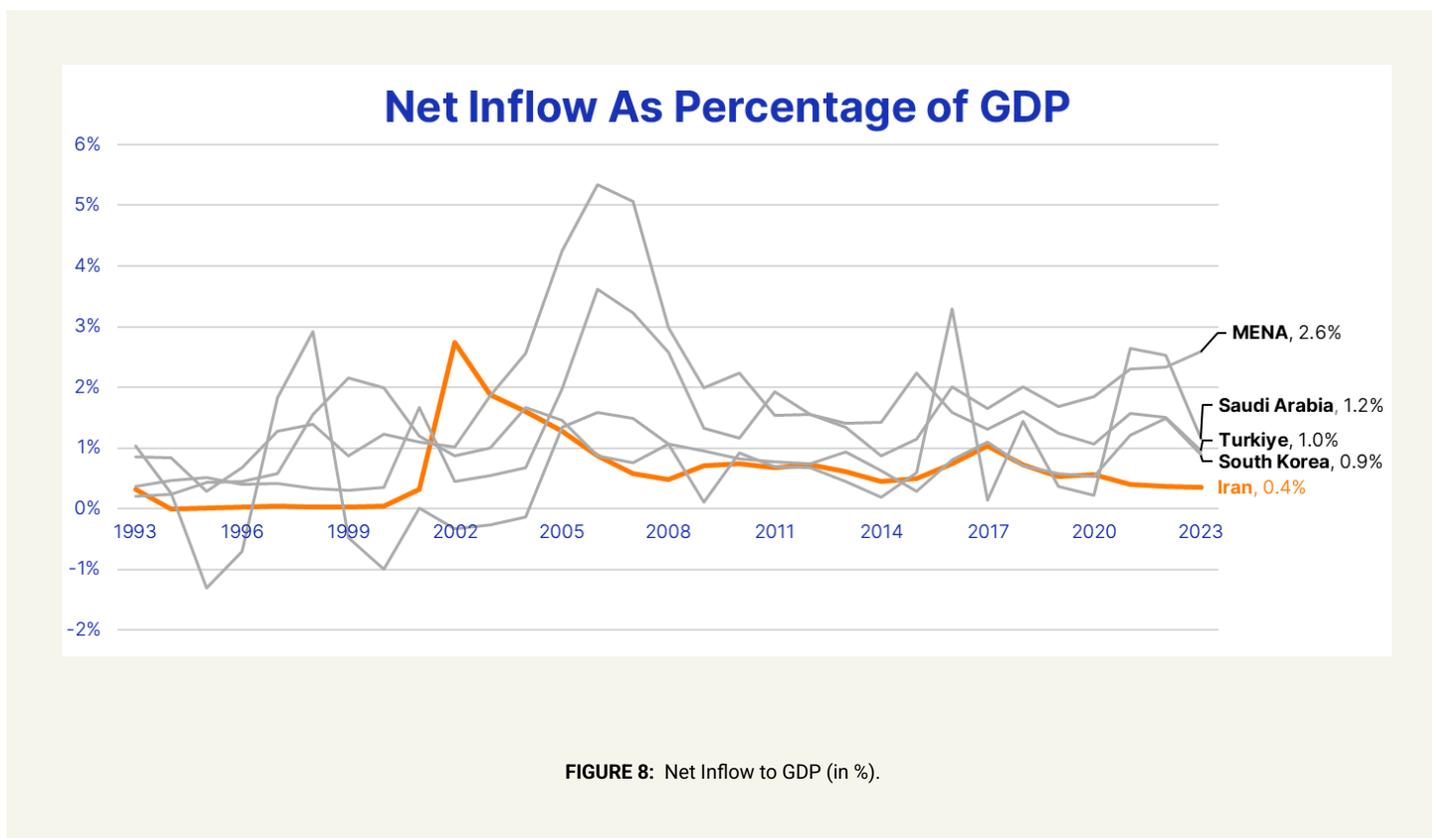
EXAMINING THE BALANCE SHEETS OF PUBLIC COMPANIES

As discussed earlier in Section 2.3, one of the major issues in Iran's financial market is the outdated accounting standards which have allowed companies to underreport their losses, significantly contributing to high levels of corruption and asymmetric information in the market. This issue is also pervasive in Iran's banking system. Thus, similar to the policy recommendation outlined in Section 4.2 of the Banking chapter, we recommend that the transition government hires external auditors to examine the balance sheets of all publicly traded companies while the market is shut down and trading is halted, ideally completing this audit within the first to second quarter following the collapse. This policy would pave the way to a more transparent financial system with reliable reporting standards.

Moreover, having a clear idea about the financial status of all public firms along with the banks in Iran's financial market would also support efforts to meet FATF compliance requirements and expedite the country's removal from the blacklist.

ATTRACT FOREIGN INVESTMENT

Due to the Islamic Republic's mismanagement, corruption, ill-conceived policies, and hostile foreign stance—which led to sanctions and FATF blacklisting—Iran has not been able to attract much foreign investment. These issues have made investment in Iran a very risky and undesirable proposition to foreign investors, as illustrated by Figures 8 and 9, which show Iran has had the region's lowest net inflow-to-GDP ratio for more than two decades. Given that the country desperately needs inflow of funds, one of the main short-term objectives of the transition government must be to send a credible signal that Iran presents a viable investment opportunity for foreign investors. Reopening the TSE and resuming trading offers an invaluable opportunity to attract foreign investment that must be leveraged. To achieve this crucial objective and to send a credible signal to foreign investors, we recommend that the transition government allows for trading to resume only after external auditors have reviewed the balance sheets of all listed companies and all market participants have a clear idea about the valuation. Additionally, reopening the TSE in collaboration with major exchange operators—such as Intercontinental Exchange (ICE) which runs NYSE; Nasdaq, Inc. which operates the Nasdaq stock exchange; or London Stock Exchange Group (LSEG) which operates the London Stock Exchange (LSE).



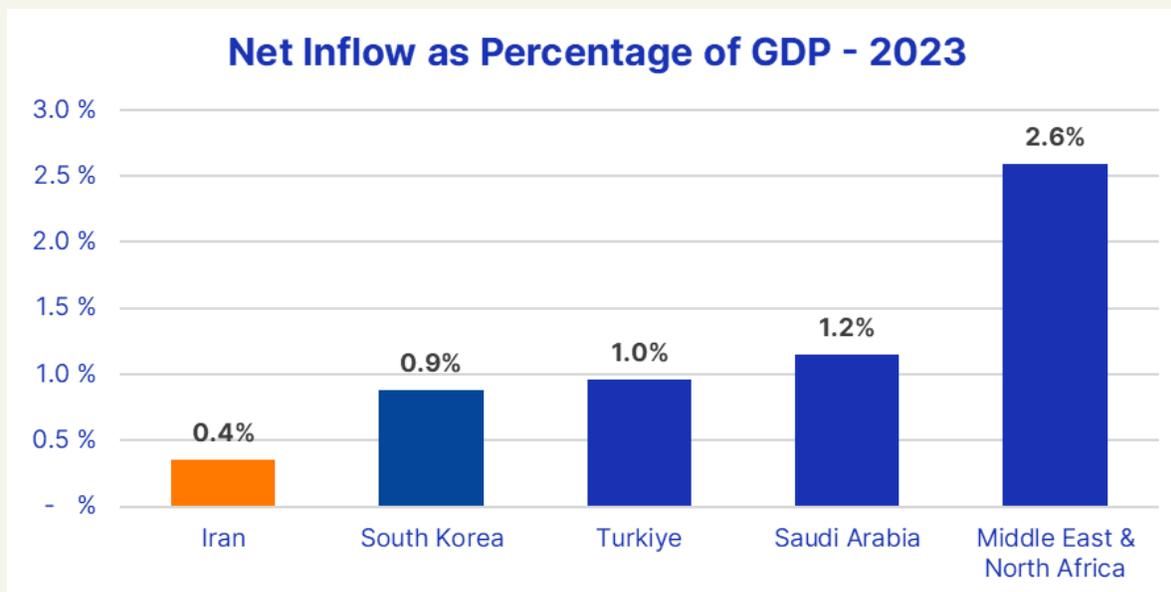


FIGURE 9: Net Inflow to GDP in 2023 (in %).

3.2. Longer-Term Risks and Policies

This section examines the longer-term risks facing the country's financial markets following the collapse of the Islamic Republic and proposes mitigation strategies. The primary goal of medium and long-term policies post-Islamic Republic is to transition the country towards a market-based (free) financial system with minimal government intervention. The ultimate objective is to create a financial system that can effectively and optimally provide financing to households and businesses, fostering predictable economic growth.

3.2.1. Mismanaging Financial Liberalization

A serious long-term risk facing any developing economy undergoing financial liberalization is the risk of mismanaging that liberalization process. This risk is also recognized and discussed extensively in Section 3.3.1 of the Banking chapter. While Section 3.3.1 of the Banking chapter addresses the implications of mismanagement in banking—such as excessive lending, heightened default rates, and eventual credit freezes—this section focuses on how similar pitfalls can affect the broader financial market, particularly the stock market.

Financial liberalization often begins with the relaxation of credit controls and interest rate caps. This typically attracts large capital inflows and accelerates credit expansion as banks and financial institutions, spurred by easy access to funds, aggressively increase lending. Consequently, investments surge, including speculative investments in the stock market, driving up stock prices as more investors seek high returns.

However, this phase of rapid growth can give rise to an asset bubble, where stock valuations far exceed the underlying economic fundamentals. Excessive lending and build-up of risky, non-performing loans render financial institutions over-leveraged and vulnerable. Central banks may respond by raising interest rates or implementing tighter credit controls to curb inflation and stabilize the financial system. This tightening can burst the asset bubble, triggering a sell-off of overvalued assets and causing stock prices to plummet.

The ensuing credit crunch, marked by liquidity issues and stricter lending standards, exacerbates the economic downturn. Falling asset prices, reduced credit availability, and declining investor confidence collectively contribute to a broader economic slowdown or recession. The stock market experiences pronounced swings—surging during credit booms and crashing during busts. Repeated boom-and-bust cycles would erode investor confidence, fostering a more risk-averse investment climate and potentially dampening long-term investment in the stock market. The frequent market corrections and crashes undermine the stability and credibility of the stock market as a reliable investment avenue, leading to broader economic consequences. The volatility and unpredictability induced by mismanaged financial liberalization underscore the critical need for prudent economic policies and regulatory oversight to ensure sustainable economic growth and financial stability in a developing economy like Iran.

To alleviate the above risk, the following guidelines will be necessary:

1. The credit culture within the banking system needs enhancement.
2. A proper credit check system must be in place to assess the creditworthiness and the default risk of households as well as firms.
3. Mandating tangible collateral when a loan is either large or risky.
4. The banking system should adhere to the Basel framework.
5. Banking regulators must actively supervise banks, compelling those with high risk to increase their capital and shutting down institutions that fail to comply.
6. Regulators must ensure deposit insurance is appropriately priced to mitigate moral hazard, requiring riskier banks to pay higher membership fees for deposit insurance benefits.
7. The new Iranian government should adopt a free-floating exchange rate system.
8. Adhere to a transparent and reliable financial statement reporting system using modern accounting standards.

3.2.2. Other Longer-Term risks

Other longer-term risks facing Iran's financial market after the IR collapse will be mostly rooted in how the financial market reform is carried out and whether the process of financial liberalization is managed prudently. Some of these risks include:

- Excessive lending and risk-taking by banks
- Accumulation of systemic risk in the financial system
- Erosion of trust in the financial market by the investors
- Unreliable financial statement reporting
- Lax monitoring and supervision of the financial system
- Increased opacity in the financial system

Again, it must be emphasized that many of these risks can be significantly mitigated if the reform process is executed correctly and financial liberalization is carefully managed.

3.3. A Framework for Reform and Other Long-term Policies

The collapse of the IR provides a unique opportunity to overhaul Iran's financial markets and implement long-term reforms—or at least create a proper foundation that promotes sustained financial development and economic growth. This reform agenda has several dimensions that will be discussed separately below.

3.3.1. *Updating Accounting Standards and Lessons from the SOX Act (2002)*

As discussed earlier in Sections 2.1 and 2.3, a critical issue in Iran's stock market is the pronounced information asymmetry between insiders—who are often affiliated with the IRGC or the regime more broadly—and outside investors. This gap is exacerbated by Iran's outdated accounting standards, contributing to systemic corruption and rampant insider trading. Any reform in the post-IR era must address these issues to restore market confidence and establish the groundwork for future policies and protections that would safeguard against these issues as the market—and the global context—evolves.

One of the most important reforms in Iran's financial market in the medium to long-term following the collapse of the IR is the adoption of modern accounting standards. As discussed earlier in Section 2.3, outdated accounting standards have exacerbated the asymmetric information that naturally exists in the market and has made corruption even more pervasive, systemic, and structural. Modernizing Iran's accounting standards according to global best practices not only enhances financial statement reliability but also increases transparency, thereby restoring trust and deterring future corruption. Lessons from the U.S. Sarbanes-Oxley Act (SOX) of 2002 are particularly relevant in this regard.

SOX was enacted in the United States to address corporate fraud and restore investor confidence in the wake of major accounting scandals. Its implementation and subsequent effects offer valuable lessons for reforming Iran's financial markets. However, considering the high compliance costs associated with SOX, it is essential to adapt these reforms in a manner that limits their financial burden while maximizing their effectiveness.

ENHANCING CORPORATE GOVERNANCE

SOX has significantly improved corporate governance by requiring CEOs and CFOs to certify the accuracy of financial statements, heightening top executives' accountability in ensuring that financial reports are reliable and transparent. Implementing similar certification requirements in Iran could enhance the integrity of corporate disclosures and foster greater investor trust.

STRENGTHENING FINANCIAL DISCLOSURES

One of the core provisions of SOX is the requirement for companies to establish and maintain adequate internal controls over financial reporting. This has led to more robust financial disclosures and greater transparency. Iran could benefit from adopting stringent internal control requirements, ensuring that companies maintain accurate financial records and provide reliable information to investors.

ESTABLISHING INDEPENDENT OVERSIGHT

The Public Company Accounting Oversight Board (PCAOB) was created as an independent body under SOX to oversee and regulate audits of public companies. Iran could establish a similar oversight body to regulate and monitor the auditing practices within its financial markets. This would help enhance the quality of audits and ensure compliance with established standards.

PROTECTING WHISTLEBLOWERS

SOX includes provisions to protect employees who report fraudulent activities, encouraging the exposure of unethical practices. Iran could implement strong whistleblower protections to promote transparency and accountability within organizations. This would help create an environment where employees feel safe to report misconduct without fear of retaliation.

As mentioned earlier, SOX has had some downside effects on the US stock market due to its high compliance cost. For instance, the high cost of compliance has been particularly burdensome for smaller companies, who have been deterred from going public. Studies have shown a decline in the number of Initial Public Offerings (IPOs) in the U.S. post-SOX, with some firms choosing to get listed on foreign exchanges or seek alternative forms of financing to avoid the compliance costs associated with SOX. When adapting SOX-like regulations in Iran, it will be essential to account for these costs and potential drawbacks. Here are a few recommendations:

TAILORING REQUIREMENTS FOR SMALLER FIRMS

To mitigate the issues of high compliance cost in Iran, the transition government could introduce tiered compliance requirements based on the size and complexity of the company. Smaller firms would be subject to less stringent reporting and auditing requirements, reducing their financial burden while still enhancing transparency and accountability. Notably, this reform would occur after auditors have assessed all companies' balance sheets, so regulators would already have solid information on each firm's size, complexity, and risk profile.

PHASED IMPLEMENTATION

Implementing reforms in a phased manner can help manage the costs associated with compliance. Iran could start by applying the most critical SOX provisions to larger companies and gradually extend them to smaller firms over time. This incremental approach allows companies to adjust to new regulations incrementally, spreading out and reducing the financial impact of compliance.

LEVERAGING TECHNOLOGY

Investing in technology can streamline compliance processes and reduce costs. Iran could encourage the use of advanced financial software and automation tools to help companies maintain accurate financial records and ensure compliance with regulatory requirements. This would not only improve efficiency but also lower the overall cost of compliance.

By adopting key SOX provisions, Iran can enhance investor protection, which is crucial for attracting both domestic and foreign investment. Improved corporate governance, financial transparency, and robust auditing practices can help build a more trustworthy and stable financial market, encouraging long-term investments. Transparent and reliable financial markets are essential for economic growth, and implementing these reforms can help Iran develop a more efficient and resilient financial system. This, in turn, can foster economic development by facilitating access to capital, promoting fair competition, and encouraging entrepreneurial activities.

3.3.2. Bank-based or Market-based Economy? Neither! Improving the Legal System

Since the 19th century, economists have debated whether bank-based or market-based financial systems are superior in mobilizing savings, identifying investments, and exerting corporate control, particularly during early economic development and in weak institutional environments such as Iran. The bank-based view highlights the role of banks in gathering information about firms, managing risks, and mobilizing capital to exploit economies of scale. In contrast, the market-based view emphasizes the benefits of well-functioning markets in fostering research, enhancing corporate governance, and facilitating risk management. Policymakers continue to grapple with the relative merits of these systems. Given decades of economic mismanagement of the IR, it is crucial to implement policies after the collapse of the IR that would pave the way for faster financial development and economic growth. Therefore, the insights of this debate have important policy implications for the development of the Iranian economy post-IR.

The bank-based view suggests that banks improve capital allocation, manage risks, and mobilize capital effectively. They mitigate problems with market-based systems, such as the quick public revelation of information that reduces incentives for individual investors. Banks form long-term relationships with firms, ensuring continuous monitoring and reducing moral hazard. However, critics argue that liquid markets create a myopic investor climate, leading to poor corporate control and hindering economic growth. Powerful

banks, especially in countries with weak contract enforcement, can enforce debt repayment more effectively than atomistic markets. The Iranian economy is classified as a bank-based economy.

On the other hand, the market-based view emphasizes the positive role of markets in aggregating information, easing takeovers, and linking managerial compensation to firm performance. It argues that competitive capital markets reduce inefficiencies associated with powerful banks, which might stymie innovation and protect established firms from competition. The market-based system is seen as better at transmitting information and enhancing economic performance.

However, there is no empirical support for the superiority of either bank-based or market-based systems in promoting economic growth (Levine 2002). Whether a country has well-developed banks or markets, or a balanced financial system, does not significantly affect its economic performance. Instead, data supports the law and finance view, which emphasizes that the main issue is not whether the system is bank-based or market-based, but how effectively it provides financial services. Legal rights and contract enforcement efficiency are strongly associated with growth, suggesting that the legal system is crucial in determining financial development and the empirical evidence suggests that well-developed financial systems positively influence economic growth. The law and finance view highlights the role of the legal system in creating a growth-promoting financial sector. Effective legal rights and enforcement mechanisms facilitate the operation of both markets and intermediaries, improving resource allocation and economic growth.

Accordingly, the transition government must implement policies aiming to reform the country's legal system and law enforcement following the collapse of the IR. Some policy recommendations include:

- Separation of powers in government
- Enhance investor rights and protection of private property
- Improve the efficiency of contract enforcement

3.3.3. Reform the Legal Origin to Common Law

Discussions in the previous section highlight the critical role of a robust legal system and effective contract enforcement in developing a healthy financial system and promoting economic growth. Closely related to this is the concept of a country's legal origin, which plays a crucial role in shaping its financial markets by influencing investor protection, corporate governance, and economic growth. Substantial research (e.g., La Porta et al., 1997, 1998, 2002) shows that nations with a common law heritage generally have more advanced financial markets than those rooted in French civil law. This is particularly relevant for Iran, whose legal system is rooted in French civil law. By examining the distinctions between French civil law and common law systems—alongside historical case studies—we can gain insights into how Iran can reform its financial markets to foster economic development and investor confidence. The collapse of the IR provides a unique opportunity to reform Iran's legal system in a way that will facilitate financial development and economic growth.

French civil law, which serves as the foundation for Iran's legal system, is characterized by extensive codified statutes and comprehensive legal codes. This system tends to offer limited protection to investors. For instance, shareholder rights under French civil law are generally weaker compared to common law countries. Additionally, creditor rights are often compromised as secured creditors might not have guaranteed rights to collateral during reorganizations, and managers can seek unilateral protection from creditors via reorganization filings.

In contrast, common law systems, such as those in the United States and the United Kingdom, provide robust protections for investors. Common law emphasizes judicial precedent and case law, resulting in more flexible and responsive legal frameworks. Shareholders in

common law countries typically enjoy stronger voting rights, while creditors benefit from clearer collateral repossession procedures and more stringent rules governing managerial protection during reorganizations.

The empirical evidence supports the legal origins view of financial development, which posits that economies with a common law tradition better protect private contracts and investors, enhancing the functioning of financial markets and institutions. Historical case studies, such as the British and French concessions in Shanghai between 1845 and 1936, illustrate this point vividly. These concessions, granted following the First Opium War, were governed by different legal traditions—British common law and French civil law—despite being geographically adjacent and otherwise similar.

Over time, two regime changes altered the application of these legal traditions, allowing researchers to examine their impact on financial development. The results showed that financial development in the British concession outpaced that in the French concession after the adoption of common law jurisdictions. Conversely, when these legal frameworks were again removed, the financial advantage of the British concession diminished. These findings underscore the importance of legal origins in shaping financial markets (Levine, Lin, Ma, and Xu, 2023). In summary, the comparative analysis of differences in legal origins lead to three main conclusions:

1. Common law countries generally offer stronger protections than civil law countries, especially those following the French civil law tradition. German and Scandinavian civil law countries take a middle ground in terms of investor protection.
2. Countries with German and Scandinavian civil law systems have the strongest law enforcement, while common law countries also have robust law enforcement. In French civil law countries, enforcement tends to be weakest.
3. Good accounting standards, strong rule of law, and solid shareholder protections—features more prevalent and better enforced under a common law legal framework—correlate strongly with lower ownership concentration. This suggests that inadequate investor protection can be costly. When small investors are not protected, companies find it challenging to raise capital, and entrepreneurs struggle to diversify their holdings.

These insights have significant policy implications in reforming Iran's financial market in the post-Islamic Republic era. By adopting elements of the common law system—particularly in areas of business and finance—Iran, which currently follows French civil law, could bolster investor protection, improve corporate governance, and stimulate economic growth. Strengthening legal enforcement, enhancing transparency, and protecting investor rights would help develop a more efficient and resilient financial market, driving long-term economic prosperity. This approach not only addresses the inherent weaknesses of the current system but also aligns with global best practices, ensuring that Iran's financial markets can compete on an international scale.

If fully transitioning to a common law system proves overly difficult or impractical, Iran can still adopt key features of a common law legal framework—particularly for business and financial matters—to improve investor safeguards, property rights, and corporate governance. Ultimately, updating corporate and bankruptcy laws to meet international standards is essential for fostering a sound, competitive financial environment.

3.3.4 *Other Recommended Longer-Term Policies*

DEVELOPING A ROBUST FINANCIAL DERIVATIVES MARKET

As discussed earlier, Islamic finance has prevented Iran from establishing a robust derivatives market, denying corporations access to a wide range of hedging instruments. Moreover, a deep and liquid derivatives market can increase market efficiency and facilitate price discovery. Therefore, in the long run following the collapse of the Islamic Republic, the new government must take steps to develop a derivatives market. It is important not to exclude any of the known participants in this market when regulations are drafted. Research shows that hedgers, arbitrageurs, and speculators all contribute to the healthy functioning of a robust derivatives market.

INCREASING THE DEPTH AND THE LIQUIDITY OF THE DEBT MARKET FOR BOTH THE GOVERNMENT SECURITIES AND CORPORATION

In many developing and emerging economies, the monetary policy transmission channel to inflation is weak, making short-term inflation targeting difficult and often counterproductive (see Section 4.5 of the Banking chapter for a discussion on restricting bank balance sheet expansion). A primary reason for this weakness is the insufficient depth of government securities and corporate debt markets. Increasing the depth and the liquidity of the debt market would strengthen monetary policy's transmission to and influence on inflation, making inflation targeting more feasible. It will also help to change the inflation expectation anchor from the exchange market to the interest rate.

ISSUING SHORTER-TERM TREASURIES

Given the heightened uncertainty expected in the aftermath of the Islamic Republic's collapse, the transitional government should initially issue treasuries with relatively short maturities—ranging from three months to three years. Long-term treasuries are more sensitive to uncertainty and carry larger risk premiums. As the reformed Central Bank of Iran succeeds in reducing inflation and overall uncertainty declines, longer-term treasuries could be issued. It must also become standard practice to publish the term structure and maturity structure of treasury securities on a daily basis.

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