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MORОCCO STOCK EXCHANGE DEVELOPMENT

Final Report

May, 1991

USAID/Rabat

Price Waterhouse

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May 10, 1991

Mark Kraczkiewicz
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USAID/Rabat
137, Avenue Allal Ben Abdellah
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Rabat, Morocco

Dear Mr. Kraczkiewicz:

Re: AID/APRE Financial Sector Development Project
Contract No. PDC-2206-Z-00-8191-00
USAID/Rabat - Casablanca Stock Exchange Development
PIO/T No. 263-0102-3-3017

Enclosed please find 10 copies of our Final Report on the Casablanca Stock Exchange Development FSDP assignment in Rabat. One copy has been forwarded to Sandra Frydman, APRE/EM.

We have enjoyed the opportunity to assist USAID/Rabat in this important assignment. We look forward to further collaboration with the Mission.

Sincerely,

J.Richard Breen
Project Director, FSDP

Attachments

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EXECUTIVE SUMMARY

As a result of recommendations made by the World Bank and the International Monetary Fund, Morocco began a program of financial sector liberalization in 1984 and initiated financial sector reforms. Part of the reform program consists of the revitalization of capital markets. In order to perform such a task, the Moroccan Ministry of Finance has developed new legislation and regulations aimed at improving the performance of capital markets in Morocco.

The Price Waterhouse team, contracted under the Financial Sector Development Project, reviewed the proposed legislation regarding the establishment of a Capital Markets Authority and other measures to reform the Stock Exchange. The team found that although structural and regulatory changes are needed, the Casablanca Stock Exchange was in general very well managed, despite the low level of tradable securities and transactions.

Reform of the capital markets in general and the Casablanca Stock Exchange in particular is vital to Morocco's planned substantial privatization of government enterprises and a shift to a market-driven economy. To this end, the team made the following recommendations and conclusions: broad public ownership of Moroccan enterprises and the resulting stock exchange liquidity are essential; and a single straight-line organization for securities industry regulation and operation should be established. Fundamental improvements are also needed in the securities law to include more comprehensive provisions for the capital markets authority, disclosure of corporate affairs, protection of minority share owners and bondholders, and conditions for issuance of securities to the public. As trading increases, the Stock Exchange should be privatized and become a self-regulating business organization. This change would also be in accordance with the increasing privatization of Moroccan companies.

The team recommended that the regulatory regime be based on principles of full disclosure; such a system would be more efficient in the long run than the current and proposed merit based review by the Exchange Committee and the Capital Markets Authority. The team further recommended that each listed company provide more information in their prospectus proposals for new issues than that which is currently being proposed. The team also stressed that accounting standards should be approved by Parliament and be strictly implemented. Periodic financial reporting should be enforced on all listed companies as well as on those companies seeking significant bank financing.

The complex taxation of dividends, interest, and capital gains impedes their usefulness in equalizing market competition for savings.

The team also noted areas in which further study would be needed before detailed recommendations could be made. For example, the team recommended an extended study on off-board trades to gather detail on a large number of such trades. Further study is also needed on takeover bids and secondary distributions before regulations are implemented.

The team did not recommend pursuit of all the proposals which it reviewed. For example, the proposed short sale devices should be discarded. Additionally, the team did not see the need for multiple stock exchanges in Morocco. Although private initiatives should not be prohibited, given the actual conditions of the financial markets in Morocco, a single stock exchange is sufficient.

In addition to the text of this report, a number of Exhibits are attached in the appendices (presented in a separate volume) which further illustrate a comprehensive operating plan for the Casablanca Stock Exchange. In contrast to the comments on current practices which are presented in the text, the Exhibits present a blueprint for operation of the Exchange in the near and long term future, and thus they describe in greater detail many concepts, procedures, and specific recommendations. The Exhibits are given as a basis for the development of rules and legislation and are based on the extensive experience which the consultant gained at the New York Stock Exchange and through working with developing stock exchanges throughout the world.

I. INTRODUCTION

A. Background and Origins of the Project

In the early 1980s, Morocco faced a severe economic crisis characterized by high inflation, budget and balance of payment deficits and negative real interest rates. In 1984, the Moroccan Government implemented a program of financial sector reform with the support of The World Bank. The objectives of the reform program were to stimulate and deepen capital market development.

A Price Waterhouse team was engaged in October 1989 to assess the evolution of Morocco's financial sector between 1984 and 1989. The team undertook an analysis of the proposed policy reforms and prepared recommendations for follow-on technical assistance funded through USAID's Financial Sector Development Project (FSDP) to support the reform program. The FSDP team's recommendations focused on the government's objectives in developing Morocco's capital markets. As a result of these recommendations two Price Waterhouse engagements were contracted and took place concurrently during September and October, 1990. This report, the result of one of these assignments, proposes and recommends changes that would improve the functioning of the Casablanca Stock Exchange.

It should be noted that this report includes several analyses that were not included in the original scope of work, but that were requested after the team arrived in Morocco. The issues addressed by these analyses include: proposed new legislation establishing a securities commission differing substantially from those in other countries; provisions for a law on investment companies, primary and secondary distributions of securities, takeover legislation and short sales through delayed delivery contracts.

B. Revised Scope of the Project

The FSDP team was contracted to:

- <u>Analyze the current condition of the stock market.</u>

- <u>Review the proposed legislation</u> regarding the organization of the Stock Exchange, accounting and auditing standards, financial disclosure, shareholder rights, and related matters.

- <u>Advise on the coherence and adequacy</u> of the proposed legislation.

- <u>Formulate proposed revisions to legislation</u> and furnish the rationale for such recommendations by making specific reference to experience in other developing and developed country stock markets, as well as analyses of the current workings of Morocco's financial markets.

- <u>Compare the differences in tax treatment</u> of returns on investments in financial instruments, real estate, and share holdings. Compare these Moroccan tax policies with dividend and capital gain taxation in other developing countries and with taxation of other types of financial instruments in those countries.

- <u>Assess whether proposed fiscal treatment</u> of capital gains on portfolio holdings and dividends will be sufficient to generate demand for purchase of shares on the Stock Exchange and make appropriate recommendations.

- <u>Analyze the brokering and underwriting of new issues.</u>

- <u>Assess the adequacy</u> of current and proposed incentives to stimulate a broader range of brokering and underwriting functions. Examine the readiness of Moroccan financial institutions to expand and deepen the range of broker and underwriting services, and propose appropriate recommendations.

- <u>Examine the status</u> and regulation of institutional investors including insurance companies, the bank for receiving and investing funds of government savings institutions, and pension funds. Determine whether and under what terms and conditions these entities should be given greater latitude to invest and trade in shares. Describe how new investment entities such as mutual funds, investment clubs, and investment banks could be promoted.

C. Project Staffing and Methodology

1. <u>Staffing</u>

A two person team was contracted to carry out this engagement. Mr. Robert M. Bishop, a retired Senior vice president and chief regulatory officer of the New York Stock Exchange was team leader. Since his retirement, Mr. Bishop has counseled developing exchanges in Africa, Asia, Eastern Europe and the Caribbean.

Mr. Bishop was supported by Richard Dangay, a French national from the Price Waterhouse International Consulting Unit in Washington, D.C.

2. Methodology

The FSDP consultants interviewed officials from USAID/Morocco and the Ministry of Finance as well as private sector leaders. In addition, the team carried out a thorough document review of materials provided by the Ministry of Finance.

II. THE STOCK EXCHANGE IN CASABLANCA AND RELATED INSTITUTIONS

A. The Casablanca Stock Exchange

The Casablanca Stock Exchange whose legal name is The Stock Exchange, dates to 1929. Although the facilities pre-date independence, they are superior to the more active exchanges in Jamaica and Sri Lanka, and to the very low-volume exchanges in Yugoslavia and Hungary. Casablanca's staff of fourteen is larger than that of any of the aforementioned exchanges. The Casablanca Stock Exchange is self-supporting, (although utilizing free space in a government building). This financial independence is due to a hidden tax, which takes the form of an exchange commission paid on off-exchange trades that must be recorded in the exchange bulletin.

Of the fourteen exchange members, twelve are banks, one is an inactive affiliate of a bank, and one is a subsidiary of two government financial institutions. The bank members profit from banking activities associated with stockbrokerage, including the fees for cutting dividend coupons, the approximate ten-day float in collecting dividends on securities held for financial institutions, and the float on money from advance payment on securities purchases.

1. Listing and Trading Activity

Gold, equities and bonds, especially government paper, are listed and traded. Listings include share issues of 71 corporations as well as 47 issues of government or government-guaranteed securities. The total value of trading in 1989 was Dh 254 (US$ 31.2) million and Dh 417 (US$ 51.3) million off-floor.

While the volume of trading on the Casablanca Stock Exchange recently has been at historically high levels, and is high compared to trading in other countries of a similar size, the activity of the Stock Exchange is relatively low. Several factors explain this situation. First, more than 60% of the listed securities are traded non-competitively, off the exchange. (This activity is considered exchange trading, however, when it is reported and a commission is paid through the exchange.) Second, fewer than 3% of the securities of listed companies are broadly owned. Most are owned in blocks either by the government or by 20 financial institutions, some of which are government entities. It is occasional block trades in these closely-held securities, usually at prices that deviate from the exchange market, which constitute the comparatively high level of off-floor volume and finance for the exchange. The reporting of such trades by participants is often long-delayed, this negating any influence of block trading prices on the floor market.

The Stock Exchange in Morocco is very well managed and the current public perception of the exchange as ineffective is a reflection of the weakness in the current Moroccan business structure rather than of the exchange.

2. Trading Practices

While the trading practices on the exchange floor appear adequate, they are not clearly described in the legislation. The system used to match trades of members over time in order to minimize deliveries and money payments between members is particularly efficient and better than usual for exchanges in their developing stage.

The settlement process (completion of contracts by exchange of securities and money), however, is unusual. Buying customers are expected to pay before making a floor contract. Buying brokers pay, in money, within 24 hours and the selling brokers remit money proceeds to their customers immediately. However, the balances of securities traded are delivered between brokers only twice a month, increasing members' exposure to possible failure or fraud. Bearer securities are not fungible in trades between two customers of the same broker, but are fungible in the balance delivery system.

In most other markets, payment for securities between brokers and banks is made only against simultaneous delivery of the securities in order to minimize risk. In Morocco, it appears that the unusual trust in payment for securities long before delivery is due to the fact that most members are banks and they are widely believed to be failure-proof.

3. Exchange Governance

The decentralized governance of the Exchange consists of a Board, a Technical Committee, a General Manager and a Government Representative. The Board, composed of five government officials and five representatives of related financial associations, has the responsibility for financial affairs of the exchange. Operating procedures for trading, approval of listings, and approval of new members are determined by the Technical Committee, which is composed of two government officials and three representatives of financial associations elected by a Brokers' Association. The chief executive and spokesman for the Exchange is a Manager, appointed by royal decree, to carry out decisions of the Board and Technical Committee. The Manager is not required to report to those bodies, however.

The Government Representative is appointed by the Minister of Finance to oversee the execution of the regulation and decisions regarding the organization and the operation of the exchange. He attends Board and Committee meetings and has the seldom-exercised power to veto decisions made by those bodies, subject to arbitration by the Minister. There is currently no government Capital Markets Authority.

On advice of the King of Morocco, the Parliament has ordered substantial privatization of government enterprises and a shift to a market-driven economy. Strengthening the Moroccan financial infrastructure is perceived to be a basic component of this economic transformation. The Ministry of Finance has proposed legislation to restructure the stock exchange and implement government oversight through a Conseil National des Valeurs Mobilieres (CNVM) equivalent to a Capital Markets Authority. The new legislation would also establish supplementary rules and tax regulations for the Exchange and the CNVM.

B. Proposed Capital Markets Authority

1. Purpose

A committee representing the Ministry of Finance, the Casablanca Stock Exchange, Intermediaries, the Central Bank, and Banks has drafted a proposal for the establishment of a National Council (Conseil National des Valeurs Mobilieres, herein referred to as CNVM). Its purpose is to govern securities matters, thereby replacing the Stock Exchange Technical Committee that currently approves new listings and exchange members. The CNVM would be the superior government authority in securities matters, and would also be charged with improving the efficiency and dynamism of securities markets in Morocco.

2. Membership Composition

The membership composition of the proposed CNVM is yet to be decided. It is not clear whether the president would be full time or part time, nor whether he should be from the public or the private sector. The CNVM's six other members would consist of two representatives from the business sector, one member of the bankers' association and three government officials, all serving on a part-time basis. The Stock Exchange Director and any others appointed by the CNVM could attend CNVM meetings as consultants.

Article Eight of the proposed legislation provides special powers to a Commissioner designated by the Minister of Finance to be a consultant to the CNVM, who, under certain circumstances, can request meetings of the Council. It remains to be defined whether his role would be to give his views to the Minister of Finance on the work of the Council, or to exercise oversight/monitor powers.

3. The CNVM's Supervisory Responsibilities

Article 11 of the proposed legislation requires that issuers of securities publish a prospectus to be distributed to interested parties. It is the CNVM's responsibility to "approve" every prospectus issued. Currently, there is only a general description of what a prospectus should include. A separate proposed bill would require the annual publication of certain information concerning listed companies, and unlisted companies with annual sales above DH 5 (US$0.6) million. A balance sheet, income statement, notice of increase or decrease of capital, and date and method of dividend payments must be published and made available within 20 days after the annual shareholder meeting.

There are only two indications of unlawful securities activity: use of "privileged information" (without any definition implying inside information), and spreading of "false information" on securities.

C. Proposed Exchange Restructure

Under the proposed legislation, the restructured Exchange would remain a government body with a Manager and a Government Representative, and governed by a Board. The Manager and Government Representative would retain their current duties. The Board, however, would be composed of three government officials, six representatives of financial institutions and businesses appointed by government, and four members who hold office as presidents of associations. The duties of the proposed Board would be confined to financial and administrative control of the Exchange. The Board would have no power over trading procedures, post trade settlement, capital requirements, approval of listing and delisting, new members, ethical business conduct, etc. (Rules in some of these areas would instead be established by a proposed law.) Furthermore, the decisions of the Board would be subject to challenge by a Government Representative (auditor). In light of the above restrictions, appointment to the Board appears to be honorary, without substantive function.

D. Proposed Law Establishing Exchange Rules

The proposed law on exchange rules consists of the following 10 sections:

- A simple description of the floor trading method, including price change limits of 3% between transactions and 6% in a trading session.

- Provision for an unusual facility for speculators to seek a profit when they believe a security price will go down in the near future. The conventional facility to accomplish this objective exists in many developed markets for securities, commodities, futures, options and money, and is called a short sale. A short sale is executed in the regular market usually without the knowledge of buyers and is settled regularly by delivery of borrowed instruments.

In the proposed Exchange rules, however, the Moroccan plan (Articles 8 to 21) is to give speculators an opportunity to profit from a security decline by buying a security in an off-exchange market for a delivery date well in the future. In this case, the seller receives a higher price (not more than 5% per month of delay in settlement above the regular market) as compensation for the delay in payment, and is initially protected from default of the buyer by a 20% down payment. There would be a margin call if market price movement is adverse by 30%. In addition, the contracts would have an option feature in that they would be cancelable by the buyer by forfeit of down payment as a premium or by early settlement at a newly negotiated price. These contracts would be possible only in a special list of securities and in minimum quantities authorized by the CNVM.

- The off-floor trading system would remain, but commissions on these trades would be increased to equal those on floor trades. Reporting within five days would be required with penalties for delays.

- Unlisted securities are permitted to be traded in a second exchange tier authorized by the Executive Director. No description of trading methods, or characteristics is given. The intention is to trade unlisted securities (as occurs presently) in a separate room next to the floor before listed trading sessions take place. A card file of bids and offers would be maintained by Exchange employees who would match equal bids and offers when they occur. The Executive Director can request the issuer to furnish information pertinent to trading value.

- An additional off-floor facility, available only to selected CNVM approved members for use on certain securities, would be introduced. Dealer purchases or sales off-the-floor would be permitted at prices not more than 3% away from floor market prices. These positions would be required to be liquidated within ten trading sessions, also at prices not more than 3% from the then current floor market price.

- Post-trade miscellaneous matters defined in the legislation include a simple matching of internal trades, bi-monthly delivery of securities with a 45-day maximum subject to close-out, transaction publication, ex-coupon rules, freezing of trading in securities subject to random call within 20 days and weekly gold deliveries.

- Listing and delisting of securities by the CNVM, as proposed in the authorizing law, is supplemented in the Exchange rule law. This law specifies information on data to be furnished as a package by the Exchange, including an agreement by the issuer for future disclosure. Governments are exempted from this requirement. Authority is granted to the CNVM to fix the offering price.

- Delisting would be determined by the CNVM for cause or at request of the issuer. The delisted security would be automatically registered for the unlisted tier.

- Listed issuer disclosure requirements are similar to those in the special bill described above. These requirements include submission of an annual balance sheet, income statement, list of ownership interest and subsidiaries, breakdown of capital, and financial results in a table to be determined by the Exchange. There is an important additional requirement for a listed company to communicate to the exchange and the public without delay any information "which can influence the quotation of securities."

- A single set of rules is proposed for both tenders in what would usually be take-over bids and secondary distributions of blocks. Both would involve at least 10% of a corporation's capital, approval of the CNVM, at least a 20-day open period, discontinuation of Exchange trading during the open period, and a bank performance guarantee. Competing offers are also provided for, but at a price at least 5% better.

- The proposed legislation makes provision for the establishment of branch or subsidiary stock exchanges in regional centers of Morocco. Subsidiary exchanges would trade securities of regional interest, and use the same card file system planned for unlisted securities in the national/main exchange.

E. Other Stock Exchange Plans

Facilities Improvement

The Stock Exchange management has drawn up a plan for improving the present trading floor. Plans include double-decking member telephone booths (to increase capacity), restructuring the quotation boards and improving the trading room appearance.

The Exchange management intends to replace its current trading and record-keeping system with one similar to those used by the Lyon Stock Exchange. The Exchange plans to seek USAID support for this purpose.

Extending Certificate Fungibility

The Exchange management is considering extending certificate fungibility and electronic transfer. Currently, when a bearer certificate is sold, the particular certificate held by the seller must be delivered to the buyer. If the trade is between two customers of the same broker, then the certificates are fungible. Lack of complete fungibility causes operations problems that may become overwhelming as volume grows.

Form Standardization

There is a draft law which would require the standardization of share and bond certificate forms, with watermarks and fine line design in two colors. There is no provision for engraving, or vignettes (engraved pictures) that increase counterfeit detection, or for holograms, considered the best protection against counterfeiting. Moroccan currency, engraved in multi-colors with vignettes and watermarks, is more counterfeit resistant.

Shares and bonds currently have coupons attached. Although this is a cumbersome and outmoded method of claiming dividends, interest and other rights, it would remain under the proposed law.

F. Matters of Law

Reform of Moroccan corporate law is in progress. Currently, the law is not clear or does not cover certain aspects of securities trading. For example:

- It is not clear if beneficial ownership of securities changes at the time an exchange contract is agreed upon by brokers.

- There is no priority for shareholders' certificates or money held by a broker or bank in distribution of a bankrupt broker or bank's estate, even for certificates in a customer's name.

- There is no established system for securities-related court injunctions. Penalties for criminal violation of securities law may be imposed only by Courts, not through administrative action.

- Present and proposed law would allow corporations to determine for themselves such matters as types of shares and transfer procedures.

G. Accounting and Auditing

A proposal for Moroccan Generally Accepted Accounting and Auditing Standards has been prepared by competent Moroccan international accountants and is under consideration by Parliament.

H. Taxation

There are currently some tax disincentives to share ownership in comparison to other uses of savings. Furthermore, there is a tax exemption on government bonds/paper which are also marketed at competitive rates of interest. Shares and corporate bonds consequently do not produce a competitive return.

Dividend Income

Since January 1, 1990, individuals receiving either dividends or interest from corporations have been subject to either the general income tax, progressing from 14% to 52%, or to an optional withholding of 15%. There are complexities for non-residents, foreigners and corporations.

A recommendation of the Ministry of Finance proposes to change the tax treatment of dividends. This change would repeal all taxation of dividends paid by listed companies to resident individuals, creating an equal status with tax exempt government bond interest. The proposed change would result in equal treatment of listed security dividend income of resident individuals and other income on intangibles. Dividend income would not be as competitive, however, for corporations and non-residents. Dividend income received by corporations, expressed in a simplified way, is taxed at a rate of 6.6%. Nevertheless, the difference in taxation of dividend income received by a share owning corporation from an issuer may limit privatization efforts.

However, after the preliminary draft report was distributed, the Ministry of Finance provided a revision in their draft proposition which would give tax exemption only to dividends of newly listed companies for three or four years, and for present listings only if theirs is a new issue in the magnitude of 10 or 20% of capital, again for a limited period.

Corporate Bonds

In contrast to tax-free government paper, a tax disincentive remains for corporate bonds whose interest is taxable to individuals at 14-52% as well as a 12% VAT rate.

One alternative under consideration is the creation of a differential in government bond non-taxable interest significantly below market rates for debt.

Dahir 8/30/46 requires announcement to the Minister of Finance before each corporate bond issuance. This is perceived by some in the financial community as discouraging bond issues by corporations.

Corporate bond issues have the usual advantage to issuers in comparison to equity issues for two reasons: 1) bond interest is a deductible business expense for income tax purposes, and 2) closely held ownership is not subject to stockholder questioning of management or to takeover attempts.

Because corporate bonds are subject to VAT and income tax, they are not competitive with the government's issues.

Capital Gains

While there is currently no capital gains tax on intangibles for ordinary individual investors, there is one on real estate and other gains on tangibles. Capital gains on intangibles by corporations receive optional treatment; taxes are either deferred at rollover of investment, or are indexed for capital gains not reinvested.

The fact that capital gains of entities engaged in securities operations as a business are taxable is a major inhibiting factor to market-making by Exchange members.

Because corporate bonds are subject to VAT and income tax, they are not competitive with the government's issues.

I. Insurance Companies

Besides commercial banks and the government/public institutions, insurance companies are the only other type of financial institution that currently exists in Morocco.

Of the 22 closely-held insurance companies in Morocco one is a reinsurer, while the rest are commercial insurers with 60% of their activity in automobile insurance. Three of these are mutual companies and two have some government ownership through the Bank for Deposits and Investment (CDG).

Sixty percent of insurance company investment portfolios must be government or government guaranteed paper. The insurers are fre to determine their own portfolio with the other 40%. There are no tax disadvantages for insurers in corporate investments.

There are about 6,000 persons acting either as agents representing insurance companies in sales, or as insurance brokers purchasing insurance for clients.

Automobile insurance premiums are regulated by the government an there have been delays of several years in adjusting premiums to inflation and loss experience. This has resulted in financial problems for some companies and advocacy by the Minister of Finance for a restructuring and recapitalization program, including public capital subscription.

Key man insurance payable to employers is not deductible as a business expense and therefore is not a significant product. Group insurance is not a widely developed product.

Little life insurance or pension annuity is purchased. The former 6% tax on such premiums has been reduced to 1%.

Insurance companies now own 13% of all presently-listed capital, which constitutes most of such shares not closely held. Although they are the dominant buyers of all shares offered for sale, they are rarely sellers because they view listed market prices as far below true value. Insurance companies also dominate the treasury bill market.

The insurance industry would like to see the ability of its companies to participate in corporate investment increased by several government changes, including:

- the reduction of the percentage of required government paper in portfolio to 35%, with a shorter term requirement;
- the establishment of tax deductible life and pension insurance premiums;
- a revision of automobile insurance premiums to more realistic terms.

J. Bank for Receiving and Investing Funds of Government Savings Institutions (CDG)

The Caisse de Dépot et de Gestion (CDG) was created in 1959 as a depository and investment manager for national savings funds.

Such funds include postal savings, pensions, social health, family allowances, and criminal justice monies.

The CDG is also in charge of specific services. Funds deposited in the CDG are invested, via the financial market, in Government or government guaranteed securities and in some cases in investment participation in the different economic sectors.

The CDG currently has Dh 11 (US$1.35) billion invested--80% in Treasury paper (40% treasury, 60% treasury guaranteed), 5% in closely held corporations, 4% in real estate and housing, 3% in tourism, 0.2% in listed equities and the balance in the money market.

The CDG presently gives no consideration to market-making in the Stock Exchange but may do so as volume grows. They buy blocks of listed securities whenever available.

The bank's chief executive has expressed interest in forming an open end mutual fund to invest in privatized securities as an intermediary step in warehousing privatized securities.

K. Pension Funds

The existing pension funds are government operated and are invested through the CDG. Supplementary pension funds are rare.

L. Competition for Savings

Banks pay competitively high rates of interest on term deposits, subject to both VAT and withholding tax.

Government paper is also rate competitive for individual savers and is tax free. This report was prepared in October 1990; since that time, interest rates have been deregulated.

Real estate is the other investment of choice because of its high appreciation record and because of the banks' insistence on tangible collateral for loans.

M. Other Financial Intermediaries

There are no investment clubs, investment banks, merchant banks, futures exchanges, commodities exchanges, or other non-commercial-bank financial intermediaries in Morocco.

There are potential merchant-investment-banking units growing in some financial institutions with early activity in mergers and acquisitions and venture capital.

The Societe Nationale d'Investissement (SNI), a holding company for the government, includes in its portfolio three companies structured in such a way that they are incipient closed end mutual funds.

Too late for review in this project, it was learned that a proposed law on investment companies had also been prepared. A copy was furnished in French. The presentation note but not the proposed law text was translated to English. Careful inspection of the text would be necessary before drawing any conclusions or recommendations.

III. RECOMMENDATIONS and CONCLUSIONS

1. Transition of the Stock Exchange to the private sector

As its trading product increases, the Stock Exchange should become a non-profit, self-regulatory business organization that promotes ethical business conduct.

The stock exchange should be an organization controlled by, and an advocate of its constituents, (investors, listed companies, member brokers and dealers alike) without government representation in the board. The public interest should be expressed through oversight by the CNVM.

Our recommendation is that government should provide by law that as soon as 10 government companies are privatized by distribution of shares to the public, the Stock Exchange will be restructured as a not-for-profit corporation governed by a Board of elected representatives of stockbroker members, listed companies and investors without any governmental representation. The Board should have power to make and enforce rules for conduct of the securities business of its member stockbrokers, trading on the exchange, post trade settlement and transfer, standards for and approval of listed companies, securities business ethics, etc.

The stock exchange is currently and by error of strategy proposed to remain a government entity with a board substantially composed of government officials without any substantive responsibility or authority. This is a very unusual setting for a stock exchange. Of the 45 or so exchanges visited over the years by the consultant, Casablanca is the only exchange which is a government body.

Several however, have been assisted financially by governments in their early years. Jamaica Stock Exchange for about eight years was furnished through the Bank of Jamaica (central bank) with office and trading space, seven employees, a chief executive and complete logistic support. The new Budapest Stock Exchange was required by law to be initially capitalized by at least 140 million forints - but about 120 million of this amount was supplied by the Ministry of Finance while the Budapest Bank (government owned) furnished a very large former banking room as a trading floor. In Egypt and Korea, the government gave a tax advantage for listing in the new stock exchanges, which produced large listing revenues for the exchanges at an early stage of development.

Stock exchanges are usually viewed not only as trading markets but as the heartbeat of capitalism, and as spokesmen for listed companies, their share-owner investors, and their intermediary stockbrokers.

Although historically organized as associations of stockbrokers, in modern times, progressive stock exchanges have shifted to governance by Boards composed with balanced influence of listed companies, institutional and individual investors and their attorney and accountant representatives, and stockbrokers. This shift originated from a study in 1971 by William McChesney Martin, first full time chief executive of the New York Stock Exchange and long time Chairman of the American Federal Reserve Bank (central bank).

For many years, British and American tradition as well as that of many other countries has been that self-policing of the stockbrokerage industry has been effective and quick to respond to innovation in this constantly developing financial business.

Continuation of the Casablanca Stock Exchange as a creature of the Moroccan government, consequently, may appear to the rest of the world financial community as a flaw in executing the King's directive toward a market driven economy.

2. Securities Public Interest and Market Structure

A. Establish a single straight-line organization system for securities industry regulation and operation.

The single straight line organization system of responsibility is internationally practiced in securities industry organization and governance. It establishes appropriate functions for government regulators, industry institutions such as stock exchanges and their boards, chief executives, and Members. The most efficient systems of management of society and business in a market driven economy has several levels of managers skilled in decision-making at their level, with straight line authority, responsibility and accountability for their objectives. This would be a more efficient system for Morocco than the one currently proposed. Such a structure would be strikingly different from present Moroccan practice under central control, but it is vital to a shift to a market driven system.

The efficiency of straight line management is not proposed in the current law drafts to be applied to the Moroccan securities industry. Moroccan structural tradition as reflected in several plans for capital markets development has potential for decreasing management efficiency through appointment of some subordinates to Ministers by royal decree without termination provisions, lessening line accountability and potential conflict between independent government commissioners, who audit, advise and oversee the stock exchange and CNVM boards, and the authority and accountability of these boards and their executives.

B. <u>The basic authority and responsibility of the Minister, CNVM and Stock Exchange Board should be conferred by law.</u>

The basic authority and responsibility of the Minister, CNVM and Stock Exchange Board should be conferred by law. It should include their authority to further define, by rule, conduct in their areas of primary responsibility. Accountability of each should be in reverse order with the acts of each subject to optional review and change by the superior authority.

C. <u>The CNVM should be the Chief Government Regulator. Its power should include interpretation of the principles of (Securities) law and enforcement by negotiation of consent decrees or reference to prosecution.</u>

The current drafts of rules for the CNVM and stock exchange need considerable expansion in many areas, particularly in enforcement and discipline. The CNVM should have oversight responsibility on the self regulation of the market. It should also have power to disapprove exchange rules which it might deem contrary to the public interest, and review appeals to Exchange decisions. This power should also extend to assigning enforcement of certain of its own responsibilities as appropriate to the Stock Exchange Board.

The CNVM is not currently assigned responsibility for writing rules to protect the public interest as expressed in securities law for all issuers of publicly distributed securities and related transactions. Nor is the CNVM responsible for administering and enforcing these rules.

The Minister of Finance is asked to establish by decree many matters which would be better established by CNVM and the stock exchange subject to the Minister's optional review.

D. <u>The Board of the Stock Exchange should have primary responsibility for rules of day to day conduct of the market and its members.</u>

Although equally competent Boards are proposed for both the CNVM and the Stock Exchange, there is a mistaken sense that the public will perceive more integrity in CNVM decisions than in stock exchange actions. Some proper stock exchange functions such as approving members and listings are therefore inappropriately proposed as CNVM functions.

The stock exchange board is currently not, but should be assigned day to day responsibility for listings, market, and members under rules they write and enforce, subject to CNVM review.

The Chief Executive of the Exchange should be solely responsible and accountable to the Board. If appointment continues by royal decree, the Board should have power to terminate such appointment for just cause. Any appropriate Exchange committees such as those for screening listing and membership applications should be appointed by, and report to, the Exchange Board.

E. The Government Representative position at both CNVM and the exchange should be modified to one of Government Auditor, with a like change in function.

The Government Auditor should not be entitled to attend meetings (unless he is to report on audit results) nor should he have the authority to challenge non-financial decisions. When the stock exchange joins the private sector, independent public accountants should audit exchange finances, reporting to its board. If the government subsidizes some exchange activities, government auditors should have the right to review proper use of such subsidies.

3. Importance of Broad Public Ownership

A. Broadly distributed public ownership of Moroccan business will strengthen the stock exchange through increased liquidity. Listing criteria for those companies to be offered for public ownership should include careful selection of profitable companies with solid reputations--whether these companies are initially privately held or government owned.

As in most developing countries without an established practice of broadly held securities, there is widespread conviction that a market-driven economy is the method of choice, but at the same time there is great skepticism that broad private ownership can be accomplished in the near future. This skepticism focuses on philosophical differences over the poser of the market as well as on practical concerns about optimal distribution mechanisms. While policymakers will ultimately decide on their position regarding the strength of market forces, developing optimal distribution mechanisms is the focus of these recommendations.

Well-known impediments to privatization through broad ownership are continuously cited. These obstacles include inadequate accounting, lack of securities investment education, better income from competing bank and real estate investments, unequal taxation, desire to maintain family control, easy business access to bank credit, and governmental indecision.

Until securities markets are further developed, family held businesses are unlikely to open their capital, and government will be slowed in its privatization efforts. In the interim, supply of publicly distributed securities will continue to be substantially immobilized by institutional hunger for investment vehicles.

B. A massive educational campaign should precede the first offering and continue during the course of privatized distributions. The formal offering document should be more comprehensive than has been customary in prior stock exchange primary distributions.

The most promising route to strengthening the stock exchange is a substantial privatization (broadly distributed) after a comprehensive educational campaign. All of the other factors advocated in the 1987 study by a Moroccan committee are secondary.

C. Inclusion of the stock exchange in primary distribution to contribute to building its image and future capacity for distributions.

The Stock Exchange does not have a well perceived image by the general public. By increasing its participation in primary distributions, the public's perception of the role of the exchange will shift.

4. Securities Law

The Securities Law in Morocco should be improved to include more comprehensive provisions.

Areas that need attention are:

- the capital markets authority - CNVM
- conditions for issuance of securities to the public
- disclosure of corporate affairs
- protection of minority share owners and bondholders
- prohibited securities practices considered criminal activities

A thorough review of a draft law for a Capital Markets Authority was inadvertently not expressed in the Scope of Work for this project. Extensive analysis of such a law would therefore require a supplemental study.

- The CNVM

  The proposed CNVM should have general oversight responsibility with power to disapprove exchange rules which they might deem contrary to the public interest, review appeals to Exchange decisions, and write their own rules of public policy or prohibiting criminal activity in the securities business, etc.

The proposed law to establish a CNVM exhibits a limited perspective of the proper government functions for regulation of the issuance and trading of broadly distributed securities. Such government regulation normally extends to all issuers with publicly distributed securities. It covers requirements and review of compliance for disclosure connected with original issues, stockholder votes (proxies), and immediate and periodic reporting to security owners as well as criminal violation of the public interest in securities matters.

Such laws in other countries grant authority of the CNVM to make and enforce rules to implement the law, among other matters expanding conditions for issuance of securities to the public, disclosure of corporate affairs thereafter, protection of minority share owners and bondholders, prohibited securities practices considered criminal activities, etc. The proposed law is a beginning of what is needed.

- <u>Price Determination</u>

  Article 47 of the proposed internal regulations for the Exchange would create by law the single most important violation in any draft of the theory of a market driven economy. It proposes that the CNVM should determine the price of a new issue. Government determined price cannot be a substitute for the market. In reality, experience demonstrates that this method of price determination by government FIAT depresses the usefulness of the market as a device for a market driven economy and discourages the participation from sellers and buyers.

- <u>Disclosure Requirements</u>

  The disclosure requirements for listed and other larger publicly held companies in a separate draft law are acceptable for the time being but will need serious improvements when the market develops. Again, a study of the disclosure requirements was not assigned in the Scope of Work for this assignment; therefore additional details cannot be provided now.

o **Reporting, Proxy, and Prospectus Requirements**

There should be requirements for full annual audits of the listed firms according to Generally Accepted Accounting Standards.

Unaudited financial results should be reported more frequently than annually, such reporting should occur semi-annually or even quarterly.

Proxy and prospectus requirements: Annual audited financial statements would be more useful to the share holders if included in a proxy statement distributed before an annual meeting rather than following such a meeting.

5. Approval of Listing and Members

Responsibility for approving exchange listings and membership should be functions of the exchange exercised by its Board.

Currently, an independent technical committee makes those decisions. Under the proposed law, however, listing and membership approvals would be the CNVM's responsibility. This is inconsistent with the primary responsibility of the CNVM position as the government regulator of the market (i.e. SEC).

Listings ordinarily have quite different characteristics from public issues of securities. First, consideration needs to be given to whether the shares issued and the number of holders are large enough to create and sustain a market with reasonable prices in the particular trading style for which they are being listed. Listing implies a degree of liquidity not present for all publicly distributed issues. Second, listing ordinarily has higher quality standards than those basic to public issuance under law.

Membership ordinarily is also different from government licensing of a person or organization to conduct a broker-dealer business. Membership requirements for capital, ethics, education, and operational practices are adjusted to the particular needs of that segment of the securities business. It is quite likely that as the securities business grows in Morocco, there will be some financial intermediaries which do not elect to become Exchange members, but should be subject to CNVM oversight.

6. Stock Exchange Facilities

<u>The efficiency of the Stock Exchange facilities could be improved by redesigning the quotation boards and modernizing the setting to give it a more professional appearance.</u>

With minor improvements, the current facilities and staff of the stock exchange are adequate to handle primary distributions and secondary trading volume produced by a realistic pace of privatization of Moroccan enterprise. Negative perceptions of the exchange are solely the product of severe inadequacy of float in supply of tradable securities. Cosmetic improvement of the trading space is desirable for public image and would increase efficiency.

When the quotation boards are redesigned, in addition to the columns for the prior session closing price and security description, there should be separate columns for best bid, best offer, last sale, volume so far of that session, symbols for two brokers with priority for best bid, symbols for two brokers with priority for best offer.

The Exchange Bulletin should list in sequence for each security the trades of the day showing size of each trade and price. As volume grows, this "transaction journal" should become a separate publication to reduce cost, and it will be important for research, and to members or customers disputing whether orders were properly handled.

The Exchange should also institute a severe cost reduction program in order to shift resources to training of stockbrokers, public promotion of securities ownership, and encouragement of listings.

Addition to the Exchange of derivative products such as trading in options or futures seems a number of years in the future. Worth exploring at present, however, would be the feasibility of a trading market in coupons of listed securities, either in the regular or unlisted market style.

Further computerization is not needed until trading volume becomes significant. Present computer systems for recording trades and producing statistics are superior for exchanges of this size. The next phases of processing likely to need computerization are the post-trade processing of settlement of contracts and a common computer accounting system for members to use in keeping customer records.

Stock Exchange trading branches in other cities would be counter productive but should not be prohibited.

7. **Settlement**

<u>The Stock Exchange should be advised of a future need to establish a delivery-against-payment settlement system.</u>

This is particularly necessary should one or more of the following scenarios develop:

a) a perception arises among financial institutions that the government might permit a bank to fail

b) non-bank brokers without a comprehensive bank guarantee are permitted to carry customer accounts or settle security trades

c) there is a substantial increase in settlement volume and in the variety of member risks.

As non-bank brokers become exchange members or as confidence that the government will not permit a bank to fail decreases, the present system, of long delay between money payment and security delivery to complete exchange trades, will become unsatisfactory to all parties. The risk of failure of a member with open positions or the discovery of stolen or counterfeit securities will be too high.

A shift to a delivery-against-payment system between banks, brokers and institutional customers should occur. A fixed settlement date a few days after trade date, a stock loan system, collateralization of fails to deliver by marks to market, and related capital penalties will all be needed.

8. **Market Making and Dealing**

<u>The proposed establishment of an off-floor dealing practice should be discarded.</u>

This practice represents some sort of black market of securities and therefore should be illegal. The alternative to such practices would be the creation of a NASD (National Association of Securities Dealers) type organization with appropriate regulation and oversight by the CNVM.

The proposed system for members to purchase securities off the exchange and resell them within 10 days within price variation limitations seems impractical and harmful to the floor market.

Rules should permit members to trade for own account subject to customer priority at the same price, and thus to begin market making as it becomes profitable. Additional regulation of market making would then be desirable. If there is deemed sufficient public purpose to subsidize market making earlier, regulation is essential.

It is unrealistic to expect market making by members until volume becomes heavy enough to make such trading profitable. Although the consultant has never seen such a system in another country, if market making is perceived as essential to extensive privatization, a coalition of government, listed companies and exchange members might be formed to absorb market making losses.

9. Short Sales by Delayed Delivery Contracts

Proposed short sale devices should be delayed until there is a better prospect that they would add to the liquidity of the market.

The system then developed should be conventional in the regular market, with regulation to control its undesirable features but not otherwise impeding freedom of action.

The proposed method of giving pessimistic operators a system for profiting from security price declines is not likely to be attractive in a stock exchange environment of acute supply shortage and excess demand.

The proposed method of delayed delivery contracts is not as favorable as stock lending to the "sellers" in the Moroccan system who also would fill the function of "lenders" in a conventional short sale system. Lending is used for many purposes other than short sale deliveries in advanced markets, the largest being a related device called repurchase agreements on government securities.

Lending and repurchase are equivalent techniques for short term loans of money at lower or no interest rate equivalent. For example, stock loans are usually made by institutions owning blocks of securities. They receive money as collateral which is 100% to 102% of the market value and this collateral is adjusted at least once a week to any change in market value. Further, the intermediary exchange member guarantees return of the security to the lender. The lender thus has absolute security plus use of the money, which he would otherwise borrow from a bank, for short term purposes without any significant interest cost.

The lender retains ownership, the right to dividends, voting or other privileges during the period of loan.

The intermediary exchange member is protected because he uses the proceeds of the short sale of the security to collateralize the lender with money. In addition, exchange rules would require that the short seller have in his account with the broker money or discounted securities value of at least say 30, 50 or 100% of the contract price as margin.

Short sales are far more dangerous to the seller than a long purchase. It is unlikely that a security owned will quickly lose all of its value. But as a security's value increases, a short seller can quickly lose all of his deposited margin and remain liable to repay the borrowed securities as their market price rises indefinitely.

Further, in a time of general market decline, unregulated short selling can accelerate a selling panic. This was a major factor in the 1929 stock market crash and consequently is now prohibited on American exchanges when the sale would be in a downward trend. On the other hand, short selling in normal markets is positive for security prices in the future as it creates an obligation to buy later by the short sellers.

The Moroccan proposal also creates a gap in protection of the seller. As the sold securities price declines, the 20% down payment protection to the seller erodes and a further decline to the 30% level would place the seller in a loss position if the buyer defaults on satisfying the contract.

10. Off Board Trading

Proposals for immediate reporting of off-board trading should be accepted and vigorously enforced.

There are proposals in the drafts for lessening the problems arising from 60% of listed securities trading being done off the Exchange, mostly in blocks related to control. These proposals would require immediate reporting of such trades with penalties for lateness. The proposals do not squarely face the probability of equal or better offers in the floor market.

Further requirements should be included in CNVM rules for immediate reporting of trades done away from the market price or accumulating positions approaching control levels. Circumstances should be defined in exchange rules when blocks should be exposed to the floor market for competition of existing equal orders or equal treatment for better orders.

In order to determine policy in this area, an extended study of off-board trades is recommended to gather detail on a large number of such trades. The purposes would be to:

a. observe price disparities between the floor market and the block trade at the time of the trade;

b. determine whether there were quotes on the floor at better prices on either side;

c. estimate whether there was buying or selling interest not expressed in floor quotes at better prices which could have been brought to the floor by requiring a few minutes advance announcement of such block crosses;

d. consider whether any accumulation exceeding 10% or any sale of a block over 10% of outstanding shares should require exposure to public participation through a floor trade;

e. consider whether off floor trades should be permitted only when negotiated and arranged directly between the seller and buyer, without participation by any third party or alternatively by any employee of a member or affiliated entity;

f. consider whether it is a violation of a broker's fiduciary duty to one customer to participate in any way in an off board trade while orders at better prices are attainable; and

g. consider possible exceptions such as swaps of securities between two corporations 100% owned by the same parent.

11. Commissions

Proposed Moroccan principles for revised commission requirements have been explained but have not been put in writing. A uniform rate for both on floor and off floor trades is planned without regard to the size of transactions. The total commission would be about 0.9% of the transaction value charged to both buyer and seller, with about 0.4% for the stock exchange and about 0.5% for brokers.

Fixed commission rates are desirable in developing markets to encourage service competition and broker growth rather than destructive price competition. But they should be low enough to encourage trading and fair in balancing work and risk involved for the broker against benefit to the customer in values traded. From that point of view, volume discounts should be retained. Round turn discounts for short term holdings should also be included. Special plans for employees selling small amounts of securities received as incentive compensation from their employers or buying their employer's securities in a company plan should also be provided.

Commission rates ordinarily vary with the value of the transaction and the number of shares as a reflection of the work involved. For very small transactions, there is usually a minimum which may be below cost as an accommodation. Smaller trades within the normal range are likely to be about 2% of transaction value. The percentage of commission ordinarily decreases as the number of round lots and values traded increase.

The percentage on institutional size blocks is sometimes as small as a fraction of 1% or a few cents per share.

Commission reform in the Stock Exchange is necessary.

Such reforms should focus on broker commissions, stock exchange commissions, discounts for floor block trades, off-board trades, volume rates, and liquidation before settlement trades.

Commission rates should be high enough to support the promotion and education which the investing public of the country needs, with adequate incentive to brokers. At the same time, they should be low enough and sufficiently varied by values and work involved to give investors a sense of fairness. As an economy becomes developed, commissions may become negotiated, but fixed commissions are appropriate in communities where policy to encourage the growth of capital is more important than competitive lowering of the cost of investing.

Exchange commissions

The stock exchange commission on trades in Morocco is far higher than in other countries. In the U.S.A. for example, volume permits the exchange share of public commission to be only 0.25% of the negotiated commission received by the broker rather than a percentage of the customer commission. The present high rate of exchange commission in Morocco is doubtless necessary to support the Stock Exchange at the present low-volume levels. It is far too high, however, to encourage securities trading. Stock exchange commission income should move in the direction of being a small percentage of the broker commission.

Broker commissions

The one half of one percent commission rate proposed for Morocco for smaller and average trades for brokers is far less than the more normal 2% overall rate for each side in other countries. Broker income from small- and average-sized trades should be increased to approximately 2% on each sides.

The broker's rate is far too low to support the training of sales forces and their education of potential customers necessary for privatization and development of the securities business. That rate will also discourage entry into the business of non bank brokers.

Discounts: floor block trades, trades off-board, liquidation before settlement date, volume rates

Discounts for floor block trades should be reduced to 1%, while those for trades off-board with no brokerage but registration only should be set at about 0.25%. Discounts for small- and average-size trades on a liquidation before settlement date should be reduced to about 1%. Common sales and purchase accounts for companies with employee stockholding plans should be at volume rates.

Unusual cases

In very unusual cases, such as negotiation of unlisted securities trades or principal purchases by a member of shares for which there is no ready market, the commission or short term mark-up may be permissible in the 2-5% range.

Bond transactions

Bond transactions are ordinarily in greater dollar amounts per unit than shares and bond commissions consequently are ordinarily less, starting for example at 1% on 100 bonds.

12. Takeover Bids and Secondary Distributions

Regulation of takeover bids and secondary distributions should be deferred until further study and need.

The proposed exchange rules for takeover bids and secondary distributions reflect the inexperience of Morocco in such matters. For example, takeover bids are contemplated only as efforts to purchase control rather than efforts to win a shareholder vote as they frequently are. The proposals would favor existing control and management against those advocating reform. The first party to file for a tender would also be favored over subsequent competitors. The complexity of competing offers involving packages of securities and money payments is not recognized in the simplistic requirement that a competing bid must be at least 5% better, in price, than the first bid.

Secondary distributions involve entirely different procedures to protect the public interest. They are not a normal part of the exchange auction process. Instead they are an organized effort to distribute a large block of an already issued security by a group of brokers at a fixed price using maximum sales efforts. They thus have some similarities to an underwriting syndicate. They are characterized by sellers paying the buyer's commission, and brokers therefore becoming only the agent of the seller although also servicing the buyer. Secondary distributions are unlikely to be needed in the near future in Morocco as there is a shortage of supply of securities, and that shortage is likely to remain for a considerable time. Blocks of already issued securities offered for sale consequently should be able to be distributed in the normal auction market by supply and demand pricing with Exchange members acting either as brokers for buyers or sellers, respectively.

In both instances, exchange trading would be halted for the duration of the offer under the proposed regulations, thus unjustly depriving shareholders of their right to sell at any time or to speculate on the probable success of the offer.

13. Centralized Promotion

A. The Executive Director of the Stock Exchange should be involved in the privatization promotional and educational campaigns.

The Executive Director's involvement in the promotional and educational campaigns would broaden his perspective in preparation for the Stock Exchange's increased role in share ownership.

B. The Price Waterhouse March 1990 recommendations for further phases of reform of the financial sector should be supplemented by a short-term consultancy to the Stock Exchange by an expert in share ownership promotion.

C. The Stock Exchange should continue this educational campaign as the privatization educational campaign closes.

Privatization with broad distribution necessarily will involve a massive educational campaign. It is likely that communications consultants will be employed for this effort.

The stock exchange should continue this educational campaign as the privatization educational campaign closes. It will be economic for origination and administration of a multi-media program to be centralized with the Exchange and largely executed by members.

14. Banks as Members and Encouraging Non-Bank Brokerage Firms

A. Banks should convert their stockbrokerage activities into profit-oriented subsidiaries.

As Morocco develops a community of non-bank members of the exchange, more extensive capital requirements will be necessary to protect the brokerage community and customers against failure of a member. Capital requirements for stockbrokerage are quite different from those for banks. Velocity of transactions for stockbrokers is rapid and risks are not easily anticipated. A number of countries do not permit banks to be stockbrokers or even underwriters because of the risk involved. On the other hand, and in contrast to bank assets in loans, securities are liquid and their market value are known daily. Stockbrokerage capital requirements are therefore expressed in liquid capital in ways which banks cannot meet.

Banks can be exempted from securities capital requirements as long as there are government guarantees that banks will not fail. Otherwise, bank brokerage activities must be spun off into subsidiaries.

The primary interest of banks is in deposits and loans. A bank's incentive to offer a securities brokerage service arises from the banking income from custody and coupon clipping fees and from money float arising from dividend and interest collection and advance customer payment for security purchases and delayed bank payment for customer securities sold. A bank incentive for promoting securities ownership and education is inferior to deposit-loan incentive. This conflict is lessened when a bank's stockbrokerage is organized as a separate profit center in a subsidiary.

B. <u>Legislation should include a deadline for banks to convert their stockbrokerage activities into profit-oriented subsidiaries.</u>

Hungary recognized this principle in providing in its 1990 law that the current 25 stock exchange member banks must spin off their stockbrokerage into subsidiaries by the end of 1991. A number of countries do not permit banks to be stockbrokers or firm underwriters because of the risk involved.

C. <u>Non-bank brokerage firms should also be encouraged.</u>

Countries with broad ownership of business are usually also characterized by financial communities with a major segment of firms engaged solely in the securities business. Some of these firms are primarily engaged in marketing to the public, some in professional trading, some in underwriting or managing mutual funds, some in specialized niches or engaging in all such activities.

Ease of entry into the securities business while maintaining qualification standards is an important balancing objective of government and exchange regulation. Government should be alert to curb broker organizations from excluding qualified new members. Special provisions for easing economic entry are possible such as provision for firms which wish to be only investment advisors or marketers of securities to avoid the operational burden of processing customer accounts by introducing their customers on a disclosed basis to another firm for custody of their accounts. Such firms can have lower capital requirements, and be exempted from requirements associated with protecting customer property.

15. Multiple Stock Exchanges for Morocco

<u>The proposal for multiple stock exchanges should not be pursued. The central stock market should be named the Morocco Stock Exchange rather than as at present for a single city.</u>

According to the actual conditions of the financial markets in Morocco, a single stock exchange, independent from the government, is enough. The economic purpose of a stock exchange is to bring to one market all buy and sell orders existing at a particular time in a particular security to compete against each other - buyers against buyers, sellers against sellers, buyers against sellers - in order to establish the best transaction price at the consensus of all willing buyers and sellers.

Further, such a market permits a large percentage of orders to be executed by stockbrokers as agents rather than dealers. This lowers cost for customers who pay only a commission rather than a dealer spread which must be higher than a commission to compensate the intermediary for the risk of owning a position.

Consideration is given in the draft legislation to the possibility of establishment of stock exchanges in other major cities of Morocco to trade in securities of only regional interest.

Such securities by definition would produce low trading volume, otherwise they would arouse nationwide interest. Brokers would be unwilling to attend trading sessions producing negligible commission income when a larger central market exists.

Small regional companies are not likely to have sufficient shares and share owners to sustain auction-type trading. If they should, all orders should be brought together in the central market. If not, it would be better to trade them by open negotiation between the larger number of brokers in the central market in an unlisted trading style.

Any additional stock exchange that develops in Morocco should result from a private sector initiative. If an investor wants to create a stock market at his own risk, he should be allowed to do so. Competition among stock exchanges will, in the long run, be beneficial to corporations which will be given the opportunity to become public at competitive rates and will in turn lower the commissions paid on their investments.

16. Disclosure Proposals

Prospectus proposals for new issues as well as proxy statements for shareholder votes should have considerably more information than those currently proposed.

Proposed disclosure requirements are incomplete for encouraging broad ownership. Disclosure requirements for listed companies and other larger, publicly held companies should be revised to include:

- a description of the risks of the business
- backgrounds of directors
- compensation to principal officers and for officers and directors as a group
- any conflicts of interest of officers and directors

In addition, more frequent reports on financial results (i.e. quarterly) should be required as well as more detailed proxy and prospectus reports. Annual audited financial results should be published and made available to share holders in advance of annual meetings rather than after such meetings.

The CNVM and the Exchange should review such documents for disclosure compliance. It is not their responsibility, however, to "approve" a prospectus, which would imply that it is a recommendation. Instead there should be a prominent statement in the prospectus that the government has only reviewed the document for compliance with disclosure requirements, and not evaluated the merits of the security. The market should be educated as to clearly understand the difference between compliance and approval of prospectus.

17. Government Commissioners

The proposed post of Government Commissioner should be abolished in favor of standard government auditing of the propriety of financial records and expenditures.

The Government Commissioner positions, with the strong powers expressed in draft laws for the CNVM and stock exchange, are inconsistent with the straight line system of management, and would conflict with the authority of the Exchange Board and the CNVM.

The proposed monitoring functions of the Commissioners could be accomplished by the Minister of Finance in two other ways: first, through his presence or that of delegate on the Boards, and second, through the review function of the CNVM.

18. Bankruptcy Law

<u>A special bankruptcy law should be written for securities exchange members, giving priority to the return of customer-owned property.</u>

Dated Moroccan bankruptcy law presents a serious threat to securities holders if a stock exchange member should fail, and prohibitively increases the cost of any Compensation fund to assist the customers of any such failed member. For this reason, a special bankruptcy law should be written for securities exchange members, giving priority to the return of customer-owned property. Preparing such a law would require further study. An exhibit on Compensation Funds follows to suggest the problems involved.

The assignment of the Brokers Association for drafting the bankruptcy law seems inappropriate, as it may give the perception of a conflict of interest. All elements of the financial and legal community should have input and comment on such proposals, but the appropriate committee of the legislature for amending bankruptcy law should be the principal drafter. The U.S. Securities Investor Protection Act, as amended in 1978, and the current drafts of legislation in Sri Lanka and Canada would be helpful sources of ideas.

19. Accounting and Auditing

<u>The proposed Plan Comptable, the generally accepted accounting and auditing standards for Morocco, should be adopted by Parliament and vigorously enforced.</u>

No copy of the proposed Plan Comptable was provided. However, the team met with some of the professionals who assisted in the writing of the proposal and is confident that the proposal is as developed as is practical at this time.

20. Taxation Policy Impedes growth of Risk Capital Market

The complexities of taxation of dividends, interest and capital gains should be simplified in order to equalize competition for savings and eliminate distortions from market-determined allocation of savings.

Where public interest in directing savings to certain channels distorts market determination, incentives should be temporary.

Future proposals for relief of the taxation of individual holders of listed shares are uncertain but any consideration of them would be an incentive to broad distribution.

21. Insurance Companies

Government should pay careful attention to the recommendations of insurance companies which would increase their ability to participate in the financing of private sector business.

Insurance Companies are the best customers for Moroccan securities. They could be encouraged to participate in short term trading in order to increase liquidity in the exchange markets. The 6,000 insurance professionals in Morocco are a potential sales force for broad securities ownership, especially mutual funds.

22. Mutual Funds

Mutual funds are especially appropriate in a community of savers not prepared for evaluation of individual equities.

Professional selection of investments for a mutual fund overcomes this deficiency, while diversification of investment reduces the risk for mutual fund purchasers. The sale of mutual funds does not require specially trained professionals in securities analyses.

23 Corporate Bonds

Changes in tax and other government policies to encourage the issue and ownership of corporate bonds and convertible securities are a great potential for increasing the experience level of public savers and closely held corporations, as well as stock exchange trading.

Current tax laws and other government disincentives to the holding of corporate bonds forfeit a major opportunity for stock exchange development, public experience in corporate investment, and familiarizing closely held firms with the advantages of broad distribution.

Moroccans today are comfortable with fixed income financial instruments such as government bonds and term bank deposits. It would be easier to encourage such savers to purchase fixed income corporate bonds rather than riskier equities. There would be additional incentives for companies that become privatized through the sale of a combination of a relatively low cost equity and a relatively large corporate bond, particularly if that bond were government guaranteed. This combination would familiarize Moroccan savers with the longer term advantages of stocks while offering them an acceptable, more secure, income product.

Owners of closely held private business in Morocco fear issuing shares to the public because of the possibilities for resulting transparency; questioning by public shareowners; or opposing control attempts which would challenge their management. The issuance of corporate bonds does not involve the same concerns. However, it would give corporations an alternative competitive route to additional capital, and, over time, decrease their resistance to public issue of share.

Subsequent trading of both stocks and bonds would strengthen the Stock Exchange.

24. Recommendations Within Rule Proposals

Many other specific recommendations are included in the accompanying drafts of rules, a legislative enabling act, and discussion of professional training and public education.

Organized under 11 topics, these exhibits comprise a comprehensive operating plan for the stock exchange. The subjects discussed above are comments on current practices and proposed changes developed in Morocco prior to this study. The exhibits on the other hand are written as a comprehensive blueprint for recommended Exchange operation in the near and longer term future. Many of the concepts and procedures embodied in the Exhibits consequently exceed in importance some of the subjects discussed above. A complete review of this report necessitates reading the Exhibits as well as this text.