



**BULGARIA:  
CAPITAL MARKETS DEVELOPMENT PROGRAM**

**U.S. Agency for International Development**  
Contract # PCE-I-00-97-00014  
Delivery Order # 804

**FINAL REPORT  
APRIL 2002**

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\*\* All deliverables were provided to USAID with the project’s monthly reports. Given their size, they are not included with this document.

# BULGARIAN CAPITAL MARKET DEVELOPMENT PROJECT FINAL REPORT

## Introduction

Bulgaria, one of the most advanced countries in Eastern Europe and the Balkans, is currently on the forefront of those countries seeking to join the European Union and successfully transitioning into a democratic, market-oriented society. The Bulgarian Capital Markets Project provided timely and significant assistance to the capital market institutions in a period when Bulgaria had to adjust to a severe crisis in the World financial system (Asian crisis and Russian Default) and turn its business and financial focus to the West. With help from the United States Agency for International Development (“USAID”) and other western donor institutions, the Bulgarian government, economy and society completed an extraordinary and difficult refocusing of its economic activity towards Western Europe, which hopefully will pave the way for its early admittance to the European Union.

## Project Background and Tasks

USAID technical assistance to Bulgaria’s capital market development began in late 1996, and was primarily focused on the development of registry and depository functions within an independent registry. Activities under USAID’s capital market initiative ceased in July 1997, and over the ensuing 12 months, USAID reformulated its assistance strategy in close coordination with senior Government counterparts. Decisive changes were made in the structure of the capital market, and in the principal market institutions, notably: the appointment of new SSEC commissioners, the formation and licensing of the BSE/S, and proclaimed GOB commitment to commercial sector ownership and the development of the Central Depository.

Given these material and substantive changes, USAID and the Government of Bulgaria negotiated the terms and conditions for a new intervention, and this relationship was formalized in a Memorandum of Understanding (“MOU”) which was ratified in by the National Assembly in June 1998 as law. Based upon this MOU, USAID proposed the current delivery order under which targeted assistance was provided to the key institutions and participants, which are critical to the development of Bulgaria’s capital market. This assistance is consistent with USAID/Sofia’s approved five-year assistance strategy, which highlights support for those legal and regulatory institutions, which are integral to Bulgaria’s transformation to a market economy.

The Task Order and its Modification specified the following objectives:

- ◆ Provide technical assistance to the development of capital market institutions
- ◆ Train market institutions and market participants to execute transactions efficiently, openly and honestly
- ◆ Assist the Bulgarian Stock Exchange (“BSE”) in strengthening its internal rules, procedures, regulation and enforcement in accordance with global “best-practices”
- ◆ Assist the BSE to install a world class trading system and improve its operational procedures
- ◆ Assure that trade execution, clearance, settlement and registration of securities transactions are well integrated, and function in an open, fair and transparent manner

- ◆ Assist the Central Depository (“CDAD”) in improving its operational efficiency and institutional capacity
- ◆ Assist professional organizations in Bulgaria, including but not limited to Bulgarian Association of Investment Intermediaries (“BALII”) the Institute for Certified Public Accountants (“ICPA”) to improve business operations including the adoption of International Accounting Standards, strengthening corporate governance standards and code of ethics and improve information dissemination
- ◆ Enhance disclosure by BSE-listed companies
- ◆ Support increased public participation in the capital market through public awareness and education
- ◆ Assistance to the newly privatized enterprises in order to improve governance, shareholder rights and participation, and compliance with State Securities Commission disclosure, reporting, and regulations

During 2000 the task order was amended to expand the scope of activities to include:

- ◆ Assist in the facilitation of cross-boarder trading
- ◆ Development of alternative financial instruments

These two amendments were added largely due to the overall success of the systems implementation, where money was saved by selecting the Russian Trading System (a USAID sponsored counterpart from the USAID-funded Russian Capital Markets Development Program during 1994-97) which provided a world class trading system for a substantially lower price than any of the other vendors who were part of the systems selection process. As resources were reallocated, it was decided by USAID Bulgaria that the task order would focus on the development of alternative trading instruments outside of the traditional equity instruments which were prevalent in emerging market economies in addition to promoting the idea of cross-boarder transactions throughout the Balkans.

These efforts are designed to continue stimulating the growth of an emerging market economy in Bulgaria.

## **Project Implementation**

### *1. Support to the BSE and CDAD*

The project began the assistance to the BSE by undertaking a structural analysis of the BSE and CDAD’s organization, operations and technical capacity to handle its regulatory mandate. A preliminary analysis of its overall operations was completed in March of 1999. This was supplemented by an in-depth analysis of the BSE and CDAD’s technological capabilities, which was completed in May 1999; a final report containing the CARANA team’s findings and recommendations was distributed to the BSE and CDAD in June of 1999. In consultation with the BSE/CDAD staff, CARANA recommended systems for selection and installation taking into consideration other systems installed by USAID. The recommendation took the form of a written report outlining the steps taken to define requirements and evaluate potential market systems; a description of all systems that were considered, but not recommended and the basis for that result; acquisition and implementation costs; a timeline for installation, testing, and launch of the systems; a description of the relevant telecommunications linkages that must be in place; the scalability of the proposed systems and their ability to accommodate different types of trading instruments; maintenance costs; space and security needs; staffing and training needs; and an

operational budget. Additionally, this report contained an itemized purchase and installation time plan; a plan and schedule for training the exchange/depository staff and the staffs of member firms; and a plan for coordinating development of the market system in a compatible and seamless manner with the hardware and software chosen for the depository component of the project.

After the systems selection process was complete, CARANA assigned a team of consultants to work with the exchange and depository to develop their internal capabilities to administer the operation of the new market system and to establish appropriate regulations for access to and use of the system by qualified participants. CARANA recommended modifications as needed with respect to the legal status, internal governance structure, rules, staffing, and day-to-day operations of the entities. The objective of this effort was to identify specific areas requiring technical assistance and to develop priorities and a timeline for delivering that assistance.

Lastly, CARANA advisors lead discussions with the brokerage community, BSE, and CDAD regarding the grey market of non-listed securities and OTC securities trading. This discussion led to the development of a strategy on how the BSE could capture the OTC trades. CARANA advisors assisted in the drafting of necessary language to the BSE Rules and Regulations to include this market segment in the trading system and develop a comprehensive audit trail of trading activity.

#### *2. Assistance with the development of business plans for BSE and CDAD*

With respect to finances, CARANA evaluated the exchange and depositories current budget practices, cost and fee structures, and its business plan. Based on this effort, CARANA developed an updated business plan and budget that recognized the additional resources needed to operate and maintain the new systems. With this information, CARANA developed a realistic plan and timeline for phasing out donor assistance as the entities progressed toward economic sustainability.

#### *3. Create a Guarantee Fund at the BSE*

CARANA advisors drafted and delivered to the Presidents of the CDAD and BSE a basic plan for creation of a settlement guarantee fund at the BSE/CDAD. The institutions themselves were willing and ready to implement such a scheme but due to the fallout of the Russian financial crisis and its detrimental impact on the Bulgarian equity market in 1998, the brokerage community has been unwilling to adopt this fund. It is hoped that sometime in the future, the industry will understand the necessity of such a fund and move quickly to implement it.

#### *4. Market Maker Rules*

In an effort to create a more dynamic market, the BSE drafted a preliminary text of rules to afford market makers entry into the BSE listed-market for equities. Towards this end, CARANA staff reviewed these rules with a view towards making recommendations for improvement. These recommendations included the adoption of revised capital standards, provisions for round-lot, odd-lot market maker registration in addition to registration and withdrawal requirements for BSE-listed securities. This report was submitted to the BSE in December of 2001.

### 5. *Netting Rules*

Separately, CARANA team members were asked to provide guidance to CDAD and BSE staff on an appropriate structure to facilitate the netting of securities at the BSE. While the CARANA staff outlined the procedures and operations for a netting facility at the CDAD and BSE, Bulgarian legislation precludes the existence of “nominee” which is a necessary prerequisite to the establishment of netting. Without nominee explicitly defined in the law, all securities are held at the beneficial owner level thus making it impossible to net. This revelation was transmitted to the BSE and CDAD staff with draft language for an amendment to the Law on Public offering of Securities in December 2001.

### 6. *Subscriber Agreements*

With the advent of a new trading and depository system comes added responsibility of both the market operator and those participants seeking access to and use of this new facility. CARANA staff recommended to the management of the BSE/CDAD creation of subscriber agreements which would qualify participants for use and access of the system in addition to prevent unauthorized access to the trading system by individuals who are not authorized or licensed by the SSEC. These subscriber agreements were accepted and incorporated into the BSE’s end-user agreements.

### 7. *Regional Cooperation*

During November 2000, the BSE announced plans for exploration of a cross-border trading linkage with EuroNext and the Athens Stock Exchange. Following announcements of these proposals, a CARANA advisor met with the BSE’s senior management to discuss the appropriate “next steps” to evaluate and develop this initiative according to the new product template mentioned below. The cross-border initiative would be a critical application of the new product methodology, as it requires the joint participation of the BSE and CDAD along with their counterparts in Greece, and possibly Austria as well.

In this connection, Memorandum of Understanding (“MOU”), were signed with the Athens Stock Exchange for cross-border clearing and settlement. At the same time, discussions were held with Macedonian, Serbian, Croatian and Romanian Stock Exchange’s on the facilitation of cross-border transactions and other Balkan linkages. These meetings proved very productive and resulted in serious progress in such creating linkages and advanced integration.

### 8. *Assistance in the Development of Alternative Trading Instruments*

As a positive first step towards developing new products and instruments outside of the traditional following of equities in USAID-funded programs, a CARANA advisor provided assistance to “ProSoft” a software company in Bulgaria in developing a prospectus for a bond offering during 2000. Separately, CARANA advisors provided assistance to First Financial Brokerage House on the development of an Offering Memorandum for a private placement of bonds issued by the financial institution. What’s more, CARANA advisors worked with another company “Lavena” in developing their prospectus for a separate corporate bond offering. Towards this end, CARANA team members assisted the BSE in reviewing its product component of its trading system in order to facilitate the trading of these bonds.

Separately, a CARANA advisor arrived in September 2000 to provide technical assistance in the area of mortgage-backed securities and mortgage bonds. This specialized assistance was

requested by the brokerage community because of the Government of Bulgaria's decision to implement legislation to create mortgage bonds in Bulgaria. This initiative is being advanced by the World Bank assistance programs utilizing the Denmark model. Nevertheless, USAID requested that CARANA provide an advisor who could provide some training that would concentrate on the economics of this segment of the bond industry and certain aspects of trading. This training led to the creation of the first Mortgage Bond issue by Bulgarian American Credit Bank and subsequent offerings by similar firms.

#### *9. Development of Marketing Program for BSE*

In April 2001, CARANA advisors worked with the BSE and CDAD counterparts, responding to questions and reinforcing business logic inherent in the "new products" template referenced above. The template was applied to the CDAD's proposed initiative to provide support services (primarily, proxy services) to issuers conducting General Meetings of shareholders under applicable corporate law. Both of these activities began in November and continued into the first half of December 2001.

Separately, in early 2002 the CARANA team worked with staff of the BSE to develop a marketing brochure that sought to highlight the new changes to the Law on Public offering of Securities, proposed procedures for the privatization of certain state-owned assets via the facilities of the Stock Exchange; and the generally agreed to principles which sought restitution under the newly adopted Law on Compensatory Notes. This brochure was distributed throughout the regions of Bulgaria in addition to the major cities of Sofia, Varna and Bourgas.

#### *10. Assisting the BSE in developing its capacity as an SRO*

CARANA advisors worked with the BSE's trading department to develop examination modules, capital adequacy regulations and analytical procedures for evaluating broker/dealer activity. In addition, they assisted the BSE staff in their review of current examination procedures for individual brokers and recommended areas for examination and procedures for evaluating the effectiveness of questions presented on the examination.

CARANA advisors began this assistance to the BSE during the later part of January 2000 and began review of the improvements to the inspection and examination program of the BSE. Their first project was an analysis of the inspection of brokerage companies and banks registered as intermediaries to see if they complied with new capital requirements required by the Law on Public offering of Securities. A CARANA advisor assisted the BSE in its examination of brokerage houses and banks registered as securities intermediaries to determine if they had met the increased capital requirements mandated by the Law. A CARANA advisor also reviewed three examinations conducted by the BSE of banks and brokerage houses registered as securities intermediaries. (Due to privacy requirements in the Bulgarian laws, the examination reports were redacted of all information that could identify the registrant or any individuals accounts held at the registrant). The review found that the BSE had made great strides in the scope and techniques of its examinations.

As part of the assistance related to regulation of Broker/Dealers, the BSE requested that CARANA advisors assist the SSEC in analyzing the new Capital Adequacy Rules of the European Union so that, along with the Bulgarian National Bank, it could meet with representatives of the European Union to discuss implementation of the new EU capital adequacy rules. A CARANA advisor prepared a memo explaining the new rules and an Excel model setting

forth the steps for conducting an analysis of a broker-dealer's compliance with the capital adequacy requirements.

#### *11. White paper on Pension Funds and Capital Markets*

As part of our liaison with our sister project in pension fund reform, CARANA advisors prepared a white paper entitled "Pension Funds and Capital Markets." The paper sought to examine the dynamic interaction that can develop between pension funds and capital markets and the practical implications for Bulgaria. Pension funds are not only a source of long term savings to support the development of bond and equity markets. They can also be a positive force for innovation, for corporate governance, and for privatization. Correspondingly, capital markets offer pension funds the opportunity for better portfolio returns and risk management. This interaction is a long, self-reinforcing process that builds on sound macroeconomic policies, effective regulatory reforms, and robust accounting, legal and information infrastructure.

#### *12. White paper on Securities Lending/Collateral Management Scheme*

At the request of the Bulgarian Central Depository, a CARANA advisor provided extensive assistance in the area of securities borrowing and lending throughout 2001. This assistance (which was specifically requested by the CDAD President) developed a template based on the general template for defining, evaluating, developing, and delivering new products and services. This template was distributed to senior management of the CDAD and BSE in November.

Further, the CDAD provided the CARANA advisor with the detailed business requirements for the securities lending and borrowing program. The Advisor reviewed this material in November and provided comments to the CDAD. The object of this exercise was to reinforce application of the concepts found in the template.

#### *13. White paper on Super Regulators*

In December 2001, the project team was tasked by the USAID mission to draft a white paper on the possible creation of a Super Regulator, which will consolidate the regulatory activities of Pension, Insurance, Health and Capital Market institutions. The genesis of this request stems from the announcement by Ivan Iskrov of the Bulgarian Parliament of their desire to create such an institution. The purpose of this white paper was to assist USAID Sofia formulate a position statement based upon experiences gleaned from other countries who have adopted such a model.

#### *14. Recommended changes to Laws and Regulations effecting the Capital Markets*

CARANA staff provided recommendations to USAID and our Bulgarian Counterparts on the Law on Public offering of Securities. CARANA advisors provide comments on the Law, which included among other things, a shortened prospectus, pledging of collateralized assets, protection of minority shareholder rights, maintenance of shareholder records, and amendments to the tender offer requirements. Moreover, CARANA/MNS identified several other related pieces of legislation such as the Commercial Code, Civil Code, and Tax Code, which are in need of amendment and forwarded these proposals to the Securities Commission.

With regard to financial reporting reform, a CARANA advisor reviewed the Accountancy and Auditing Acts and proposed amendments, which were adopted by Parliament during October 2001. These amendments were a seminal achievement for this project as they mandate the adoption of IAS in Bulgaria by 2003.

Lastly, during November 2001, the project was contacted by a Valery Dimitrov, Chair of the Economic Policy Commission of the Bulgarian Parliament regarding the adoption of a “venture capital law”. After initial meetings and consultation with USAID, it was decided that the project team would conduct background research into the concept of venture capital laws and propose recommendation to Mr. Dimitrov. Towards this end, research revealed that Poland, Russia, Hungary, the Czech Republic, and India have drafted such stand-alone legislation. However, in other Central Eastern and European countries, there was little evidence of a separate law, which focused strictly on venture capital regulation. The sum results of this research and our meetings with Mr. Dimitrov were that the Bulgarian Parliament would defer discussion of this issue until the third quarter of 2002.

### *15. Financial Reporting Reform*

A CARANA advisor, worked directly with Boyko Kostov and Petar Grancharov of the Accounting Institute outlining our proposed amendments to the Act in order to ensure that the Institute understood the issues and its proposed new role and responsibility assumed under the Act. At the same time, the CARANA advisor continued to work closely with the Accounting Institute in developing their institutional capacity. Towards this end, she completed her review of the Code of Ethics and By-Laws with a view towards making recommendations that are consistent with those promulgated under the International Federation of Accountants (“IFAC”) guidelines.

CARANA staff provided assistance in the reformation of financial reporting reform in Bulgaria across a broad array of topics. CARANA staff undertook the following activities:

- ◆ Recommended training initiatives for other Ministries related to Securities Market
- ◆ Reviewed draft Accounting Law for compliance with International Accounting Standards (IAS), and International Standards of Auditing (ISA)
- ◆ Assisted the Institute of CPAs in promoting a transparent licensing regime
- ◆ Assisted in developing the institutional capacity of Accounting Institute, by reviewing their By-Law, Code of Ethics and Qualification Requirements
- ◆ Conducted a seminar for auditors on development of private practice and marketing.
- ◆ Reviewed University Curriculum

Lastly, CARANA staff signed a Memorandum of Understanding with the ICPA, which outlined significant steps that the Institute will undertake to achieve “best practices” in the profession and in promoting improved Bulgarian financial reports and auditing during April 2001.

### *16. Bulgarian Association of Licensed Investment Intermediaries (“BALII”)*

CARANA provided assistance to BALII discussed strategies for strengthening those services it provided and creating incentives for membership. These recommendations included, draft charters and by-laws for the associations outlining key elements; establishing membership qualifications, suspension and expulsion criteria; the associations role, delegation of authority

from the SSEC, and responsibilities; organizational structure; operational rules; and procedures for conducting investigations and disciplinary actions. In accordance with the regulatory review conducted for the SSEC, a comprehensive review of the Bulgarian administrative code, criminal code, and procedural code with a view towards delegation of authority in order to ensure there is no overlap in responsibility with regard to enforcement powers and investigative responsibility.

Regrettably, BALII as an organization failed to engender itself as an SRO or an Industry Advocacy Group and was subsequently disbanded in 2000. The reasons for which could be attributed to the impact of the Russian financial crisis on the Bulgarian brokerage community and a general pull back in the financial industry as a whole. The result being a measurable decline in the number of licensed brokerage houses and the abandonment of BALII due to financial considerations.

### *17. Training*

CARANA advisors conducted extensive training for the investment and financial community across a broad array of subjects related to investing, brokerage management and financial reporting. A brief list and chronology of these seminars and roundtables follows:

#### **Seminars/Round tables**

- ◆ Corporate Advisory Training Workshops in Sofia, Plovdiv, Pleven, Varna and Bourgas (with BALII – March – June 99). Sessions integrated trainers from BALII, BSE, CDAD, SSEC, lawyers, financial analysts
- ◆ IAS seminar – with BSE; March ‘99
- ◆ Representatives from BSE and CDAD in the areas of trading, surveillance, IT, clearing and settlement visited the Boston and NY stock exchanges, NSCC, DTC, NASD and SIAC (April ‘99)
- ◆ Training for 21 employees of the SSC regarding the functioning and operations of the BSE and CDAD (April 99)
- ◆ Financial Analyses and Portfolio Management seminar (Oct 99)
- ◆ South Eastern European Economic Forum seminar on capital markets development (Oct 99)
- ◆ Financial Reporting and Control Systems seminar for Brokers & Dealers (Nov 99)
- ◆ Financial Reporting and Control for Investment Intermediaries (April 00)
- ◆ Methods for Raising Capital (Dec 99)
- ◆ Fixed Income Seminar – March 00
- ◆ Fixed Income Conference – March 00
- ◆ Global Depository Receipts (“GDRs”) – Delivered by CARANA advisor
- ◆ IAS/ISA – Delivered by CARANA advisor
- ◆ Round table on the practical issues regarding the issuance of mortgage backed securities
- ◆ Corporate governance training program for Bulgarian investors and companies (May 2001)
- ◆ CED Training/Seminars on Corporate Governance Practices for Bulgarian companies and investment community held in Sofia and Albena
- ◆ Practice Development Seminar for Bulgarian accounting firms
- ◆ Seminar “The Nuts and Bolts of Capital” – Nov 2001
- ◆ Round table on the Law on Public Offering of Securities (Sept 2001)

### *18. Improved Corporate Governance and Shareholder Rights*

As part of CARANA's activities in Bulgaria a subcontract was executed with the Centre for Economic Development ("CED") which sought to develop the corporate governance practices of public enterprises in Bulgaria in addition to work towards the protection of shareholder rights. Towards this end, a series of seminars were held (as mentioned above under our training initiatives) where public companies, holding corporations, and various advocacy groups were invited to participate in round-table discussions. Lastly, as a concluding element to these activities, the CED was tasked by the CARANA team to develop a "Listed Company Manual for BSE issuers" which sought to among other things, detail original and continued listing requirements of the Exchange and sets forth BSE rules and policies on such matters as corporate governance, shareholder communications, and shareholder approval. A Web-based version of the full BSE-Listed Company Manual is now available directly from the BSE website. This is a significant step towards the adoption of global best practices in the corporate governance arena as the BSE will be the first exchange in the region to adopt such a manual.

## **Project Impacts and Concerns**

### *1. Strengths and Contributions*

The Bulgarian Capital Markets Project made some extremely important contributions to the development of the financial markets.

#### *Bulgarian Financial Reporting Reform*

The Project was extremely successful in establishing a vehicle in Bulgaria for the adoption of financial accounting standards in accordance with IAS. The previous system that required the approval of the Ministry of Finance proved to be too unwieldy and subject to political interference. The post-Soviet system of accounting has been mainly fiscally oriented to provide a means of measuring the revenue to the State. It was not geared to provide financial information in a format that would be useful to investors and managers in evaluating the company's performance.

The final laws of Accounting and Auditing, which were adopted by Bulgaria make significant inroads towards the adoption of both IAS and ISA. IAS will be adopted for publicly traded companies, pension funds, banks, etc. beginning in 2003, and the rest of the companies beginning 2005. ISA will be adopted for all companies beginning 2003. In addition, the mandatory chart of accounts was eliminated, written and/or oral qualifying exams were instituted, written (not oral) exams for qualified foreigners, quality control and review for auditors, and elimination of restrictions on auditors from performing other services were some of the major implications of the legislation.

#### *CDAD - Enhanced Operational Functions to Improve Viability*

The CDAD was extremely responsive to the assistance provided. It had a clear vision of its current abilities and areas in which it needed additional technical assistance for future growth. Although its operations were already advanced, the BCMP was able to assist the CDAD in providing new services, such as securities borrowing and lending, and corporate shareholder democracy services (proxy services). In addition, the BCMP significantly assisted the CDAD in avoiding problems from Y2K and in establishing a disaster recovery plan.

### *BSE - Enhanced Operational and Regulatory Functions*

The BSE received assistance in the areas of a world class trading systems proved by USAID, developing new products/services, and enforcement of exchange rules. The RTS system, selected by USAID was the second opportunity (the republic of Georgia being the other) where USAID was able to tap into the resources of an institution it helped create and utilize them in another market. RTS was created by USAID through the capital markets program of the Russian Federation during 1994-97. Through this world class trading system supplied by USAID, the BSE was thus able to conduct expanded surveillance of the market and had the disciplinary procedures to conduct an investigation and sanction violators of its rules. In a related vein, the BSE was provided with specific recommendations for rules, and training to implement a market maker system to allow for a more dynamic quite driven market for less liquid shares. Finally, from a business standpoint, the BSE was well equipped to handle changes in the market environment and to take the lead on initiatives such as the integration of the Balkan Regional Markets.

### *Training and Strengthening Private Sector Knowledge*

CARANA training programs significantly increased the skill levels of the brokerage community and the surveillance capacity of the BSE. Most importantly, the Accounting Training programs had a significant effect on furthering the education of Bulgarian accountants in regards to International Accounting Standards and furthering the adoption of a mechanism for the promulgation of Bulgarian accounting standards based on IAS. Lastly, the corporate governance program was quite successful in raising the issue of shareholder rights and fiduciary duties of officers and directors of corporations while creating a more participant-active market in the financial industry.

### *Development of Alternative Trading Instruments*

CARANA made significant inroads towards the development of alternative trading instruments in the form of corporate bonds, mortgage backed and various other asset-backed securities. Moreover, the securitization aspect of the project has generated additional initiatives in other areas such as leasing and commercial lending. CARANA would like to underscore the importance of this aspect of the project as it creates a viable pool of investments for both institutional and retail customers to chose from. This in turn, assists in the diversification of financial risk and creates a more dynamic lending environment, which affords select financial institutions a greater flexibility in both gaining access to and granting credit facilities to qualified participants. With the exception of Kazakhstan, Bulgaria is the only other USAID program where these alternative instruments have been employed and the success of this effort have lead to a re-examining of such initiative in other USAID programs, most notably Romania and the Balkans (Croatia, Bosnia, Macedonia). It is hoped that these other markets will build upon the success of these two programs and continue to expand the viable pool of instruments.

## *2. Issues and Concerns*

### *Low Levels of Capital Market Activity*

The most significant problem facing the Bulgarian capital markets is the very low level of activity on the Bulgarian Stock Exchange. The BSE was doing well until the Russian crisis in the spring of 1998. The market suffered a precipitous decline at that time when large amounts of foreign

capital left the market, from which it has never recovered. The later Russian Bond Crisis of August 1998, cut off a small recovery in the market, but was not the cause of the decline.

Of particular importance, the market did not recover when other emerging markets began to recover in 1999. A number of reasons have been put forth to explain the failure of the Bulgarian market to recover. First, few companies have attempted to use the capital market to raise capital for their activities, resulting in the lack of new securities on the market. In addition, it has been argued that there are few products on the market due to inadequate privatization of the largest and most liquid Bulgarian companies. Moreover, even if privatized, the argument is made that due to the small size of the Bulgarian market, it would not be possible for the market to grow to any size. Finally, recognition began to develop among the market participants that a low level of safeguards existed for minority shareholder rights. This factor, in turn, discourages portfolio investors or venture capitalists from investing in Bulgarian companies.

The market participants began to address these problems by tackling the legislative issue first as to making necessary changes in the securities law. By the end of the project, this effort to affect the drafting of the new legislation had progressed significantly. The overall development of the market has been assisted by Bulgaria's strides towards joining the EU. This push has provided the stimulus for development of alternative products such as asset-backed securities and bonds while pushing the Government of Bulgaria to take additional steps towards privatization of key assets. More specifically, in recent weeks the BSE launched a seminar, which was joined by representatives of the Bulgarian Government on the capital markets and its role in the economic reform program in Bulgaria. It is clear that these and other issues are a priority for both the industry and the Government in Bulgaria. However, it is unclear as to how these priorities are going to be realized.

#### *Pension Funds and Insurance Company's*

At this time, the pension funds are beginning to play an ever-increasing role in the development of the capital markets. The size of these funds and their ability to act as institutional investors are quickly eclipsing the domestic capital markets ability to provide them with the products and liquidity they need. On a positive note, they will foster innovation, corporate governance and promote a greater diversity in the universe of financial products available. However, there is a growing consensus that they will need to lift the current 5% restriction on foreign investments in order to comply with the current government-mandated return on investment guidelines. Going forward, these two classes of institutional investors will play a greater role in the domestic capital markets and any further technical assistance provided to either pensions or capital markets should ensure that there is effective coordination between these two programs.

#### *Financial Intermediaries*

The financial intermediaries in Bulgaria (banks, brokers, investment advisors) are still rather underdeveloped and lack the basic skill set to operate effectively. This can be blamed in part due to the failure of BALII, which would have provided a set of guidelines with regard to code of ethics, by laws and broker-dealer reporting requirements and operations. However, the intermediaries lack a basic knowledge of what types of products and services they should be offering and have been slow to meet the growing demands of institutional investors by supplying the market with new and innovative products. Any future technical assistance should focus on training these intermediaries as the bank-training programs do in order to broaden the skill set of these institutions and enabling them to play a greater role in the development of the capital markets.

### *Privatization*

As mentioned, a second cause of concern is the upcoming plans for privatization by the Government of Bulgaria. At this time, the GOB is seeking to privatize three very important sectors, Tobacco, Banking and Energy via the facilities of the stock exchange. What are not clear are the sequencing (what portion of these assets will go over the exchange and what portion will go to a private investor(s)), timing and procedures for how this will be handled. At the close of the project, the CARANA team had ensured that the software installed at the BSE and CDAD would fully support the auction of any privatized assets but it was not clear how the market participants and investing public would be allowed to participate in this process. Going forward, it would be CARANA's recommendation that the Cash Auction procedures from the USAID-funded Romania Capital Markets project be utilized to mitigate any delay in this privatization.

### *Consolidated Financial Supervision*

As stated, there is an initiative underway in Bulgaria to create a consolidated financial supervision framework. If this is merely a framework which seeks to align the laws and regulations of the Pension, Insurance, Health, Non-Bank Financial Institutions and Banking industries; and which seeks to create an industry working group as was discussed in a USAID workshop in the spring of 2002, this could prove to be a highly effective endeavor. However, if the Bulgarian government forges ahead with the establishment of a consolidated financial supervision regulatory *Agency*, which seeks to merge all the aforementioned functions with the exclusion of Bank Supervision, the implications could be far reaching. What's more, such an undertaking would invalidate a considerable amount of technical assistance already funded by USAID. At this time, CARANA would like to underscore the importance of this potential issue and its implications on current and/or future USAID-funded assistance.

### *Compensatory Notes*

Lastly, the issue of Compensatory Notes and the impact on the economic reform program funded by USAID. At this time, the Government of Bulgaria is seeking to legalize the trading of these notes via the facilities of the stock exchange in addition to establishing the parameters for conversion of these notes into actual shares of soon-to-be-privatized companies. Two fundamental issues are in need of redress towards these efforts.

First, these notes are in physical form or act as bearer instruments, which implies that there is an opportunity for forgery, manipulation and fraud. It has come to our attention that several well regarded professionals in the financial industry have come across fraudulent instruments and we suspect that there may be many, many more. Should a Bulgarian citizen be involved in such a fraudulent transaction or be sold one of these counterfeit notes, what are the Government of Bulgaria's plans for remedy? What sort of arbitration mechanism is available? Steps should be taken to dematerialize these instruments immediately and as part of that process, verify the authenticity of these instruments.

Second and no less important are the valuation of these instruments and how they will be transferred into securities of privatized shares. At present, there are several different proposals under consideration by the Bulgarian government. However, given the potential for fraud in trading of these bearer instruments, the stakes for "getting this right" will be quite high. The Bulgarian government should take immediate steps to outline its action plan for the conversion of these vouchers into shares, the methodology for pricing these instruments and create a dispute resolution mechanism for remedy of any investor complaints.

### *3. Conclusion*

The Bulgarian capital markets institutions are adapting to new market conditions as well as can be expected. The Bulgarian Government has an ambitious economic reform plan for accession into the European Union, which has created a great strain on the financial industry as a whole. However, the institutions are well managed with forward-looking, market-oriented leaders. The assistance provided by the USAID Bulgarian Capital Markets Project significantly assisted the institutions in meeting the demands of the new global financial market conditions and has laid the groundwork for a sustainable economic transition over the next several years.

*\*\* All deliverables were provided to USAID with the project's monthly reports. Given their size, they are not included with this document.*