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# FINAL REPORT

REGULATORY IMPACT ASSESSMENT

GEORGIAN LAW ON SECURITIES MARKET

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TUESDAY, SEPTEMBER 09, 2014

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GEORGIAN LAW ON SECURITIES MARKET
Final

USAID ECONOMIC PROSPERITY INITIATIVE (EPI)
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DELOITTE CONSULTING LLP
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# ACRONYMS

**Table 1 - List of Acronyms**

| | |
|---|---|
| **AA** | Association Agreement |
| **CEI** | Caucasus Energy and Infrastructure |
| **CBA** | Cost-Benefit Analysis |
| **DCFTA** | Deep and Comprehensive Free Trade Area |
| **EU** | European Union |
| **GDP** | Gross Domestic Product |
| **GEL** | Georgian Lari |
| **GCSD** | Georgian Central Securities Depository |
| **GSE** | Georgian Stock Exchange |
| **IPO** | Initial Public Offering |
| **IT** | Information Technology |
| **JSC** | Joint Stock Company |
| **LSM** | Law on Securities Market |
| **MTF** | Multilateral Trading Facility |
| **MiFID** | Markets in Financial Instruments Directive |
| **MoESD** | Ministry of Economic and Sustainable Development of Georgia |
| **NPV** | Net Present Value |
| **NBG** | National Bank of Georgia |
| **OTC** | Over the Counter (Trade) |
| **RIA** | Regulatory Impact Analysis |
| **SI** | Systematic Internalizers |
| **SME** | Small and Medium Enterprises |
| **USAID** | United States Agency for International Development |
| **USD** | US Dollar |

# KEY TERMS

**Capital market** is a market for buying and selling equity and debt instruments. Capital markets channel savings and investment between suppliers of capital (retail investors and institutional investors) and users of capital (businesses, government, and individuals). Capital markets are vital to the functioning of an economy, since capital is a critical component for generating economic output.

**Deep and Comprehensive Free Trade Area** is a trade agreement between the EU and its Eastern neighbors (Georgia, Moldova, and Ukraine). It is a part of the EU Association Agreement. DCFTA is EU's most ambitious trade agreement yet. It facilitates technical and tariff barriers to trade and harmonizes legislation of the partner countries with the EU directives.

**Georgian Central Securities Depository** stores all securities accepted for trade by the Georgian Stock Exchange.

**Initial Public Offering** is the first public sale of securities by a private firm. With the assistance of an underwriting firm, the issuer firm determines the type of security to issue (common or preferred), the best offering price, and the time to bring the offer to the market.

**Joint Stock Company** is a company whose stock is owned jointly by the shareholders. It issues stock and allows for secondary market trading. The stockholders are liable for company's debt.

**Multilateral Trading Facility** is a multilateral system, operated by an investment firm or a market operator, which brings together multiple third party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract.

**Markets in Financial Instruments Directive** is the Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field sought to establish the conditions under which authorized investment firms and banks could provide specified services or establish branches in other Member States on the basis of home country authorization and supervision. To this end, that Directive aimed to harmonize the initial authorization and operating requirements for investment firms including conduct of business rules. It also provided for the harmonization of some conditions governing the operation of regulated markets.

**Over-The-Counter (Trade)** refers to any trade transaction other than on a formal stock exchange. OTC includes stocks traded via a dealer network, debt securities, and other financial instruments such as derivatives.

**Primary market** is the market where the initial issuance of the securities occurs. It is a way for companies to raise capital. The types of securities issued can be bonds, shares, debt securities, etc.

**Secondary market** is a market where the issued stocks are traded between the parties on the stock market. The secondary market is not for raising the capital, it is a market for buyers and sellers of securities.

**Security** is a financial instrument that represents an ownership position in a publicly-traded corporation (stock or **equity securities**), a creditor relationship with governmental body or a corporation (bond or **debt securities**), or rights to ownership as represented by an option.

**Systematic Internalizers** are investment firms or banks that can match “buy” and “sell” orders from clients in-house, on its own book, instead of sending orders to a central exchange. SIs have to make such dealings transparent – show a price before the trade is made and after it is made. Examples of such firms are Credit Suisse and UBS.

# CONTENTS

# I. EXECUTIVE SUMMARY

Georgia's securities market is largely underdeveloped and has been shrinking further over the past 5 years. This situation is commonly explained by the small scale of the Georgian economy and an almost inexistent corporate population. However, the regulatory framework is also a contributing factor and may require in-depth and thoughtful revision. The immature securities market leaves the majority of local business with limited options for attracting additional capital. Commercial banks have almost fully assumed the role of capital providers for small and medium size businesses. Some of the largest Georgian companies who have needed to obtain financing through the capital markets have sought it through foreign stock exchanges (e.g., Bank of Georgia, Georgian Railway, and TBC Bank).

The parties that have been affected directly are the brokerage firms and trade organizers (the GSE and the Depository); however, the absence of a vital, developed securities market has an impact on joint stock companies, investment funds, and individual investors. The RIA team conducted in-depth interviews with representatives of all major stakeholder groups and consulted with the national and international experts and market observers.

The goal of the RIA was to assess the costs and benefits of the harmonization of Georgian Law on Securities Market with the EU regulatory framework, which should be completed within a 5-7 year timeframe. Specifically, the EU directive on MiFID was selected for this analysis, based on feedback received from the national regulator of the securities market. The main conflict between the MiFID requirements and the existing law in Georgia, selected by the RIA team, is the pre-trade price transparency regulation. Equal access to information on pre-trade pricing is not guaranteed by the current LSM of Georgia. This particularly concerns transactions conducted off the stock exchange. The fragmentation of the market, the low quality and lack of financial disclosures from the corporate community, and the absence of centralized data sources were identified as the drivers of the problem.

The RIA team studied the baseline context and developed two scenarios:

- Option I analyzed how the market would react if there were no future interventions in the regulatory framework of the Georgian securities market;
- Option 2 projected the impact of introducing new trade transparency requirements in accordance with the MiFID.

Both qualitative and quantitative analyses were conducted. The comparison of the scenarios showed that no intervention would have disastrous results for the market; however, the introduction of trade transparency requirements alone will have only a modest positive effect. This indicates that the market is in need of a more complex treatment.

The table below presents the results of projected calculations, with the incremental Net Present Value for introducing the Directive in the area of pre-trade price transparency is over GEL 2 billion over a period of 15 years. There are also other benefits (as well as costs) associated with the Option 2, presented in further parts of the Report.

**Table 2 - Evaluation Criteria**

| EVALUATION CRITERIA | OPTION 1 | OPTION 2 |
|---|---|---|
| **Benefits – costs (NPV)** | Cost and benefits were assumed to be zero. | GEL 2,024,195,144 (this is incremental value – difference between Option 2 and Option 1) |
| **Effectiveness** | - - - | + |
| **Feasibility / Ease to Comply** | + | ++ |
| **Risk** | ++ | - |
| **SUMMARY** | **+** | **++** |

As a result of the analysis, the RIA concludes that the MiFID Directive should be introduced in Georgia.

In addition to the main findings and conclusions of the RIA, key recommendations for the implementation of securities market reform and harmonization of Georgian legislation with the EU directives are included below:

- There is very low awareness of MiFID requirements (as well as other major EU directives concerning the capital markets) among key stakeholders. The main market makers are only partially familiar with some portions of what the legislative harmonization process would entail. Therefore, meetings and consultations should take place with key market makers to continue to raise awareness of MiFID requirements.

- There is distrust among key stakeholders, mostly due to the lack of communication and direct dialogue. Measures should be taken to overcome these information and communication gaps, either through direct dialogue with key stakeholders or through public consultations and roundtables regarding the upcoming legislative amendments.

- The introduction of additional transparency, reporting, and consultation requirements alone will not have a desired effect on the securities market. A complex approach is needed, which will include amendments for up to ten Georgian laws and a number of non-regulatory incentives. These should be combined under the strategic vision for the development of Georgia's securities market.

# II. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

## A. ORGANIZATION AND TIMING

A pilot RIA of the Georgian LSM was conducted over a 3-month period from April-July 2014, which was devoted to completing three major tasks:

- Defining the problem and the scope of the study;
- Conducting in-depth interviews and consultations
- Conducting cost-benefit analyses of the two scenarios and producing the final report.

The core team consisted of four analysts from the Economic Policy Research Center (EPRC). Two of the analysts participated in an extensive training in RIA methodology, organized and sponsored by the USAID Economic Prosperity Initiative, including a senior analyst with a broad financial background and a junior analyst with a background in business administration. The four analysts were:

- Nino Ghvinadze, Leading Analyst
- Irina Guruli, Leading Analyst
- Vakhtang Berishvili, Financial Analyst
- Teimuraz Mamatsashvili, Junior Analyst

The team worked in close cooperation with representatives from the Ministry of Economic and Sustainable Development of Georgia (MoESD) led by Giorgi Chitadze (adviser to the Analytic Department at MoESD. The core team also benefited from the expertise and continues oversight from the team leader, Nino Evgenidze (EPRC's Executive Director), and David Chkadua, a consultant engaged on the project who has over two decades of extensive experience in banking and financial markets.

In addition to the official consultations and interviews conducted during the second stage of the RIA, the team also collected formal and informal feedback from external sources. These sources included Luc Caltrider (Investment and Finance Specialist on USAID EPI with Deloitte US),  Robert Singletary (capital markets consultant to the World Bank), Ewelina Uljanicka (RIA Specialist with Deloitte Poland), and Nino Chokheli (Business Enabling Environment Component Lead at the USAID EPI with Deloitte Georgia).

Generally, decision-making in the team was based on gaining consensus among the members; however, the opinions of the MoESD and the National Bank of Georgia (NBG) factored heavily into defining the problem and the focus of the study. The core team of EPRC analysts took up the leading role in the cost-benefit analysis and final report writing.

# B. CONSULTATION AND EXPERTISE

Consultations were conducted with all major securities market stakeholders who could offer valuable insights and different points of views of the issue. The stakeholders chosen were the NBG, the Georgian Stock Exchange (GSE – the only regulated stock market in the country), the GCSD, two brokerage firms holding over 90% of the market share (BG Capital and Liberty Securities), two capital markets experts (Mr. Robert Singletary and Mr. Giorgi Paresishvili), and two firms that conducted an Initial Public Offering through the GSE (Teliani Valley and Caucasus Energy & Infrastructure).

The two experts chosen for the consultations both had extensive knowledge of the Georgian securities market. Mr. Singletary had taken part in the development of the initial securities market legislation passed in 1999 and is an author of the World Bank report on the current securities market state in Georgia. Mr. Paresishvili is the former Director of Galt & Taggart Securities and is currently commercial director of KSB Bank. Furthermore, he has managed two brokerage firms during his career.

Two additional independent experts were contacted for in-depth interviews, including a Georgian professor at the Tbilisi State University and a former broker, Mr. David Aslanishvili and Mr. Maciej Czarnecki, the Regional Network Head for Europe at State Street Bank; however, the interviews did not take place due to time constraints.

**Table 3 - Influence-Interest Matrix**

| | LOW INFLUENCE | HIGH INFLUENCE |
|---|---|---|
| **Low Interest** | • Independent observers and experts<br>• International organizations | • Prime Minister's Economic Council<br>• Parliament of Georgia |
| **High Interest** | • Issuers/Listed and Unlisted companies<br>• Independent registrars of securities | • Georgian Stock Exchange<br>• The National Bank of Georgia<br>• Brokerage firms<br>• Private banks |

The following table presents the summary of stakeholder consultations:

**Table 4 - Summary of consultation process**

| STAKEHOLDER | METHOD OF CONSULTATION | SUMMARY OF RESPONSES | COMMENT |
|---|---|---|---|
| **Brokerage Firm (BG capital)** | In-depth interview | • The four different agencies that undertook the regulatory function over the past 15 years were purely regulators and did not create any stimulus for market development.<br>• The slight market growth until 2007 was due to various external stimuli (e.g., mass privatizations, Rose Revolution hype).<br>• The market needs a more | • BG Capital is the leading brokerage firm in Georgia; therefore, comments on its readiness and the capacity to adapt to MiFID requirements was taken into consideration during the analysis of Option 2.<br>• The difficulties faced due to the lack of data and statistics on the |

| STAKEHOLDER | METHOD OF CONSULTATION | SUMMARY OF RESPONSES | COMMENT |
|---|---|---|---|
| | | user-friendly platform for trading and market statistics as well as for the corporate community in Georgia.<br>• Transformation into MTF/SI would be considered; however, more incentives and assistance from the state will be required. | corporate community and the securities market were also noted. |
| **Listed company (Teliani Valley)** | In-depth interview | • GSE is not an effective source to raise capital. There is no point in issuing new securities on the Georgian market.<br>• The company is considering entering the Warsaw Stock Market but is not sure it can sustain its presence there. | • Teliani Valley is one of the 3 listed companies on the GSE.<br>• Its assessment of GSE's potential is considered.<br>• Its objective was taken into account. |
| **Unlisted Company (Caucasus Energy & Infrastructure) and Abbey Asset Management** | In-depth interview | • Conducted its IPO in 2008 and raised USD 50 million, of which roughly 90% was from foreign investment funds.<br>• 1.0% of the funds raised from the IPO were paid to the broker, BG Capital.<br>• GSE's main problem is its weak management. Neither the management team nor the supervisory board has a strategic vision for the GSE.<br>• Today, shareholders pay 5% tax on dividends received. Abolishment of this tax would increase the motivation of local investors to invest in securities.<br>• Bank of Georgia decreased deposit interest rates recently. This should increase incentives for potential investors to invest their savings somewhere profitably.<br>• Pension reform should be another mechanism to revive the market.<br>• More transparency measures would probably increase the trust in the | • Assessment of the GSE management was considered as the person interviewed is a shareholder of the GSE and has participated in board meetings personally.<br>• Assessment of the impact of MiFID measures and requirements were also considered, as the person is well aware of the Georgian and foreign capital markets and has a good understanding of the factors influencing the Georgian corporate community. |

<table>
<tr><th>STAKEHOLDER</th><th>METHOD OF CONSULTATION</th><th>SUMMARY OF RESPONSES</th><th>COMMENT</th></tr>
<tr><td></td><td></td><td>market, but its effect on the market overall will be moderate.</td><td></td></tr>
<tr><td>Brokerage Firm (Liberty Securities)</td><td>In-depth interview</td><td><ul><li>Trade through GSE is inconvenient as the sessions are short and few (1hr 15 min, 3 times a week), and it does not practice the “T+3” settlement rule. There are no such limitations on OTC.</li><li>The main barriers for stock market development are the weak corporate culture and accounting practices, as well as a lack of financial education.</li></ul></td><td><ul><li>The importance of T+3 was assessed differently by different players. Some consider it as an additional (and needed) insurance from failed deals. The GSE itself is considering offering alternative solutions to this problem. Hence, this argument was not included in the analysis.</li></ul></td></tr>
<tr><td>The Stock Exchange (Georgian Stock Exchange, Central Depository)</td><td>In-depth interview</td><td><ul><li>Market Capitalization to GDP is roughly 5%. The same share on average in the world is 65%, while in developed countries it reaches 106%.</li><li>Trade organization is managed by the Russian software system RTC 2 (in Armenia RTC 7), but even this system is fully capable of transmitting far more operations than today.</li><li>Nasdaq OMX expressed the interest to take over the GSE, but the initiative was negatively met by the Prime Minister at the time.</li><li>Only brokers pay the service fee to the GSE. There is no cost for shareholders or JSCs.</li><li>In 2007, BoG pressured GSE directly to reduce the transaction fee to 0.025%, which was then increased to 0.05% in 2010.</li></ul></td><td><ul><li>GSE’s comments were taken into account for calculating potential costs and benefits (GSE’s fees and income sources, cost of human resources, etc.)</li><li>GSE’s feedback on comments expressed by other stakeholders was important for counter-balancing/counter-assessing the opinions collected throughout previous consultations.</li></ul></td></tr>
<tr><td>Expert (Robert Singletary)</td><td>In-depth interview</td><td><ul><li>Extreme fragmentation of trading and low level of transparency among the issuers and of the price is a problem. MiFID (best execution rule) will have a positive effect on</li></ul></td><td><ul><li>Comments on the role of market fragmentation and the possible implications of MiFID were fully considered.</li></ul></td></tr>
</table>

| STAKEHOLDER | METHOD OF CONSULTATION | SUMMARY OF RESPONSES | COMMENT |
|---|---|---|---|
| | | Georgian market.<br>• It is necessary to improve statistics of the corporate population (number of shareholders, assets and liabilities) for future analysis. | |
| **Giorgi Paresishvili (former Galt & Taggart Securities head, currently commercial director of KSB Bank)** | In-depth interview | • MiFID's positive effect is better protection of client's interests.<br>• Separate department of at least 2-3 employees who are fully familiarized with MiFID requirements and understand how they should communicate information to their clients according to this regulation will be needed at brokerage companies.<br>• MiFID also implies more regulatory responsibilities to make sure the compliance, therefore more staff for the NBG.<br>• Deficient infrastructure is the main problem, why international investors hesitate to enter the market. | • Comments were very useful for counting the costs of the brokerage firms. Interviewee has managed two leading brokerage companies at different times and has a good internal insight. |
| **Regulator (National bank of Georgia)** | | • Many blame the 2007-2010 amendments for stagnation on securities market, but forget that the market was not developed before the amendments either.<br>• Cornerstone of the problem is the mass privatization of 1990s.<br>• Harmonizing Georgian legislation with the European directives as part of the EU Association process will be difficult because Georgian market is immensely underdeveloped, while the EU directives are designed for advanced market. Adjusting them to Georgian reality is a challenge, especially MiFID, as it is one of the largest and advanced. | • Regulator's comments played the key role in defining the problem and selecting the focus of the RIA.<br>• Regulator's assessment of the market's current challenges was also incorporated in the analysis. |

# III. PROBLEM DEFINITION

## A. POLICY CONTEXT

### *A policy context and existing legal framework*

Similar to the experience of other post-soviet states in the region, Georgia's securities market emerged in the late 1990s. The GSE and the CD were founded in 1999 and the legislative base was developed simultaneously. Georgia's securities market is largely underdeveloped and has been shrinking further over the past 5 years. This situation is commonly explained by the small scale of the Georgian economy and an almost inexistent corporate population. However, the regulatory framework is also a contributing factor and may require in-depth and thoughtful revision. The immature securities market leaves the majority of local business with limited options for attracting additional capital. Commercial banks have almost fully assumed the role of capital providers for small and medium size businesses. Some of the largest Georgian companies who have needed to obtain financing through the capital markets have sought it through foreign stock exchanges (e.g., Bank of Georgia, Georgian Railway, and TBC Bank).

Since 2007, the stock market's activity has been declining and the number of transactions reached its lowest in 2013. Secondary trading volumes decreased from USD 70 million in 2008 to USD 10 million in 2012 while the number of licensed investment firms and share registries decreased by 50 percent over the same period.

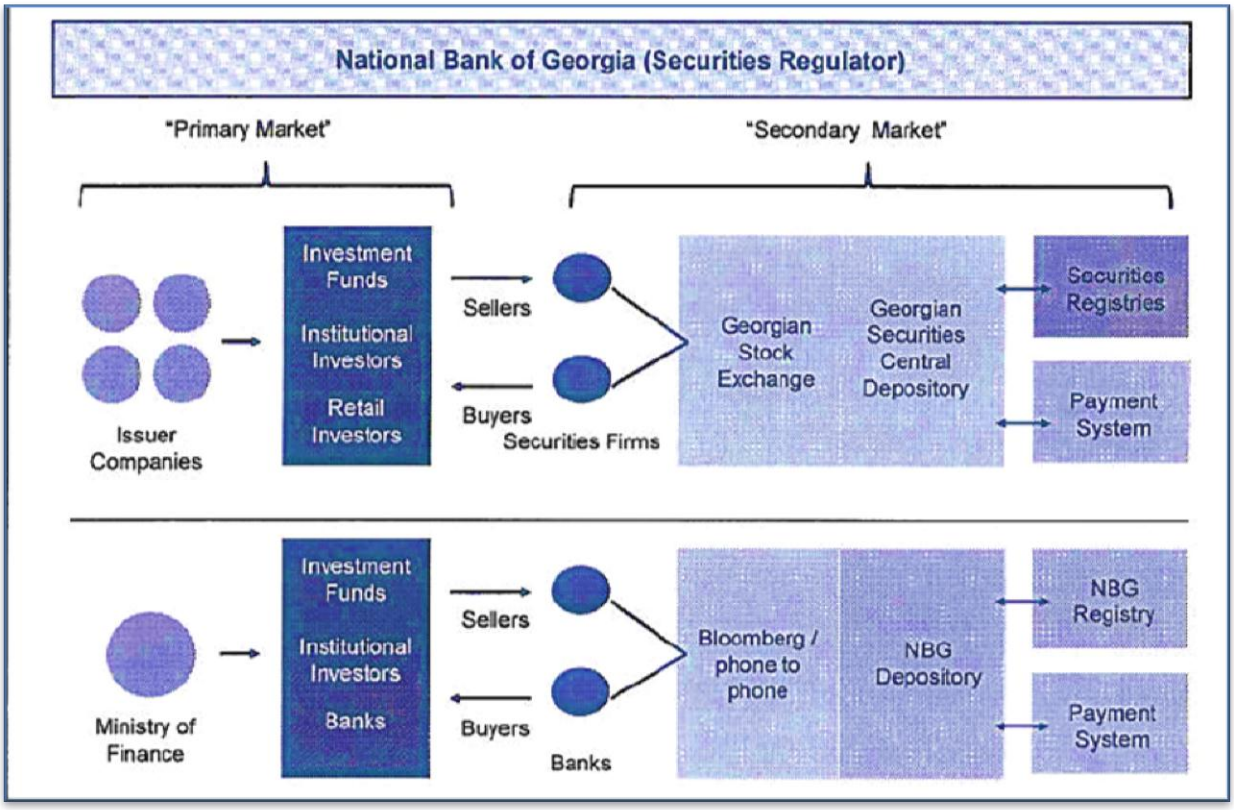
Some stakeholders and market observers attribute this rapid decline to the existing Law on Securities Market (LSM) and the frequent amendments to the regulatory framework. The initial version of the LSM was developed and adopted in 1998-2000. Since then, the LSM has been amended 19 times (or roughly once every nine months over the last 14 years). The same applies to other laws related to investors. For example, the Georgian Law on Entrepreneurs has been amended 44 times since 1996.[1] The LSM was thoroughly modified and liberalized from 2007 to 2011. The current version of the law is expected to undergo further revisions in the coming years due to the ongoing approximation and harmonization of Georgian legislation with EU laws and directives.

The 2007 amendments changed the requirement that all transactions in securities should take place on the Georgian Stock Exchange (GSE). Thus, the current regulatory framework allows trades through the GSE as well as off the exchange and through share registries, which is a widely accepted practice in many developed economies. From 2007 to 2013, the frequency of transactions has decreased sharply both on the GSE and off the exchange. Market Capitalization (a share of the value of all outstanding securities in the country's Gross Domestic Product (GDP)) decreased by about 6% over the past 5 years. In terms of the values of transactions, as much as 94% of the total value of the traded securities in Georgia in 2013 was directly handled by share registries.

[1] The World Bank Report; "Access to Finance in Georgia: Role of the Capital Markets." summary points; 2014.

The figure below provides an overview of Georgia's primary and secondary securities markets as well as the role of the national regulator, the NBG:

**Figure 1 - Overview of the Georgian Securities Market[2]**




## *Grounds for Government Intervention*

The current government administration and representatives of the executive branch have repeatedly made public statements supporting the development of the capital markets. In spring 2013, the Financial-Budgetary and the Legal affairs committees of the Parliament of Georgia initiated the latest round of revisions to the Law on Securities Market. The package of amendments included adjustments to multiple related laws, such as the Law on the National Bank of Georgia, the Law on Commercial Banks, the Law on Entrepreneurs, and the tax code, as well as several others. The aim of these revisions is the improvement of the securities market in Georgia to harmonize regulations with international (i.e., EU) standards, and overcoming the negative consequences of the previous amendments enacted in 2007. However, the draft legislation developed in 2013 was discussed by the committee only; it was not sent to the hearings of the Parliamentary session and is held for unspecified period of time.

On June 27, 2014, Georgia signed the Association Agreement (AA) with the European Union. As part of the AA and an agreement on the Deep and Comprehensive Free Trade Area (DCFTA), Georgia agreed to approximate and harmonize its legislation (including the LSM) with 22 EU Directives over the next 5-7 years. Therefore, another wave of major government intervention is expected over the next few years.

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[2] The World Bank Report; "Access to Finance in Georgia: Role of the Capital Markets." summary points; 2014.

The current administration's decision to (a) develop capital markets in Georgia, (b) establish fair treatment and equal opportunity for both investors and issuers, and (c) harmonize Georgian legislation with EU standards represents grounds for government intervention. There are a number of loopholes in the current regulatory framework that must be resolved. Furthermore, market makers and operators could benefit from more precise wording in the LSM, as well as from various non-regulatory incentives to encourage the public ownership of companies, the development and encouragement of self-regulatory standards, and the development of investment and pension funds.

From this wide range of issues, this RIA focuses on the issue of market transparency. Specifically, this RIA addresses pre- and post-trade price transparency on the stock exchange and, more importantly, in the Over-the-Counter (OTC) trading. Equal access to information on trade, price offers, and transactions carried out for all market participants can considerably increase their trust in the market, contribute to fair treatment and an equal opportunity environment, and prepare the ground for additional regulatory and non-regulatory interventions in the future. Consultations with a number of independent experts, brokerage firms, and, most importantly, with the regulator underscored this problem.

One of the major obstacles identified by this RIA is the lack of evidence-based analysis and assessment of the performance of the securities markets over the past decade. A recent study of the level of access to finance in Georgia, commissioned by the World Bank in 2014, is a rare source, but is not publicly available. Deep evaluations of the economic impact of proposed amendments were not conducted in 2008 or in 2013. A lack of public discussions, consultations, and direct dialogue between stakeholders is another major problem identified through stakeholder consultations. As such, there is a considerable mistrust amongst the stakeholders and towards expected amendments to the LSM.

# B. PROBLEM DEFINED

### *Problem statement*

**Equal access to the information on pre-trade pricing is not guaranteed by the current LSM of Georgia**. This specifically concerns transactions carried out off the exchange. The current regulation related to price reporting and the making public of the price offers either can be interpreted in different ways or does not exist at all. While post-trade reporting is more or less regulated for both formal and OTC markets, pre-trade reporting is only partially applied to the formal stock market.

### *Post-trade reporting*

- If a transaction of publicly-traded securities is conducted outside of the GSE and the amount exceeds 100 GEL, then the trading sides (or the broker, if the transaction was conducted through a broker) have the obligation to register the number and the price of the securities only after the transaction takes place and according to the rules established by the GSE (Article 18.6).
    - According to GSE regulations (section 19.1), dissemination of the information happens through the 'Electronic Trading System' accessible for all firms

registered with the stock exchange. An automatically-generated transaction report is sent to the members of the GSE and to the general public via the agencies that acquire stock market data from the GSE on a commercial basis. Transactions taking place off the exchange are also reported to the GSE (under the tab 'fixing').

### *Pre-trade reporting*

- The GSE is responsible for setting the quoting and announcement procedures. The GSE regulations should facilitate an organized procedure for the collection and distribution of quotations (Article 34[1]).
- Precise price and number of the securities offered at the regulated market (GSE) should be reported to the NBG within the month after the offer (Article 8.1).
- The law does not mandate publication of volume and price quotes outside the formal stock exchange.

To summarize, pre-trade price offers on the formal stock market are somewhat transparent – accessible to the market participants (brokerage firms registered with the GSE and to the market operator itself) a few minutes before the trade session starts. This information is also available to the regulator only in a month-period after the trade session takes places.

However, price offers on the OTC market are not reported. Hence, so-called "dark pools" are formed where the stocks are traded without competition and price is created only by the dealers rather than the market. This undermines the transparency of not only pre-trade pricing, but also post-trade reporting, as observers doubt that the prices reported post-trade reflect reality. In the end, this undermines trust in the OTC market and weakens competition within the securities market in general.

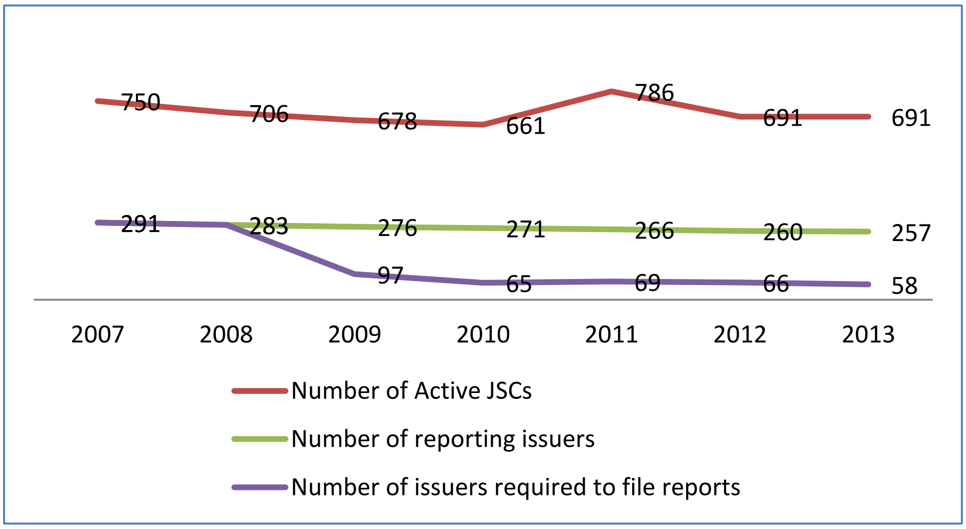
Other economies with developed capital and stock markets are trying to regulate this problem either by mandating (or creating incentives) for trading through the formal stock exchange only, or by requiring pre-trade price-reporting by OTC market participants as well (such as investment funds and banks). This reporting can occur either individually by the trade organizers (as in EU after introducing MiFID) or through a centralized platform that collects and published data on all markets (as in the United States).

**Fragmentation of the market** is one of the primary drivers of the problem. At least 5 registries are processing transactions – the GSE, off exchange fixing by brokers, and the 3 share registries. This is a fragmented picture, given the size of the Georgian market. There are no requirements to report the bid/ask quotations, which complicates the compilation of information for interested parties. A simple price reporting mechanism that equally applies to the stock exchange and off exchange transactions would make access to, and analyses of, trade information much easier.

**The quality and lack of financial reporting** is another primary driver of the problem. Financial statements and annual reports submitted to the regulator, in the majority of cases, do not meet international standards and are in conflict with the information reported by the GSE. Furthermore, reports are in Georgian only; therefore, they are inaccessible or more difficult to access for foreign investors. This is largely a consequence of the mass privatization that took place in the mid-1990s in Georgia when JSCs were formed arbitrarily, without proper financial education or sufficient understanding of the capital market. The outcome is a very weak corporate community that has no interest in trading shares publicly and that has no adequately educated or skilled management to take advantage of the market. Therefore, the perspective of the majority of the corporate community differs greatly from that of brokerage firms and investment funds.

Chart 1 indicates that only 8.4% of all JSCs in Georgia are required to submit financial reports to the regulator. The low quality of those reports is another, more significant matter. Neither the regulator, nor the brokerage firms and investments funds have reliable information on corporate assets, turnover, and capital and, hence, is not able to conduct a proper analysis of the market.

**Figure 2 - Transparency of JSCs[3]**




**Absence of a centralized data source** is another problem. JSCs accepted to trade on the GSE file separate reports to the GSE and to the NBG, but often these annual reports contradict each other. More coordination and comparison of data and reports filed to different sources (e.g., NBG, GSE, Revenue Service) would allow the regulator to better follow-up on potential insider-trading or other illegally forged deals and would create a high-quality database for interested parties to use for market analysis.

The EU MiFID regulates some of these problematic issues in the European market and, if transposed on Georgia, will require amendments to the regulatory framework, including for MiFID's requirements on pre- and post-trade transparency and the best execution rule.

### *Impact on the businesses*

The current state of Georgia's securities market is caused by the fact that **neither the market, nor the regulatory framework provides the necessary incentives for it to grow and develop**. Price transparency and equal access to information are just two aspects of the problem, but they plays a significant role in driving the already limited number of investors

[3] The World Bank Report; "Access to Finance in Georgia: Role of the Capital Markets." summary points; 2014.

out, eliminating the securities market as a funding vehicle for the SMEs. Representatives of Georgia's modest corporate community (e.g., large companies, private banks) have no incentive to trade on Georgian market and prefer to seek capital on more developed markets abroad. The introduction of more transparency on the Georgian market will not counterbalance the disadvantage of the scale of trading, but it will increase the motivation of medium-sized companies to enter the market.

Small and medium-size companies that do not have the capacity to enter foreign stock exchanges have little incentive to enter the Georgian market. Structural deficiencies – such as the lack of price transparency and lack of stock market information – do not encourage them to trade their shares publicly. Similarly, these deficiencies discourage potential Georgian or foreign investors from investing in the companies already on the market. Total private deposits reported by private banks in the end of June 2014 amounted to GEL 9.9 billion. This capital could be invested in the securities market much more profitably.

Ultimately, the crippled securities market makes it much harder to attract foreign investments in the country. In other words, it limits the access to the capital for Georgian businesses and decreases business activities in the country. **Limited access to capital** is named as one of the main challenges of Georgia's economy by the World Bank, as well as by the Global Competitiveness Report 2012-13[4].

# C. BASELINE SCENARIO

### *Georgian securities market today*

Today, the Georgian securities market is completely dominated by one firm/banking group, which holds 82% of the market share as an investment firm, 60% as a share registry, and 44% of the GSE.[5] It is a small market, with a relatively small number of participants, which has been declining over the past 5 years. Out of the 17 securities firms operating in 2007, only 5 were still active in 2013. Similarly, only 3 of the 7 share registries operating in 2007 were functioning in 2013. The NBG has 9 companies registered as brokerage firms, but 4 were inactive for the past two years and 2 are not GSE members.

**Table 5 - Securities Market Participants and Infrastructure Institutions[6]**

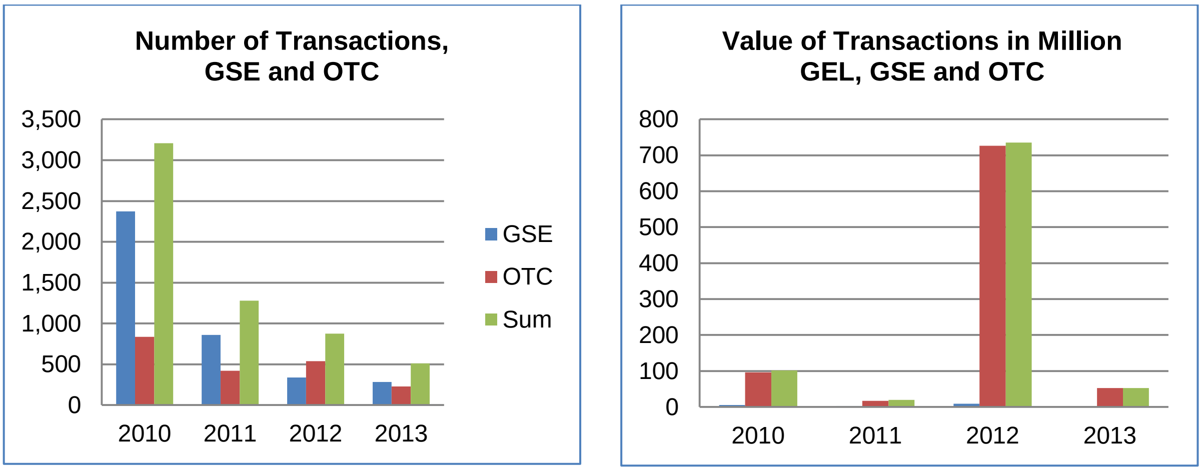
| Market Participants and Infrastructure Institutions | 2007 | 2013 |
|---|---|---|
| **Securities Firms** | 17 | 5 |
| **Share Registries** | 7 | 3 |
| **Stock Exchanges** | 1 | 1 |
| **Depositories** | 1 | 1 |

The number of market participants and infrastructure institutions has declined by more than 50 percent and the number of transactions recorded with the GSE is decreasing on average by 28 percent annually. Today, GSE offers only 3 trade sessions a week, and the sessions

[4] Klaus Schwab, "The Global Competitiveness Report 2012–2013", World Economic Forum.
[5] The World Bank Report; "Access to Finance in Georgia: Role of the Capital Markets." summary points; 2014.
[6] Ibid.

last only an hour and fifteen minutes each. According to official GSE data, there were only 4 transactions in February 2014, compared to the 561 transactions in February 2007. There are often trade days when there are no transactions at the GSE at all.

**Figure 3 - Number and Value of Transactions On and Off the Stock Exchange, by Years**[7]




There has been a shift in the distribution of transactions by the means of trade. Since off exchange transactions became legal in 2007, its share in total security transactions has increased, especially in terms of the value of the traded securities, but not as much in the number of transactions conducted. In 2013, the number of transactions on the GSE slightly exceeded the number of transactions off the exchange; however, the value and the number of securities traded were significantly higher for OTC transactions registered with the share registries. 2012 was an exception, however; despite the low number of transactions registered with the GSE, the value (GEL 735.6 million) far exceeded the 2008 level. This deviation is due to the Bank of Georgia selling off the vast majority of its shares admitted for trade on the Georgian stock market and transferring it to the London Stock Exchange.

In 2013, there were 129 Issuers registered with the GSE. The total value of securities traded both on and off the GSE was GEL 52.5 million, about 14x less than in 2012, even though the number of the securities traded was higher. The picture is the same at the GCSD.

There is a declining trend in brokerage companies' activities as well. Total assets of the 9 brokerage companies in 2013 were GEL 30.3 million, which is 35% less than in 2012. Similarly, total capital and client portfolios decreased by 17% and 64%, respectively.

Stakeholders commonly identify the structural deficiencies of Georgia's capital market, the global financial crisis, and the 2008 war as the three main factors causing the market decline.

Comparing the decrease of market activity on the Georgian market to that of the Baltic States provides an estimate of the impact of the crisis. For example, in Estonia, 2007 was the peak year in terms of the number of transactions on the stock exchange while the period from 2005 to 2008 included the highest turnover. In Estonia, the value of total transactions in 2008 was 59% less than in 2007, while in 2013 the total value was only 13% of that in 2007. Hence, despite the fact that Estonia was one of the leaders in post-crisis recovery in Europe, the securities market did not recover, and the declining trend is continuing.

[7] The National Bank of Georgia; Annual reports 2010 through 2013.

Comparing this degree of decline to the Georgian case shows that the Georgian securities market may not differ greatly from the wider regional picture. The first strong decline in Georgia post-2008 was 61% in value of transactions (from GEL 256.6 million in 2008 to GEL 98.9 million in 2009). The value of traded securities in 2013 was about 20% of that in 2008.

Comparing Estonian and Georgian trends with those of Poland, which is considered a leader in the region, indicates that Poland managed to overcome the brief contraction in 2008-2009 and returned to pre-crisis volumes in 2011.

**Table 6 - Comparative Total Value of Transactions by Years, Formal Stock Exchanges Only (in USD Million)**[8]

| YEAR | POLAND | BALTIC REGION | GEORGIA |
|---|---|---|---|
| **2007** | 79,143 | 3,244 | 17.80 |
| **2008** | 54,687 | 1,333 | 5.63 |
| **2009** | 58,082 | 676 | 1.47 |
| **2010** | 77,343 | 661 | 2.69 |
| **2011** | 88,518 | 546 | 1.00 |
| **2012** | 66,975 | 384 | 4.95 |
| **2013** | 84,559 | 411 | 0.27 |
| **2014 (5 months)** | 32,429 | 143 | 0.10 |

The Georgian economy began to recover from the 2008 war and the global financial crisis in 2010. In fact, GDP grew by 6.3% in 2010 and 7.2% in 2011. This growth was initially reflected on the stock market as the number of transactions increased both on and off the exchange in 2010; however, transaction volume continued to decline in the following three years, which speaks of the contributing factor of structural deficiencies. From 2010 to 2013, the average annual decline in the number of transactions on market was 46% and the average annual decline in the value of transactions was 20%.

### *Expected trends and possible changes*

The development of Georgia's securities market in the next 15 years will depend on both external factors (e.g., wars, geopolitical crises, global or regional economic and financial downturns) and on internal factors (e.g., regulatory and non-regulatory changes in the domestic capital market).

The impact of the 2008 war and the world financial crisis is considered more or less annulled. Unless the Russo-Ukrainian crisis expands into the region, no significant external events are expected to impact the Georgian capital market in the immediate future. Still, the Georgian financial market is not closely integrated with the Ukrainian and Russian markets; therefore, no direct implications are expected from the conflict. Non-regulatory changes that could offset the current declining trend of the Georgian stock market could include the development of pension funds. The pension reform project is being discussed by the current administration; however, as of now, it is not clear what could be the shape and the specific timeline of the reform. A rough estimate would forecast the reform package to be finalized in 2015-2016 and will require a few more years to generate any significant impact on the

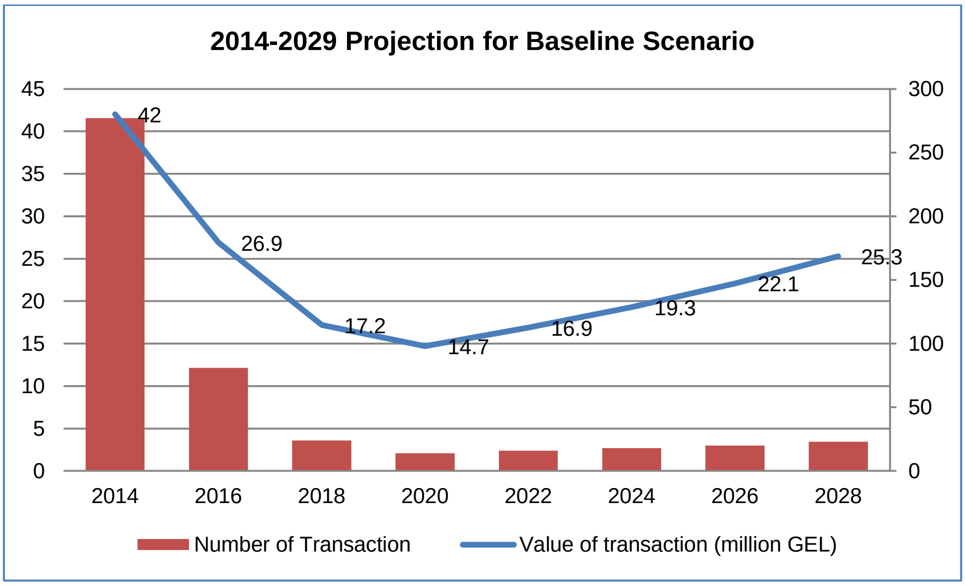
[8] Data gathered from the websites of formal stock exchanges of Poland, Baltic States, and Georgia.

capital market. Therefore, it could begin to counterbalance the declining trend in roughly 5 years, starting from 2020.

Other external factors that could encourage Georgian companies to issue equity shares and other types of securities publicly include various tax incentives (e.g., lower tax on dividends, more tax discrimination by types of financial activities). However, the effect of tax and other external incentives will not be significant unless the stock market's transparency and infrastructure are improved. Attracting more foreign and local capital to this market is possible only through introducing a better price-setting mechanism and greater integrity.

Therefore, all things being equal (i.e., no major external crises in the region and domestic elements influencing capital markets remain constant), it is assumed that the number and value of transactions will continue to decline on average 46% and 20% annually, respectively, for the next 5 years. The potential counterbalancing effect of pension reform may be seen starting from 2020, which, in the best-case scenario, can offset the decline and stimulate a moderate growth of 7% on average.

**Figure 4 - Projections for Number and Value of Transactions in 2014-2029**




According to the projections, by 2020, the annual value of transactions will decrease to around GEL 14 million and to about 14 trades per year. This pessimistic estimate is not groundless, given that there are already only three listed companies at the GSE. Two of these are banks that also own major brokerage companies and largely dominate the market while the third (Teliani Valley) is a subsidiary of one of the banks. Teliani Valley issued its IPO in 2006-2007 and lost interest in the market soon thereafter. Its financial management does not see any reason to maintain its listing as it is the last resort the company considers when it needs to attract capital. Caucasus Energy and Infrastructure (CEI), which issued its IPO on the GSE in 2008, raising a record high sum (up to GEL 50 million) on the Georgian market is no longer listed on the GSE.

# IV. OBJECTIVES

## A. GENERAL OBJECTIVES

### *Policy objectives*

- Increase access to capital for Georgian businesses through the development of the capital market;
- Establish fair treatment and equal opportunity for both investors and issuers on the securities market;
- Harmonize Georgian legislation with the relevant EU directives and standards set for the financial markets.

## B. SPECIFIC AND OPERATIONAL OBJECTIVES

### *Short-term objectives (to be implemented within 5 years)*

- Increase of the trade, to be reflected in the number of transactions, number and the value of traded securities;
- Improvement of market transparency reflected in the ease of access to the market information and the quality of the information.

### *Long-term objectives (to be implemented within 10 years)*

- Development of a more vibrant securities market, reflected in:
  - Higher number of active brokerage companies, with a commensurate increase in their capital and annual turnover;
  - Presence of more security types traded on the market;
  - Increased number of issuers and active JSCs in Georgia.

**Table 7 - Summary of Objectives**

| OBJECTIVE | INDICATOR | RESPONSIBILITY | TIMING |
|---|---|---|---|
| **Improvement Of Market Transparency and Access to Information** | • Ease of access to information:<br>• Pre-trade information (bids and offers) is publicized both on the GSE and OTC;<br>• Information is accessible for all interested parties (members of stock market, regulators). | NBG | 2019 (Immediately after enactment of changes) |
| **Increased Trade Turnout and Turnover** | • Increase of number of transactions on average by 60% annually;<br>• That will give roughly 650% | GSE, NBG | 2024 (5 years after enactment of changes) |

| OBJECTIVE | INDICATOR | RESPONSIBILITY | TIMING |
|---|---|---|---|
| | increase in number by 2024 and up to tenfold increase by the end of 2029.<br>• Increase of the value of traded securities by 30% on average annually;<br>• That would give up to 286% increase in the first 5 years and roughly 370% increase in 2024-2029. | | |
| **More Vibrant Securities Market** | • Better price creation on the stock market, which could be measured by more compatible prices reported on the GSE and OTC markets;<br>• Increase in the number of active brokerage companies by almost 7 times (from 5 to 35), and more than 400% increase in their total capital and assets;<br>• Increase in the number of listed members at the GSE<br>• Increase in the number of types of securities traded | GSE, NBG | 2029<br>(10 years after enactment of changes) |

# V. POLICY OPTIONS

The study analyses two regulatory policy options:

- Option 1 is the baseline scenario option and provides forecast of how will the market develop if no policy action is taken;
- Option 2 is analyzing how the market will react to the regulatory intervention, particularly to the harmonization of Georgian Law on Securities Market with the European directive on MiFID.

A third option, a non-regulatory intervention in the market, was also considered; however, this option was discarded during the later stages of analysis. Non-regulatory intervention assumed the creation of incentives for more transparency and better financial reporting standards by means of non-mandatory standards, development of rating system of JSCs, broker companies, and investment funds. These ratings would assess the level of financial transparency, performance, and capital of companies and securities firms. Stakeholder consultations indicated that, while this would an interesting endeavor, the initiative and implementation should originate from the private sector. The only leverage that the regulators have in these circumstances is the taxation. Both JSCs and brokerage companies are looking for additional tax incentives, and, since tax law is outside the scope of the LSM, this third option was dropped.

It should be noted that the regulatory impact of MiFID's "best execution rule" analyzed in Option 2 is largely self-regulatory in nature.

## A. POLICY OPTION 1

### *No policy change (Baseline Scenario)*

In case of no policy change, the Georgian securities market will not disappear but will continue to be an insignificant source of capital. The GSE is on the brink of bankruptcy and can go bankrupt if the pension fund reforms will fail to revive the market. However, if the pension reforms are successful, if there are no improvements in market infrastructure and if price-creation on the OTC market remains opaque and uncompetitive, then the market impact of the pension reforms will be only 7% annual growth at best. This modest growth will be felt only after the 4-5 years, starting from 2020.

Under this scenario of development, the majority of transactions (at least in terms of the total transaction value) will remain in the OTC market. While the GSE will be on the verge of a bankruptcy, the OTC market will not grow either. Due to existing infrastructure and price-creation mechanism, it will not be possible to attract capital without trustworthy personal contacts. The vast majority of brokerage companies is already running operating losses every year and is almost fully depend on financial support from their parent organizations (i.e., private banks). Further contraction in the securities market will induce these parent organizations to dispose of the costly subsidiaries.

Therefore, it is likely that only 2 to 3 brokerage companies will remain active. The only alternative source of capital from the securities markets for large Georgian corporations will be through issuing on foreign securities markets, which is not an appropriate for medium-sized companies since issuing securities on a foreign securities market is expensive and unsustainable for most Georgian companies. Primarily, only the dominant companies in the Georgian market (e.g., Bank of Georgia, TBC Bank) can take advantage of these opportunities.

# B. POLICY OPTION 2

### *Harmonization of Georgian LSM with MiFID's "Best Execution Rule" Requirements*

The Government of Georgia signed the Association Agreement with the EU at the end of June 2014. One of the conditions of the agreement is to harmonize Georgian legislation with EU directives, amongst which is the MiFID, which must be transposed to Georgian law within 5 years. MiFID establishes almost identical standards for trading on and off the stock exchange and, therefore, introduces some new regulations for OTC trading.

Implementation of MiFID requirements may address some of the issues related to market integrity and lack of transparency discussed in the "Problem Definition" section above. Due to the complexity of these issues and the nascent stage of the Georgian securities market, it is expected that Georgian legislators and the Government will not hurry to make the amendment to the law until the end of the allowed transition period (in 2019).

National regulators of member states have a certain flexibility to "translate" MiFID based on the local context, as well as the level and the scale of the local market. The NBG will also have the possibility to adjust MiFID requirements to Georgian reality. In practical terms, implementation of MiFID in Georgia implies the following:

- Introduction of the "Best Execution Rule", which has the greatest impact on the daily work of brokers and the regulator and provides the greatest benefits for investors (i.e., clients). The "Best Execution Rule", in brief, requires brokers to provide the best possible service (i.e., identify the best deals, lowest price, and explain potential risks and benefits properly) to their clients. This requires from brokers a very sound understanding of what category their client belongs to (professional or retail) and to inform them accordingly. Implementation of the "Best Execution Rule" requires three pre-conditions:
    - Availability of the information (data) to analyze the market (the mandatory pre-trade price-reporting on all markets is an essential part of this);
    - Educated and well-trained brokers;
    - Incentives to follow the best execution standards, which should come from either the regulator's proactive regulatory approach or from the clients, who can assess the quality of service and demand more (i.e. from market)
- Many aspects of the "Best Execution Rule" are hard to regulate and are largely self-regulatory, which has its pros and cons.
- Transforming the OTC market into something similar to the formal stock exchange, requires market participants to publicize pre-trade prices and securities offers and to

report transactions post-trade in the shortest possible period of time. MiFID does not mandate trading on the formal stock exchange only; however, by setting new transparency and reporting requirements, the introduction of MiFID in Georgia can affect the trade volume distribution between the GSE and OTC in favor of the GSE.

- Eventually, equal access to information and more transparent price creation on the OTC and GSE will make the securities market more competitive, which is beneficial for investors, for corporations, and the whole economy.
- The requirement to extend the length of storing trade information for 5 years will allow for greater statistical analysis and for more opportunities for the regulator to monitor market activity.

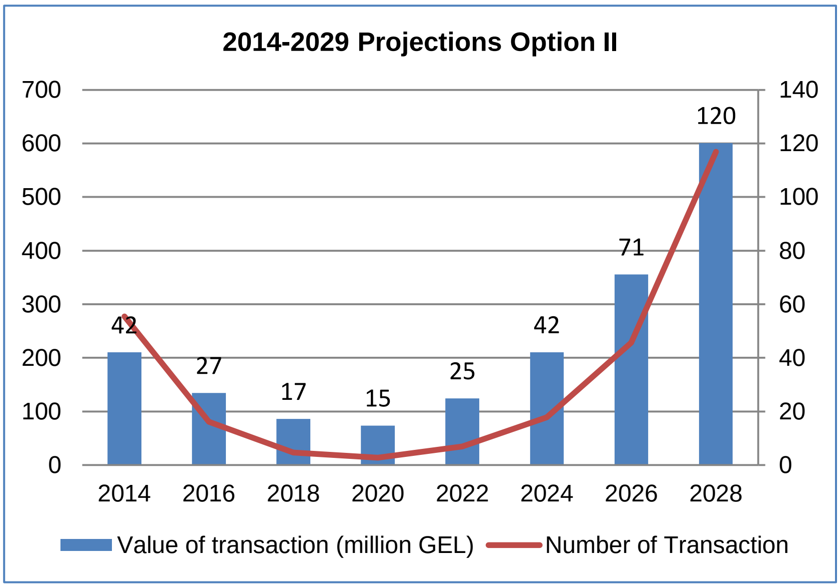
### *Pros and Cons / Risks*

Eventually, the introduction of new pre-trade requirements for the GSE and the OTC market to establish "best execution" standards for brokers will have a positive impact on the integrity of the market and will increase trust in the system. This will represent another step forward towards harmonization with European legislation, which is a long but inevitable process.

However, the Georgian securities market requires a complex treatment. The "Best Execution Rule" alone cannot sufficiently stimulate market development to the desirable extent. It does not offer enough incentives for JSCs to issue more IPOs, does not respond to the need of financial education in Georgia's corporate community, and does not resolve the current challenges resulting from the mass privatization carried out in mid-1990s. Better market infrastructure alone will not attract massive foreign investments to a tiny market like Georgia.

Therefore, this scenario projects a growth that can return the currently depressed market to the 2006-2007 scale. For further development and expansion, parallel interventions need to take place.

**Figure 5 - Projections for Number and Value of Transactions in 2014-2029 for Option 2**



A certain degree of redistribution of security transactions should be expected soon after amendments to the law are made. Since the leading Georgian brokerage companies have no capacity to organize OTC trading internally in a way similar to MTF or SIs, the MiFID requirements creates incentives to return transactions to the GSE. This does not necessarily imply a significant loss for brokerage companies, other than the lost opportunity of becoming the trade organizers themselves. However, given the current market size and total annual turnover, it will be much more cost-efficient for brokers to trade through the GSE than to incur significant costs for establishing an alternative parallel trading system.

This scenario assumes that the GSE adapts to the new reality, which, given the current weakness of the GSE's management, will be challenging; however, GSE does not need vast investments in their technical capacity. Stakeholder consultations indicated that the current operational software is fully capable to meet the new requirements, at least in the initial stages, assuming the market and trade intensity will remain more or less of the same scale.

The entrance of a large international investment firm with the capacity to introduce an alternative trading system internally is not expected as long as the Georgian market remains small. Such a development is more feasible only in the long-run (i.e., after 15 years). However, NASDAQ did express an interest to buy the GSE in 2007; therefore, similar developments soon after or prior to reforms (2019-2020) are not excluded. The entrance of such a firm and its alternative trading system alone will not guarantee a rapid development of the market, but could significantly improve local market infrastructure and could serve as an important facilitator of further development.

# VI. ANALYSIS OF IMPACTS

## A. METHODOLOGY APPROACH

An analysis and assessment of the potential implications of the two scenarios were conducting using the Cost-Benefit Analysis (CBA) framework, for which a 15-year timeframe was chosen. This timeframe covers the first 5 years prior to the intervention (2014-2019) and the ten years (2019-2029) afterwards.

The Net Present Value (NPV) of each option was calculated by applying a 7% discount rate to the value of capital and assets from the year 2020, because this is the milestone from which the two scenarios will diverge. Individual costs and benefits were accounted for from the same period. Additionally, inflation rate is taken into account when calculating the costs associated with the human resources (e.g., salaries, trainings, insurance, administrative costs). In May 2014, the year-to-year change in prices was estimated to be 2.4%,[9] while the average inflation rate in 2014 varied around 3.0%. However, starting from 2015, the official government target is 5% inflation rate to go down to the 3% in the long-run.[10] For the scenario analysis purposes, the 5% average long-run inflation rate was applied for the next 15 years.

Certain costs and benefits (e.g., projections of the annual value of transactions, revenues of trade organizers from membership and other fees) were "exempted" from discount or inflation rates for the simplicity purposes.

The main sources of data for the quantitative analysis were annual reports of the NBG, the GSE, and brokerage companies (also posted on the website of the GSE). Additionally, certain fees and estimates were drawn out from the consultations with subject matter experts.

Key assumptions used for defining the potential impact of interventions were derived from qualitative assessments conducted during stakeholder consultations. All stakeholders agreed that the improvement of trading infrastructure and the integrity of the market would encourage public trading of securities, but the impact would not be too large. In other words, Option 2 interventions alone would lead to a moderate growth, but not too significant. Therefore, it is assumed that incorporation of MiFID standards in the Georgian market could return trading turnover to around 2006-2007 figures, but not more than that. To do so would require an average 30% annual increase in the number and value of securities traded. This estimate is quite reasonable given the past record of sharp fluctuations of these figures.

The following two assumptions were estimated using the same logic. The impact of the potential pension reforms was estimated at 7% annually due to the qualitative assessments conducted with relevant stakeholders, while the aggregated assets and capital of brokerage companies is assumed to reflect half of the 30% annual increase in trading. Hence, the growth rate for brokerage companies is assumed to be 15%.

[9] http://geostat.ge/cms/site_images/_files/english/price/CPI%20Press%20release_05_2014_Eng.pdf
[10] https://www.nbg.gov.ge/index.php?m=550&lng=eng

***A Sensitivity Analysis*** was not applied in the quantitative analysis, because the estimated growth rates used in the scenarios are very rough approximations and a slight divergence from the projected rate would not alter the cost-benefit ratio significantly. However, there are a number of uncertainties and risks that exist in the qualitative analysis that could change the overall picture. For example, the 7% annual growth expected due to successful pension reforms is not certain. As of today, the pension reforms are still in a nascent stage and its future is rather vague. However, it is still included in the analysis as many stakeholders consider it to be a possibility and the only "indirect intervention" to the market expected in the medium-term. If the reform fails, and no other changes occur, there is a high probability for Georgia's securities market to cease existence in the next 15 years.

## B. ANALYSIS OF IMPACTS

The following table summarizes the potential impacts of the two different options

**Table 8 - Summary Impact of Selected Options**

| IMPACT | OPTION 1 | OPTION 2 |
|---|---|---|
| **Economy** | Disappearance of the securities market | • Modest revival of securities market<br>• Relatively better access to capital<br>• Potential to grow further |
| **Brokerage Companies** | • Loss of the market<br>• Sustained decline in operations and profitability | • Expansion of operations<br>• More turnover, greater profitability<br>• Potential for growth |
| **Georgian Stock Exchange** | • High risk of closing down<br>• Insignificant operations and revenue | • Opportunity to regain market share from the OTC market<br>• Expansion of operations, increased revenues<br>• Potential to grow |
| **Investors (local)** | • Few opportunities to invest. Left with the bank deposits mostly | • More opportunities to invest profitably<br>• More trust in stock market |
| **JSCs (Issuers)** | • Difficulty attracting large capital<br>• Low liquidity of its securities | • More opportunities to attract capital and expand business operations<br>• Higher liquidity of its securities and higher dividends for shareholders |
| **Administrative / Regulator** | • Fewer administrative costs (if the number of actors and operations decreases) | • Additional human resources and administrative costs<br>• Increased costs to improve capacity to regulate evolving financial sector |
| **Banking Sector** | • Increased financial losses through their subsidiary brokerage companies<br>• Loss of a profitable financial sector | • An alternative, profitable sector to invest<br>• More opportunities through the subsidized brokerage companies |

**High impact** **Medium impact** **Low impact**

# C. COST AND BENEFITS ANALYSIS

## OPTION 1

### *Analysis of costs*

The major costs of the shrinking securities market are imposed on the key participants and stakeholders (i.e., brokerage companies, GSE, GCSD, registrars). Only 5 out of 17 brokerage companies survived over the past 5 years. If this trend continues, the 5 firms operating as of today will sustain permanent losses in their assets and capital. Given that most of these brokerage companies already depend on financial support from their parent organizations, any further decline in operations and profitability may lead to bankruptcy for some. The same applies to the GSE. If trading continues to shrink and/or shift to the OTC market, then GSE's existence may become financially unjustified. A modest revival (reflected in an average 7% growth) is expected due to the potential pension reforms. Nevertheless, its effect will be tangible in 4-5 years at the earliest.

Therefore, costs are highest for brokerage companies and for the GSE. Additionally, high costs are incurred by potential investors, joint stock companies, and their shareholders, as they will lose opportunities to invest money more profitably or to attract additional capital for potentially profitable initiatives. Moderate costs will be sustained by banks as well, since they are the current key financiers of the brokerage companies and key actors on the market. In total, these costs represent a significant high cost for the economy, which is deprives the entire sector of a financial market.

### *Analysis of benefits*

There are no real benefits in disappearance of the securities market. The scale of the trade projected by the baseline scenario (about GEL 25 million and less than 50 deals a year) is not beneficial for brokerage companies or for the trade organizers and the economy in general. The only theoretical benefit would be a more efficient allocation of resources managed solely by market forces in case of the disappearance of the securities market. If most brokerage companies and trade organizers (e.g., GSE, GCSD) have negative balance sheets in most years, then allocating these resources to other sectors of the financial markets may be justified.

There are speculations that the decline of the securities market is in the interests of private banks, its main competitors. However, this perception is not backed up by any solid argument. The types of services and the scale of capital offered by the banking sector and by the stock market are not competing but rather complementary. Furthermore, Georgia's securities market, in its current shape, is already dominated by the banking sector. Hence, its prosperity would also imply higher yields for banks.

## OPTION 2

### *Analysis of costs*

There are administrative costs associated with the implementation of the "Best Execution Rule" and additional transparency requirements set by MiFID. Brokerage companies, the

GSE, and the NBG will need to hire additional human resources and train them on new standards and regulatory mechanisms. For a medium/large-sized brokerage company, this would mean an additional GEL 180,000 per year, while for the regulator, which will need more human resources to take up the additional regulatory responsibilities, the annual costs will be a minimum of GEL 171,000. The cost of additional staff may be bearable for leading brokerage companies and the national regulator, but it would be a painful investment for the GSE and smaller brokerage companies. The minimum costs for the GSE are estimated at GEL 58,800 a year.

Further investment in technical and IT infrastructure for brokers, GSE, and the regulator was also considered, but because of the moderate growth (30% annually) predicted, such investments will not be an absolute necessity. It would be more relevant in the long-term if the market continues to expand faster.

Indirect costs, which are accounted for only qualitatively in this analysis, would include relatively higher service fees for investors and issuers. Because “Best Execution Rule” imposes greater requirements on investment funds and brokerage companies, it is expected that their service fees will go up. However, due to the market size and low trading volumes, the fees will grow only moderately to not discourage clients.

Small brokerage companies may not be able to keep up with these changes and might close down in the first few years after the intervention. However, this will be a low cost for the economy, because the capital of the four smallest brokerage companies together (GEL 1,137,942) constituted only 5% of the total capital of brokerage companies (GEL 24,000,000) in 2013. Furthermore, these costs are (1) a more efficient reallocation of resources and (2) only temporary as new brokerage companies are expected to enter the market as the trading begins to expand.

### *Analysis of benefits*

The majority of direct benefits from expanded trading will go to brokerage companies. Their assets and capital are expected to grow an average 15% annually. The net increase in assets and capital of brokerage firms within 10 years after the intervention is estimated at GEL 143 million (GEL 88 million in assets and GEL 55 million in capital).

Another significant beneficiary of the new transparency requirements will be the GSE, as it is expected to regain up to 90% of total annual trading from the OTC market. The GSE management does not appear ready and/or capable of carrying out in-depth reforms or of introducing new products and services to the market that would create additional benefits. Additionally, it is assumed that the GSE’s main benefits will not be generated from the performance of its management team, but rather from transaction services and membership fees. Since transparency requirements will encourage trading through the GSE, the number of its listed members and brokerage companies registered with the stock exchange is expected to increase. Therefore, the net benefit from increased trading volumes on the GSE, within10 years after the intervention, is estimated at slightly more than GEL 1 million.

Implementation of MiFID requirements would benefit the overall economy and would increase access to the capital for local businesses and offer more possibilities for medium-sized local investors to invest profitably. This would be measured by the total value of securities available on the market, which, according to the World Bank data, was at GEL

1.669 million in 2012. This means that the market capitalization to GDP ratio in Georgia was 6%, while for developed economies, such as the USA and the UK, ratios were 120% and 123%, respectively. Furthermore, the ratio in Poland was 35% and 9% for Estonia the same year. Estimated net benefit to the economy from increased availability of capital and opportunities to invest is estimated to be GEL 1.887 million by 2029. However, due to only modest securities market growth, coupled with projected GDP growth of 4-6% in the long-term, Georgia's market capitalization to GDP ratio will remain low (4-5%).

Investors, issuers, shareholders, and the overall economy will benefit from the more transparent price-creation, more realistic stock prices due to greater transparency and access to information, and a more trusted market. However, the overall effect on these stakeholders is assessed as modest, because full-scale securities market reforms are needed to achieve a significant growth.

One uncertainty of the scenario is the redistribution of trade between the GSE and the OTC. It is assumed that the majority of trading will return to the GSE; however, whether this will be a reality depends on how prepared the GSE will be and whether a new actor (e.g., international MTF or SI) will enter the OTC market or will buy the GSE.

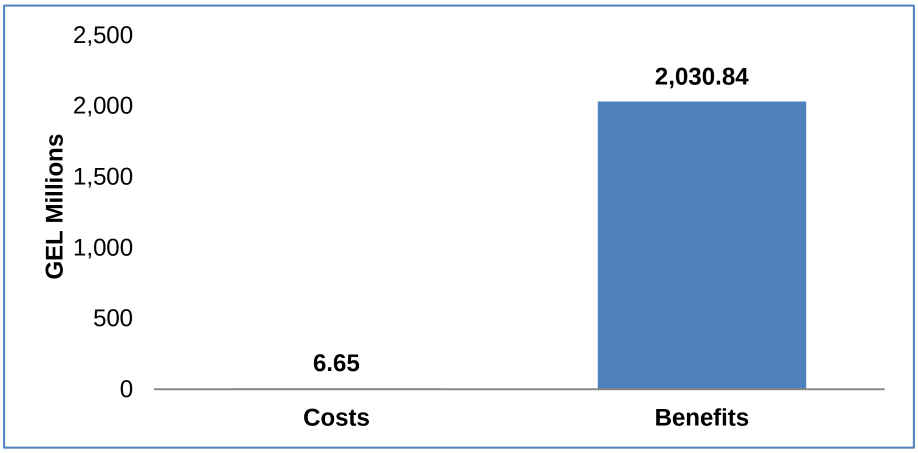
## D. SUMMARY

The comparison of Option 2's costs and benefits is outlined in the following chart and indicates that estimated costs of the intervention are quite low (GEL 6.65 million over 10 years), while estimated benefits for the same period are over GEL 2 billion. This is significant, especially considering the fact that this intervention is considered to be modest measure compared to a full-scale market recovery. Such vast difference between the estimates has two explanations:

- Very rough numbers and calculations were used to estimate potential benefits, the purpose was to show the scale the benefits could reach;
- The nature of the financial markets and securities sector, where small infrastructural changes can stimulate new market opportunities.

To conclude, although complying with MiFID's trading transparency requirements is just the beginning of a much-needed complex reform package, the benefits of introducing this requirement alone can be significant for the key players on the market.

**Figure 6 - Comparison of Costs and Benefits of Policy Option 2 (NPV, GEL)**



The following table presents a summary of the costs and benefits for undertaking Option 2. As Option 1 is the baseline scenario for which the RIA assumes no additional costs or benefits, it is not possible to compare any similarities between these two scenarios, but the contrasts are clear and evident.

**Table 9 - Summary of Costs and Benefits**

| | OPTION 1 | OPTION 2 |
|---|---|---|
| **Benefits (NPV)** | - | GEL 2,030,841,487 |
| **Costs (NPV)** | - | GEL 6,646,343 |
| **Benefits – Costs (NPV)** | - | GEL 2,024,195,144 |
| **Quantified but not monetized impacts** | - | • Most small brokerage companies risk bankruptcy in the medium-term;<br>• Market capitalization remains low (at 4%). |
| **Qualitative impacts (if quantitative not possible)** | - | • Medium positive impact on potential investors and issuers, due to increased trust and higher competition on the market. |

# VII. COMPARING THE OPTIONS

In addition to cost and benefit analysis, scenarios were assessed in terms of the effectiveness, easiness to comply, and risks to implementation. “Effectiveness” measures the scale of the impact of the specific scenario. Option 1 presumes a large-scale negative impact on the securities market through reduction of its operations to almost zero while Option 2 predicts a modest revival of the market (hence assessed with only ‘+’). In terms of compliance and feasibility, Option 1 is feasible because this regulatory framework already exists as the status quo and is followed by all stakeholders, despite their level of satisfaction. Option 2 will not be very problematic to comply in terms of costs; however, because there are no clear-cut rules on how MiFID’s implementation should be regulated nationally, setting up an efficient regulatory framework may be challenging.

Finally, there are a few risks associated with implementation of Option 2. First, the successful implementation of the potential pension reform is uncertain. Its failure will negate an estimated 7% growth annually. Other risks are associated with potential new actors and re-balancing/re-distribution of transactions amongst them, the GSE, and the OTC market. In post-MiFID Europe, many new actors (alternative trade operators) emerged and changed the market for conventional stock markets completely. Similarly, this process is inevitable in Georgia, but when this will occur is difficult to predict. It depends on whether and when international actors decide to enter the market and how prepared the management of the GSE and other leading brokerage companies will be to take advantage of the new opportunities.

## A. SUMMARY OF OPTIONS

A 6-point scale of “- - -“and “+++” was used for multi-criteria analysis. Three minuses indicate the highest negative circumstances, while one minus indicates moderately negative. Similarly, three pluses indicate the highest positive conditions and greater probability of success, while one plus indicates only a moderately positive effect.

**Table 10 - Comparison of Options Using Multi-Criteria Analysis**

| EVALUATION CRITERIA | OPTION 1 | OPTION 2 |
|---|---|---|
| **Benefits – costs (NPV)** | Cost and benefits were assumed to be zero. | GEL 2,024,195,144 (this is incremental value – difference between Option 2 and Option 1) |
| **Effectiveness** | - - - | + |
| **Feasibility / Ease to Comply** | + | ++ |
| **Risk** | ++ | - |
| **SUMMARY** | **+** | **++** |

# B. MONITORING AND EVALUATION

Monitoring and evaluation (M&E) of the implementation of the amended regulations should be conducted periodically (at minimum every 5 years). A comprehensive re-assessment of the market 5 years after the intervention (by 2020) will allow M&E specialists to review and measure whether the market is following the projected baseline scenario and adjust the baseline if necessary. The subsequent re-assessments in 2024 and 2029 will allow the M&E Specialists to compare the real effects of the intervention to prior projections for Option 2 and to identify where failures and/or unforeseen successes occurred.

M&E of the implementation's progress can be conducted either by an independent body contracted for the M&E, by the Prime Minister's Economic Council, the regulator (NBG), or the MoESD.

**Recommended indicators for M&E include:**

- <u>Increased trade turnout and turnover</u>
  - Increase of number of transactions on average by 60% annually;
  - Increase of the value of traded securities by 30% on average annually;

- <u>Improvement of market transparency and access to information</u>
  - Pre-trade information (bids & offers) is publicized on the GSE and OTC;

- <u>More vibrant securities market</u>
  - Better price creation (more competitive prices) on the stock market;
  - Increase in the number of active brokerage companies by almost 7 times (from 5 to 35), and more than 400% increase in their total capital and assets;
  - Increase in the number of listed members at the GSE;
  - Increase in the number of types of securities traded.

# C. RECOMMENDATIONS

In addition to the main findings and conclusions of the RIA, key recommendations for the implementation of securities market reform and harmonization of Georgian legislation with the EU directives are included below:

- There is very low awareness of MiFID requirements (as well as other major EU directives concerning the capital markets) among key stakeholders. The main market makers are only partially familiar with some portions of what the legislative harmonization process would entail. Therefore, meetings and consultations should take place with key market makers to continue to raise awareness of MiFID requirements.

- There is distrust among key stakeholders, mostly due to the lack of communication and direct dialogue. Measures should be taken to overcome these information and communication gaps, either through direct dialogue with key stakeholders or through public consultations and roundtables regarding the upcoming legislative amendments.

The introduction of additional transparency, reporting, and consultation requirements alone will not have a desired effect on the securities market. A complex approach is needed, which will include amendments for up to ten Georgian laws and a number of non-regulatory incentives. These should be combined under the strategic vision for the development of Georgia's securities market.

# VIII. APPENDIX

1. Cost and Benefit Analysis for Option 2.
2. MiFID Matrix (comparison between MiFID, Georgian LSM, and corresponding Polish and Estonian regulations).
3. EU Directive on MiFID, full text.
4. Georgian LSM (as of April 2014), full text, unofficial translation.