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UNITED STATES
FINANCIAL SERVICES VOLUNTEER CORPS

MISSION TO HUNGARY

September 16 - 21, 1990

OBSERVATIONS, FINDINGS AND RECOMMENDATIONS

October 5, 1990

FILE COPY

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BACKGROUND AND SUMMARY

MISSION TO HUNGARY
SEPTEMBER 16 - 21, 1990

At the request of the Hungarian Government, the Financial Services Volunteer Corps (FSVC) conducted a Mission to Hungary from September 16-21, 1990.

The FSVC Mission was led by the Honorable John C. Whitehead, Chairman, AEA Investors Inc., former Deputy Secretary of State, and Co-chairman of the FSVC. Executive Director of the Mission was the Honorable Herbert S. Okun, former U.S. Ambassador to the German Democratic Republic.

Background

The Financial Services Volunteer Corps is a new program of the Department of State/Agency for International Development designed to apply the experience of senior financial-sector professionals in promoting private-sector growth and market economies in the emerging democracies of Eastern Europe. It was created in response to President Bush's initiative to encourage voluntarism. The FSVC is comprised of leading specialists from U.S. commercial and investment banks, as well as law and accounting firms. They provide their services on a volunteer basis. A mission to Poland was undertaken in May, 1990.

Steering Committee

The Honorable Cyrus R. Vance, Presiding Partner, Simpson Thacher & Bartlett and former Secretary of State, is Co-chairman of the FSVC Steering Committee together with Mr. Whitehead. Other members of the Steering Committee are:

James E. Burke
Chairman, Strategic Planning Committee
Johnson & Johnson

John J. Phelan, Jr.
Former Chairman
New York Stock Exchange

Lewis T. Preston
Chairman, Executive Committee
J.P. Morgan & Co.

The Honorable Paul A. Volcker
Chairman
James D. Wolfensohn Inc.

Marina v. N. Whitman
Vice President and Group Executive
General Motors Corporation

Members of the Mission to Hungary

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Observer

Alexander C. Tomlinson
President
Hungarian-American Enterprise Fund

Administration

Robert J. Rourke
Director for International Development
Ernst & Young

Objectives

The principal objectives of the mission to Hungary included:

-- Strengthening the role of the banking system and capital markets in promoting privatization;

-- Increasing the effectiveness of Hungary's commercial banking system, including supervision thereof; and

-- Promoting development of the Budapest Stock Exchange.

The Commercial Banking Team advised the Government on Hungarian banking laws and the role and function of off-site and on-site banking operations. The Capital Markets/Privatization Team advised its Hungarian counterparts on international securities trading practices; establishment of an over-the-counter market; regulation of trading floor operations; settlement/accounting issues; and training for securities brokers. Additionally, the Team discussed and made proposals concerning the role of the stock market and commercial banks in privatization.

Meetings

During its stay in Budapest, the FSVC Mission met, inter alia, with the following members of the Hungarian Government and of the Hungarian financial community: President Goncz; Prime Minister Antall; Finance Minister Ferenc Rabar; President of the National Bank of Hungary, Gyorgy Suranyi; State Secretary Katalin Botos, Finance Ministry; Maria Doros, General Manager of the Banking Department, National Bank of Hungary; Dr. Klara Kovari-Csoor, President, Bank Supervisory Board; representatives of Hungary's three largest wholesale banks and the largest retail bank; a number of smaller specialized banks; representatives of the State Securities Surveillance (Hungary's SEC); the Budapest Stock Exchange; as well as with representatives of issuers whose securities are trading on the Exchange.

Summary of Findings and Recommendations

The conventional wisdom on Hungary can be summed up approximately as follows:

-- The entrepreneurial spirit is alive and well in the Hungarian people;

-- Of all the post-Communist, democratic regimes in East-Central Europe, Hungary has progressed the farthest toward a market economy;

-- The economic reforms of the later Kadar years aided this movement; and

-- Hungary's transition will therefore be smoother than that of other post-Communist countries.

The unconventional truth, as we see it, is that this smoothness has been deceptive and has left serious problems. While Hungary has made progress in the last year or two, a great deal remains to be done, much of which will not be easy. The spirit of enterprise indeed does exist, but only in certain segments of Hungarian society. Most notably it is not a conspicuous trait of Hungary's new bankers. As Communism withered away, the adjustments made in the direction of a "socialist market economy" left present-day Hungary with vestigial remnants of the old system. These remnants are proving hard to remove -- sometimes even hard to recognize.

In the opinion of the FSVC, Hungary's principal problems in the financial area are:

1. The attitude of the Government itself. Beyond the normal cut-and-thrust of democratic politics, its deeds simply do not match its exemplary words. The Government, to be sure, has had to take arms against a sea of economic troubles. Its foreign debt is extremely high; the recent oil-price rise hurts badly; its traditional markets in Eastern Europe have been disrupted; and a serious drought has harmed Hungary's important agricultural sector. Nevertheless, we believe the Government has been unnecessarily ambivalent in implementing its free-market program. Its commitment to the market has occasionally seemed less than whole-hearted. This attitude has naturally communicated itself to the body politic.

2. The Hungarian banking system, an essential mechanism for creating and distributing wealth, remains extremely risk-averse. Many, if not most, of Hungary's private banks still have a statist mentality. Budapest's new bankers are slow to loan and quick to seek Government credit guarantees for their loans. (To be sure, they are not alone in this respect within the Capitalist world.) They need to begin to act like commercially-minded bankers, and quickly.

3. Allied to these two problems is a desire for "perfect privatization." This perhaps may be another remnant of the plan era, but whatever the cause it is becoming a brake on Hungarian economic progress. The country needs to denationalize many large loss-making enterprises and smaller ones as well. Now, however, there is a good deal of tinkering going on. The Government's laudable desire is to improve the companies and to make them worth more when they are eventually privatized. This desire, however, does not appear to be feasible except in rare cases. We believe the Government would be better advised to get on with the job. We also believe that the need for speed requires that Hungarian financial authorities take minor risks in privatization, risks that may: (a) cause proceeds not to be maximized; (b) occasionally mean that an unqualified advisor may be employed by a state-owned enterprise; or (c) result in excessive sell-offs to foreigners.

In the final analysis, speed plus transparency will serve Hungary better in privatizing than the cautious

search for perfection. We stressed this point to our Hungarian interlocutors.

As Mr. Whitehead stated, the purpose of the FSVC Mission to Hungary was not to observe or to find fault -- the purpose of the Mission was to help. The following report was prepared in that spirit. It contains recommendations and offers of assistance that we hope will be of help in increasing the pace of privatization efforts and expanding the scope of Hungary's financial markets. For example, to accelerate the process of listing companies on the Exchange we have started a search for persons, experienced in preparing prospectuses and who speak Hungarian, to work with the Budapest Stock Exchange for six months to a year on a volunteer basis. To follow up several discussions we had with members and staff of the Exchange regarding the importance of public education and encouraging potential investors, we are having the soundtrack of a film used by the New York Stock Exchange translated into Hungarian for use with tours or other visitors to the Budapest Exchange. As part of this effort, we will be pleased to assist the Exchange develop displays and other exhibits for the Visitors' Gallery in time for its opening in June 1991.

Much of the concern of the Banking Team stemmed from the lack of retail services available to the Hungarian public and the impediment this represents to attracting domestic capital into the economy. The FSVC is offering to provide additional volunteers to assist in defining the payments and other automated systems required to establish these retail banking services and, if requested, to assist in identifying sources for these systems. We also are offering to assist in establishing a government securities market as a means of attracting domestic capital and providing liquidity to the banking system. The situation with regard to the low-interest home mortgages came up in many of our conversations with bankers. We are examining the options available to the banks holding these mortgages, and will be providing some additional advice and offer of assistance on this topic in the near future.

We look forward to the opportunity to discuss these and other offers of assistance contained in the report with Hungary's public officials and representatives of the private sector.

BANKING

INTRODUCTION

The FSVC Banking Team[1/] met with representatives of the National Bank of Hungary (the Hungarian Central Bank); the Ministry of Finance; the State Bank Supervisory Board; the three largest wholesale banks (the National Commercial and Credit Bank, the Hungarian Credit Bank and the Budapest Bank); the largest retail bank (the National Savings Bank); and a number of smaller, more specialized banks, including two of the four banks that involve joint ventures between Hungarian and foreign interests (including foreign banks). The meetings were frank and useful, and we are grateful to our hosts for their patience and openness. These meetings provided the basis for the observations, findings, and recommendations presented below.

In the past several years Hungary has moved from a "one-tier" banking system, which consisted solely of the National Bank of Hungary and a few specialized financial institutions, to a "two-tier" system in which the National Bank of Hungary spun off its commercial banking operations into three banks that focus on business customers, and

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1/ Consisting of Ms. Green, and Messrs. Hinds, Kelly, and Rona, Chairman. Ambassador Okun accompanied the team for most of its meetings.

expanded the activities of two banks (one wholesale and one retail) that it had previously spun off. At the same time, the activities of the formerly specialized financial institutions have been expanded and new banks have been formed. There are now ten banks that may engage in a full range of commercial banking activities and another ten that may accept deposits from businesses and make commercial loans but may not accept consumer deposits. Completing the current banking picture are 260 savings cooperatives that are scattered throughout the country. These cooperatives accept deposits and make consumer and mortgage loans.

I. PRIVATE BANKING SYSTEM

A. The most basic function of the banking industry in a market economy is the collection of the nation's savings and the allocation of such savings based on an assessment and assumption of risk. Hungarian banks, however, are not yet playing a significant role in either gathering or allocating the nation's financial resources.

B. Moreover, the ability of, and the incentives for, the Hungarian banking industry to assume a more active role in the economy are problematical since:

1. About half of the nation's savings are held in cash, that is to say, outside the banking system; and

2. Bad loans are very high and likely to rise.

C. The banks are heavily reliant on State funding (some 35% of all bank liabilities are provided by the central bank) as well as State support for their credit risks. Because some 80% of Hungarian enterprises are loss makers (according to the Government), the banks regard continued support as vital to their own survival. With both sides of their balance sheets subject to Government control to such a significant extent, the banks do not appear to seek ways and means to enhance their contribution to, and role in, the private sector. At the same time, although the Government appears to be in favor of privatization as a matter of policy, the banks as currently structured provide a convenient means of exercising control over the economy.

D. We recommend the following.

The roughly US $5 billion of cash (about half of the nation's savings) now being held by the populace "under the mattress" should be brought into the financial system as quickly as possible by:

1. Offering the consumer convenient and financially attractive banking products and services, such as interest bearing checking accounts, convenient savings accounts, etc.;
2. Offering to Hungarian households the opportunity to invest in Government

securities by making available to them the smallest possible denominations (e.g., HUF 5,000) in addition to developing payroll deduction schemes that would permit people to commit to such investments on a regular basis; and

3. Reducing and eliminating, as quickly as possible, commercial banks' dependence on the National Bank, thereby forcing them to compete for consumer deposits by offering better service, better rates, terms, etc.

In short, the first priority, in our view, is to anchor the liability side of the industry's balance sheets firmly in the savings of the average citizen. Although the quality of credits on the asset side is a serious and complex question, we think that the first thing to do is eliminate any Government guarantees, express or implied, with respect to any new credit extensions. At the same time, the banks should be forced to take an active role in the restructuring of troubled credits by the phasing out of existing guarantees over time.

E. The adoption of a "two-tier" system, with the creation of a number of banks that are authorized to engage in a full range of activities, has created a suitable structure for the development of a private banking system in

Hungary. While there should be no absolute bars to the creation of new banks in Hungary, or to the establishment (subject to reasonable conditions) of branches or subsidiaries of foreign banks, there appear to be enough banks to create the potential for adequate competition in serving the needs of Hungarian businesses and consumers. This assumes, of course, that the banks ultimately are privatized and operated independently of the State and of each other. In keeping with Hungary's drive to achieve a market economy, we urge the Government to privatize the banks as soon as possible. We recommend that the Government include the savings cooperatives in this bank privatization program and arrange for the sale of the cooperatives to banks, possibly in exchange for shares, for operation as bank branches. In taking these steps the Government would be providing a wide distribution of ownership of the banks, as well as increasing the effectiveness of banking services.

F. The FSVC would welcome an opportunity to assist the Government of Hungary develop a plan and strategy for privatizing the state banks.

II. HUMAN RESOURCES

A. There is a severe shortage of qualified bank examiners. Adequate numbers of examiners will be crucial to establishing a sound private banking system. Accordingly,

we recommend that a training program be established for bank examiners.

B. Similarly, there is a severe shortage of qualified management personnel. Such personnel will be crucial not only to the overall management of each bank, but also to the operation of the extensive branch networks currently maintained by some banks and that ultimately may have to be developed by others in order to serve adequately the needs of their customers, particularly consumers. Accordingly, we recommend that a training program be established for management personnel.

C. The FSVC would be pleased to work with the National Bank of Hungary or individual banks in developing a management training program, and with the State Bank Supervisory Board in developing an examiner training program.

III. PAYMENT SERVICES

A. Perhaps the highest priority in developing a modern banking system is the development of the technological and operational infrastructure necessary to permit the free and rapid flow of money among Hungary's banks and the central bank. Along with the establishment of a retail banking sector, this will permit liquidity to flow throughout the economy (see VI.B below). This is important

not only to serve the needs of business customers, but also to serve the needs of consumers. In the absence of a reliable payments system, it will be impossible to develop sophisticated and efficient financial markets and, in particular, an active interbank market which is vital to the development of Hungary's financial sector.

B. There is a pressing need to introduce modern computer technology generally into the banking industry.

C. Additional volunteers from the FSVC are available to provide specialized assistance in developing these payments and automated systems.

IV. ESTABLISHING A CREDIT CULTURE

A. Under the current system, it is extremely difficult to evaluate the asset quality of a bank's portfolio, although asset quality problems seem to be prevalent throughout the banking industry. Rigorous credit analysis and credit discipline need to become an integral part of the banking culture.

B. As a necessary prerequisite, it is crucial to develop a uniform system of accounting that conforms to international standards. Effective credit analysis is impossible in the absence of an accounting system that accurately reflects the financial status of a borrower. The development of a reliable accounting system is also

necessary to permit bank supervisory authorities to assess the quality of banks' loan portfolios.

C. The FSVC welcomes an opportunity to discuss how it might assist Hungary establish an internationally-accepted accounting system.

V. PROBLEM LOANS

A. To overcome the asset quality problems and put the banks on a sound footing, it will be necessary to identify problem loans and then make adequate provisions for anticipated losses on these loans. This is also a necessary step in preparing the banks for privatization.

B. In order to permit recoveries in connection with problem loans, a legal system must be established that provides for bankruptcies, foreclosures, and the enforcement generally of security agreements.

C. The particular problem posed by the existence of a substantial amount of low interest (3%) home mortgage loans must be addressed. There are a number of options for dealing with this problem, including the establishment of "liquidating" banks that could be managed by the private banks under "shared recovery" agreements with the Government.

D. We are continuing to consider this difficult issue and plan to provide interested parties with materials that describe and analyze the various options.

VI. MOBILIZATION OF FINANCIAL ASSETS

A. As mentioned previously, we believe that a significant amount of private savings is being held outside the banking system as idle cash. We attribute this primarily to the failure of the banking sector to provide even the most basic retail banking services to the general population. We further note that the proportion of financial assets to total assets in the Hungarian economy appears to be quite low. Efforts must be made to "monetize" more assets, such as real property, in order to unlock domestic capital.

B. For that reason, we recommend that highest priority be given to developing a retail banking network throughout Hungary. Assistance should be given to at least one or two of the largest Hungarian banks to help them establish a retail network. The objective should be to provide banking services that assure depositors easy access and a fair rate of return on their deposits. Artificial limits on consumer deposit interest rates and consumer loans should also be removed.

C. As noted above (under I. "Private Banking System"), the Hungarian Government also should undertake a comprehensive program to issue government securities in various maturities and in various denominations to appeal both to the population and to institutions. A government securities program should be devised and marketed to tap the savings of a broad array of households, including those in rural communities with limited or no experience with financial instruments. Two critical attributes of any program should be liquidity and uniform pricing in order to gain widespread participation. A deep and liquid government securities market will also help the central bank in shifting from a system where liquidity is supplied thorough refinancing credit to a system that uses open-market operations to control its monetary policy activities.

D. The FSVC stands ready to provide additional support in developing a government securities market.

CAPITAL MARKETS AND PRIVATIZATION

INTRODUCTION

The Capital Markets and Privatization Team[1/] met, inter alia, with representatives of the State Securities Surveillance ("SSS") and the Budapest Stock Exchange (the "Stock Exchange"). The SSS is responsible for supervising the public offering and trading of securities and the operation of the Stock Exchange. We also met with representatives of issuers whose securities are traded on the Stock Exchange and members of the Stock Exchange.

Our meetings with the SSS and Stock Exchange were devoted primarily to responding to a series of questions posed in advance, and our observations are to some extent limited to the areas discussed as a result of that agenda. There follow our observations, findings and recommendations.

I. IMPRESSIVE PROGRESS

Hungary has made remarkable progress toward the development of a stock market. It has adopted a securities law, effective March 1, 1990. It has established a regulatory agency, the SSS, consisting of approximately 8 employees of whom 5 are professionals. It has organized a stock exchange consisting of 41 members (including 31 banks and 10 securities dealers not

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1/ Consisting of Messrs, Dueweke, Ferrari, Pryor, Weil and Williams, Chairman. During many of its meetings the Team was accompanied by Mr. Whitehead.

affiliated with banks) that officially commenced operations on June 21, 1990. The Stock Exchange, in five daily one-hour sessions, trades approximately 20 stocks, including one (the Ibusz Plc. travel company) that is officially fully listed. The Stock Exchange also trades bonds during its hourly trading sessions. This trading is inactive though the Exchange estimates that the bonds are owned by some 200,000 to 300,000 people. At present transactions average about 30 per day. The Stock Exchange has approximately 22 employees.

The representatives of the SSS and Stock Exchange are young and, understandably, inexperienced. Nonetheless they struck us as very intelligent and hard-working. While somewhat overwhelmed by the magnitude of the tasks confronting their small staffs, they are learning very fast.

We are a bit surprised by the fact they seem not to have sought out and learned from the experience of other countries as much as we might have expected, although one staff member of the Stock Exchange had spent time at the Frankfurt Stock Exchange. Nonetheless, we were impressed by the extent of their knowledge and the sophistication of their questions.

With respect to training of Stock Exchange staff and members, we understand that the staff would prefer that the principal training effort be in Budapest and that, if possible, it be done in a manner that other interested Eastern European countries be included in a regional training effort.

We are prepared to address this proposal with both materials and manpower.

II. THE SSS AND THE STOCK EXCHANGE

We were somewhat concerned by the relationship that seems to be developing between the SSS and the Stock Exchange. Faced with the prospect of over 30 prospectuses or reports required to be submitted by issuers and reviewed between now and the end of the year, issuers inexperienced in preparing such documents and the small staffs, each seems to feel that it must review all such documents and cannot rely on or trust the other to do the job properly. As another example of emerging difficulties, the Stock Exchange apparently resisted a request by the SSS for information with respect to a trading anomaly to which the SSS seemed to be entitled under the law.

We believe that there is a need for greater coordination between the SSS and the Stock Exchange. Whether as a matter of efficiency or just cost, they cannot afford to duplicate each other's efforts or spend time struggling with each other. There is too much to be done in too little time. At the same time the SSS should be sensitive to the feelings of the people toward government regulation in the light of the experience of the last 40 years. The SSS should realize that even in countries with a happier governmental experience effective securities regulation requires a delicate touch if it is to avoid overregulation that stifles legitimate development in

the marketplace. The SSS should also work to develop public confidence that it will not misuse the information that it legitimately must acquire in order to discharge its obligations under the law.

III. PROSPECTUS/LISTING PROBLEM

As mentioned above, the SSS and the Stock Exchange face the prospect of reviewing and commenting on over 30 prospectuses or reports by issuers between now and the end of the year. In view of the understandable inexperience of the issuers, the staff know that these prospectuses and reports will be incomplete and unsatisfactory. Because of their own limitations, it does not seem possible that these materials can be revised on a timely basis to serve their purpose. The staff of the Stock Exchange is reluctant to push the documents through and accept low standards at this important stage in the development of the market. They have considered bringing in outside experts on a temporary basis, but recognize that their own experience limits their ability to train outsiders. In addition the costs of utilizing outside experts may be prohibitive.

We believe we can provide suggestions that may assist the staff of the SSS and of the Exchange in reviewing prospectuses and reports during the period when they are so understaffed.

IV. PRIVATIZATION PROCEDURE

The major goals of privatization in Hungary were set forth for us as follows:

- -- Bringing in foreign capital;
- -- Obtaining as many market actors as possible;
- -- Giving employees a new relationship to enterprises, so they really feel like owners; and
- -- Providing a source of income for communities to finance social needs.

It was pointed out to us that these are in conflict with each other; nonetheless the structure of a privatization can be planned to meet these goals. While some enterprises will have more need for a foreign participant than others, the balance can be achieved through domestic emphasis in other cases.

There is a general feeling in Budapest, which we share, that the privatization process is proceeding too slowly. While the procedure for privatization has been greatly improved with the formation of the State Property Agency (SPA), we are of the view that privatization is an essential ingredient in the Government's plan to reform the economy and delay will endanger the overall program.

"Spontaneous" (i.e., privately arranged) transactions are no longer being abused, because of the veto power placed in the SPA earlier this year. These have continued largely in the form of joint ventures which bring in foreign (or Hungarian) management capability, technical know-how and capital to finance modernization and expansion. With a small staff the SPA has been able to provide the required approval, request change, or exercise its veto (the latter having been rare) within the 30-day period. Generally speaking, however, most of these produce no proceeds for the state as owner, and a minority position remains for later disposal. We believe there are many more such transactions under study, and understand there is no intent on the part of the SPA to discourage them.

Hungary might wish to examine the experience of other countries with privatization programs. Hungary's experience, while very broad in its scope, is not unique. Both the United Kingdom and Spain have carried out successful privatization programs in the last five years and similar programs are currently underway in Mexico, Brazil and Argentina. To our knowledge in all of these cases the governments have selected experienced outside advisors, investment bankers, lawyers, accountants and commercial bankers.

In Spain for example, which has some parallels with Hungary in its recent political and economic history, investment bankers and international lawyers were selected after extensive

interviews (known as "beauty contests") with the leading firms in London and New York. The firms then worked with their Spanish counterparts to develop a program and execute it. We can provide the names of the persons in the Spanish Government who can discuss the steps taken to achieve the success of this system.

V. PRIVATIZATION PROSPECTUSES

The small staff of the Stock Exchange can easily be overwhelmed by the volume and difficulty of reviewing and clearing prospectuses generated by the privatization program. This will slow the privatization process considerably.

We recommend that the State Property Agency make it a condition of each bid which involves a prospectus or report to be reviewed by the Stock Exchange that the investment advisor or bidding company undertake to prepare and file the necessary prospectus or report. The advisor should also be responsible for seeing the review process through in close cooperation with the staffs of the SSS and the Stock Exchange.

VI. THE STOCK EXCHANGE AND THE PUBLIC

Quite naturally the Stock Exchange seems to be pursuing the interests of its members, and that is as it should be. From time to time, however, we wondered whether the staff of the Stock Exchange and the members appreciate sufficiently that it is in their own long-range interest to put the protection of investors as their primary goal. A senior official of the Stock Exchange,

for example, told us that they were leaving the relationship of the broker and its customer to the broker. It is easier to build investor confidence than to rebuild it after it has been lost.

Accordingly, we believe the Act on Securities and the Stock Exchange should be amended to include a general anti-fraud provision. We urge the Stock Exchange to consider the adoption of customer protection rules covering selling practices (including a "know your customer" requirement) and safeguarding of customer funds and securities.

To provide a basis for beginning to establish a proper relationship between the broker and its customers, we will furnish to the staff of the Stock Exchange material developed by the Securities and Investments Board of the United Kingdom. These consist of Statements of Principle and Proposed Core Rules on Conduct of Business. While we do not endorse them in their entirety as appropriate for Hungary under current circumstances, we believe they will be a workable starting point for the staff to develop its own rules.

VII. OVER-THE-COUNTER MARKET

We understand that the SSS and Stock Exchange are concerned about trading in securities away from the Stock Exchange, and we believe that they are correct in being so concerned. In the United States there is a saying that sunshine is the best disinfectant. Also, concentration of trading makes for better pricing. We note that under Section 38 of the Act on

Securities and the Stock Exchange, transactions by dealers in securities traded on the Stock Exchange must be executed on the Stock Exchange. However, there seems to be some question as to whether this applies only to fully listed securities (there being only one at the moment) or all securities in fact traded there.

We urge the SSS and the Stock Exchange to adopt the position that all publicly tradeable securities may be traded at the Stock Exchange and interpret Section 38 to require that all transactions by dealers in publicly traded securities take place at the Stock Exchange. There can be two or three classes of securities that can be traded at different times, the secondary classes not being subject to the same disclosure requirements as the fully listed securities. But all transactions should take place under uniform trading, clearance and settlement rules. We understand this is being done on the Vienna Stock Exchange. We have also been advised that this would not impose any hardship on dealers operating outside Budapest. If all securities are so traded, the SSS will avoid having to set up an entire separate procedure for regulating the over-the-counter markets.

VIII. CLEARANCE AND SETTLEMENT

We applaud the Stock Exchange's decision to move toward book-entry clearance and settlement and urge it to act on this as quickly as possible. We also recommend the elimination, or immobilization in a book-entry system, of all certificates in respect of publicly traded securities. Bearer securities

encourage disrespect for the tax laws. They also give rise to opportunities for theft. Accordingly, bearer securities should be prohibited. Physical certificates are very expensive to produce (particularly in a form that makes counterfeiting difficult) and costly and inefficient to process. As a result, the use of bearer certificates is dying out even in Western Europe where they were so popular for so long.

While impressed by the progress being made in the clearance and settlement area, we are concerned that the Stock Exchange may not be paying enough attention to the financial exposure of the Exchange and its members. We believe that the Exchange should monitor and perhaps regulate the extent to which members borrow to finance their securities activities. If, as and when credit becomes available, consideration should be given to limiting the extent to which customers may borrow from dealers, banks or other professional lenders to finance their securities activities. Consideration should be given to requiring collateral in connection with delayed settlement sales and options transactions on the Exchange. A member should not be permitted to sell a security unless it already has that security in its possession or is sure it can obtain possession in time to meet its settlement obligations. The fact that a member has not received a security from one member should not be an acceptable excuse for its failure to deliver that security to another member. Rules governing the borrowing, buy-in and sell-out of

securities should be adopted. Clearance and settlement discipline should be rigorously enforced from the beginning.

IX. EDUCATION AND TRAINING

We agree with the Stock Exchange that education and training must cover a broad spectrum of the population. It should begin with programs, directed at the general public, designed to explain capital markets, stocks and bonds, and why they are important to a nation's economy. There is also a need to develop programs for secondary and university level students which integrate this information into basic economic programs. Finally, there is the need for specific skills training programs for the SSS and Stock Exchange staffs, trading floor members and broker dealers.

We presented to the Stock Exchange examples of programs used to educate floor members, training programs of the New York Institute of Finance, with which they were familiar, and the extensive programs utilized by Merrill Lynch for the training of Financial Consultants. We will examine available material and work with the Stock Exchange to provide other examples of programs that have been designed to address each of the specific areas.

X. OTHER RECOMMENDATIONS

We understand that the SSS and Stock Exchange are working on legislation relating to collective investment

vehicles, e.g., mutual funds. We agree this is a good idea and recommend that they follow the model contemplated by the European Community's Directives on the subject.

We are concerned that after the issuance of a prospectus issuers may not be obliged to furnish adequate information to enable the marketplace to assess their performance. We believe that listed companies should be required to include in their annual reports full financial statements, prepared in accordance with internationally accepted accounting principles, together with an audit report of independent accountants, and to disseminate at least semi-annually interim reports containing a summary balance sheet and income statement. Further, listed companies should be required to report promptly to the Stock Exchange information with respect to their transactions on the Stock Exchange in their own securities.

We believe that the Stock Exchange should adopt rules prohibiting the more egregious forms of manipulation.

Finally, in order to encourage participation in the securities market, and to create a favorable climate for the privatization program, we believe that the government should seriously consider suspending the tax on capital gains. Moreover, because of the difficulties of monitoring capital gains on securities transactions, the elimination of the tax at this stage will avoid the problem of investors' temptation not to report the gain. In the absence of effective tax administration

at this time, it will also avoid the embarrassing situation of not being able to collect the tax.

XI. PROMOTING THE STOCK EXCHANGE

We were informed that the Stock Exchange is well aware of the need to inform and educate the public about Stock Exchange activities. It has been the experience of countries with well developed stock exchanges that a full and steady supply of information leads to increased public participation and activity. Among the benefits of increased volume are greater liquidity and a more efficient market for investors and issuers.

We recommend the Exchange accelerate its efforts to encourage the news media to carry market tables and news and to establish and publicize a Budapest Stock Market Index. The Stock Exchange should also avoid providing its trading data to anyone on an exclusive basis. Every effort should be made to provide broad distribution of data to all interested parties.

Upon receipt of the necessary data and proposed formula, the New York Stock Exchange has agreed to work with the staff of the Budapest Exchange to design a stock index.

With respect to a Visitors' Gallery, we are most interested in assisting the Stock Exchange in developing an appropriate and effective series of displays, including video, for the Gallery at or near the site of the new Stock Exchange floor. The New York Stock Exchange is in the process of having the educational film, which is used in its Visitors' Gallery,

translated into Hungarian. This film will be available by November 1990.

We will work with the Stock Exchange staff on appropriate presentations and displays to be used in the Visitors' Gallery adjacent to the new trading floor scheduled to open in June 1991.