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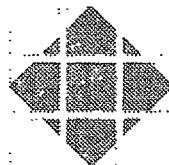
## **USAID Lithuania Capital Markets Project**

### **COMPLETION REPORT**

Contract Number: EPE-I-00-95-00040-00-T.O. #5

**Funded by:**  
**U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT**

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## **Lithuania Capital Market Systems Project**

### **Project Completion Report**

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## 1. Executive Summary

This Project Completion Report (hereinafter the "Report") summarizes the successful completion of the United States Agency for International Development ("USAID") Lithuania Capital Market Development Project ("Project"), which was implemented by the Pragma Corporation ("Pragma") during the period October 1, 1997 through February 27, 2000. The Project under review is a continuation of USAID's technical assistance to the Lithuanian capital markets that started in September 1995 (initially implemented by Price Waterhouse (through November 1996) and then by Pragma). The original Task Order, and the subsequent follow-on, concentrated on the legal and regulatory development of the Lithuanian Securities Commission ("LSC"), the organizational development of the National Stock Exchange of Lithuania ("NSEL") and the National Association of Finance Brokers ("NAFB"). Also, some assistance was provided to the Central Securities Depository of Lithuania ("CSDL") (collectively the four institutions are referred to as the "Counterparts"). The follow-on Task Order shifted the focus to implementing a new trading environment in response to the dramatic increases in trading volume and activity on the Lithuanian stock market, trading on the NSEL, and respective regulation.

Pragma undertook the task of assisting the NSEL in developing an effective and efficient trading system. As a part of the Project, Pragma was required to procure and install software necessary for the operation in Vilnius of an up-to-date trading mechanism. This requirement was initially carried out through a bidding process in which suppliers were asked to submit proposals for the system. The process yielded numerous responses; however, price and other considerations made it necessary to abandon this procurement activity. In its place, the NSEL opted to develop the software through its own in-house capabilities and to rely on USAID funding to obtain the necessary hardware for its modified and upgraded trading system. In order to undertake this assignment, it was necessary to obtain from AID a modification of the Task Order. During the month of May 1999, Pragma forwarded its final proposal for modifying the existing contract to USAID/ENI and OP for review and approval. No other project related activity took place during this month. In early June 1999, the Task Order was amended, changing the original scope of procurement from the acquisition of software to the purchase of hardware for the NSEL. The work contracted under this Task Order was scheduled to end on December 31, 1999.

On November 30, 1999 PRAGMA was notified that a 60-day, no-cost extension of the contract was approved by USAID, thereby enabling the suppliers to deliver the equipment ordered prior to the new Project Termination Date of February 27, 2000.

### 1.1. The Team

When the implementation of the follow-on Task Order began at the end of 1997, long-term Chief of Party, Dow Heard, and nine full-time local staff members staffed the Project. The staff included two legal advisors, **Žilvinas Zinkevičius** (later replaced by **Evaldas Valčiukas**) and **Gediminas Rečiūnas**, a financial advisor **Skirmantas Rimkus**, an advisor in macroeconomics **Dr. Arvydas Paškevičius**, two market research specialists, two translators, an office manager, and a driver. During the Project's implementation period, seven American advisors worked with the local team on a short term bases: **Donald Buddenbohn** provided assistance on accounting issues, internal control, record keeping, and capital adequacy; **James Ryan**, a former NASD examiner, assisted on broker regulation matters; **Kevin Salisbury** worked in the field of corporate finance and corporate governance; **Stanley Judd** contributed a great deal to the development of investment company legislation; **Kevin O'Hara**, a former chief of party, consulted on enforcement issues (inside deals and market manipulation); **Bill Gorman** evaluated the NSEL trading system, prepared tender requirements and evaluated the initial bids; and **Bendy Viragh** conducted the hardware procurement for the NSEL during the final stage of the Project implementation.

After the first two years, the LSC made a decision that was supported by both USAID and Pragma, to have the same consultants that had already worked for the LSC return to Lithuania on several occasions and provide necessary advisory capabilities. This ensured continuity in the development of different projects and their completion, and saved time on briefings and debriefings each time a newcomer arrived. The local team was recruited to implement the Task Order requirements and to carry out regular on-site consulting as needed. The Chairman of the LSC, Mr. **Poderys**, commented that this had been the best arrangement they ever had.

From the start of the Project until June 15, 1998, the LSC and the NSEL were receiving assistance from a full-time advisor assigned to them by USAID through the Pragma Task Order. Thereafter, due to budgetary reasons, USAID decided to use short-term experts rather than one long-term chief of party. The reallocated funds, which were initially earmarked for the chief of party, were instead used to hire

additional short-term experts to work with the LSC on some particular issues that required profound specialization. Although the risk was taken at the LSC request, to lose a long-term outlook for their on-going duties, they gained additional short-term help that had been nearly exhausted under the original budget. The change proved to be fruitful as four more American experts' visits were arranged to consult on the most pressing issues. These experts assisted the LSC in finalizing amendments to Company Law, Investment Companies Law, and accounting rules.

## 1.2. The Results

The assistance that Pragma's team provided in implementing the Project resulted in the following accomplishments: procurement, installation, and adaptation of fully operational hardware to support the NSEL's newly developed trading system; establishment of continuous trading which increased market transparency and liquidity, and provided listing reform amendments to the main legal acts regulating the Lithuanian securities market, and regulations implementing investment company laws; increased internal control, risk management, and inspection of licensed persons and investment companies, and created additional oversight and more intensive disclosure by public companies; established new capital adequacy requirements for licensed brokerage firms; introduced of international accounting standards in the accounting procedures of issuers (in their disclosure reports), brokerage firms, and investment companies; new forms of financial statements, takeover regulations, the Code of Ethics of Intermediaries of Public Trading of Securities, more knowledgeable market regulators and intermediaries; and more informed investors.

The Pragma Corporation takes great pride in the fact that the Task Order Objectives were successfully attained. The success of the project was emphasized by the Chairman of the LSC, **Virgilijus Poderys**, Director of the Management Board of the NSEL, **Rimantas Busila**, President of the NAFB **Romas Matiukas**, and the President of the CSDL, **Artūras Keleras**. An article on the Project successful completion and results was published in the main Lithuanian business paper "Verslo Žinios" (No 85 (524) May 5, 1999).

This Report summarizes the current situation on the Lithuanian capital markets and the main results achieved, with the assistance of Pragma, for the Counterparts. It should be noted that statistical data in the Report is derived from the Annual Reports (for the years 1997 and 1998) of the LSC and the NSEL, and also from the employees of the Market Research Department of the LSC and the Trading Department

of the NSEL concerning the year 1999 with the permission of the heads of the organizations. Further, in successfully implementing the project, Pragma sometimes worked with other USAID funded donor agencies including Partners for International Educational Training (PIET), Financial Services Volunteer Corp. (FSVC), and the Commercial Law Center (CEELI), which are also referenced herein.

## **2. Background and Recent Developments**

USAID initiated the capital markets development program in Lithuania in 1995 when all institutions in need of assistance, the LSC, the NSEL, the CSDL, and the NAFB, were at a rudimentary stage in their development. The Law on Public Trading of Securities of the Republic of Lithuania ("Securities Law"), the main law regulating the market institutions and their proper functioning, had not even been passed yet. The Lithuanian Securities Commission ("LSC") established under the Government decree in September 1992, barely one year after Russia recognized the independence of Lithuania, was taking the first steps in its organizational development. The National Stock Exchange of Lithuania ("NSEL") and the Central Securities Depository of Lithuania ("CSDL") opened for business in September 1993. Brokers united into an association in December 1993. Therefore, the foundation for the Lithuanian securities market infrastructure was laid with relative speed.

At the same time, they demonstrate the commitment of the new Lithuanian State to the creation of one of the citadels of capitalism - the capital market. These efforts were appreciated by the developed foreign countries, which provided technical assistance to the emerging capital market of Lithuania. The two main donor nations were France, which donated the NSEL's new trading system, and the USA, through its USAID mission in Vilnius, which provided technical and organizational assistance to the four institutions that emerged as a result of these historical changes.

After the first two years of activity, the Project could already boast very tangible results: a number of regulations to support implementation of the Securities Law were adopted, the number of daily trades increased, the staff of the institutions, and the broker/dealer community underwent considerable training, and gained experience while struggling to create a viable market for capital formation and securities trading. In light of these achievements the LSC was still confronted by a series of major market policy issues, such as the need to develop additional regulations applicable to financial brokers, investment companies, corporate finance disclosure, etc. The follow-on Task Order addressed most of these issues,

although the focus, as mentioned above, was subsequently changed. (See the analysis of the legal assistance in the LSC section.)

In March 1998 amendments to the Law on Public Trading in Securities were passed by the Seimas (Parliament), and was a very significant event for the Lithuanian capital market and its participants. In principle, the Securities Law was harmonized with the requirements of the European Union Directives, which regulate public trading of securities. The amendments changed the status of the NSEL and the CSDL. These market participants converted from not-for-profit organizations to profit seeking companies. These changes were expected to stimulate more effective functioning of both the NSEL and CSDL. The role of the Pragma team in preparation of the amendments cannot be overstated and can be considered responsible for the major achievements of this project.

The NSEL, which serves as a market place for the Lithuanian broker community, aims at providing its members with the ability to safely trade securities. One of the major Task Order objectives for the NSEL was to introduce continuous trading. This objective was achieved in April 1998. This was an important step toward the development of the NSEL trading system, which is centralized, dematerialized, and order-driven. Both corporate equity and treasury bills (T-bills) are traded. At the opening of the trading session, the share prices are fixed and the continuous trading begins.

Another major improvement was the establishment of new order and regulations for voluntary entry of corporate securities onto the trading lists of the NSEL. Three trading lists were created, namely, the Official List, the Current List, and the Unlisted Securities List. The requirements for the admission to the Official List were made fully compatible with the European Union directives. The Current List underwent certain changes, for example, only most liquid securities of fast-growing companies remained. The creation of the Unlisted Securities List made it possible to trade the remaining securities.

During the years of Pragma's presence, special attention was given to the inclusion of large, successful Lithuanian companies in the trading lists of the Exchange in order to increase listing and liquidity in the market. At the start of 1998, there were 667 securities from 607 issuers on the Current List: 600 issues of 546 public companies, 51 issues of 49 holding companies, and 16 issues of 12 banks. However, by December of 1999, the Current List was only comprised of 40 joint-stock companies, 5 banks, and 2 holding companies.

Seeking to provide the NSEL members with more favorable conditions in which to clear and settle registered transactions, changes in settlement procedures were introduced in April 1998. The information presented to the Exchange members after the trading session included the detailed accounts of its liabilities and terms of payment.

The processes of consolidation and capital concentration were adapted within the broker/dealer community. Starting from 1993, a number of finance brokerage firms (FBF) and finance brokerage departments (FBD) at commercial banks were established, to ensure competition in the capital market. In 1994, there were 102 firms holding licenses to act as market intermediaries in securities trading. At the end of 1999, their number had been reduced to 54 financial intermediaries, 43 FBFs and 11 FBDs. More than half of the firms disappeared from the market during the last four years as a result of merges or liquidation. One of the main causes of this process was the application of the Capital Adequacy Rule (see below), which set forth rigid capital requirements on broker/dealers. Naturally, only larger and more reliable financial intermediaries remained in business.

Based on the amount of capital held, brokerage firms were divided into categories A, B, and C, and permitted to perform operations accordingly. Category A firms are allowed to act both as brokers and dealers. Category B firms can only perform functions of an agent, i.e. act as brokers. Category C firms are not allowed to accept clients' money or operate their securities accounts, but they can consult their clients on issues of investing and accept their orders, which are then forwarded to either a category A or B brokerage firm for placement on the NSEL. Today there are 5 category A firms, 24 category B firms, and 3 category C firms. More category C firms are desirable for future commerce to compensate for the uneven distribution of brokerage firms across the country, most of which are situation in the capital city of Vilnius, and to better serve the market needs of local clients in smaller towns.

All finance brokerage firms and commercial banks started implementing the Code of Ethics of Intermediaries of Public Trading of Securities in their activities. The Code regulates mutual relations between market intermediaries and their clients and within the industry.

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**3. MAJOR ACHIEVEMENTS****3.1. LITHUANIAN SECURITIES COMMISSION**

The main supervisory and regulatory institution of the securities industry is the Lithuanian Securities Commission (LSC), which was modelled after the U.S. Securities and Exchange Commission. Since the adoption of the Securities Law in January 1996, the status of the LSC has changed from a government agency to an independent institution reporting to the Seimas (the Parliament). The Chairman of the LSC and four members are appointed by the Seimas at the proposal of the President for five-year terms. The Chairman is also the head of the administration. Each Commissioner is in charge of one sector. The LSC presently operates with the staff of 50 employees. Six departments, namely, Market Regulation, Corporate Finance, Investment Management, Enforcement, Market Research and Public Relations, and European Integration Affairs, were established to assist the five Securities Commissioners in implementing the objectives stipulated in the Securities Law.

The LSC oversees functioning of financial brokerage firms and financial brokerage departments at commercial banks, the NSEL and CSDL, issuers and investment companies, it also monitors how these market participants comply with the requirements regarding information disclosure about securities and issuers to investors. Moreover, the Law on Pension Funds that was passed in June 1999 delegates regulatory and supervisory authority over these funds to the LSC, placing a tremendous burden upon the LSC both in terms of resources and social impact in case of failure.

Under the Project Task Order, Pragma agreed to continue assisting the LSC and helping develop further refinement of the legal and regulatory framework for the capital markets and, as market development warrants, in the areas of investment funds, investment advisors, market regulation, corporate finance, corporate governance, and securities legislation and disclosure. The Task Order also provided for assistance in the areas of market surveillance, enforcement, compliance audits and examination. They will also be advised the implications of a continuous trading system.

**3.1.1. Refinement of the Principal Legal Acts**

The principal legal acts regulating the capital markets in Lithuania are the Securities Law, the Company Law, and the Law on Investment Companies. The Chief of Party, **Dow Heard**, and all local legal advisors

worked on the amendments to these laws. Short-term advisors contributed with revisions and made valuable suggestions on how to improve the laws.

On March 19, 1998, the amendments to the Securities Law were passed. The most important of these amendments were the change of the legal status of the NSEL and the CSDL, both institutions became public companies with the introduction of voluntary entry of the company's securities onto the trading lists of the NSEL, and the liability for market manipulation and sanctions for these types of violations. Furthermore, the order of notification about acquisition or disposal of a substantial block of shares was harmonized with the requirements of the EU Directive 88/627/EEC on information to be published when a major holding in a listed company is acquired or disposed of.

The Pragma team contributed much to drafting and reviewing the new wording of the Company Law. It was prepared by the Ministry of Economy with the participation of other institutions (particularly the LSC) and aimed at full compliance with EU Company laws. The working group approved most of Pragma's proposals, which were submitted to the LSC by **Dow Heard, Kevin Salisbury, and Žilvinas Zinkevičius**. The underlining idea of all the proposals was the protection of the shareholders' interests and the increase of their influence in company management. Provisions for voting by proxy, disclosure of more information to the shareholders, shareholder notification, buying back of company shares, and increase in the maximum number of shareholders in a private company were all included in the Law.

Pragma's legal advisor, Stanley Judd, and local legal expert, Evaldas Valčiukas, amended the Law on Investment Companies. Their amendments eliminated contradictions between the Law on Investment Companies and the Company Law that appeared after amendments were made to the latter. These amendments also aimed to bring the Law in line with the requirements of the European Union Directive 611/85/EEC. As a result, conditions for emergence of local investment funds (as of today, there are none) were created on the basis of the European standard. Many controversial provisions of the Law were amended (e.g. governance of the fund was simplified).

The Pragma team contributed to discussions and improvement of other legal acts, especially the Audit Law and amendments to tax laws. Their proposals were significant not only in aiding the development of the capital market, but also in improving the general legal environment of business in Lithuania. The major achievement of these proposals was that the tax on investment companies was partially accepted, i.e. open-

end investment companies were exempt from the profit tax. However, other suggestions concerning improvement of the tax laws were not taken into consideration.

Challenges within the pension funds have recently become an issue for the LSC as the Government has finally decided to delegate the regulatory and supervisory function of these funds to the LSC. Currently, the state social insurance system is the only way for the residents of Lithuania to provide for their retirement, a pension fund would create an optional source of income upon retirement. Since there was no law regulating the appearance of a pension fund, there was no legal way to establish one. The importance of public confidence and protection of contributed assets require that the Law be given the utmost consideration. Although the Law on Pension Funds was beyond the scope of the Project Task Order, the Pragma team was asked to assist in reviewing the Law and also in drafting the regulations complementing it. With USAID agreement, **Stanley Judd** and the local advisors prepared comments and amendments to different sections of the draft Law.

### **3.1.2. Further Development of Regulatory Framework: Corporate Governance and Corporate Finance**

The Task Order listed the improvement of both corporate governance and corporate finance legislation as one of its major goals. Therefore, the team concentrated on issues concerning tender offers, registration and public offering of securities, disclosure of financial and material information, due diligence, underwriting, and related liability issues to produce guidelines and rules for the Commission and market participants. Currently, there are neither significant activities by underwriters nor meaningful due diligence for the capital markets participants in Lithuania.

The Rules on Execution of the Tender Offer should foster investor confidence. These rules are designed to protect the rights of minority shareholders by requiring a bidder, who acquires more than 50 percent of the voting shares at an issuer's general meeting (i.e., "control" of the company), to announce publicly a tender offer to purchase the remaining shares of all minority shareholders. The Rules on Execution of the Tender Offer were contributed to by the chief of party **Dow Heard**, and finalised by legal advisor **Žilvinas Zinkevičius**.

The LSC's commitment to reform is evident through the adoption of major modifications to the Rules on Registration and Offering of Securities, the Rules on Periodic Disclosure of Information about Issuers'

Activities and their Securities, the Rules on Acquisition (Disposal) of a Block of Shares, and the Rules on Disclosure of Information about Issuers and their Securities. These modifications have resulted in more timely disclosure and greater transparency. They also require issuers on the Official List of the NSEL to prepare their financial statements consistent with International Accounting Standards (IAS) and they may be audited in accordance with generally accepted auditing principles (GAAP). Finally, prospectuses and annual accounts are required to comply with the relevant European Union Directives and the recommendations set forth by the International Organisation of Securities Commissions (IOSC). All these rules were the product of common efforts of the LSC Corporate Finance Department and the Project.

The Rules on Registration and Offering of Securities occupy a very special place in the regulation of corporate activities. Passed on December 22, 1998, they replace the Rules that had been adopted in March 1993. During that five-year period, the market has changed dramatically: the NSEL listing requirements became more stringent, the number of companies seeking capital by way of issuing securities increased, and investors gained experience and became more safety-conscious. The new version of the rule was designed to arise to the needs of the changing market. The Rules went into effect on April 1, 1999.

Three consultants, **Jurga Dermontaitė**, **Skirmantas Rimkus**, and **Gediminas Rečiūnas**, worked on different sections of this Rule. Ms. **Dermontaite** prepared Annexes to the Rule with regard to requirements for the Prospectus of Public Share Offering and for the Prospectus of Public Debt Securities Offering; Requirements for the Memorandums of Share and Debt Securities Offering (in case of private offerings); and Requirements for the Prospectus Offering Shares Representing Certificates. **Skirmantas Rimkus** reviewed and finalized the financial section of the Rule. **Gediminas Rečiūnas** revised the entire Rule in an effort to make different sections legally consistent. He also worked on the provisions dealing with the distinction between private placement and public offering (the Law on Public Trading of Securities requires that both private and public securities issues by public companies be registered with the LSC) and regulation of public offerings (including underwriting).

### **3.1.3. Development of Regulatory Framework: Market Regulation**

The beginning of the follow-on Task Order coincided with the introduction of one of the most significant rules for the capital markets in Lithuania, the Rules on Calculation of Capital Adequacy of Financial Brokerage Firms (effective from December 31, 1997). The Rules set a standard for monitoring the risk exposure on investment firms. It had a tremendous impact on the market situation causing changes in the

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market structure, consolidation processes of broker/dealers, mergers and disappearances from the market.

Before the Rules came into effect, Mr. **Buddenbohn** reviewed broker/dealer financial reporting using the third quarter (1997) reports of the firms and completing an impact analysis with regards to changes in capital requirements. Extensive training was also carried out.

In addition to the capital adequacy rules, other measures were employed to improve broker/dealer regulation. It is noteworthy that on July 10, 1998 the Rules on Acceptance and Execution of the Clients' Orders (prepared by legal advisor, Mr. **Rečiūnas**) were passed. The adopted rules are intended to protect clients' interest in connection with orders placed through financial brokerage firms. The most important goal these rules achieved is the provision of mechanisms to ensure that a client's order will be executed in the same turn as it is presented to the financial brokerage firm. It also prevents the financial brokerage firm from executing its own trades prior to those of its clients. Another very important issue covered in the rule is the segregation of a financial brokerage firm's "front office" from its "back office". This rule provides for a safe way to execute a client's trades through a broker that does not hold a client's relevant securities account. The rule further details ways in which orders can be placed with a financial brokerage firm, cancellation and alteration of the order, aggregation and division of orders, as well as the firm's reporting procedures to its clients regarding executed transactions.

On October 16, 1998, the Rules on Agreements between Financial Brokerage Firms and Clients were passed, thus supplementing the above referenced rules. Drafted by Mr. **Rečiūnas**, these Rules set forth the general requirements for agreements between a financial brokerage firm and its clients and special requirements for agreements on custody of clients' securities, contracts on placement, and execution of clients' orders and contracts on discretionary accounts. The rules are designed to protect investor rights against possible abuse from financial brokerage firms. It also contains client asset protection provisions covering both clients' monies and securities.

### **3.1.4. Development of Regulatory Framework: Examination and Accounting**

One of the major achievements of the Pragma team is the completion of the rules governing accounting methods and forms of financial statements used by financial brokerage firms. These rules were prepared by Mr. **Rimkus** and reviewed by Mr. **Buddenbohn**. The accounting methods and the new forms of financial statements are based on the International Accounting Standards and comply with the EU directive on accounting of financial institutions.

Previous rules on financial statements were designed to suit manufacturing enterprises and commercial firms but not financial institutions. They did not make it possible to show operations such as collateralized securities lending, or marking securities to market, and many others. Hence, the Project's preparation of new rules for financial accounting and new forms for financial statements was necessary.

A final version of the rules was approved by the LSC and presented to the Ministry of Finance for further approval. If approved, the Ministry of Finance will coordinate the documents with other state institutions (e.g. tax inspectorate) and then send them to the Government. It was intended that the Government would approve these acts by the end of 1998. The new forms of financial statements of brokerage firms may come into effect in either late 1999 or 2000, and the following documents were submitted to the Ministry of Finance:

- (a) Financial statements - Balance Sheet, Off-Balance Account, Profit (Loss) Account, Cash Flow Statement, and requirements for the Notes on Financial Accounts;
- (b) New Model Chart of Accounts and a detailed description of this Chart of Accounts;
- (c) Description of accounting methods, recommendations for financial accounting of investment in securities.

The adoption of these methods will be instrumental in attracting more foreign capital for the companies. They will enable securities companies to disclose their financial status and performance in a more comprehensive, internationally accepted format. The adaptation of these methods will also better equip the LSC to understand and analyze the specific operations of financial firms and follow their liquidity and capital adequacy.

At the request of the LSC, **James Ryan** and **Donald Buddenbohn** worked on the rules governing reporting requirements for financial brokerage firms and requirements for internal controls in the financial brokerage firm. Mr. **Buddenbohn** also drafted an inspection program to supplement the Rule on Financial Brokerage Firm's Inspections. All these regulations relate to issues of compliance, internal controls, internal audit and supervision of all aspects of financial brokerage firm activities. Mr. **Buddenbohn** had numerous meetings with representatives from the Market Regulation Department of the LSC and provided them with expert advice and training. He also took part in on site inspections, which resulted in drafting an inspection procedure to be carried out by the LSC inspector.

### **3.1.5. Development of Regulatory Framework: Investment Funds and Investment Advisors**

The basis of legislation dealing with investment companies was laid at the very beginning of the Project's implementation (actually, **Stanley Judd** was the first advisor to come to Lithuania in 1995). Subsequent Task Orders devoted as much attention to this issue as the initial one, and investment funds remained one of the most significant issues for Lithuanian capital markets.

It must be stressed that the development of these regulations is an on-going process. Sometimes new developments in the legal framework necessitate changes. For example, soon after the Rules on Discretionary Accounts for Investment Management and Consulting Firms came into effect, the Rule on Acceptance and Execution of the Client's Order was passed. This rule included new provisions for segregation of securities custody and trading services, and set forth the option of keeping cash for operations with securities in bank accounts, which was earlier prohibited. Prior to July, all operations concerning securities were allowed only by brokerage firms that operated the personal securities account of a particular client. Thus, amendments to the former rule were necessary.

Material changes were made to almost all rules regulating investment companies and other related enterprises during the period of Project implementation. On March 6, 1998 the Rules on Securities Management Agreements between Management and Consulting Firms and their Clients were passed. On June 26, 1998 the Rules on Issuance and Revocation of Licenses to Investment Management Enterprises were adopted. Passed on October 5, 1998, the Rules on Issuance and Revocation of Licenses for Investment Companies was amended and supplemented in order to create more favorable conditions for the appearance of investment funds. All the rules and amendments were prepared with help from the Project, especially with the personal assistance of the ex-pat advisor Mr. **Judd** and a local team member Mr. **Rečiūnas**.

Mr. **Valčiukas**, the team's other local legal advisor, devoted much of his time to amendments to the Law on Investment Companies. Additionally, he contributed to the drafting of rules for investment funds, such as, the Rule on Registration and Public Offering of the Investment Fund's Shares. This Rule is a constituent part of a more general Rule on Registration and Public Offering of an Investment Fund's

Shares. The advisor regularly reviewed, and collaborated with the LSC staff on, the latter Rule, which is being prepared by the Investment Management Department staff, to ensure that the requirements of both Rules are consistent. For the first time the procedure of registration, public offering, and redemption of the investment fund's shares will be determined by these Rules.

The task of Pragma's consultant, **Skirmantas Rimkus**, after he had prepared accounting rules for broker/dealers, was to address the issues of accounting of investment companies. As a result, he drafted forms of financial statements and principles of accounting for open-end and closed-end investment funds and investment management and consulting firms. The importance of the task was of the same magnitude as the case of broker/dealers: today all financial institutions in Lithuania, except banks, complete the same forms of financial statements as manufacturing companies. Moreover, the statements are the same for regulatory purposes and for tax authorities. The Project was challenged to prepare accounting requirements for financial brokerage firms and all types of other companies providing investment services. The task has been successfully fulfilled: all the forms were approved by the LSC and are waiting further approval from the Ministry of Finance. This procedure of approving changes in accounting matters is rather complicated and is a matter of Government policy, but the LSC anticipates adoption of the new forms of financial statements in the very near future.

Donald Buddenbohn and Dr. Arvydas Paškevičius, who were also working on the methodology of calculating asset valuations, addressed accounting problems of investment holding companies.

### **3.1.6. Development of Regulatory Framework: Market Surveillance and Enforcement**

There were only two major projects in the field of market surveillance and enforcement; namely, writing and training on rules concerning inside deals, and rules on market and price manipulation. The Rules on Identification of Insider Trading Dealing with Material Events were passed on December 4, 1997 after lengthy discussions with the Enforcement department and other market participants. The Rules were drafted before the follow-on Task Order commenced, but they were finalized under the supervision of the Chief of Party, **Dow Heard**.

Market manipulation is an issue that the LSC is concerned about. On his visit to Lithuania in June 1998, Kevin O'Hara wrote a memorandum on market manipulation that was distributed to the staff members of the LSC Enforcement Department. A discussion took place, though no further steps were taken in the direction of implementation of the provisions.

### 3.2. NATIONAL STOCK EXCHANGE OF LITHUANIA

The Lithuania Capital Markets Development Performance Work Statement revealed that the NSEL was rapidly outgrowing its small trading system, which had reached the limits of its expandability and the defined objectives of the Task Order with regard to the NSEL development. The objectives were to (1) implement an efficient, continuous trading system in Lithuania that would satisfy the needs of a growing market, including design, selection, installation, adaptation, testing and training; (2) develop securities regulation, Exchange rules and operations, and broker/dealer operations and protocols to support a continuous trading environment.

Under the terms of the Project Task Order, Pragma agreed to provide assistance to the NSEL in the following areas:

- i. Assist the Exchange in issuing a tender for a new trading system and with the evaluation of bidders;
- ii. Assist the Exchange with installing a trading system and adapt it to the Lithuanian capital markets environment;
- iii. Train the Exchange and its members to use and maintain the trading system;
- iv. Assist the Exchange in modifications to the rules and internal procedures to support the new trading environment;
- v. Assist the Exchange with developing a maintenance schedule.

USAID amended this Task Order on June 3, 1999, changing the original scope of procurement from the acquisition of software to the purchase of hardware for the NSEL. The events that lead to this change are briefly reported below.

As a result of this change, five of Pragma's consultants provided assistance to the NSEL; namely, **Bill Gorman, Dow Heard, Kevin O'Hara, Bendy Viragh**, and, Pragma's technical advisor, **Timothy Smith**. Dr. Mohammad Fatoorechie supervised the hardware procurement process.

### **3.2.1. Issuance of a tender for a new trading system and the evaluation of bidders**

On December 18, 1997, **Bill Gorman** began a short-term assignment to draft the Request for Proposal (RFP) for the acquisition of the Exchange's automated trading system. He met with all the counterparts and their staff. Afterwards, Mr. **Gorman** made presentations to the NAFB, significant members of the broker/dealer community in Lithuania, and the NSEL. After reviewing the trading regulations and technical aspects of the NSEL, Mr. **Gorman** commenced the drafting of the Project bid documents. Drafts of the Request for Proposals (RFP) were presented to broker-dealers and executives of the NSEL and revised using their input in January. The completed RFP 98-01 was finalized by Mr. **Gorman** and forwarded to USAID and the Pragma home office. A time line for procurement and training on the automated trading system was produced. The Selection Committee, made up entirely of Lithuanian market participants, was established to assist in the procurement process. They were representatives of the LSC, NSEL, NFBA, CSDL, and the head of the largest broker/dealer in Lithuania.

During the subsequent months of February, March, and April, US vendors raised questions concerning the RFP 98-01 for the Procurement of Software for the NSEL during the pending tender. **Dow Heard**, Chief of Party of the Project at the time, worked to provide the vendors with answers to all of their questions. The Evaluation Sheet for the procurement of the software was revised and updated. The Evaluation Sheet allowed the Selection Committee to have access to all the selection criteria and a rating system to highlight the priority values assigned by the market participants to each criterion.

On May 4, 1998, a total of four bids were received pursuant to the tender. Mr. **Gorman** and Mr. **Heard** distributed the bids to the Selection Committee on May 7, 1998. The Selection Committee held meetings on May 7, 11, 12, and 21. Additional meetings were held between Pragma and the NSEL. (**Kevin O'Hara** from the Pragma home office joined the team on May 13). Mr. **Gorman** made written and verbal evaluations of each bid and an overall summary of the technical aspects of all the bids. The Selection Committee after extensive evaluation and discussion of the technical merits, current and future costs, maintenance, training, and other factors, voted to reject all four bids.

The Selection Committee subsequently discussed alternatives including the possibility of an international tender. Ongoing discussions were held between the Pragma team, the NSEL staff, the Selection Committee and USAID. By the end of May 1998 no firm decision had been reached between USAID and the Committee on the manner in which to proceed. The following options were discussed:

1. Retender of the RFP to ensure that all eligible and interested US vendors had an opportunity to submit bids.
2. Perform a final review of the best US bids - (this requires negotiating with the vendors to procure improved bids to meet the NSEL needs).
3. The NSEL purchases the software system without the assistance of USAID and the funds set aside for this purpose are used for training and other support needed in implementing the system.

In the following months discussions were held with the NSEL and the Selection Committee to determine the most suitable course for all parties and the steps necessary to implement the decisions made.

### **3.2.2. Analysis of the NSEL trading system**

Following a market needs assessment and systems analysis carried out with regard to the RFP, and the major shortcomings of the NSEL hardware/software system were identified. The analysis of the NSEL trading system and comments of the brokers showed that most of the AS/400 machine resources often reached a high usage rate (critical zone) during active trading, i.e. when traders were working with buy and sell orders at the same time. This was especially obvious during the peaks in the number of orders and trades at the NSEL. (The maximum number of orders was recorded at 5,014 on 13 May 1997. The maximum number of trades concluded during a single trading session was recorded at 3,971 on 25 March 1999.)

Brokers also complained about the trading system's response time which is too low (15...20 seconds) and the interface, which is old-fashioned (operating on the text mode). It was impossible to release groups of orders as a package from the members' automated front-office systems to the NSEL trading system, which was considered the main disadvantage. In addition, a link of the current trading system with the members' internal automated back-office system was also impossible.

In order to resolve these outstanding issues, it was determined that the existing system of hardware and software had to be modified and upgraded. In consideration of the existing limitation of funds and the problems related to the software procurement process, it was decided to only upgrade the existing hardware. At the same time, to simultaneously modify and develop the existing trading system (software), using the NSEL in-house programming capability. An agreement was reached with USAID to support the purchase of required hardware with the available funding.

### **3.2.3. Change of the original scope of procurement**

During the first quarter of 1999, Pragma received (through USAID) a list of hardware required by the NSEL for the upgrade of its trading system. Pragma's technical advisor, **Timothy Smith**, reviewed the plan, suggested modifications to the NSEL, and a final list, as agreed by all parties, was prepared. The Task Order charged Pragma to assist the NSEL in the purchase of the necessary hardware for its upgraded trading system and to ensure that USAID procurement rules were observed in the acquisition process.

Pragma appointed Mr. **Bendy Viragh**, former senior USAID procurement advisor, to manage the procurement process and to serve as advisor to the NSEL on procurement related issues. Mr. **Viragh** visited Vilnius July 6 – 16 to prepare and finalize the specifications needed for the Request for Proposals. Mr. **Viragh** worked with Dr. **Gurskas** and his staff and consulted with the USAID Program Manager, **Mark Segal**. The specifications, which were prepared, were further reviewed and approved by Pragma's technical expert Mr. **Smith**.

The procurement list included the purchase of three UNIX platform machines and an upgrade of the NSEL operated IBM AS/400 mainframe and the required accessories. The first two UNIX platforms were to be used for database and communications, while the third to be used for developmental work and as a redundant (backup) gateway. The IBM upgrade was exclusively targeted for use as the engine for the trading system in the immediate to medium term – one and a half to two years. Thus, the hardware procurement process commenced.

### **3.2.4. Procurement of the Hardware**

The equipment needs, as envisioned by the NSEL, are specific and restricted to a few eligible suppliers. There are only ten known suppliers of this equipment in the eligible source countries (the US and Lithuania). Of these firms, only three have in-country maintenance and support capability. Both Mr. **Viragh** and Pragma's technical expert Mr. **Smith** determined that the suppliers to be contacted were IBM, Hewlett-Packard, and SUN Microsystems, as well as their local in-country representatives, qualified to offer prompt in-country service and maintenance support.

The RFP was issued to selected suppliers on August 21, 1999 and mailed to both the US and Lithuanian suppliers, which were capable of responding to the RFP. The suppliers were asked to return their offers by September 20, 1999. All the three selected suppliers responded, presenting their proposals on that date. Mr. **Viragh** brought all unopened offer packages to Vilnius on September 22, 1999. On September 24 an evaluation meeting was held at the NSEL office. The meeting was attended by the NSEL/Pragma Procurement Committee, which was appointed by the Project manager of the onset of the Project. The Committee members **Dalia Jasulaityte**, **Dr. Antanas Gurskas**, and **Chairman Bendy Viragh** conducted a thorough evaluation of the offers received.

Offers were received from IBM International, Hewlett Packard and Sun (CompuServe). The offers were reviewed in terms of responsiveness to RFP terms, suitability of equipment offered, and price quotes.

All required equipment was grouped from A through H. After a careful consideration, the awards were made as follows: Group A hardware, upgrading the existing NSEL trading system, was awarded to IBM International; Group B through F, providing a UNIX-based trading system, with accessories, was awarded to Hewlett-Packard; Group H procurement, the acquisition of 20 PCs, was delayed because three of the four suppliers participating in the solicitation for computers offered non-US equipment. Therefore, Mr. **Viragh** decided to solicit new offers, in accordance with applicable AID procurement guidelines.

The four vendors were requested to submit new, qualifying offers, providing equipment, which meets AID source/origin requirements. Two responses were received. Compaq replied that it could not supply US-made computers. Unitech International offered US made computers at reasonable prices. Upon consultation with the NSEL an award was made to Unitech as the sole responsive and responsible supplier for the 20 computers requested under the RFP. Continued care was taken to insure that AID procurement rules are observed and that delivery of equipment is proceeding efficiently.

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The first shipment of the equipment, the HP UNIX machines with accessories, delivered by HP International, acting through its local distributor, ALNA AB, arrived on December 16, 1999. Installation and testing began immediately and training was arranged for key NSEL personnel. Start-up took place in January and was fully successful. The hardware procurement process entered the final stage.

### 3.2.5. Completion of the Hardware Procurement

In January, IBM International also delivered its upgraded AS 400 system. NSEL proceeded to immediately integrate the system into NSEL's existing equipment and operational system. During the final days of January, Unitech International received and forwarded to NSEL the complete order of 20 IBM PCs. The equipment arrived in Vilnius during the first week of February. All of the newly acquired equipment was made fully operational and functioning by the middle of February.

During the first two weeks of February, the Program Director, **Dr. Fatoorechie** and the Senior Procurement Advisor, **Bendy Viragh**, traveled to Vilnius to verify the installation and operation of the newly acquired systems and hardware and the integration of the new hardware and systems into the existing stock exchange operations. At the same time, documentation was prepared for the transfer of the equipment from AID to NSEL, in accordance with applicable AID regulations.

In order to verify receipt, installation, and operational integration as well as actual operational capability, the NSEL was requested to provide certifications attesting to the following:

- a) The equipment ordered was received, in full compliance with RFQ specifications. An inventory of purchased items is attached;
- b) The equipment purchased and received was installed and satisfactorily tested. Software was loaded and tested for operational competence;
- c) The in-house developed software was successfully integrated into the new system and tested to be fully compatible with newly acquired hardware.

Pragma's Senior Procurement Advisor, **Bendy Viragh**, inspected the equipment installed and examined the status of integration of the in-house developed software into the upgraded operational system as well as its compatibility with existing and/or acquired hardware. Mr. **Viragh** concluded that all the requirements set in the Contract were fully met.

On February 11, AID Director **Gary Imhoff** and other AID/Vilnius officials visited NSEL facilities for a visual inspection of the equipment and operational systems. Dr. **Antanas Gurskas**, NSEL's Technical Director, presented a briefing on the capabilities of the upgraded system and an explanation of the functions of newly acquired equipment.

Mr. **Imhoff** expressed a preference for a final IRM review of the integration of the newly acquired software and hardware into the NSEL system and a verification of the operation and operational capability of the Stock Exchange. He suggested that, in addition to the documentation prepared by Pragma for the actual transfer, a review by an IRM expert should take place. This review/visit is to be arranged by AID/Vilnius and should take place prior to February 27.

### **3.2.6. Legal environment for the new trading system**

Continuous trading is a recent development for the NSEL. This activity was preceded by a careful revision of the legal and regulatory requirements to support the qualitative change of trading. During 1998, the NSEL Management Board introduced improvements to most of its rules; the most significant of which were the new Trading Rules of the Stock Exchange approved by the LSC on 22 December 1998. They came into effect on 1 February 1999. The local Pragma advisors assisted in preparation and modification of various sections of the new Trading Rules, especially the annex - Listing Particulars for the Admission of Securities to the Official List of the NSEL, which was prepared by **Skirmantas Rimkus**, the Project's financial advisor. Dr. **Paškevičius** assisted in preparing Methods of Ratio Analysis (published in a brochure).

The Trading Rules cover all-important aspects of the NSEL activity that had previously been regulated by Exchange Regulations and separate instructions. They include formation and management of trading lists, de-listing of securities, trading, clearing and settlement procedures, admission to the NSEL membership, member rights and obligations, suspension and renewal of the member right to trade, supervision of member activities, expulsion of the member, the Stock Exchange information system, information dissemination, fees and dues of the Exchange.

Although many stipulations from the original Regulations and different instructions were transferred to the Trading Rules, a considerable number of innovations were introduced. A new concept of "investment

custodian" was introduced, which created legal conditions for investment custodians to act at the NSEL. Further, listing principles and methods as well as management of trading lists were improved. Listing procedures were brought in line with the EU standards and recommendations. The new Rules on Registration and Public Offering of Securities were adopted by the LSC (prepared with the help of the entire Pragma team). Stages of the trading session, types of transactions, and ways of offering securities for trading were defined. In addition to corporate equity, continuous trading was applied for debt securities, and rules regarding new membership requirements, member rights and obligations, suspension of the member right to trade on the Exchange and revocation of the suspension, expulsion from the Exchange members, member responsibility and right to appeal the Exchange Board's decisions were established. The main principles of member supervision and the rights of the NSEL while carrying out the supervision were determined. The Exchange informational system, levels and methods of information dissemination, were clearly and thoroughly defined.

Changes were introduced to the Rule on Block Transactions, adopted in February. The Rule provides for an automated execution of block trades and creates a possibility for market intermediaries to publicize their offers to buy or sell securities on an electronic bulletin board. The new wording of the Rule on Placement and Execution of Brokers' Orders established that the information contained in the market intermediaries' orders is not disclosed publicly until the securities price is fixed; the Rule on Continuous Trading at Variable Prices set forth an option for an exchange transaction to be concluded not only at the fixed (single) price, but also at variable prices.

In May 1998, the Rules on Execution of a Tender Offer at the NSEL were adopted as a follow up to the LSC Rule on Submission, Registration and Execution of a Tender Offer, also prepared with the assistance of the Project (advisor **Kevin Salisbury**). It is a significant event in the securities market, as the Rules provide for the protection of small investors. During the period of 1998–1999, 29 tender offers (1 voluntary and 28 mandatory) were executed.

On the basis of the Regulations on Privatization of State and Municipal Property by Way of Public Sale passed by the Government of the Republic of Lithuania, the NSEL established the procedure for the public sale of objects undergoing privatization. The experience of other countries shows that privatization of state enterprises through the stock exchange fosters the promotion of the national investing community and creates conditions for the residents to participate in the capital market. It further contributes to the understanding of its functioning principles and to evaluating the importance of the capital market in the

development of the national economy. However, privatization transactions accounted for a mere fraction of 0.2 per cent of the total NSEL turnover. The government policy and public awareness may have been a cause of this failure at the moment. The improvement of the legal environment and the new trading system in place may stimulate the activity on the NSEL in the privatization plan, while public awareness was one of the important contributions of the Project itself in funding the program carried out by the NAFB (see below).

### 3.3. NATIONAL ASSOCIATION OF FINANCE BROKERS

Under the Project Task Order, Pragma agreed to continue assistance to all the Project's counterparts including the NAFB, an important market participant. This assistance concerned primarily organizational development of the NAFB, broker training, and enhancing public awareness of the capital markets.

As the total number of FBFs was reduced due to the concentration processes on the market discussed above, the number of member firms in the NAFB decreased too, from 26 in 1997 to 21 in November 1999. Only two FBFs were refused membership because of failure to pay membership dues and meet other requirements. However, the qualitative structure of the NAFB has improved, and of all market participants, NSEL members, are the most active members of the NAFB. The weight of the NAFB in decision-making concerning market development has increased considerably. The NAFB representatives participated in the work of the Selection Committee that assisted in selection of the automated trading system for the NSEL. Their feedback was always taken into account when new regulations were prepared by the LSC or the NSEL.

Although only one of Pragma's consultants, former NASD examiner, **James Ryan**, provided direct assistance to the NAFB, his contribution was highly appreciated and it led to completion and adoption of a Code of Ethics of Intermediaries of Public Trading of Securities ("Code of Ethics"). It is notable that the same Code of Ethics was approved by the LSC for the non-members of the NAFB (membership in the NAFB is voluntary). Former Chief of Party **Kevin O'Hara** established an excellent relationship with the President of the NAFB, **Romas Matiukas**, and provided much advice concerning the organizational development of the NAFB and enhancing public awareness of the capital markets.

#### 3.3.1. The Code of Ethics of Intermediaries of Public Trading of Securities

Drafts of the Code of Ethics were prepared during the first year of the Project's implementation, yet only through the direct participation of Mr. **Ryan** was it possible to finalize the draft and reach consensus among the brokerage community on many issues that had been previously disagreed upon. The Code of Ethics was passed in December 1997 and came into effect from January 1, 1998. As a next step and after consultations with Mr. **Ryan**, an Ethics Committee was established. The committee was comprised of seven members and designed to process complaints against NAFB members received from other market participants or the public with regards to their activities. The Ethics Committee functions in compliance with the Working Regulations of the Ethics Committee, Rules on Imposing Sanctions on the NAFB Members, and Ethical Principles of the Ethics Committee, passed by the NAFB following the adoption of the Code of Ethics. The Ethics Committee meets once a month, unless there is a pressing issue to discuss, in that case, they meet as needed.

Paragraph 16 of the Code of Ethics requires that each member firm have the Order of Internal Control prescribed to its staff. To meet the requirement, all brokerages prepared and approved their own Rules of Internal Controls. Extensive training on internal controls and risk management was provided to the brokerage community and other market participants in three-day seminars conducted by **James Ryan** and **Donald Buddenbohn** (see the section on training below).

As the NAFB human and financial resources are limited, an arrangement was made with the LSC concerning enforcement of the Code of Ethics. An Agreement was signed between the LSC and the Ethics Committee that all violations or misconduct discovered by the LSC inspectors and complaints against the NAFB members received by the LSC be transferred to the Ethics Committee of the NAFB for further investigation. The arrangement proved successful, as both the LSC and the NAFB could co-ordinate their efforts in prevention of violations. Furthermore, sanctions applied by members of the same industry seem to have more effect than those imposed by a government unit.

During the years 1998 and 1999, the Ethics Committee analyzed five cases. Sanctions were imposed in two cases. Although the Rules on Imposing Sanctions provide for four types of sanctions, i.e. a warning, a public warning in a means of mass media, a fine, and exclusion from NAFB members, so far only a warning and a public warning have been applied, the latter being especially effective.

In October 1998, Mr. **Ryan** drafted a Code of Procedure to be applied in cases of offence. The brokers consult this Code in drafting their own procedural rules, yet at the moment the market is not sophisticated

enough to implement the procedures proposed in it. The NAFB intends to continue work in the same direction.

### **3.3.2. Capital Market Internet Web Page**

The capital market web site page originated from a capital market newsletter *Bull Sheets* created to educate foreign and domestic investors about the Lithuanian capital market and to promote the NAFB. The success of the newsletter inspired the idea to transfer the page to the Internet in order to provide interested readers with more timely and accurate information and data concerning the Lithuanian capital market.

The page is updated weekly and informs readers about the latest developments in the capital market, the week's news, trading results and comments thereon, features of public companies, investment company problems, and many other issues. Writers were journalists, students, Pragma staff, and brokers that were asked to participate. **Diana Sokolova** was the coordinator of the page. Ms. **Jurga Dermontaitė** and **Vita Markevičiūtė** were active writers and were simultaneously doing market research on the listed Lithuanian companies in order to encourage investment in them. The feedback received included letters and e-mail messages inquiring for more detail, asking for advice, or expressing appreciation. At the completion of the Task Order (before the last extension) the WWW page was taken over solely by the NAFB.

### **3.3.3. Public Awareness Program**

It is no secret that after six years, the NSEL and other market institutions' public awareness of the capital markets is very low. Although the NSEL and the LSC took their own steps in the promotion of the capital market through national dailies and TV, these measures were not sufficient. With the assistance of Pragma, the NAFB carried out a program of lectures to promote the stock market, to explain its mechanism and procedures, and encourage stock investment. The program was called "Securities as an Option for Investment". Lectures were delivered in six major towns of the Republic of Lithuania, including Vilnius, Šiauliai, Panevėžys, Klaipėda, and Marijampolė, and attracted 143 listeners. Another lecture course was prepared for the employees of the Ministry of Interior. The officials of this ministry often have to deal with economic crimes, in which different aspects of the stock market functioning are involved. Thirty people participated.

## **3.4. CENTRAL SECURITIES DEPOSITORY OF LITHUANIA**

The Pragma's assistance to the CSDL was fragmented, yet, it was nonetheless important. Most often, expertise from the local legal and financial advisers was employed when amendments to the Securities Law and the Company Law were being prepared and especially when drafting the Rules on Securities Accounting and Circulation. Besides, specialists of the CSDL took an active part in all training events that were organized by the Project (see the section on training below).

The last project of major significance that the Pragma team helped to accomplish before the modification of the Task Order was the Rules on Accounting of Securities and their Circulation. As no ex-pat advisers were available from January through April 1999, local Pragma employee **Gediminas Rečiūnas** was asked to assist specialists of the CSDL on the legal aspects of these Rules. **Evaldas Valčiukas**, the other legal advisor of the Project, also worked on certain sections of these rules.

The Rules on Securities Accounting and Circulation were adopted on May 7, 1999 to replace the ones passed in 1993 and last amended in 1995, before the Law of Public Trading in Securities of the Republic of Lithuania was passed (in January 1996). The former Rules no longer reflected the market situation or the requirements for securities settlement in the current trading environment. Therefore, the new version of the Rules was among the priorities of the CSDL, the LSC and the broker/dealers as they were to address many issues of securities accounting and settlement. They were quite detailed and required careful consideration from both an accounting and a legal perspective.

The Rules on Securities Accounting and Circulation include provisions on local and international custody of securities, and transactions executed on the NSEL (both central market transactions and block trades) to be reflected in the securities accounts operated by intermediaries and the CSDL. They also include provisions on securities transfers among intermediaries (operators of securities accounts) and recording of OTC transactions in the securities accounts. Many other important issues are also addressed. With the adoption of the Rules on Accounting of Securities and their Circulation the Lithuanian capital market has passed into another, more sophisticated level of its development.

#### 4. MARKET RESEARCH

Market research that was carried out by the local Pragma team aimed at one of the objectives of the Task Order – (3) to continue to establish the capital markets as a viable alternative to the banking sector for

investments and savings. Primarily, the task was performed to increase public awareness by writing feature articles about Lithuania's best companies and sectors (see section 3.3.2), lecturing (see sections 3.3.3. and 5) and supporting the LSC and the NSEL in their research analyses.

The Pragma team was regularly asked to do research on different issues of capital markets functioning, such as, analyzing the status of agricultural producers' shares when the official position of the LSC had to be worked out, and analyzing periodical information received by the LSC from the issuers. (The NSEL carries out a thorough analysis on the financial performance of about 70 listed companies. The scope of enterprises under supervision of the LSC is much larger - there are about 1500 enterprises reporting to it.)

In March and April of 1999, Dr. Paškevičius carried out market research on acquisition and disposal of blocks of shares during 1998. The results of this analysis were incorporated into the LSC Annual Report. He also instructed the staff of the LSC on processing of information received from the issuers concerning those acquisitions and disposals.

## 5. RESOURCE LIBRARY

A resource library was augmented from the outset of the Project's implementation. Each extension of the Project guaranteed additional inflow of books and materials on regulatory issues and other capital markets topics for use by market participants. The library includes books and materials, videotapes, audiotapes and slides (79 items). In April 1999, at the end of the USAID assistance to the LSC, NAFB, and CSDL, these books were donated to the LSC, the counterpart that agreed to make them publicly available. Although the NAFB had also interested in operating the library, the LSC was the more practical choice as the library is housed in the same building as many brokerages, the LSC, CSDL, the NSEL, and is also open to the public at large.

Besides the resource library, the LSC, the NSEL, and the NAFB received donated computers, a copier, fax machines, telephones, and other office equipment that had been used by the Project until its completion.

## 6. TRAINING

The training of Lithuanian market participants under the Task Order was designed to maximize rapid skill transfer to assure that Lithuanian nationals were able to operate and maintain the systems and

organizations being established. Therefore, during the Project implementation, training was an on-going process. It took various forms from individual consulting to seminars and workshops conducted to meet the needs of different categories of clients (broker candidates, brokers, directors of listed companies, other financial intermediaries, judges, NSEL and LSC staff). The level of expertise attained by the counterparts' staff members has increased immensely compared to the situation at the beginning of the Project. The role of the project management in this process cannot be overstated.

The first training event, which was held in conjunction with the extended Task Order, was a seminar on Margin Accounts conducted by **James Ryan** (October 1997). The seminar was organized in four sessions: two for the staff of the LSC, and two for the brokers. Two members of the CSDL attended the seminar. This topic was of great interest to the professional traders even though it is currently not permitted.

During late December and early January 1998 **Bill Gorman** gave presentations to broker/dealer members of the NAFB and to the staff of the NSEL on trading systems. The eighteen participants represented seven institutions.

Later in the spring, the chief of party, **Dow Heard**, worked with **Dorothy Ballantyne**, an International Executive Service Corps volunteer, to prepare a presentation on mutual funds to a large group of brokers and government advisors. Ms. **Ballantyne** was advising the largest Lithuanian brokerage firm, Vilfima VB, with regards to investment funds and management enterprises. Pragma supplied her with knowledge on the current status of regulations, arranged meetings with counterparts, and helped to arrange a seminar on investment funds to the NAFB members.

The seminar was held on March 10, 1998 with approximately 50 participants. It dealt with the advantages of mutual fund ownership, the U.S. mutual fund industry, the ways investors and funds make money, organization and functions of funds, distribution, pricing, analysis, promotion, and types of accounts.

On October 6-8, 1998 a three-day seminar was held on Internal Controls and Risk Management conducted by the Pragma consultants **James Ryan** and **Donald Buddenbohn**. This seminar attracted a great deal of attention and was attended by over 30 people each day. The participants of the seminar were staff members of the LSC, the NSEL, the CSDL, brokers and managers of brokerage firms and brokerage departments of banks. The presentation included videos and Power Point slides to illustrate the material.

The speakers answered questions and provided practical examples of risk management and good internal controls.

**Liucija Naudžiūnienė**, head of Market Regulation Department of the LSC, stressed the timeliness of training on the issues that were discussed in the seminar. In view of the Russian financial crisis and capital crisis in Asia, risk management was becoming more and more significant for each company participating in the securities business. Good internal controls ensure better risk management. Having adopted capital adequacy requirements in 1998 (they were also prepared by experts of the Pragma team), requirements for risk management were set forth. The Rules on Internal Controls were drafted by Mr. **Buddenbohn** in the spring of 1998 and were adopted soon after the seminar. Broker/dealers also adopted their Rules of Internal Controls at the beginning of 1999. Mr. **Buddenbohn**'s draft was taken as a model.

At the end of 1998, **Stanley Judd** instructed the staff of the Investment Companies Department on the regulation of pension funds in the US. He also commented on the draft Law on Pension Funds of the Republic of Lithuania and participated in the discussion thereof.

In February 1999, a seminar on International Accounting Standards (IAS) was organized by the Pragma team and conducted by **Skirmantas Rimkus**, the Project's financial advisor, to enlighten the participants on changes in the financial disclosure requirements of companies based on the IAS in the new Rules on Securities Registration and Public Trading. The seminar was attended by the staff of the LSC (16 people), the NSEL (3 persons), the CSDL (2 persons), and the Pragma office. The same requirements for financial information disclosure are incorporated in the Trading Rules of the NSEL. Therefore, it is essential that all employees working with the accounts submitted by the issuers understand all aspects of the new requirements.

Lectures were delivered to the broker candidates getting ready for the qualification examinations. **Dr. Arvydas Paškevičius** gave lectures on "Taxation of Financial Institutions and Financial Operations" and "Financial Ratios: Liquidity, Profitability, Assets Utilization, and Market Value Ratios" to brokers and other interested persons.

A number of market participants, staff members of the LSC and the NSEL, received assist in covering participation fees or accommodation and travel costs to make their participation at international training events possible. These included the European Forum on Financial Policies in Luxembourg, IOSCO

Europe Regional Committee Conference in Montreal, Canada, the Course RPG IV Advanced Topics in IBM in Basingstoke, UK, Bourse Development of Securities in Central and Eastern Europe and Russia, in Paris, and others.

## 7. CONCLUSIONS

As discussed above, there were many achievements in the area of market development, new regulation of the market, training of market participants and procurement of the hardware for the NSEL. The technical assistance extended during this program has dealt with important issues in the development of several Lithuanian institutions that are key to the future development of the Lithuanian capital market.

Prime among these institutions is the LSC, which, during the course of the project, has been effectively established in law and provided with the necessary tools to carry out its mission. The Project has been highly successful in assisting the LSC in drafting proposed amendments to laws and regulations, as well as providing legal and financial consultants to work with the staff of the LSC on a daily basis. The project has witnessed the growth of this institution in all respects, especially in the qualification of the staff, which now can successfully operate without any regular guidance.

During the last two years, the NSEL has introduced continuous trading. New hardware was procured to support its trading system. This will facilitate further growth of the NSEL in particular and the capital markets in general, especially in light of the creation of a joint Baltic List of the most prominent companies in the three Baltic States for cross-country trading and the negotiations with NOREX Alliance (the Bourses of Norway, Sweden, and Denmark) and with regard to cross-membership. The common Baltic market is in the plans of the Lithuanian, Latvian, and Estonian stock exchanges, which makes the upgrade of the trading system especially timely.

The NAFB has established itself as an authoritative institution too. Although the number of brokerage firms has decreased considerably due to the consolidation processes, all major market participants are members of the Association. The fact that the Code of Ethics of Intermediaries of Public Trading was successfully adopted and approved by all member firms is the best indication of the positive developments within the industry.

The assistance provided to the CSDL, though rather fragmented, helped to foster rapid adoption of certain rules and regulations, in particular, the Rules on Securities Accounting and Circulation. Also, employees of the CSDL were very active participants in all training events organized by the Project.

It is difficult to list all the achievements of the Pragma team during the course of the Capital Markets Development Project. The innovation of the Project staff and the enthusiasm of counterparts led to the creation of an Internet page for the Lithuanian capital markets to be continued by the NAFB, the fulfilment of a public awareness program, the development of a resource library, and especially extensive training. Market research was carried out on issues such as, the role of the tax system in discouraging capital raising and secondary market trading of equity securities, as well as on appearance of local investment funds. Other market research topics included the state of shares of agricultural producers in the country, and the effects of capital adequacy requirements on FBFs. These studies led to amendments of the securities and investment company laws, which are expected to bring about positive effects on the future development of the capital markets.

It is noteworthy that the local professionals hired by Pragma had a unique chance to work in close guidance of far more experienced colleagues from the US. They accomplished a lot and gained even more in the field that was new to most of them. Today they work for private firms (e.g. Žilvinas Zinkevičius works with one of the largest legal firms, Vita Markevičiūtė became an employee of "Balticum Management", a brokerage and consulting firm, Skirmantas Rimkus, Gediminas Rečiūnas, and Jurga Dermontaitė were hired by a private Swedish bank "Vystymo Bankas"; Evaldas Valčiukas is a legal advisor with the LSC and continues work on investment management; Diana Sokolova, Pragma's office manager, works for the NSEL as a public relations director).

Naturally, there are areas in which continuous efforts will be needed for future growth. Secondary market institutions are suffering from a lack of volume. However, it seems that this has little to do with the design of trading systems and more to do with the economic situation in general. Today it is far from favorable. The Asian financial crisis and especially the Russian crisis had grievous consequences on the development of the Lithuanian economy in general and the capital markets in particular. Trading volumes dropped, investment activities are sluggish, and most foreign investors view Lithuania as part of the region in crisis where the investing capacity of the residents is limited.

Nevertheless, despite these many obstacles, the Lithuanian Capital Markets have made tremendous progress in the past two years. All the key institutions of the market have made marked advances in developing, organizing, staffing, and implementing new programs. We are proud that Pragma, through the Capital Markets Development Project, was part of their success.

**APPENDIX A****PROJECT SEMINARS WITH ALL COUNTERPARTS**

<b>Activity Title</b>	<b>Speaker, date</b>	<b>Number of attendees</b>	<b>Comments</b>
Margin Accounts	James Ryan, October 1, 1997	13	Seminar for the LSC
Margin Accounts	James Ryan, October 8, 1997	15	Seminar for the LSC
Margin Accounts	James Ryan, October 16, 1997	40	Seminar for the NAFB
Discussion on the Capital Adequacy Rule	James Ryan, Donald Buddenbohn, Skirmantas Rimkus, October 16, 1997	26	Discussion
Automated Trading System	Bill Gorman December 22, 1997	12	Seminar
Automated Trading System	Bill Gorman January 5, 1998	16	Seminar
Mutual Funds in the USA	Dorothy Ballantyne, March 10, 1998	49	Seminar conducted by FSVC consultant with the assistance of Pragma

Mutual Funds in the USA	Dorothy Ballantyne, April 7, 1998	21	Seminar conducted by FSVC consultant with the assistance of Pragma
Internal Controls and Risk Management	James Ryan, Donald Buddenbohn, October 6-8, 1998	Over 30 people every day	Three-day seminar
Pension Funds in the US	Stanley Judd, December 1998	7	A workshop for the Invest. Companies Department of the LSC
Financial Ratios: Liquidity, Profitability, Assets Utilization, and Market Value Ratios	Arvydas Paškevičius	About 35	A lecture
The Fiscal Policy of the Lithuanian Government	Arvydas Paškevičius	About 26	A lecture
International Accounting Standards	Skirmantas Rimkus	21	Seminar for the LSC
IOSCO Europe Regional Committee Conference in Montreal, Canada	April 22-26, 1998	1	Conference, with the Project's financial assistance
Course RPG IV Advanced Topics in IBM in Basingstoke, UK	March 30, 1998 – April 2, 1998	2	Training courses, with the Project's financial assistance
European forum on Financial Policies, Luxembourg Bourse	June 6 - 8, 1998	1	Convention, with the Project's financial assistance

Development of Securities in Central and Eastern Europe and Russia, in Paris	October 20-21, 1997	1	Workshop, with the Project's financial assistance
CEEPN Academy – Fall'97 in Ljubljana, Slovenia	October, 1997	1	Training course, with the Project's financial assistance
Capital Markets Conference in Bucharest	November 4-6, 1997	1	Conference, with the Project's financial assistance
International Conference on Accounting Standards/ Capital Markets, in Brussels	March 9 – 12, 1998	2	Conference, with the Project's financial assistance
Securities as an option for investment		173	With the Project's financial assistance
<b>TOTAL ATTENDEES</b>		<b>577</b>	

### Training Statistics

	<b>In-country Female</b>	<b>In-country Male</b>	<b>3<sup>rd</sup> country Female</b>	<b>3<sup>rd</sup> country Male</b>
Oct-Dec 1997	30	76		4
Jan-Dec 1998	67	78	3	3
Jan-Dec 1999				

Note that only statistics on training market participants is included, not on lectures or courses for the public at large.

**APPENDIX B****LIST OF EFFECTIVE LSC, NSEL, AND CSDL REGULATIONS PREPARED WITH THE ASSISTANCE OF PRAGMA****Rules Regulating Activities of Intermediaries of Public Trading of Securities**

1. Provisional Rules on Capital Adequacy Calculation of Finance Brokerage Firms (Resolution No.38, 22 12 1998).
2. Rules on Agreements between Finance Brokerage Firms and their Clients (Resolution No.31, 16 10 1998)
3. Rules on Acceptance and Execution of Clients' Orders (Resolution No.25, 10 07 1998).
4. On the Code of Ethics of Unassociated Intermediaries of Public Trading of Securities (Resolution No.5, 06 02 1998).
5. Rules on Calculation of Capital Adequacy of Finance Brokerage Firms (Resolution No.26, 21 11 1997).

**Rules Regulating Trading on the NSEL and on the OTC Market**

1. Trading Rules of the AB "National Stock Exchange of Lithuania" (Resolution No.36, 22 12 1998).
2. Rules on Submission, Registration, and Implementation of a Tender Offer (Resolution No. 7, 20 02 1998; supplemented by Resolution No.16, 15 05 1998).

**Rules Regulating Disclosure of Information about the Issuers' Activities, Registration and Offering of Securities**

1. Rules on Periodical Disclosure of Information about the Issuers' Activities and their Securities (Resolution No.1, 15 01 1999) - a new wording became effective from July 1, 1999.
2. Rules on Registration and Offering of Securities (Resolution No.35, 22 12 1998) - a new wording became effective from April 1, 1999.
3. Rules on Disclosure of Information about the Issuers' Material Events (Resolution No.6, 17 05 1996; Resolution No.1, 23 01 1998; Resolution No.15, 15 05 1998).

4. Rules on Rights Issuance and Offering (Resolution No.27, 04 12 1997).
5. Rules on Notification about Acquisition of a Block of Shares (Resolution No.2, 31 01 1997; Resolution No.14, 01 05 1998).

#### **Rules Regulating the Activities of Investment Companies and Investment Management Enterprises**

1. Rules on Concluding a Securities Portfolio Management Agreement with the Clients of Investment Management and Consulting Firms (Resolution No.6, 29 01 1999)
2. Rules on Issuance and Revocation of Licenses of Investment Management Enterprises (Resolution No.23, 26 06 1998).
3. Rules on Issuance and Revocation of Licenses of Investment Companies (Resolution No.30, 05 10 1998).

#### **Rules Regulating Accounting of Securities**

1. On the Procedure of Acceptance and Execution of Banks' Instruction to Transfer Pledged Securities Issued by the Government of the Bank of Lithuania into their Accounts (Resolution No.19 29 08 1997).
2. General Accounting Rules of Securities and their Circulation at the CSDL (Minutes No.38, 05 08 1993)

#### **Rules Regulating Imposition of Sanctions according to the Law on Public Trading in Securities of the Republic of Lithuania and Other Legal Acts**

1. Rules on Identification of Insider Trading Dealing with Material Events (Resolution No.29, 04 12 1997).