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USAID/RABAT

CASABLANCA STOCK EXCHANGE DEVELOPMENT FOLLOW-ON VISIT

Final Report

April 13, 1992

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April 13, 1992

Re: AID/PRE Financial Sector Development Project (FSDP)
Contract No. PDC-2206-Z-00-8191-00
USAID/Rabat - Casablanca Stock Exchange Development Follow-on Visit
FSDP Activity no. 56

Dear Mr. Kraczkiewicz:

Please find enclosed a copy of our trip report for the follow-on visit to the Casablanca Stock Exchange Development assignment, as prepared by Price Waterhouse, Prime Contractor under FSDP.

It has been a pleasure to work with you on this activity. We look forward to working with you on other projects in the future.

Sincerely,

J. Richard Breen
Director, FSDP

Enclosure (as stated)

USAID/Rabat
FSDP/Price Waterhouse
Morocco Stock Exchange Development
Follow-on Visit Trip Report and Recommendations

I. BACKGROUND

From March 2 to 6, 1992, an FSDP team comprised of Robert Bishop, retired Senior Vice President of the New York Stock Exchange and Richard Dangay, a Price Waterhouse Senior Consultant, conducted a follow-up assignment with USAID/Rabat on the Casablanca Stock Exchange. This assignment provided an opportunity for a dialogue between the Moroccan capital market participants and the FSDP team. Since the team last visited Morocco, the Ministry of Finance prepared new draft laws and decrees on the Stock Exchange, capital market regulatory agency (CNMVM), public offerings and information disclosure. Copies of the revised drafts were forwarded to the FSDP team for an analysis prior to the trip.

In September 1990, at the request of USAID/Rabat and the Ministry of Finance, an FSDP team was engaged to assist the Government of Morocco in strengthening the role of the Casablanca Stock Exchange. The team found that the Stock Exchange was not operating at full capacity and identified several factors that would be key to the growth and development of the Exchange. Among these key factors were privatization of state-owned enterprises and requiring brokers to be organized as separate corporations whether or not they are subsidiaries of banks or other financial parents. In addition, the team recommended that the Exchange be transferred to the private sector and that the government limit its role to a regulatory capacity. The team further suggested that the proposed draft laws and regulations be strengthened to support more effective information disclosure. The team issued a two volume report: volume 1 presented the team's conclusions and recommendations, and volume 2 presented a set of rules for the Stock Exchange, a discussion for the creation of a compensation fund, and recommendations for training and public relations activities. This report was then distributed by USAID/Rabat to the parties involved in the Moroccan securities market.

This trip report is organized as follows: Section II summarizes the points that were discussed during the various meetings. Section III outlines a new set of recommendations that were presented to the Ministry of Finance and Section IV presents the conclusions that can be drawn from this follow-on visit. Finally, specific comments on the new draft laws and regulation are presented in Appendix A, while Appendix B contains answers to specific ministry of Finance questions.

II. MEETINGS

During the course of the week, the team met with USAID, the Ministry of Finance, the Caisse de Depot et de Gestion, the Price Waterhouse advisor in the Ministry of Economic Affairs and Privatization, the Director of the Stock Exchange and the Brokers Association. The content of the meetings with the Caisse de Depot et de Gestion and the Brokers Association is described below.

Caisse de Depot et de Gestion

The meeting with the Caisse de Depot et de Gestion (CDG) focused mainly on mutual funds. In light of the upcoming privatizations, and with the goal of the Moroccan Government to promote broad public share ownership, the Finance Director of the CDG expressed interest in the possible creation of mutual funds with shares of newly privatized companies. The CDG sees mutual funds as the best method to achieve broad public share ownership and would be willing to set up such a mutual fund in order to help this new instrument in Morocco. The CDG manages the funds coming from public savings and state-owned enterprises and would have a sufficiently large funds base to create a mutual fund, manage it and sell its shares to the public. The Moroccan Privatization Law, however, states that it is forbidden for a government institution to acquire shares of a privatized company. This law, although aimed at increasing broad public share ownership, prevents the CDG from establishing a mutual fund composed of privatized securities.

Brokers Association

During the meeting with the Brokers Association, several points were raised and are listed below:

- Privatization is scheduled to take place shortly and the brokers feel confident that they will be able to distribute publicly the privatized shares through the banks' networks.

- As soon as the brokers operate independently from the banks, their new status will force them to generate enough revenues to survive. This, in turn, will result in an increase in the level of transactions on the Stock Exchange.

- Although the current securities delivery system has not caused any problems to date, with a greater number of transactions, risks are likely to increase.

- Off board transactions of securities: more than 60% of securities transactions are performed outside the exchange on a non-competitive basis. This issue, raised during the 1990 FSDP study, is a major challenge for the brokers.

- A question raised by a broker during this meeting was related to the kind of actions the brokers could undertake immediately in the perspective of an Exchange operating at full capacity. The team's main recommendations were for the brokers to join their forces in order to:

  - standardize their operating methods, internal controls and accounting standards and practices

  - participate actively in a promotion campaign for broad public share ownership

  - identify and promote professional training in investment counselling, financial analysis, etc.

  After further reflection on this important question a supplementary suggestion involving the method of recruiting and paying account executives has been developed and is explained at the end of this report.

Ministry of Finance

The team met with the Ministry of Finance (MOF) on two occasions to provide advice on the new draft laws and decrees. The new drafts include some of the FSDP recommendations, such as the "privatization" of the Stock Exchange, of which at least 50% will be owned by the private sector, and the obligation of brokers to be organized as separate corporations. The team brought to the MOF a copy of the 1933 U.S. Securities Act, the Securities Investors Protection Act, The Securities Company Act of 1934 and four examples of prospectus for the distribution of shares. The Acts will provide the MOF with specific examples of a capital market legislation that could be useful during their draft reviewing efforts. The draft laws are currently in the Secretariat General Office (Attorney General's Office equivalent) for review prior to submission to the Parliament. The MOF mentioned that they will participate in this final review and will make more changes to the drafts.

III. RECOMMENDATIONS

Among the recommendations made to the Ministry of Finance, the team suggested that:

- the laws on public offerings (to sell and to purchase) be divided into two distinct sections and the current provisions on takeovers be eliminated from the drafts until needed.

- **the laws and regulations on the CNMVM** (the regulatory agency) be further developed. Specific comments are included in Appendix A.

- **mutual funds** should be considered as the best means to achieve broad public share ownership. Although a draft law has been developed regarding the creation of mutual funds, it has not been passed by the Parliament and might need to be studied by experts in this field. With such developments in a near future, the Moroccan financial industry will probably need technical assistance in the actual set up of a mutual fund.

- **a Stock Exchange Promotion/Share ownership Educational Campaign** be implemented. With the upcoming privatizations, a need has been felt to promote broad public share ownership. The Casablanca Stock Exchange has already started to publish some pamphlets on financial instruments, the stock exchange and government-issued instruments. A global approach focusing on both the Stock Exchange and the upcoming privatizations would have a broader impact.

IV. CONCLUSION

The revised draft laws as presented to the team reflect some of the recommendations specified in the 1991 FSDP report. The major improvements from the previous drafts are the transfer of the exchange to the private sector and the separation of the brokers from the banks. During the final meeting with the Ministry of Finance, the FSDP team further recommended that the MOF team review the 1991 FSDP report with a view towards applying some of the other recommendations included in the report.

Appendix A

COMMENTS ON THE DRAFT LAWS AND DECREES ON THE SECURITIES MARKET

CNMVM DRAFT LAW

The purpose of this project was to advise the MOF regarding the Stock Exchange, not on the formation of a CNMVM. However, the overall divisions of responsibility between such a governmental organization and stock exchanges were reviewed. A separate study was recommended for development of specific legislation for a CNMVM. This study has not been implemented, but comments on the current draft of a CNMVM law are provided below when provisions in this draft may conflict with recommended stock exchange functions and rules.

Article 3 does not clearly state whether the President of the CNMVM would be a full, or part time employee, and/or a government official. Given the present level of securities activity, all members of the CNMVM should be employed on a part-time basis, however the Secretary General should be assigned a full-time position.

There should also be provision for the initial appointment of the non-government members staggered for 1 to 5 years each with the objective of having subsequent turnover of only one such person a year. In case of death or resignation of such a person during his term, it should be clarified whether another person would be appointed to fill the unexpired part of a term or for a full five year term.

The power to levy fines is limited to instances where a company does not publish rectifying statements. There are likely to be instances where a company should be fined for misrepresentation whether or not it publishes rectifying statements. Further, authority to discipline responsible individuals within offending companies pursuant to article 17, should not be limited to failures to satisfy CNMVM review of prospectus, but should also extend to misrepresentation not detected by CNMVM review or any failure to timely disclose information material to investment decision.

In article 10, the publication of a prospectus in a legal announcements publication seems a questionable expense for issuing companies. The emphasis should be placed on delivery of a prospectus to purchasers before they are finally bound to the transaction. In the United States, a preliminary prospectus is published in advance of the underwriting date to give investors an opportunity to evaluate the issue. The delivery of a final prospectus to a purchaser with the trade confirmation is then required, with the purchasers having the right to cancel their trade within a period of time. A set of preliminary and final prospectus was delivered to the Ministry of Finance for their review.

The only reference to the Stock Exchange in the draft law is in Articles 14 and 15: "The CNMVM can make regulation regarding the operations of the markets placed under its supervision and the licensing of the brokers and the prudential regulation that can be applied to them." "The CNMVM can request the suspension of quotation in order to protect investors." These provisions are not objectionable, however, it is recommended that in practice, CNMVM regulation of the stock exchange be performed by approving, disapproving, requesting or amending stock exchange rules formulated by the stock exchange managing committee, and overseeing the diligence and effectiveness of the exchange in enforcing compliance with such rules by its members. Further, the CNMVM law should provide for publication of any proposed CNMVM rule with a period in which comment is invited by interested parties, with consideration of such comment by CNMVM before adoption of such rules.

For the foreseeable future, the team recommends that securities broker/dealers be required to be members of the Stock Exchange.

PUBLIC OFFERS DECREE

The draft decree on regulation of public offers has several references to notice to the stock exchange which are not objectionable. Article 11, however, contains a very serious impediment to a continuous public market on the exchange in providing that upon CNMVM authorization of a public offer the trading price (presumably on the exchange) of target company shares be frozen until two trading days after the end of the offer period. Such a provision unfairly deprives existing shareholders of liquidity during any public offer.

Article 14 appears to restrict the right of others to compete with a first public offer both in the time periods required and the 5% price differentials. See page 29 of the original report under "Takeover bids and secondary distributions" for further discussion.

STOCK EXCHANGE LAW DRAFT

The presentation note contains two expressions of principle which are of concern:

Modification 3 is literally acceptable, but caution is recommended in approving those member companies to extend their activities to custodial service and settling of exchange transactions. Capital and internal control requirements should be different for firms settling transactions and holding customer securities and moneys than for firms only advising customers, and accepting and executing transaction orders. There should be provision for firms not qualified to carry customer accounts and clear transactions to contract with banks, an exchange settlement agency or another qualified member to do so on their behalf. (See proposed rule 101 which should be modified to permit introduction of accounts to banks).

Modification 4 is not clear as to the meaning of present or proposed capital required. As expressed in Article 14 of the proposed draft law a single capital requirement is inadequate. See proposed rule 310 for a recommended capital requirement.

Articles 1-3, 5-9, 13, 17, 25, 27, and 28 are not objectionable as presented in the draft law.

The proposed articles 10 - 12, 18, 20-24 and 26, do not appear to be appropriate stock exchange regulations, but should be part of CNMVM regulations.

Articles 5 and 6 would be greatly improved by substituting the text on Page 56-7 of the Exhibits in the 1991 report, Article 4 (Powers of Board). The other Articles in this Exhibit, Pages 56-59 of the report should also be added to the draft law.

Very important provisions, such as the composition of the Managing Company Board are apparently left to the by-laws to be separately approved by the Minister of Finance.

Article 4 of the draft law proposes a government auditor which in our opinion creates a duplication and conflict of interest with the responsibility of the new CNMVM. See Page 33 of our 1991 report for further discussion.

Article 15 would require all brokerage firms to be members of a brokers association. For a developing securities brokerage community, one self-regulatory organization is desirable, and it should be the stock exchange. The functions contemplated for a brokers association should be those of the stock exchange. With a Managing Committee as recommended composed of brokers, representatives of listed companies, and investors, regulation biased only in favor of brokers would be avoided and general perception of the exchange improved.

The Compensation Fund proposed in Article 16 is not practical under the administration of either a brokers association or the exchange. Primarily this is because setting aside a small part of the brokers commissions for this purpose would not accumulate, within a reasonable time, to a sufficient fund to make whole reimbursements to customers of failing firms. The

only feasible funding for such a compensation fund at present is the government, and in that event such a fund should be government administered. It is unlikely that Moroccan bankruptcy law would permit restoring of missing customer securities and moneys without also restoring general creditor claims. If a compensation fund is to be practical special bankruptcy provisions for stockbrokers with supporting regulations by CNMVM and the exchange would be necessary. The only developing securities community known to have planned such a fund is Sri Lanka, for which proposed law and rules have been drafted under sponsorship of the Asian Development Bank by Mr. Bishop.

The proposed language of Article 16 which would reimburse customers for whom "losses are the broker's fault" opens the doors to claims for changes in market prices of security holdings between bankruptcy and reimbursement dates, or for poor advice by brokers. Other compensation funds limit assistance to the values incurred as of bankruptcy date.

STOCK EXCHANGE GENERAL REGULATIONS

The proposed general regulations are far less comprehensive than those recommended in our 1991 report. We continue to advocate these 1991 recommendations unless specific acceptable reasons are cited for deferring adoption of particular proposed rules.

In addition, the following articles of the proposed draft rules do not seem to be adequate:

Articles 9 & 10 are unclear as to whether members must execute unlisted transactions at the exchange. Such a provision should be included.

Articles 11-17 seem contrary to the interests of investors as discussed in the 1991 report, Page 24. This facility for members dealing for own account by buying securities off the exchange and reselling on the exchange denies the opportunity for public participation and is likely to lead to a perception of broker profiteering. The negatives are exacerbated by charging of commissions on dealing transactions which is contrary to ethical practice in securities markets.

Articles 29-38 are not clear as to how new issues are distributed in an exchange auction as implied in Article 34 referring to quotation "by opposition". Is the offer price limited by terms of the offer? Must the offered securities by distributed no matter how low a price demand determines? Does price vary at different times during the distribution? During our interviewing, we found that a new issue has not been marketed on the Exchange in many years, and there is no clear plan for how it should be done. A specific written plan should be developed and promptly issued to the financial community for review.

Article 30 - Why must a listing application be presented to the Exchange by a broker rather than by the company itself?

Article 35 - Delisting at the issuers request should not be permitted without a favorable vote by a large percentage of share owners.

Appendix B

ANSWERS TO SPECIFIC MINISTRY OF FINANCE QUESTIONS

Brokers activities and protection of investors

The activities of the brokers will be extended to the custody of securities and to contrepartie. What would be the safety measures to be taken in order to protect the interest of the investors, specially in case of manipulation of the quotes.

Should a law be drafted which would define the rights and obligations of the brokers as well as the punishment they could face in case of abuse?

Are the minimum capital required and the common fund, as stated in article 14 and 15 of the draft law on the Stock Exchange, a sufficient guarantee against the bankruptcy of a broker?

The 1990 recommendations for stock exchange rules provide for the areas of concern more comprehensively than the current proposals. Some of the concerns are specifically addressed above. Some of the areas recommended in the proposed exchange rules merit back-up in CNMVM law or rules and would be identified in the recommended project for this purpose.

The growth of large broad public ownership

It is highly hoped that the privatizations be used to favor a broad public ownership in Morocco. Several industrialized countries already achieved this goal and some developing countries are currently in the process. What kind of lessons can be drawn?

All of the measures being approached by the Moroccan government and financial community seem to be in the proper direction for encouraging broad public ownership - privatization, education of securities professionals and the public, sound markets. There are no quick and simple paths.

Contrepartie/Deal Making

The brokers will be able to do contrepartie only after having received the authorization of the CNMVM.

What would be the specific qualifications to be requested by the CNMVM to grant this authorization/license?

What would be preventive measures against fraud?

We do not perceive that CNMVM qualification of exchange members to deal for own account is necessary. The basic rules of the CNMVM and Exchange should be adequate to establish the integrity and knowledge of all members to do so, while the capital rules and operating rules for clearing transactions should be phrased so as to identify those members qualified to trade. General anti-manipulative rules should adequately govern member as well as public trading. Appropriate rules in each area are included in the 1991 recommendations for exchange rules, some of which should be backed-up in CNMVM rules.

As explained earlier above, we feel that the specific deal making plan in the current drafts are contrary to the public interest.

Listing and delisting on the official Board

What do you think of the current admission criteria of the Casablanca Stock Exchange?

Should these criteria be softened in order for a greater number of companies to be able to access direct financing, but at the risk of admitting on the board securities with greater risk?

Or on the contrary, should the Bourse be more strict and go as to eliminate securities with very little transactions recorded or securities for which no dividend was paid, risking therefore to end up with a very small number of listed securities?

The recommended rules 1-20 of the 1991 report are reiterated. Further, it was recommended that unlisted as well as listed securities be traded on the exchange in order to give maximum centralization to trades in such securities and encourage access to public financing for unlisted companies.

It is not a proper function of the exchange or CNMVM to try to limit risk to investors - rather to provide for disclosure of relevant information about each publicly owned company for evaluation by investors and their professional advisors.

Clearance and settlement

What is the practice in terms of clearance and settlement in American Exchanges and to what extent is possible to adapt them to Morocco?

It is feasible to adapt the clearance and settlement procedures of American exchanges to Morocco and it will be highly desirable to do so when banks cease to be direct members and a delivery against payment system for trades becomes necessary. The 1991 report recommended rules 100-120 provide a framework for such a system. Supporting computer processing systems have been designed during the past four years for developing stock exchanges in Jamaica, Indonesia, and Sri Lanka. The consultants who designed these systems should be available for assistance in Morocco.

The problem of Cessions Directes (Off-Board Sales)

The majority of the transactions recorded in the Exchange are the result of off the Board sales, which did not result from an offer and demand confrontation.

Despite the fact that only a small portion of these transactions are recorded which prevents the exchange from a large revenue, the extremely large volume of these transactions makes the quotes of the Exchange Board a very imperfect figure since the market is not the central connection point between the offers and the demands of listed securities.

What is the practice in foreign securities market in these matters and how could this problem be resolved?

We share the concern of the Moroccan financial community and government with the dominance of off-board sales of publicly distributed securities. The incidence of similar off-board sales is very small in other countries and brokers may not usually be parties to such trades.

Our 1991 recommendation was for a depth study of a sufficiently large number of such trades to determine whether any merit continued exemption to exposure to the exchange market. Our inclination is that all should be exposed to the market to clear public interest at competitive price. We also believe that such a study will show that private off-board sales are done at prices higher than the market because the more knowledgeable institutions and other investors involved evaluate the securities at substantially higher than public market prices. If so, the establishment of public exchange prices at a low level is inconsistent with the perceived shortage of supply of Exchange traded securities. An explanation of such an inconsistency would be the underdeveloped research and marketing power of the bank securities departments which are now exchange members. An important component of this weakness is probably bank salary compensation practices for their employees.

One underlying reason for our recommendation that brokers be organized as separate corporations is to free those which are bank subsidiaries for commission incentive compensation of their account executives.

We also noted that Morocco, like many other countries in the current worldwide economic climate, has many unemployed university graduates. It should be profitable in the long run for the Exchange Member parent banks to select and train account executives in charge of marketing a limited selection of publicly traded securities which each members selects for recommendation. The American practice is to pay such beginners a subsistence salary for six months to two years with the clear understanding that the objective is commission compensation. Securities are sold person-to-person individually. Organizing a significant number of educated young account executives to explain investment opportunities to appropriate Moroccans should result in market prices becoming identical with the price evaluations of knowledgeable institutional investors. Therefore, public trading rather than off-board trading could become the method of choice. Such a sales would also be of key assistance in distribution of privatized securities.