

**European Bank
for Reconstruction and Development**

**SECURITIES MARKETS
LEGISLATION ASSESSMENT PROJECT**

**REPORT ON
THE 2004 ASSESSMENT RESULTS**

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BY

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SECURITIES MARKETS LEGISLATION ASSESSMENT PROJECT

-- Report on the 2004 Assessment Results --

The European Bank for Reconstruction and Development (“EBRD”) engaged SALANS¹, attorneys-at-law, to conduct the securities markets legislation assessment project (the “SML Assessment” or the “Project”) described in this report. The SML Assessment is meant to measure the current status of the legal framework governing the securities markets in the twenty seven countries where EBRD operates. Through the SML Assessment, the EBRD seeks to gauge the extent to which securities legislation is present in each of these countries (the “extensiveness” factor). Thus, the findings reported below are not a measure of the degree to which emerging markets securities laws are enforced in practice or are effective, but rather, are intended as an initial measure of whether securities laws and regulations in these countries are in place at all and, if so, to what degree when compared to applicable international standards.

I. PROJECT OVERVIEW

The implementation of the Project consisted of four parts: (i) the refinement of a securities market legislation assessment checklist originally developed by the EBRD for submission to local counsel, including SALANS attorneys, in each of the countries where the EBRD operates, (ii) local counsels’ compilations of responses to the assessment checklists, (iii) SALANS’ analysis of the results and rating of the countries based on the assessment checklist results, and (iv) this report on the extensiveness of the securities laws in each of the jurisdictions, the trends observed and the areas where further legislative improvement is required to make these developing markets functional, accessible and safe for investors. Through rating the country checklist responses as a measure of their compliance with general international standards of securities legislation, SALANS was able to determine a single numerical value to each country and group the 27 countries into categories from low to high compliance. The map chart in Annex I shows these rating results of 2004. Compliance levels overall were generally high, but no country had achieved complete development of a sophisticated legislative framework. The methodology used in rating the countries through the checklist questionnaires and the categories into which the countries have been grouped are discussed in more detail below.

II. SECURITIES MARKETS LEGISLATION ASSESSMENT CHECKLIST

In order to collect the basic data on the existing legislation in the EBRD countries of operation and the conformity of that legislation with international standards of securities law, the EBRD devised a questionnaire covering all aspects of securities legislation based largely on the *Objectives and Principles of Securities Regulation* published by the International Organization of Securities Commissions (“IOSCO”). The three basic objectives of securities

¹ Key attorneys of Salans working on this project include Mira Davidovski, Muriel Goldberg-Darmon, Judith Aron, Natalie Bej and Ellen H. Clark.

regulation, as expressed by IOSCO, are: (i) the protection of investors; (ii) ensuring that markets are fair, efficient and transparent; and (iii) the reduction of systemic risk. In refining the questionnaire originally developed by the EBRD, SALANS expanded from these core concepts to formulate additional questions addressing each of the activities involved in the regulation, issuance, and trading of securities in a public marketplace.

The refined EBRD questionnaire was organised as a checklist (the “EBRD/SALANS Checklist”) to which local counsel could answer compliance questions with either “yes” or “no” responses. With nearly three hundred questions, the EBRD/SALANS Checklist covered the following eleven subject areas: (i) the powers of the regulator(s) of securities markets, (ii) self-regulatory organisations, (iii) issuers and their disclosure obligations, (iv) collective investment schemes, (v) market intermediaries, (vi) secondary markets, (vii) clearance and settlement, (viii) accounting and auditing standards for financial disclosure, (ix) money laundering, (x) financial instruments, and (xi) investment service providers. In addition to responding to questions that assessed the general compliance levels of the laws in the securities market area, local counsel were also required to provide an exhaustive listing of the relevant securities markets-related laws and regulations, a summary of their dates of promulgation and all amendments, and the identity of each market regulatory authority along with a listing of the activities that each authority regulates. Finally, local counsel collected and submitted to the EBRD copies of the applicable legislation which was assessed under this Project.

A. Contents of the EBRD/SALANS Checklist

The eleven categories covered by the EBRD/SALANS Checklist included questions to elicit both the extent to which legislation was in place, and to the extent legislation existed, more in-depth information about the quality and expansiveness of that legislation. The following is a brief summary of the types of questions asked in each of the eleven categories contained in the EBRD/SALANS Checklist circulated to local counsel.

1. Regulator

Under the first category heading, “Regulator”, local counsel were asked about the scope of responsibility, the methods for appointment and removal of members of the regulator’s governing body, as well as its independence and latitude for enforcement, surveillance, inspection and policy-making. To the extent inspection power existed, local counsel were then asked whether there were limitations on inspection powers, whether norms of confidentiality were in place, whether inspection powers could be delegated, and whether the regulator had authority to impose sanctions for non-compliance, injunctive orders or criminal proceedings.

2. Self-regulation

For the category of “Self-regulation”, the threshold question was whether a regime for self-regulatory organisations (“SRO”s) was contemplated under existing legislation at all and whether there were any such organisations that establish rules that must be satisfied by their members in order for them to participate in securities activities. If local counsel could not answer in the affirmative, they were instructed to answer “no” to the rest of the section’s questions, all of which examined the details of how existing SROs are authorised to operate, what standards they must meet, and how they are monitored. For countries that did have SRO

legislation, however, additional questions explored further subjects such as whether a set of professional standards is in place for SROs, whether SROs are subject to inspection and whether the regulator has the power to intervene into matters affecting investors and the markets with respect to functions that might be shared with SROs. Further, counsel was asked whether, as a condition of on-going authorisation, the SRO is required to assure that its rules do not create anti-competitive situations. These questions aimed at assessing whether SRO legislation complies with a very high level of free market standards, professional ethics, and accountability to investors.

3. Issuers and Their Information-Disclosure Obligation

The third category, “Issuers and their Information-Disclosure Obligation” focused on public offerings of securities including prospectus requirements, whether regulator review and approval of a prospectus were required and whether there was content, language, truthfulness and materiality specifications for issuer disclosure and any related advertising. Counsel was also asked what types of securities required a prospectus and whether there were situations, such as private placements, where a prospectus might not be required. This section examined whether listing particulars were required for listing securities for trading on the market and, if so, the content, availability, and extent of disclosure that the listing particulars would entail. Similarly, this section examined whether annual and periodic reports were required, what their content would be, and what entities would be legally responsible for their content. Another area of focus included shareholders’ rights with regard to (i) fair and equitable treatment, (ii) rights of appraisal and mandatory buy-outs, (iii) petitioning the regulator or appointing an auditor, and (iv) other mechanisms to protect minority shareholders such as the right to request a shareholder meeting, mandatory take-over bids at certain ownership thresholds, public disclosure of shareholders owning certain percentages of a listed company, and disclosure with regard to changes in corporate control. In keeping with the IOSCO standards, the questions ran from the most basic disclosure thresholds to penetrating treatment of directors’ compensation and benefits. The responses to this section were assessed in conjunction with the responses to “Accounting and Auditing”, described below, as both sections relate to the transparency and disclosure of financial information to the regulators and the marketplace as a whole.

4. Collective Investment Schemes

Section four, on “Collective Investment Schemes” (“CIS”), was deemed less critical to a functioning securities marketplace. However, the existence of collective investment schemes did provide an indication of the securities market development that some of the countries achieved. Local counsel in several countries simply indicated that there were no specific standards or requirements set forth in relevant law to market or operate a collective investment scheme, be it a mutual fund, unit investment trust or European UCITS (uniform collective investment trust schemes). In absence of legislation, counsel was requested leave the remaining questions in the section blank, resulting in lower scores. Counsel in countries with CIS legislation, on the other hand, were required to describe the licensing standards for CIS operators, reporting requirements to the regulator, public disclosure concerning CIS operators and managers, asset valuation and redemptions, the availability for sanctions against operating unlicensed CIS, and reporting obligations as to changes in management and conflict of interest situations. A decision was made, however, in keeping with IOSCO standards, to exclude the areas of real estate, mortgages, and venture capital funds from the body of CIS legislation that this section measured.

5. Market Intermediaries

Section five, “Market Intermediaries”, addressed the licensing criteria for market intermediaries, such as brokers, dealers, and asset managers, to conduct business. The EBRD/SALANS Checklist raised questions that examined the operational controls, risk management and internal supervisory systems as an assessment of systemic risk. Other questions focused on the track-record, work experience, and honesty and integrity of senior management and staff of financial intermediaries, such as brokers and dealers. Another important aspect of this section of the EBRD/SALANS Checklist was the inquiry into minimum capital requirements for all intermediaries and whether capital adequacy is measured against balance sheet items, off-balance sheet items and activities of affiliates. As an extension of this inquiry, local counsel were asked to give an assessment of the role of the regulator and its ability to impose liquidity and insolvency requirements on intermediaries and take action if an intermediary falls into financial difficulty. On the investor level, local counsel were asked to provide regulatory information about the intermediary’s relationship with its clients, any “know-your-customer” rules, confidentiality obligations and disclosure.

6. Secondary Market

The EBRD/SALANS Checklist addressed the “Secondary Market” in section six, dealing with the licensing of (i) securities exchanges, (ii) trading systems, and (iii) clearing and settlement organisations. This section also covered legislation prohibiting price manipulation, misleading statements, insider trading, front-running and other market abuses on an exchange. In addition to proscriptive legislation, the Checklist also elicited information as to the regulator’s powers of surveillance and actions it is empowered to take upon discovering a violation – remedies such as trading bans, fines, and liquidation of positions. This section included questions concerning prudential requirements for members of trading systems, arrangements for failed deliveries, and a regulatory framework under which clearing firms or others could monitor trades to identify large exposures or require margin postings or exposure reductions. Here and throughout the checklist, close attention was paid to the systemic risk that trading failures, market disruptions and inadequate margin requirements could have on investors.

7. Clearance and Settlement

Section seven of the EBRD/SALANS Checklist addressed “Clearance and Settlement” from a supervisory and procedural prospective. It examined in detail the surveillance and auditing of clearing systems, the framework for settling trades (such as compliance with the internationally recognised T+3 settlement period), highly developed delivery versus payment and net settlement systems, and book-entry transfers of “dematerialised” or non-documentary shares. The questions for this section were based not only on IOSCO standards, but also on “Recommendations for Securities Settlements Systems” published in the *Joint Report from the Technical Committee of IOSCO and the Committee on Payment and Settlement Systems of the Bank for International Settlements* (November 2001)²

² The report can be found at <http://www.iosco.org/library/index.cfm?whereami=pubdocs&year=2001>

8. Accounting and Auditing of Financial Reports

The “Accounting and Auditing of Financial Reports” section assessed compliance by companies with financial disclosure and adherence to international accounting norms. Questions in this section focused on legal responsibility for reporting and specific elements of audited financial statements. Counsel were asked whether local accounting standards addressed general topics like consolidation of financial information, business combinations, and leases and whether auditors are required to follow a set of generally accepted auditing standards. More questions detailed what those standards involve and whether they ensure auditor independence, auditor licensing, and continuing professional education.

9. Anti-Money Laundering, Financial Instruments and Investment Service Providers

The three final sections of the EBRD/SALANS Checklist, “Anti-Money Laundering”, “Financial Instruments”, and “Investment Service Providers”, were not given as much weight as other sections of the Checklist in the overall rating analysis, but they nevertheless remain important measures of the individual countries’ securities markets development. These sections measured legislative awareness of the need to prevent and discourage money laundering operations, to open markets to more sophisticated financial products such as options and derivatives, and to accommodate investment service providers as a separate class of securities professional. The questions in these and the other sections described above can be read in the EBRD/SALANS Checklist available on the EBRD website.³

B. Individual Country Checklist Assessment Reports 2004

Local counsel worked on researching and responding to the EBRD/SALANS Checklist during the first quarter of 2004, with some follow-up research and verifications being made during the second quarter of 2004. The general results of the Checklist assessment in 2004 are discussed in this report, but the country-specific Checklist assessment reports themselves, containing the raw data and responses from local counsel, are in 28 separate documents⁴. These documents, together with responses to all the questions can be found on the EBRD website.⁵ The names of the local counsel involved in completing the specific checklist are listed on the cover page of each Checklist report. The funding for implementing the SML Assessment was mainly provided by the Government of France.

³ See <http://www.ebrd.com/country/sector/law/index.htm> and then click on the link of “Capital markets & Corporate governance”.

⁴ Although Serbia & Montenegro is recognised as one country, local counsel examined the relevant legislation and prepared a separate checklist for each of Serbia and Montenegro respectively. As a result, there are 28 documents available for review for 27 countries. SALANS combined the results of the Serbia and Montenegro assessment scores to establish a single rating for that country.

⁵ See <http://www.ebrd.com/country/sector/law> and then click on the link of “Capital Markets and Corporate Governance”.

C. Country Ratings 2004

Based on the EBRD/SALANS Checklist responses received from local counsel in each country assessed under this Project, SALANS analyzed the data provided from each country and assigned ratings to the results from each category of the Checklist responses. SALANS then added or deducted points from each category score based on weightings assigned to specific sections. The sum of these weighted section scores was averaged to derive a single numerical value for each country. Based on these results, each country was placed into a grouping that indicates its level of adherence to international standards in and for securities markets legislation.

1. Rating Methodology

SALANS developed a rating system for the Checklist results when it first refined the EBRD assessment questionnaire for local counsel as part of its Assessment Methodology Report to the EBRD in January 2004. The ultimate goal was to assign a rating category to each country which would reflect that country's general compliance with international norms of securities legislation. It should be noted that this general compliance test differs from the IOSCO approach of measuring compliance with multiple, separate and specific principles of securities legislation.

The rating system developed by SALANS also includes scope for some subjective assessment. Although each of the questions on the EBRD/SALANS Checklist was intended to carry equal weight, many of the questions had subparts that were not applicable to all situations. Moreover, SALANS took careful note of the commentary provided by local counsel with each response on the checklist and gave greater significance to certain responses based on the observations of local counsel. This rating method, together with the weightings described below, formed the basis for the rating assigned to each country.

2. Weightings

Although individual question responses were subjectively evaluated, the categories of questions themselves were assigned fixed and uniform weightings depending on their subject matter. Sections that were considered more important were assigned a higher weighting, while sections that were considered less important received a lower weighting, with increases or deductions being made to the initial assessment by SALANS. Specifically, each of the eleven checklist categories were rated as either low importance, medium importance, or high importance.

SALANS considered the existence of a strong regulator and legislative powers of enforcement to be an element critical to the development of an effective securities market, and thus, gave extra weighting to the results on the "Regulator" section of the Checklist. The other sections given a higher weighting were "Issuers and their Information-Disclosure Obligation" and "Accounting and Auditing of Financial Reports". In contrast, SALANS did not deem the existence of SRO legislation as an essential building block to securities markets development but rather a discretionary policy decision. This section was weighted downwards, as were the sections on "Collective Investment Schemes", "Anti-Money-Laundering", "Financial Instruments" and "Investment Service Providers" – all important areas, but less critical to a sound securities law framework. A neutral weighting, with no

adjustment up or down, was assigned to the remaining sections on “Market Intermediaries”, “Secondary Markets”, and “Clearance and Settlement”.

3. Scoring

For each country assessed under this Project, the results for each category were rated and adjusted for the weightings described above. The final overall score for each country was then arrived at by taking the average of the eleven weighted category scores. The overall score gives a sense of the country’s overall compliance level with standard international regulatory expectations.

4. Country Groupings

The final scores of countries were categorised into five different groupings as follows:

- Group 1 = very low compliance;
- Group 2 = low compliance;
- Group 3 = medium compliance;
- Group 4 = high compliance; and
- Group 5 = very high compliance.

<u>GROUP 5</u> Very High Compliance <i>(No countries)</i>	<u>GROUP 4</u> High Compliance <i>(6 countries)</i>	<u>GROUP 3</u> Medium Compliance <i>(14 countries)</i>	<u>GROUP 2</u> Low Compliance <i>(4 countries)</i>	<u>GROUP 1</u> Very Low Compliance <i>(3 countries)</i>
	Croatia Estonia FYR Macedonia Latvia Lithuania Slovenia	Armenia Bosnia & Herzegovina Bulgaria Czech Republic Georgia Hungary Kazakhstan Poland Romania Russia Serbia & Montenegro Slovak Republic Ukraine Uzbekistan	Albania Belarus Moldova Kyrgyz Republic	Azerbaijan Tajikistan Turkmenistan

Over 50% of these EBRD’s countries of operations scored in a medium or high compliance category, including all the countries that joined the European Union on May 1, 2004. Interestingly, some of the highest scoring countries, Croatia and FYR Macedonia, were not European Union accession countries, but had benefited from adopting securities market legislation within the last three years. The results showed that, in most cases, the countries

with the most recently adopted legislation had the most highly evolved securities law framework.

III. SOME COMMENTS AND OBSERVATIONS

The country assessment results and the country ratings should all be read in the context of the following observations, in particular in light of the fact that the SML Assessment is a tally of promulgated laws (“extensiveness”), but not of their successful implementation (“effectiveness”).

A. Comments

1. Survey on the Extensiveness of the Law

The SML Assessment is a measure of the existing securities laws in each of the EBRD’s countries of operations and how they comply with IOSCO standards and other principles of international capital market prudential requirements and best practices. Thus, the Project measures the “extensiveness” rather than the “effectiveness” of the adopted securities legislation as of the first quarter of 2004. It is important to keep in mind that the business practices of companies conducting securities trading, share acquisitions or public offerings and the application of the laws described in the EBRD/SALANS Checklists for each of the twenty seven countries assessed under this Project have not been taken into consideration for the rating assigned to each country. As has been shown in several EBRD studies over the years, there is a gap between law development and law enforcement in these countries. Thus, it is not surprising to find some of the highest scoring countries have the most recently adopted legislation. It would be reasonable to expect that these countries ratings could slip downward if the effectiveness of implementation of their securities laws is measured.

2. Timing of the Assessment

The SML Assessment in 2004 was conducted during the first quarter of the year. Any laws that were under review by the relevant country in draft form, but not yet adopted by **31 March 2004**, were not included in the survey responses. Certain countries, like the Russian Federation, had been working on significant legislative proposals to improve its securities market regulation during the time when the assessment of this Project in 2004 was carried out. Nevertheless, if legislation was not yet adopted by the end of the first quarter, it would not have been reflected in the country rating and grouping described in this report.

3. Structural Limitations of the EBRD/SALANS Checklist

The EBRD/SALANS Checklist used to conduct the SML Assessment is inherently limited by its structure and format. While such limitations are not by any means definitive of outcome, they could have had some impact on the results due to the rigidity and uniformity typical of survey questionnaires. In short, the structural limitations were two-fold: first, the broad IOSCO principles on which the Checklist questions were based had to be understood and transformed into concrete questions by focusing on core elements of these principles, and second, the answer choices were limited to a “yes or no” format. Although the Checklist was intentionally organised in this way so as to make the questions easy to understand and to result in uniform presentation of responses, local counsel did not always find the questions

easy to follow and an unambiguous yes/no answer was not always possible. In some areas, such as the presence or absence of self-regulatory organisations, certain local counsel respondents deemed their stock exchange to be an SRO and responded to the questions in the SRO section accordingly. Other respondents had a stock exchange, but no SRO legislation, and responded as being negatively compliant in the SRO category, but more fully compliant in the trading and clearing systems and secondary market sections.

Occasionally, the questions presupposed a certain level of knowledge about more sophisticated trading systems that did not exist yet in some of the EBRD's countries of operations. For example, some respondents missed the significance of T+0 trade confirmations and T+3 trade settlements. Fortunately, there was space beside the answer columns for brief commentary and local counsel were able to indicate if a question seemed unclear or were concerned that a response might be inappropriate. With help from local counsel's commentary and the general sense given by the answers provided, SALANS was able to discern the general compliance level of each country's existing legislation. SALANS does not wish to assert, however, that the process of collecting and scoring the data in the SML Assessment was a perfectly precise or exact scientific process.

B. Observations

In reviewing the responses from local counsel under this Project, SALANS observed two general trends: one relating to the EU accession countries and the other relating to the timing of legislation and the contributions from donor organisations that have assisted certain countries in their legislative development.

1. New EU Member Country Trends

As noted above, the new EU member countries where the EBRD operates (i.e., Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia) scored in the medium or high compliance category. However, while economically advanced, these countries did not categorically rate in the high compliance category. In fact, only Estonia, Latvia, Lithuania and Slovenia were rated as high compliance among these eight countries.

Although explanations vary, one reason the new EU member countries assessed under the Project were not all high or very highly rated might be that they were among the earliest ones to implement basic securities laws. The assessment results of this Project reflect the trend that legislation introduced in the early to mid-1990s has been less extensive in its coverage than the legislation adopted in other countries within the last five years. Reasons for this disparity could be due to differences in legislative tradition, but more likely are based on the intensity of more recent donor assistance programs to a particular region.

Already in the mid-1990s the candidates for accession to the EU in 2004 needed to meet a minimum threshold from which their capital markets could mesh with the larger European community, including the readiness for implementation of EU laws under the concept of *acquis communautaire*. However, the focus of EU accession concerned more the achievement of certain economic and democratic thresholds than that of a highly sophisticated level of securities law development. Indeed, as the assessment results of this Project show, other non-EU accession countries in which the EBRD operates, with more recent securities legislation, have achieved higher compliance scores as to the laws on their books. Yet, once again, the effectiveness of these laws has not been tested. Without attempting any pre-judgment, it

cannot be excluded that some EU accession countries may achieve greater success in implementing their “medium compliance” laws than other transition countries with more recent and extensive securities legislation.

2. The Impact of Legal Models and Donor Funding

Borrowing on a theme cited in the EBRD’s Report on the 2002 Results of the Corporate Governance Assessment Project, there are three basic factors that have an impact on how the securities markets legislation in an EBRD’s country of operations will develop. The first factor is the time at which the securities markets legislation is adopted. As observed above, the more recent the legislation, the more it seems to reflect the latest in industry standards. A second factor is the divergence in legal traditions between the EBRD’s country of operations and the country or countries whose laws have served as models for the new securities laws being implemented. For example, countries with a complete absence of free market trading or western models of legislation have had the greatest obstacles to overcome. The Baltic States (i.e., Latvia, Lithuania and Estonia), for example, went from independence from Soviet rule in 1991 to EU accession on May 1, 2004. All three states had strong European legal traditions to which they were able to return. In 1992 Estonia and Lithuania adopted new constitutions, while Latvia relied on its pre-Soviet-era legal regime. Though similar legislative results were achieved, Estonia and Lithuania benefited most from adopting legal models borrowed from the best of modern European traditions, while Latvia, though working with German and French inspired pre-war codes, lacked the benefit of fifty years of legislative development its neighbours quickly adopted.⁶

Finally, the impact of donor programs and development agencies in assisting the EBRD’s countries of operations in the development of their securities legislation can not be ignored. Take the Czech Republic as an example. The EBRD provided legal assistance to the Czech Securities Exchange Commission to review and revise its securities law and to establish a regulatory function that will enable the Czech capital markets to operate in an efficient, fair and transparent manner. Funded by the EU PHARE program, in 1999 the EBRD assisted with the training of commissioners and staff, development of a management structure, and the drafting of rules and regulations themselves.⁷ Another more recent example is that Uzbekistan benefited from technical assistance provided by the Asian Development Bank in 2002 and 2003 to draft and implement legislation providing for an independent securities regulator with enforcement powers and umbrella-coverage securities regulations.⁸

Despite the imperfections and influences on results of the SML Assessment, the findings tell a story that can be observed in the promulgation of legislation throughout the EBRD countries of operations. Securities markets legislation has been implemented in each of these countries and significant improvements have been made over the last five years. Few countries are non-functioning in the securities markets area and most score towards the top half of the assessment scale.

⁶ See, “A Decade of Reform in the Baltic States”, by Filip Klavins, Klavins, Slaidins & Loze, in *Law in Transition*, Spring 2000, at 2.

⁷ See, “The Legal Anchoring of Sound Financial Markets, by Gerard Sanders, Chief Counsel, EBRD, and Douglas Arner, Fellow, University of London, *Law in Transition*, Spring 1999, Table 3.

⁸ See, “Technical Assistance to the Republic of Uzbekistan for Development of the Capital Market”, TAR:UZB 36498, July 2003, Asian Development Bank.

IV. GENERAL TRENDS IN THE COUNTRY GROUPINGS AND COUNTRY-SPECIFIC COMMENTS

In an article entitled “Market Perceptions of Financial Law in the Region – EBRD Survey Results”, published by the EBRD in the Spring 1999 edition of *Law in Transition*⁹, commentators found that the capital markets legislation was most highly developed in the then EU accession candidate countries. They also found that the areas most seriously underdeveloped in all the EBRD operating countries were laws created to protect investors. Confidence schemes were flourishing and trading volume remained low. Investment funds were largely unregulated and there seemed to be a complete absence of disclosure requirements. There was also a perception that self-regulatory organisations were lacking and would be a welcome improvement in most jurisdictions. The capital markets of FYR Macedonia, one of the top scorers in the 2004 results of the SML Assessment, were described as “minimally functioning at best” five years earlier. Many Group Three countries, using a scale similar to the one described in this report, were described as needing “significant improvement” in the areas of either investment funds, financial intermediaries or shareholder protection. Most of the Group Four countries seemed to have basic regulation of public offerings in place but were just beginning to implement regulations that would monitor and regulate market participants more directly.

Since the 1999 Survey mentioned above, implementing legislation has improved dramatically. Non-conforming, or very low compliance, countries have dropped from twelve to three. Weakly conforming, or low compliance, countries have dropped from five to four. The greatest gains have been made in the mid- to high compliance categories, with 51% of the countries rated in 2004 achieving a medium compliance level and about 20%, or one fifth of all EBRD operating countries, achieving a score of high compliance. Group Three countries are now largely CIS and SRO compliant, while Group Four countries have addressed the regulation of financial intermediaries and are in need of the more refined investor protection, conflict of interest prohibitions, and systemic risk reductions that a fully developed securities law system would embody. Overall, the EBRD operating countries are making considerable progress in adopting securities laws and providing a basis for effective domestic capital markets. Details of the trends discovered in each of these groups are explored below.

A. Group One – Very Low Compliance Countries

The development of securities markets legislation in the Group One countries is extremely limited. The legislation in place appears to be in its earliest stage of development. The Group One countries have either no stock exchange or one that is non-functioning. The legal rules that do exist with regard to securities markets are often unclear or ambiguous. Regulators exist, but their supervisory powers are scant. Laws that are intended to protect investors are non-existent. The SML Assessment results of 2004 placed **Azerbaijan, Tajikistan, and Turkmenistan** in Group One.

⁹ Available at <http://www.ebrd.com/country/sector/law/index.htm> , then click on the link of *Law in transition*.

1. Azerbaijan and Turkmenistan

Azerbaijan and Turkmenistan had almost identical low scores with the exception of the category on “Accounting and Auditing of Financial Reports”, where both countries achieved medium compliance. For Azerbaijan, in most of the section on “Issuers and the Information-Disclosure Obligations”, local counsel noted that the legislation, though existing, was not clear. For Turkmenistan, local counsel noted unequivocally that securities offering legislation and disclosure requirements were non-existent. Collective investment schemes are illegal there. Similarly, there are no financial intermediaries and no stock exchange. In Azerbaijan, a stock exchange exists, but the regulator has no monitoring or surveillance powers. There are no investment protection measures or prudential requirements. Securities clearance is not centralised, nor are there regulations regarding confirmation and settlement of trades. Turkmenistan has no SRO framework. The legislative framework in Azerbaijan contemplates SROs, but there is almost no implementing legislation in the area and virtually no legislation in place addressing money laundering, financial instruments, or investment service providers. Room for improvement remains in all areas for both countries.

2. Tajikistan

Tajikistan does not have a functioning stock market. Collective investment schemes are not yet contemplated by law. Similarly, money laundering, legislation and rules addressing financial instruments and investment service providers are non-existent. Although there are laws regulating accounting and bookkeeping activities, local counsel notes that there are no professional accounting firms in the country. Accounting standards lack specificity and there is no oversight board for this activity. Most of the laws on the books that relate to securities were promulgated as company law and financial regulation. Tajikistan is in need of the creation of a strong securities regulator and the implementation of laws specific to securities regulation and the protection of securities investors.

B. Group Two – Low Compliance Countries

The SML Assessment results of 2004 rank **Albania, Belarus, Kyrgyz Republic and Moldova** in Group Two as Low Compliance Countries. This grouping tends to have limited securities legislation in place with securities markets in an early stage of development. These countries tend not to have any regulation of financial intermediaries or collective investment schemes. Regulators exist but their powers are limited or are not well-defined. The concept of regulators cooperating and sharing information with regulators from foreign jurisdictions has not yet been introduced into the law. Investor protections are non-existent and there are few professional training or conduct codes imposed on securities markets regulators, intermediaries or service providers, to the extent these entities exist at all.

1. Albania

In Albania, improvements need to be made in legislation addressing issuers and their disclosure obligations, accounting and auditing standards, and the implementation of a strong framework for securities trading on the secondary markets. Once these areas are strengthened, Albania could more naturally evolve towards SRO legislation, collective investment schemes and a better regulatory framework for financial intermediaries and investment service providers.

2. Belarus and Moldova

Belarus did the best among the Low Compliance Countries for regulation of “Issuers and their Information Disclosure Obligations”. Unfortunately, it did not have strong corollary legislation on the accounting standards that should apply to financial statement reporting, a critical element for issuer disclosure in securities offerings. Low scores in the section of “Clearance and Settlement” and non-existent legislation for the sections of “SROs”, “Financial Instruments”, and “Investment Service Providers” all contributed to the low compliance result for Belarus. Moldova had an overall low scoring and mirrored the Belarus results in most categories. Most encouraging for Moldova, however, was its high compliance result on the heavily weighted “Accounting and Auditing of Financial Reports”. Moldova is in a solid position to improve on its issuer disclosure regulation given that strong accounting standards are already in place.

3. Kyrgyz Republic

While the Kyrgyz Republic was rated as a Low Compliance Country according to the 2004 assessment results, the country has benefited from recent legislation, much of it adopted in 2003, addressing the securities markets: disclosure obligations, stock exchange rules, investment laws, and regulation of depositaries. Some of this legislation evolved as a result of a technical assistance program provided by the Asian Development Bank in 2001 as the second part of the Corporate Governance and Enterprise Reform Program commenced in 2000. The program targeted improvements in financial disclosure and minority shareholder protections in addition to its corporate governance goals which assisted the development of its securities markets regulation as well.

The Kyrgyz Republic now has a State Commission on Securities and a State Commission on Accounting. Comparing to other Low Compliance Countries, the Kyrgyz Republic scored highest for the accounting and auditing category, the regulator category, and the issuer and its disclosure obligation categories. This triumvirate serves as the basis necessary for a minimum standard of securities legislation. The Kyrgyz Republic also stood out for its highly compliant SRO and financial instruments legislation. With further progress needed particularly in the market intermediaries, secondary market, clearing and settlement areas, the country is primed to achieve better results in the future.

C. Group Three – Medium Compliance Countries

The fifteen countries in this medium compliance category constitute the largest grouping of countries according to the 2004 assessment results of the Project. **Bosnia & Herzegovina, Georgia, Poland, Romania, Russian Federation, and Serbia & Montenegro** were ranked lowest in the grouping. **Armenia, Bulgaria, Hungary, Kazakhstan, Slovak Republic and Ukraine** came in with stronger results within the grouping, while the **Czech Republic and Uzbekistan** came very close to reaching the high compliance category.

It is at the higher end of Group Three where details about the existing legislation made a difference. Countries were scored lower if they had incomplete prudential and systemic risk protection, such as failing to provide for minimum capital requirements for financial intermediaries, not requiring margin calls for exchange based trading, or a lack of surveillance or monitoring of large exposure trades. Lack of international cooperation with foreign

regulators became a tipping point as did the non-existence of minority shareholder rights and information disclosure about large share positions and takeover triggers. Failure to have SRO legislation or a system of protection against money laundering also cost points, even though these areas were not weighted as being critical to an efficient securities market. Some comments about a few of the countries in the medium compliance category are worth noting.

1. Czech Republic

The Czech Republic is a country that scored so high within the medium compliance group as to be worthy of consideration as a borderline High Compliance Country. Most of its securities legislation was adopted in 1998 when, as mentioned above, the Czech Republic benefited from EBRD and EU PHARE assistance with the drafting of new securities legislation and the creation of a very strong securities regulator modelled on the US Securities and Exchange Commission. Where the Czech Republic has room for improvement, however, are in the areas of (i) SRO legislation, of which local counsel considers there is none, despite the existence of a stock exchange, and (ii) prudential requirements in the areas of clearance and settlement and the secondary market. In particular, existing legislation does nothing to reduce the risk of the non-completion of transactions, either by applying margin requirements, imposing capital contributions, or setting credit, market, or position limits. Monitoring and surveillance of the market participants is not conducted on an on-going basis, and, thus, there is no system to safe-guard against insider-trading, market fraud, price manipulation, or excess margins. If the Czech Republic were to address these aspects of its securities markets regulations, focusing on the protection of investors and the reduction of systemic risk, it will ensure itself a berth in the high compliance category for the future.

2. Hungary

Hungary's assessment results, which again came close to the high compliance category, indicated a lack of strength at the regulator level, issuer disclosure obligations and responsibility, and shareholders' rights. Although strong in SROs, collective investment schemes, and market intermediary legislation, Hungary needs to establish a body responsible for its accounting standards and their interpretation. Hungary will also need to develop its financial instruments legislation and investment service provider regulations further in order to establish a high compliance rating overall.

3. Romania

Romanian securities laws have developed in the last two years with significant legislative improvements. In April 2002, the Government of Romania adopted ordinances creating a Romanian National Securities Commission, legislation regarding the collective investments of securities, and commodities and derivative financial instruments trading laws. In June 2003, the National Securities Commission created regulations authorising financial investment companies, open-end funds, investment management companies and depositories and in August of that year adopted regulations regarding public offer of securities and other financial instruments. As a result of this new legislation, Romania was able to build up its securities funds and financial intermediaries, two areas that respondents had noted were lacking in an earlier survey.¹⁰

¹⁰ See *id.*, at 32.

Romania's overall score did not move into the high compliance category, however, as local counsel noted that in several important areas, implementing regulation was still not in place. For example, the scope of the regulator's surveillance powers has yet not been clearly defined. Romanian law still does not provide for listing particulars for securities being listed on an exchange. No competency requirements are in place for system operators on the secondary market, and regulators have no measures to deal with the failure of a financial intermediary.

A typical tipping point between high and medium scores under the SML Assessment in 2004 was the presence or absence of laws reducing systemic risk. Romania does not yet have legislation permitting market authorities to take action to increase margin requirements or suspend trading at times of market disruption. As a result, its score was dragged down. In addition, there are no prudential requirements in place for members of the trading system, non-clearing members or other users of a trading system to take precautions about capital adequacy, monitoring large positions or guarding against fraudulent trading. Securities are not yet in an "immobilised" or "dematerialised" global form and there is no central securities depository in Romania for clearance and settlement. Attention to these areas in future legislation will bring further improvements.

4. Russia

By decree effective March 12, 2004, President Putin abolished Russia's Federal Commission for the Securities Market and transferred its control and surveillance powers to the Federal Service for Financial Markets ("FSFM") which operates directly under the jurisdiction of the national government. Further resolutions in April this year established the main functions of the FSFM to include: (i) state registration of securities offerings, as well as registration of securities prospectuses, (ii) ensuring disclosure of information on the securities market in compliance with the law, and (iii) control and surveillance powers with respect to issuers, professional securities market participants, and SROs.

The competence of the FSFM appears to differ from that of its predecessor regulatory body but its functions and authority remain unclear for the moment. Although the Russian Government appears to have assumed the authority to implement securities regulations, no provisions have yet been implemented on the status of various acts relating to the competence and powers of the federal authority responsible for the securities market. For the time being, legislation referring to the former regulator or its functions is probably not effective in respect of such references. Amendments or new legislation can address this problem, but for the time being, there is nothing to ensure the continued enforceability of pre-March 12, 2004 acts relating to the competence and powers of a now-defunct regulatory body. On the other hand, the securities regulations listed by local counsel which were already in place prior to March 12, 2004, should still be applicable and no amendments have yet been implemented by the Government.

In order to read the SML Assessment results in the most positive light, local counsel has indicated in the notes section to the EBRD/SALANS Checklist those areas where the predecessor regulator had implemented legislation responsive to international securities law norms. Over time, as further implementing laws and amendments are put into place, the securities law framework in Russia will become clearer. For now, as local experts have pointed out, the securities laws remain in flux. Hopefully, the legislative framework will not regress in its development under the new regime, but, even this supposition is not certain.

Based upon documented and enacted legislation, including the regulations adopted by the previous regulator, Russia's overall scores on the SML Assessment are in the medium category. In addition to the prior regulator's work, there is extensive law in place regarding accounting, money laundering, and investment service providers. However, there is still much progress to be made in market supervision, clearance, and prudential requirements for exchanges and intermediaries. For example, the regulator should be subject to a code of conduct and its activities made more public, should have investigatory and rule-making powers, and should cooperate with regulators from other jurisdictions. In other areas, Russia needs to implement listing particular requirements, further minority shareholder protections and impose T+0 trade confirmations and delivery versus payment clearance systems, as well as to centralize securities depositories. There currently are no "know your customer" rules and no regulatory powers to impose margin calls, reduce exposures to large share positions, or otherwise empower a market authority to take action against systemic risks.

5. Uzbekistan

Thanks to special funding and technical assistance in 2003 from the Asian Development Bank, as mentioned above, Uzbekistan now has laws on its books that allowed it to make remarkable progress with high scores in the areas of "Clearing and Settlement", "Accounting and Auditing of Financial Reports", "SROs", and "Money Laundering" legislation. As recently as 1999, commentators rated Uzbekistan in the 1999 survey mentioned above¹¹ as "non-conforming", a score equivalent to Group One, or very low compliance. Under the SML Assessment results in 2004, Uzbekistan has moved to the medium compliance scale.

Uzbekistan introduced legislation on the regulation of investment intermediaries and information disclosure requirements for securities markets participants in 2002. In 2003 Uzbekistan adopted regulations on the licensing of securities markets professionals, clearing and settlement, and stock exchange trading rules. Securities markets have been regulated by the Center for Coordination and Control of Securities Markets since 1996. Areas of improvement remain in further strengthening the powers of the regulator and enhancing disclosure to shareholders during changes in corporate control. Further progress could also be made in the licensing of market intermediaries, in granting the power to take remedial actions to market authorities in case of market disruption, and in prudential systems such as increasing margin requirements, increasing the capital of a carrying firm, or the suspension of trading. Uzbekistan scored less well in the categories of the "Secondary Market", "Financial Instruments", and "Investment Service Providers".

D. Group Four – High Compliance Countries

High Compliance countries have comprehensive securities markets legislation in place conforming generally with international standards. Most countries had one or two areas where progress remained to be made, but the essential keystones of independent securities market regulator, issuer disclosure obligations, and financial disclosure requirements in compliance with recognised accounting rules were present across the board. The SML Assessment results in 2004 found **Croatia, Estonia, FYR Macedonia, Latvia, Lithuania, and Slovenia** ranked in this high compliance category. Typical areas for improvement related to disclosure of personal benefits or background by the senior management of financial

¹¹ *Id.*

intermediaries, requirements to provide account statements or information about the financials or shareholders of financial intermediaries, and whether derivatives securities must settle and clear on a specialized trading system. Other areas for improvement lie in the continuing education requirements for accountants, auditors and other financial professionals. Few countries have specific legislation in place for the regulation of securities issued to employees as part of a share purchase plan. These insufficiencies signal areas for refinement but do not detract from the overall high compliance level of the securities law frameworks in place.

1. Croatia

Croatia showed exceptionally strong results. With slight weaknesses in financial instruments, clearance and settlement, and accounting and auditing of financial reports, Croatia had top scores in all other categories. It is worth noting that Croatia benefited from the European Commission “Community Assistance for Reconstruction, Development and Stabilisation Programme (CARDS)” to develop its legislative framework, as well as more tangible economic and physical infrastructure needs. In May 2001, the World Bank-International Monetary Fund program of Reports on the Observance of Standards and Codes (“ROSC”), designed to strengthen a country’s financial architecture, worked with the Croatian Securities Commission to review relevant Croat securities legislation. The 2001 ROSC Report observed that Croatia needed to improve its disclosure of share ownership and control structures, and the independence of auditors. Its capital markets regulator, the Croatian Securities Commission, and its central securities depository agency were deemed in compliance with most but not all international norms.¹²

The SML Assessment shows that further progress has been made by Croatia since the 2001 ROSC Report mentioned above. In 2002, the Croatian Parliament passed the Securities Act, the Law on Takeover of Joint Stock Companies, and Licensing Regulations for Financial Intermediaries. In 2003, the Croatian Parliament further passed amendments to the Money-Laundering Act, the Act on Registry of Annual Reports, Brokerage Regulations, Prospectus Requirements, and Investment Conditions for Residents into Foreign Securities and Investment Funds. As a result of this recent legislation, Croatia has few areas where additional improvements are required. Shareholders still lack appraisal rights or mandatory cash buy-outs upon take-overs; take-over disclosure is less extensive than prospectus disclosure requirements; and directors and senior management are not required to disclose compensation or personal benefits they would receive in a takeover. CIS schemes could be improved by requiring the on-going professional training of their managers, and the separation a single entity of custodial and investment functions. In clearance and settlement, only the shift from settlement on day T+4 to T+3 remains to be improved.

2. Lithuania and Estonia

As noted above, Lithuania and Estonia both addressed the problem of updating their regional laws by implementing new constitutions in 1992, creating a Securities Commission in the same year, and modernising their body of laws based on western models. The Lithuanian Parliament adopted its Law on Collective Investment Undertakings in 2003, along with its Company Law, Law on Controlling Investment Companies, Stock Exchange Rules, Licensing Financial Intermediaries, Annual Reports to the Public by Brokerage Firms, and Regulations

¹² *Report on the Observance of Standards and Codes, Corporate Governance Country Assessment – Republic of Croatia*, at 5.

on Prospectus Contents Requirements. A year earlier it had adopted the Law on Financial Institutions, Rules on the Registration of Securities, Rules on Issuer Disclosure Information, and Rules for the Submission of Quarterly Reports to the Securities Commission. Estonia implemented legislation covering these same areas a few years earlier, but as recently as 2004 introduced amendments to its Securities Markets Act, Investment Funds Act, Financial Inspectorate Act, Money Laundering Act, Accounting Act, and Stock Exchange Rules.

Both countries joined the European Union on 1 May 2004, and scored high on the compliance rating of the SML Assessment in 2004. With their recently adopted legislation covering the expectations of international securities law norms, these Baltic countries can now focus on refinements in their corporate laws to accommodate shareholder appraisal rights, shareholder disclosure obligations in takeover situations, and adopt further financial service provider regulations to address such luxuries as on-going professional training for CIS management, brokers, and investment advisers.

3. FYR Macedonia

In a November 2003 ROSC report, several improvements were recommended for enhancing the integrity of the financial system in FYR Macedonia including the development of a government securities market, upgrading accounting standards and enforcement, and terminating abuses by company employers that are able to forcibly remove voting rights of shareholder employees. The 2003 ROSC report noted that the development of equity markets in FYR Macedonia had been adversely affected by this worker abuse of employee shareholders through the privatisation process, effectively blocking trading of shares. Although the 2003 ROSC Report found the legal framework for FYR Macedonia's financial operations generally sound, its implementation and enforcement were perceived as weak. It noted, too, the difficulty FYR Macedonia faces in combating organised crime and money laundering activities, yet recognised the strides the country has made in implementing new laws against money laundering in 2001 and the prevention of corruption in 2002. FYR Macedonia has received funding from the International Monetary Fund ("IMF") for many reforms, including the development of a government securities market and to introduce over the counter trading, but more progress is needed.

Against this backdrop, however, the 2004 SML Assessment of FYR Macedonia found positive results. Although enforcement may well be a continuing problem, the framework for a sound securities market is in place. There is a Securities Commission and it does have enforcement powers. It lacks provisions to protect staff from lawsuits in carrying out their duties, and could begin publishing its policy decisions and being more transparent about its activities and investigations. Yet its results on the "Regulator" section of the EBRD/SALANS Checklist were strong. As indicated in the 2003 ROSC report mentioned above, there is not enough protection of minority shareholders, such as appraisal rights and disclosure of shareholder percentage ownership above certain thresholds, but overall, FYR Macedonia scored well on the "Issuers and their Information Disclosure Obligations" section of the Checklist. Most interestingly, FYR Macedonia had top scores for its accounting policies and procedures regulation in the section on "Accounting and Auditing of Financial Reports". Again, the laws seem to be in place and need only be implemented. The country also scored well on clearing and settlement, anti-money laundering laws and financial instruments. Some of these strong results can be attributed to funding from organisations such as the IMF to address areas of greatest concern: auditing and money-laundering, regulation and enforcement ability.

The next steps for FYR Macedonia, purely on the level of implementation of law, will be to improve the publication of information about and licensing of financial intermediaries and to establish at the same time systems of risk management and internal controls. In the secondary market area, regulations need to be put into place that will reduce the systemic risk of defaults and market failures, including monitoring of trades, compulsory margin calls, and the increase of a carrying firm's capital levels when necessary.

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ANNEX I - COUNTRY RATING MAP 2004

