

PD-ABS-332
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LATVIA:
**CAPITAL MARKET
DEVELOPMENT PROJECT**

FINAL REPORT

U.S. Agency for International Development
Contract # EPE-I-00-95-00039-00
Task Order No. 5

June 2000

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** All deliverables were provided to USAID with the project's monthly reports. Given their size, they are not included with this document.

LATVIAN CAPITAL MARKETS PROJECT FINAL REPORT

I. Introduction

Latvia, one of the most advanced parts of the old Soviet Union, is currently on the forefront of the countries seeking to join the European Union and become a democratic, market-oriented society. The Latvian Capital Markets Project provided timely and significant assistance to the capital market institutions in a period when Latvia had to adjust to a severe crisis in the Russian financial system and turn its business and financial focus to the West. With help from the United States Agency for International Development (USAID) and other western donor institutions, the Latvian government, economy and society completed an extraordinary and difficult refocusing of its economic activity towards Western Europe and Scandinavia which hopefully will pave the way for its early admittance to the European Union.

II. Project Background and Tasks

Previous projects had assisted in the creation of the Riga Stock Exchange (RSE) and the Latvian Central Depository (LCD). The Securities Market Commission (SMC) was created after the commencement of the operations of the RSE and the Latvian Central Depository as part of Latvia's efforts to improve the operation and regulation of its financial markets for harmonization with and entry into the European Union. The Capital Markets Project was designed to assist these institutions in establishing sound market and regulatory practices to increase the flow of capital into Latvia and improve the economic conditions of the country.

The Task Order and its Modification specified three broad objectives:

- ◆ To develop the regulatory capacity of the Securities Market Commission of Latvia (SMC) by continuing to provide assistance in the comprehensive reform of the legal environment and further development of the regulatory environment as it applies to the Republic's capital markets;
- ◆ To continue providing assistance in the comprehensive reform of the financial reporting system currently in use in Latvia, with the Latvian Association of Sworn Auditors (LASA) and the Latvian Association of Accountants (LAA) being the main counterparts; and
- ◆ To continue assisting the Riga Stock Exchange (RSE) and Latvian Central Depository (LCD) in developing into commercially viable trading, clearance, settlement, and depository mechanisms while maintaining and improving systemic integrity and providing for the continued professional development of market participants.

These efforts are designed to continue stimulating the growth of an emerging market economy in Latvia.

III. Project Implementation

A. Developing Regulatory Capacity of Securities Market Commission

1. Developing the Infrastructure of SMC

a. Organizational Structure of SMC

The project began the assistance to the SMC by undertaking a structural analysis of the SMC's organization, operations and technical capacity to handle its mandate. The analysis resulted in recommendations to the SMC to institute new procedures for handling its activity. The SMC accepted many of the recommendations, the first of which was to hire an attorney/government liaison staff member to assist the SMC in dealing with the Latvian government in regards to new legislation and the appointment of another attorney to handle the issues of harmonization with the European Union and Baltic integration issues. In addition, a Press Officer was appointed to handle the SMC's relations with the press.

The analysis also showed the importance of establishing a database that was Commission-wide, which would create greater access to information throughout the SMC. The automation of the SMC's activities would enable it to do more with the minimal staff that it had been given. The SMC requested that this activity be given priority.

The organization of the SMC also needed to be clarified as to the responsibilities of staff members within the general organization of the system. Job descriptions tied to the organizational structure were the best way to accomplish this and the SMC during the period of the project established job descriptions for its employees.

Finally, the procedures for handling investor complaints were organized and standardized for use by all staff members.

b. Budgetary Analysis

During the discussions with the management of the SMC, it became apparent that the Commission suffered from serious budgetary limitations. As a result, Barents provided a consultant who began analyzing the SMC's operations with a view towards providing a recommendation to the Commission on organization and budgeting so that the Commission could obtain adequate resources to fund Commission operations. The Consultant worked closely with the Chairman and Vice Chairman of the SMC to develop budget planning for the SMC. His final report included a computer based budgeting program for the SMC to use which could modify the budget depending on varying financing scenarios.

The SMC also decided to proceed along a path leading to self-funding. In that regard, legislation was proposed by the SMC, and approved by Parliament, to allow the SMC to retain fee income derived from industry participants. The Barents advisor also prepared an Excel model to support the Activity Based Costing Analysis for the SMC, which was used to justify a change in its fee structure. This assisted the SMC in developing a method to implement a means by which fees could be charged to market participants to help fund the activity of the SMC.

Barents was also requested by the SMC's senior management to assist in the task of developing a budget model for the Consolidated Regulator (consisting of the SMC, the Insurance Inspectorate, and the bank supervision arm of the Bank of Latvia). The Consolidation of the Financial Regulators was the goal of the Latvian government and the SMC's Chairman had been put in charge of the project. The Barents advisor collected and analyzed background information relating to the Insurance and Bank Supervision agencies and consolidated financial regulation in other countries (e.g., U.K., Australia, etc). These provided precedents for the development of a framework for the estimation of transition costs and a consolidated budget for the proposed Consolidated Regulator and a model budget were prepared. As a result of this assistance, it was hoped that the securities regulatory function would not suffer in such a reorganization.

c. Development of the Data Base of SMC

In keeping with the analysis of the SMC's needs, Barents began work with the IT and Operational Departments of the SMC to establish the structure and parameters of the SMC's databases for registrants and issuers. Barents Advisors assisted the SMC in refining its statement of business requirements for the development of its internal database to accommodate registration data as well as financial information filed by SMC-licensed entities. Based on these requirements, Barents procured the hardware and software components needed by SMC. Delivery of these items to Latvia occurred in early 1999.

A Barents advisor assisted the installation of the information technology infrastructure for the SMC by reviewing SMC plans for deploying Microsoft BackOffice and providing recommendations and guidance and developing a plan outline for implementing Microsoft BackOffice. He also developed other applications to support the Securities Market Commission. In doing so, he investigated the feasibility of using Microsoft Outlook 98 in conjunction with Microsoft Exchange to develop different applications, especially those applications for collaboration and knowledge management. (Knowledge management refers to formal actions taken to capture and evolve organizational knowledge--expertise and experience--for use throughout the Commission, to retain the knowledge of departed staff, and to bring new staff up to speed more quickly.)

One of the goals of this work was to establish a means to capture knowledge that would otherwise be lost upon departure of staff and to be able to make it readily available upon accession of new staff. A key means of accomplishing this goal is to create a so-called 'knowledge repository' that maintains laws, rules, policies, procedures, sample

documents, and lessons learned. This was accomplished by identifying organizational processes and the facilities needed to effectively and efficiently support these processes.

3. The Legal Capacity and Regulatory Structure of the SMC

The initial effort of the Barents Advisors consisted of the following:

- ◆ The analysis and delivery of detailed comments on proposed legislation that would authorize the SMC to license and regulate the operation of investment companies; and
- ◆ The compilation and review of an inventory of laws affecting the securities industry with the objective of recommending amendments that the Barents team of advisors considered to be essential.

Subsequently, Barents activities centered on the efforts of the SMC to prepare modifications to the Law on Securities and the Law on Joint Stock Companies for consideration by the Latvian Parliament. Barents consultants prepared an exhaustive analysis of these two laws for consideration by the SMC. They also participated in regular working group meetings on the laws with the SMC staff. By April 1998, the recommendations on the Law on Securities and Law on Joint Stock Companies had been completed and submitted to the Commission.

Barents Advisors continued to provide specialized legal assistance to the SMC in the form of draft regulations and research memoranda in specific areas requested by the SMC's senior management:

- ◆ The regulation of setting record dates for distribution of corporate dividends;
- ◆ An analysis of EU Directive 77/91, Rule 10b-18 under the Securities Exchange Act of 1934, and Article 35 of the Latvian Law on Joint Stock Companies (and Article 246 under the Draft Commercial Law) to illustrate different approaches to the regulation of issuer buy-backs;
- ◆ A draft regulation to implement the SMC's authority to review and approve rule changes proposed by the RSE and LCD under Articles 33(2) and 44(1)-(2) of the Law on Securities; and
- ◆ A series of draft regulations to implement Article 64 by standardizing disclosure requirements and procedures that must be satisfied by persons acquiring significant stakes in joint stock companies;
- ◆ Draft Rule 65 to implement Article 65 of the Law on Securities relating to the acquisitions of control blocks of shares and tender offers; this material included information schedules to be filed by the tender offer bidder and the target company; these tender offer provisions were drafted in conformance with a proposed EU Directive on take-over bids;

- ◆ Policy guidance on a “mandatory bid” requirement in conjunction with the draft rule to implement Article 65;
- ◆ A draft policy statement providing specific guidance on how the SMC can protect the confidentiality of certain information filed by regulated issuers; this material was patterned after established procedures followed by the U.S. Securities and Exchange Commission;
- ◆ Interpretative advice regarding Article 40 of the Law on Joint Stock Companies, in the context of a simultaneous public offering and private placement by a major Latvian company;
- ◆ Guidelines for the protection of minority shareholders in a going private transaction;
- ◆ The role of proxies at shareholders meetings;
- ◆ Disclosure requirements for debt securities;
- ◆ Disclosure requirements for "closed issue" securities (private placements);
- ◆ Capital structure of a joint stock company under the new Commercial Code; and
- ◆ Issues related to preferred shares and convertible bonds;
- ◆ Analyzing the current regulation of settlement in Latvia by the LCD to determine if it was in harmony the European Union Regulations; and
- ◆ Developing regulations related to takeovers of public corporations, including advice, as needed on amendments to the Commercial Code related to the Section on Joint Stock Companies, which will replace the Law on Joint Stock Companies that currently exists.

4. Enforcement Capacity

Barents began its training of the Department of Enforcement of the SMC with extensive training to the Department’s staff on market surveillance. At the recommendation of Barents’ Chief of Party, a terminal was installed at the SMC that was connected to a line providing a direct feed of trading activity from the exchange. As a result, Commission staff began monitoring the market on a daily basis.

Barents Advisors also worked on developing the SMC’s enforcement capabilities by conducting training classes for the SMC staff. This training assisted the SMC in refining its processes for conducting on-site inspections and investigating possible violations in order to bring enforcement actions. The training provided included the following subjects:

- ◆ Boiler Rooms and Pyramid Schemes;
- ◆ Surveillance Techniques;
- ◆ Market Manipulation;
- ◆ Equity Options;
- ◆ Conduct of a Registrant During an Examination;
- ◆ Investigating Non-Registrants;
- ◆ Insider Trading; and
- ◆ Unauthorized Trading/Misuse of Client Information.

5. Market Surveillance System of the SMC

In conjunction with the installation of the hardware upgrades to create the SMC's database, Barents Advisors assisted the SMC in the development of automated market surveillance techniques and related investigative procedures. At Barents' recommendation, the SMC dedicated a full time staff member to this regulatory activity.

The Barents Advisor worked with the SMC staff member to build his understanding of illicit market practices; develop data process flows; and improve investigative procedures. Toward this end, the Latvian staff member and a Barents Advisor gave a presentation on December 15, 1998 to the enforcement training class to illustrate how the market surveillance function identified questionable activity by analysis of market data supplied by the RSE.

In addition, the Barents Advisor extended the market surveillance capabilities of the Securities Market Commission by identifying the post-break investigatory process that will be used to structure information in the knowledge repository. In so doing, he developed preliminary knowledge repository formats for violative behaviours, alerts, and documents.

6. Capacity for Supervision of Intermediaries

Barents Advisors worked with the Department of Market Oversight to develop examination modules, capital adequacy regulations and analytical procedures for evaluating broker/dealer activity. In addition, they assisted the Commission staff in their review of current examination procedures for individual brokers and recommended areas for examination and procedures for evaluating the effectiveness of questions presented on the examination.

Barents Advisors began this assistance to the SMC during the later part of January 1998 and began review of the improvements to the inspection and examination program of the SMC. Their first project was an analysis of the inspection of brokerage companies and banks registered as intermediaries to see if they complied with new capital requirements required by the Law on Securities. A Barents Advisor assisted the SMC in its examination of brokerage houses and banks registered as securities intermediaries to determine if they had met the increased capital requirements mandated by the Law "On Securities." A Barents advisor also conducted a review of three examinations of

conducted by the SMC of banks and brokerage houses registered as securities intermediaries. (Due to privacy requirements in the Latvian laws, the examination reports were redacted of all information that could identify the registrant or any individuals accounts held at the registrant). The review found that the SMC had made great strides in the scope and techniques of its examinations.

Barents Advisors continued their assistance in developing the SMC's examination ability by preparing drafts of an Examination Manual and examination modules for broker dealers, including work on customer protection, sales practices and supervision modules for the Examination manual.

As part of the assistance related to regulation of Broker/Dealers, the Deputy Chairman of the SMC requested that Barents Advisors assist the SMC in analyzing the new Capital Adequacy Rules of the European Union so that, along with the Latvian National Bank, it could meet with representatives of the European Union to discuss implementation of the new EU capital adequacy rules. A Barents Advisor prepared a memo explaining the new rules and an Excel model setting forth the steps for conducting an analysis of a broker-dealer's compliance with the capital adequacy requirements. In addition, he prepared a new draft Capital Adequacy Regulation for the SMC to consider for approval.

7. Capacity for Regulating New Instruments

a. Mortgage Backed Securities

A Barents Advisor arrived in September 1998 to provide technical assistance in the area of mortgage-backed securities and mortgage bonds. This specialized assistance was requested by the SMC because of the Government of Latvia's decision to implement legislation to create mortgage bonds in Latvia. This initiative is being advanced by a World Bank assistance program staffed by mortgage bond experts from Denmark. Nonetheless, the SMC requested that Barents provide an advisor who could provide some training that would concentrate on the economics of this segment of the bond industry and certain aspects of trading. Based on input from the SMC Deputy Chair, it was decided that the Barents advisor would cover the U.S. and German models. (The German model was chosen as Germany has one of the oldest and largest mortgage bond markets in Europe. Additionally, the SMC advised Barents that there are some similarities between the German model and the conceptual approach being followed in Latvia.)

With this background, the Barents Advisor prepared the presentation that was delivered to the SMC staff and subsequently to selected staff from the RSE and LCD.

b. Options

Barents Advisors prepared an Options Regulation and Training Course that was offered in March 1998 as a three-day seminar relating to the characteristics, functionality and regulation of financial options. (As part of that preparation, Barents Advisors worked with the SMC staff to conduct a survey as to the extent that securities options were being

used in Latvia). The seminar was given twice: first at the Ministry of Finance for the Financial Regulatory agencies and second at the Riga Business School for industry practitioners. Barents advisors also provided a one-half day section on the tax treatment of options, which was very well received.

8. Capacity for Regulating Investment Funds

Due to the fact that the investment fund industry has been slow to develop in Latvia, the SMC did not give it the highest priority for regulation. After the initial regulations were prepared in 1998 on a high priority basis, regulatory activity slowed. Nonetheless, as the excellent attendance at Barents's investment fund seminars showed, there is still great interest in mutual funds. A Barents Advisor assisted the SMC staff responsible for regulating investment funds by developing a preliminary set of examination modules. This will provide a sound basis for the SMC to develop practical examination modules when the industry begins functioning.

a. Training

A Barents Advisor conducted extensive training for the investment community on the subject of the formation and operation of investment companies. This consisted of a half-day course co-sponsored with the Latvian Business School to facilitate participation in a two-day Asset Management Conference hosted by the School. In addition, on June 1, 3, and 5, 1998, the Barents Advisor conducted a series of three, daylong workshops on the creation and management of mutual funds at the Riga Business School. Finally, as contemplated by the Task Order, these three sessions were videotaped.

A Barents Advisor returned to Riga in April 1999 to continue the work to assist the SMC and market participants in the development and regulation of investment funds. At the request of Maris Grinbergs, the Director at the Securities Market Commission responsible for investment funds, the Advisor prepared memoranda on specific problem areas related to funds, such as Standards for Executives, Diversification of Portfolios, Valuation of Securities and Mortgage Backed Bonds. Shortly thereafter he met with management and members of the Commission staff to discuss the covered subject and to answer their questions.

In addition, Grinbergs also asked that the Advisor deliver, once again, the Mutual Fund Seminar that he had delivered in June 1998. The seminar was conducted on 23, 26 and 28 of April, 1999. The topics covered were Mutual Fund Accounting, Marketing Funds, Shareholder Services, Portfolio Management including Investment Valuation, and the Organization of an Investment Management Company.

The Barents Advisor's major effort during May 1999 was to design, create and deliver a two-day seminar on Investment Analysis for the benefit of future mutual fund portfolio managers and other market professionals. The seminar was successfully delivered at the Riga Business School on May 10 and 12, 1999. Over forty people attended the two sessions and received certificates. The seminar covered Financial Statement Analysis;

Fixed Income Analysis and Portfolio Management; and Equity Analysis and Portfolio Management.

b. Supervision and Examination

During 1999, a Barents Advisor assisted the SMC in setting up a series of examination modules for mutual funds. Since no funds had begun operations, this was a preparatory training and development program. The Advisor reviewed all relevant regulations to determine how they would be approached from the standpoint of determining compliance with the regulations. In addition, he met with Talis Laizans, Deputy Chairman of the SMC, and Maris Grinsbergs, Director of the Issuer Department, who is responsible for mutual funds. Based on these discussions and analysis, the Barents Advisor prepared a set of Model Investment Fund Inspection Modules.

This set of Inspection Modules will need to be constantly updated and revised to meet the changing investment and market environment in Latvia. Nonetheless, it will provide a solid framework for advanced examinations in Latvia.

9. Regional Integration of Regulation

The three securities regulators from the Baltic countries, at the instigation of SMC Chairman Viktors Gustsons, began a process of harmonization of their regulatory schemes in 1997. Barents advisors went to numerous meetings in Riga, Tallin and Vilnius with the SMC delegation to assist in the harmonization process. During the course of the Project, the regulators made significant strides in harmonizing registration and qualification requirements for brokers and for the cross border listing and sale of securities.

10. Capacity for Oversight of Riga Stock Exchange and Latvian Central Depository

The Barents COP assisted the SMC in the area of supervising the activities of the RSE and LCD. In that regard, Mr. Kulczak prepared and presented a seminar in March 1999 regarding the supervision of stock exchanges and depositories (i.e., self-regulatory organizations) by a securities regulatory body.

In addition, at the request of the SMC, a Barents Adviser conducted an analysis of small order execution on the RSE. This memorandum was used as the basis for discussions between the SMC and RSE regarding small orders, their effect on the market, and the possible abuse of the current system to manipulate the market.

11. Capital Market Research

The SMC, at the encouragement of USAID Riga, conducted a study of the Latvian capital markets to determine the causes of the decline in activity on the Riga Stock Exchange and in the OTC market after the Russian crisis of Spring 1998 (which for Latvia was far more serious than the bond default in August 1998). Barents assisted the SMC in this

effort by providing two Latvian research assistants to the SMC. They worked under the supervision of the Deputy Chairman of the SMC. The SMC is using the research in developing its analytical framework and policies for dealing with the Latvian capital markets.

B. Assisting in the Comprehensive Reform of the Financial Reporting System in Latvia

1. Institutional Development of LASA and LAA

a. Development of LAA

1) Evaluation of Possible Strategic Alliance between LASA and LAA

In November 1998, a Barents Advisor completed an evaluation of a strategic alliance between the Latvian Sworn Auditors Association ("LASA") and the Latvian Accountants Association ("LAA"). The evaluation concluded that a merger of the two organizations is not advisable because of the disparate qualification requirements for membership in the respective organizations. For the near future, the Barents advocates assisting LAA in building its own certification program for accountants to increase the level of professionalism among accountants. Toward this end, Barents arranged for the LAA President, Mrs. Vilma Paupa, to attend the OECD conference on professional certification programs, "The Development of Training, Accreditation, and Licensing Programs for Accountants and Auditors in Transition Economies", which was held in Paris on December 7-9, 1998.

2) Development of LAA Certification Program for Latvian Accountants (Bookkeepers)

Barents Advisors met with Vilma Paupa, President of the Latvian Association of Accountants, on March 24, 1999, and reviewed the plan for the accountant certification program that will be introduced in September 1999. She and her assistant developed the program with the help of materials they gathered at the OECD seminar held in Paris in December 1998. The program consists of a series of review lectures to be delivered at the University of Latvia.

1. September – December 1999

Financial accounting practice and theory and Financial management and analysis

Barents expressed the opinion that, because the certified accountants would mainly be working within enterprises, the program should also incorporate management accounting.

2. Spring semester 2000

Business Law and taxation and Fundamentals of auditing

Coverage of auditing in the program is a very positive feature because it would provide a basis for the certified accountant program to constitute a second-tier audit structure. This is a feature that the current Latvian legislation lacks. All enterprises are required to be audited but, while large and medium-size enterprises are required to be audited by Sworn Auditors, there are no legislative controls over the audits of small enterprises.

Two examinations were to be administered: the first in December 1999, covering the first two modules, and the second, at the end of the Spring Semester, covering the last two modules. Certificates will be issued to the successful candidates by the LAA.

b. Certification of Latvian Sworn Auditors by LASA

A Barents Advisor arrived in mid-September 1998 to evaluate LASA certification processes and procedures for compliance with the European Union's Eighth Directive and the International Federation of Accounts (IFAC) International Education Guidelines. Compliance with these items is critical to qualify LASA for IFAC membership. Given the high priority of creating the standards setting body, the Certification Process report was finalized in January 1999.

c. Report on LASA's Organization for Entry to IFAC

A Barents Advisor developed a draft report that analyzed and made recommendations on the LASA's charter, mission statement, and committee structure; the definition of structural and institutional changes for IFAC membership; and certification processes and procedures for auditors. On February 15, 1999, the Barents Advisor delivered the Report on LASA's structure to LASA's President Sandra Vilcane.

d. Business Plan for LASA

A Barents Advisor prepared a business plan for LASA to assist in the establishment of its fee structure and financial planning.

2. Assistance in Establishing a Viable Mechanism for the Adoption of International Accounting Standards in Latvia

a. Phase One: Assessment of and Recommendations Regarding the Current Procedures for Drafting IAS by LASA

The procedure that existed prior to 1999 provided that the adoption of new accounting standards originated with the LASA Methodology Committee. It would develop and submit draft standards to the LASA Board for review, comment and approval. Thereafter, a standard would be submitted to the Accounting Consultancy Board for review/comment, and then, via the Ministry of Finance, to the Cabinet of Ministers.

With respect to the development and implementation of IAS in Latvia, a Barents Advisor produced a written assessment of the pre-1999 process and its problems, which examined

the work performed in drafting the Latvian version of the Cash Flow Standard under IAS. This process proceeded very slowly for several reasons: (i) the accounting professionals participating in LASA's Methodology Committee were active professionals volunteering their time and working without full time support staff; (ii) the legal framework for drafting and implementing IAS was cumbersome, and therefore time-consuming because standards issued by LASA were submitted to an independent Consultative Board appointed by the Ministry of Finance; and (iii) finally, the Council of Ministers was required to approve standards once they have passed scrutiny with the Consultative Board. Hence, the law recognized LASA as the drafter of accounting standards, while the Government of Latvia actually approved the standards before they could be implemented.

On June 9, 1998, the Barents COP and the Barents accounting team met with Mrs. Valentina Andrejeva and Mr. Dainis Mucins of the Ministry of Finance to discuss options for reforming the process of approving accounting standards in Latvia. Experience demonstrated that completed standards did not get approved by the Council of Ministers because they could not be readily formatted into regulations. Moreover, neither LASA nor the Accounting Consultancy Board had the technical expertise needed to format the standards according to the technical requirements of the Council. And, for reasons unknown, the MOF was not willing to provide the necessary technical expertise. Accordingly, the MOF pushed the formatting burden back on LASA.

Based on the June 9th meeting, Mrs. Andrejeva and Mr. Mucins seemed to agree, in principle, with a Barents proposal to remove the Cabinet of Ministers from the standards setting process for financial accounting standards. Toward this end, examples of other nation's models for standard setting were requested. A Barents Advisor completed a report on possible standard setting models that Latvia might adopt. In any event, a legislative amendment would be needed to implement any proposal to eliminate the Cabinet from the approval process.

b. Phase Two: Assistance to LASA in the Drafting of Latvian Accounting Standards Based on IAS

In order to expedite the process of LASA's issuing standards, a Barents advisor worked with the Association's Methodology Committee to draft a budget that would include two permanent support staff to handle clerical and administrative tasks and related overhead. The budget developed by the Barents Advisor (working with the Chair of LASA's Methodology Committee) was formally approved by the LASA Board on March 31, 1998. This budget included specific targets for the Methodology Committee's issuance of Latvian accounting standards harmonized to IAS. In this connection, Barents retained the services of an existing member of LASA's Methodology Committee to prepare draft standards for submission to the Committee. Additionally, Barents retained a language specialist to review the draft standards for consistency in usage of Latvian language and grammar.

Barents Advisors worked extensively on the development of Latvian Accounting Standards (LAS) harmonized to International Standards. During the period August 1998 and August 1999, this working group completed work on LAS 2, 7, 8, 10, 14, 16, 20, 21, 22, 23, 24, 27, 34, and the new IAS Standard 1 which comprised old standards 1,5, and 13.

c. Phase Three: Creation of the Latvian Financial Accounting Standards Board

1) Creation of Latvian Financial Accounting Standards Board Task Force

On September 11, 1998, Barents Advisors conducted a mini-workshop at LASA headquarters for LASA Board members to gain an understanding of the accounting standard setting process and the mechanisms used in neighboring countries. A follow-up meeting was convened on September 16 that included participants from LASA, Ernst & Young, the RSE, the Bank of Latvia, LAA, the State Treasury, the Ministry of Finance, and Barents. This meeting resulted in the formation of a Task Force. To further the search for an appropriate standard setting body, the Latvian Financial Accounting Standards Board ("LFASB") Task Force was formed to develop: (i) the most appropriate mechanism for setting accounting standards in Latvia and (ii) a draft of legislative changes needed to implement this initiative. At the first Task Force meeting convened on October 30, 1998, Barents' Advisors Dagnija Danevica and Ivars Ozols were elected to the posts of Chair and Secretary of the Task Force.

During November, the Task Force met on the 13th and the 27th to continue its work. The first meeting focussed on a discussion of proposed organizational structure and operating procedures for the new standards setting body modeled on those of the Financial Accounting Standards Board in the U.S. The second meeting focused on discussion of a model charter and a draft legislative proposal prepared by the Barents team.

During December, a Barents Advisor produced the following items in conjunction with development of the proposed Latvian Accounting Standards Board (LASB): (i) a draft Business Plan, Organizational Structure, and Budget Summary listing major revenue and expense categories; and (ii) a draft charter. Production of these items flowed from the Task Force's meeting on November 27.

2) Use of Latvian National Center of Standardization

The Task Force explored alternatives for official sponsorship of LFASB's pronouncements. One possibility was the Latvian National Center of Standardization and Metrology that operates as part of the Ministry of Economics. Research into the Latvian Standardization law was conducted and preliminary contact was made with the Standardization Center.

On February 2, 1999, Barents Advisors had an initial meeting with the Director of the National Center for Standardization and Metrology. He indicated a strong willingness to work with the Accounting Task Force to establish a means for the official promulgation and recognition of Latvian Accounting Standards based on International Accounting Standards. As a result of the meeting, the Barents team determined that the Latvian Standardization process, with the above-mentioned necessary statutory modifications, was an appropriate manner to promulgate voluntary accounting standards in Latvia. Consequently, preparations were begun to inform the Task Force and initiate the procedures provided for in the Standardization Law. To further the use of the standardization process to promulgate the Latvian accounting standards, a Technical Committee, required by the Law on Standardization, needed to be created to oversee the preparation of the Latvian Accounting Standards.

The date was set for Friday, May 14th, for the founding of the Latvian Technical Committee, "Latvijas Grāmatvedības standartu tehniskā komiteja" (roughly translated as the Latvian Financial Accounting Standards Board or LFASB). An ad was subsequently placed in the official governmental notice newspaper "Latvijas Vestnesis" which ran on April 14th (one month in advance, as required by "Latvijas Standarts" procedural rules), inviting all interested parties to attend. Barents also had prepared draft LFASB by-laws, using the standard by-laws provided by VSIA Latvijas Standarts as a base, which were distributed at the April 9 meeting to the Task Force participants for comments.

3) Creation of LFASB

The Latvian Financial Accounting Standards Board ("LFASB") was founded on May 21, 1999 after many months of hard work on the part of the Task Force. The 8 members of the Task Force voted unanimously to found the LFASB (including the RSE proxy). The seven attending members of the Task Force then voted unanimously to approve the draft by-laws as the official by-laws of the LFASB. The approved by-laws were submitted to Latvia Standards for official registration and approval on May 24.

The Task Force also agreed not to form a separate entity for LFASB at this time, leaving it under the auspices of VSIA Latvijas Standarts, but decided to explore the founding of a separate fund, which would be set up as a separate entity financing and supervising LFASB (as is the model with FASB in the US). This fund could accept donations and membership dues, and would be the entity accounting for the expenditures of the organization.

The Board of the LFASB is by far the most professional group assembled to address accounting standards issues since the start of the Capital Markets project.

4) Legislative Changes Passed

As news of the development spread in the accounting community of the development of the Task Force, a sub-unit of the Ministry of Finance proposed a modification to the Law on Accounting that would have radically changed the legal process for accounting reform

in Latvia. Barents was requested by the SMC to meet on March 1 and 2, 1999, to discuss the proposed statutory changes. On March 3rd, an internal Ministry of Finance (MOF) meeting was held to discuss the proposed changes to the Law on Accounting. Among the topics to be considered were changes dealing with the approval process of financial accounting standards.

The MOF's sub-unit had proposed a regressive, non-transparent approval process: closed procedures, 19 delegates appointed by the Cabinet of Ministers, and dominated by government employees rather than accountants. The SMC, represented by Talis Laizans and a Barents Advisor, successfully presented and defended a position that ran contrary to that of the original draft; namely:

- a) accounting standard adoption should be an open, transparent process governed by the Law on Standardization (Nov 1998); and
- b) Financial accounting board participants should be those with a direct interest in financial accounting and capital markets development.

This position also gained support from other, previously neutral, parties within the MOF, damaging the credibility of the initial proposal to the point that it was subsequently revised to take into account the SMC's position.

Had it not been for the relationship developed with the SMC, Barents would have never found out about the meeting or proposal until after the fact. The trust developed over the project term with this counter-party enabled Barents to present a solution to the SMC on short notice, which they were confident enough to successfully present as their own.

On July 8, 1999, the Latvian Parliament passed changes to Article 15 of the Law on Accounting, for which the members of LFASB had been lobbying. The President of Latvia signed this legislation on July 20, 1999.

The new law states that accounting standard approval is governed by the "Law on Standardization," marking a major victory for Latvian financial accounting reform. Although LFASB was founded under the auspices of the Law on Standardization, there existed a potential challenge to the Board's authority due to the fact that the previous version of the Law on Accounting was in conflict with the Standardization Law.

The old version of the Law on Accounting stipulated that accounting standards are to be drafted by the Latvian Association of Sworn Auditors (LASA), then preliminarily approved by the "Accounting Standards Consultative Board" (a Ministry of Finance [MOF] appointed body poorly suited for this task), and finally approved by the Cabinet of Ministers. Despite the submission of numerous draft standards to the Consultative Board, beginning in early 1998, not a single standard ever made it through this approval process. By the spring of 1999, the Consultative Board had stopped accepting draft standards from LASA altogether.

The passage of the amendment to Article 15 of the Law on Accounting, effectively removed the Cabinet of Ministers and the Consultative Board (traditional opponents of meaningful reform in the accounting area) from the direct involvement in the financial accounting standards approval process.

The new law specifically states the standards are to be approved under the auspices of the Standardization Law and officially confers the responsibility for drafting and approving financial accounting standards to LFASB, a major victory for the Capital Markets Project.

C. Assisting the Riga Stock Exchange and Latvian Central Depository in Developing into Commercially Viable and Effective Regulatory Financial Industry Institutions

1. Evaluation of Technological Capabilities of RSE and LCD

With respect to the LCD, a preliminary analysis of its overall operations was completed in November 1997. This was supplemented by an in-depth analysis of the LCD's technological capabilities, which was completed in December, 1997; a final report containing the Barents team's findings and recommendations was distributed to the LCD in January, 1998. The Latvian Central Depository received supplemental technical evaluations of its computer system from Barents consultants David Wall and Joan Carroll which included Barents' recommendations for modifications and upgrades to improve the current operations and to meet future expansion of the LCD and RSE.

Simultaneously, Barents advisor David Wall prepared a matrix of possible software systems (and their corresponding hardware requirements) which consisted of an inventory and evaluation of available technical solutions and systems previously developed by AID contractors that could be used by the RSE and LCD to upgrade their systems to increase the systemic integrity of the RSE and LCD. It was thought that this inventory would assist the RSE and LCD in developing technology strategies to meet projected business needs.

With respect to the RSE, the Task Order specified a technical review of the Exchange's operations similar to that specified for the LCD. Barents completed a preliminary, written analysis of the RSE's operations in November 1997. This initial review was supplemented by a report containing a detailed analysis of the RSE's technological capabilities in January 1998. As was true of the parallel report prepared for the LCD, a draft of the final report was circulated to the RSE management for review and comment, and the final report reflects the comments received.

Although the Task Order did not provide any financial support for acquisition or enhancement of software/hardware owned by the LCD or RSE, the analyses performed by Barents could be used to assist technology planning at these organizations.

2. Development of Market Surveillance Capability

In July 1998, a Barents Advisor worked closely with Egils Sturmanis, Head of the Market Regulation Department at the RSE. The principal goal of the work was to define parameters for computerized exception reports that would highlight patterns of unusual trading activity and thus become the basis for the RSE to investigate questionable trading activity. This work involved the analysis of historical trade data in several stocks over a period of five hundred (500) trading sessions, or about two years. Based on the joint effort with Mr. Sturmanis, specific recommendations were produced in the following areas:

- ◆ the definition of surveillance parameters to highlight anomalous activity in individual securities based on historical trading activity in the respective securities;
- ◆ the definition of processes, data, analytical techniques, and technology enhancements needed for RSE to implement an effective market oversight system; and
- ◆ the definition of training and/or educational initiatives that would target RSE members, public investors, and listed issuers.

2. Development of Arbitration Procedures

During November 1998, a Barents Advisor assessed and recommended appropriate changes to the arbitration mechanisms developed by the LCD and RSE, respectively. Martins Riksis, President of the LCD, specifically requested this assistance. These evaluations were furnished to the senior management of the affected organization only. The material contained a series of eight recommendations for consideration by both organizations to bolster the arbitration program of the Latvian securities industry. The Advisor also provided a series of "next steps" to implement the recommendations contained in the report.

A subsequent Barents Advisor arrived in February 1999, to assist the RSE and LCD develop their arbitration program along the lines suggested. The Barents Advisor prepared recommendations for the creation of a joint LCD and RSE Arbitration tribunal to reduce costs, on improvements in the Arbitration procedures at the LCD and RSE, and on a training course for Arbitrators. In addition to the analysis of the arbitration system, the Barents Advisor gave a daylong seminar for the training of Arbitrators patterned on the NASD training program. Due to the high demand for the program, the seminar was held twice on March 17 and 18, 1999. These seminars were well attended with an average of 20 participants at each seminar.

4. Methodology for Y2K Compliance for LCD and RSE

Barents Advisors arrived in late October 1998 and concluded an initial assessment of Year 2000 Compliance at the SMC, RSE and LSC. The SMC's in-house systems were largely in the developmental stage. Nevertheless, the Advisors met with the SMC's

technology staff and confirmed the staff's awareness of the need to be vigilant for Year 2000 Compliance in acquiring/customizing software.

Regarding the RSE and LCD, it was critical that both organizations develop a methodology to test their existing systems, which underpin Latvia's capital market. Toward this end, the Advisors developed a template for the RSE's and LCD's use in assessing their own systems, and thereafter, for conducting end-to-end testing with market participants.

This template was well received by the counterparts and internal testing efforts began soon afterward. On or about December 10, 1998, the RSE staff identified some problems and the Barents Advisors provided suggestions on how to respond to them. As to the SMC, new hardware had not had not yet been installed; SMC staff were developing software based on Y2K standards; and all off-the-shelf software (including operating systems and development tools) being acquired were certified as Y2K compliant by the manufacturer.

5. Development of Disaster Recovery Systems

A Barents Advisor conducted an analysis of the disaster recovery system at the Latvian Central Depository in 1999. Based on his discussions with the LCD staff, he prepared a Disaster Recovery Plan with recommendations as to hardware and software to run the system.

6. Business Development of RSE

In the Fall of 1997, a Barents Advisor assisted the RSE in developing its business planning such as the attraction of new companies to listing on the exchange. Additionally, the Advisor offered a strategy for providing value-added services to first tier issuers in return for continued support of their RSE listings and payment of higher listing fees. This advice was well received by the RSE.

7. System for Review for Accuracy of Financial Filings

During the fall of 1997, Barents advisors worked with the RSE to develop sound review procedures respecting issuer filings made with the RSE.

8. Risk Review analysis for RSE Admission to FIBV

During the month of April 1999, a Barents Advisor began a risk assessment review of the Riga Stock Exchange. At the request of Uldis Cerpes, the President of the RSE, the review was conducted from the perspective of the requirements that the RSE would need to meet to obtain membership in the International Federation of Stock Exchanges (known by its French acronym "FIBV"). In conducting this review, the Barents Advisor examined RSE background information (annual report, rules and regulations, etc.) and FIBV membership criteria to develop the criteria for the RSE operational risk assessment. In

addition, he developed a risk assessment questionnaire to be used for interviews with RSE managers.

During May, the Advisor conducted risk assessment interviews and follow-up sessions with RSE department directors. This work resulted in the completed Operational Risk Assessment of the RSE that evaluated the RSE's compliance with the FIBV's criteria for member stock exchanges. It should be noted that the RSE met substantially all of the criteria. There were a few minor gaps where the FIBV suggests specific regulations for certain customer protection (e.g., gathering information from customers to determine suitability of investments), but the laws, rules and regulations in Latvia provide general protection. The RSE appears to have a strong "culture of control" which is recognized to be the key foundation to a good system of internal controls.

9. Disciplinary Procedures

In mid-December 1998 through mid-January 1999, a Barents Advisor developed the anti-fraud rules and disciplinary procedures for the RSE. This specialized assistance was specifically requested by RSE President Uldis Cerps and was consistent with the organizational development of the RSE.

10. Baltic Integration

During November 1998, the RSE announced plans for exploration of a cross-border trading linkage with the Tallinn Stock Exchange. Following announcements of these proposals, a Barents Advisor met with the RSE's senior management on the appropriate "next steps" to evaluate and develop this initiative according to the new product template mentioned below. The cross-border initiative would be a critical application of the new product methodology, as it requires the joint participation of the RSE and LCD along with their counterparts in Estonia, and possibly Lithuania as well.

During the month of August 1999, Barents' Advisors assisted the RSE in meetings with other Baltic countries and the Stockholm Stock Exchange regarding Baltic and Nordic linkages of the stock markets in the various countries. The meeting was held in Tallin on August 5 and 6, 1999. The meeting proved very productive and resulted in serious progress in such creating linkages and advanced integration. The Stockholm Exchange tentatively considered the offering of linkages to the Baltic Exchanges on the same terms that it offered the Denmark exchange. In addition, it appears likely that Norway will also be made the same offer. The Baltic exchanges were considering the viability of such an offer during the term of the project.

11. New Products Methodology for RSE and LCD

In September 1998, Barents Advisors provided technical assistance in the areas of budgeting and financial planning to LCD, but not the RSE. (The availability of this

assistance was mentioned to the RSE President on two occasions, but no interest was expressed in receiving it.)

The point of this exercise was to identify potential services that would be useful to depository participants; materially assist the financial sustainability of the LCD; and promote a sound product development methodology that the LCD could employ in developing value-added services for the Latvian securities market.

a. Assistance in the Development of the Bond Trading System

A Barents Advisor also assisted the RSE in reviewing its development of a new product component of its trading system: the ACCEPT system for trading bonds.

b. Proxy Services

In December, Barents Advisors continued to work with RSE/LCD counterparts, responding to questions and reinforcing business logic inherent in the "new products" template referenced above. The template was applied to the LCD's proposed initiative to provide support services (primarily, proxy services) to issuers conducting General Meetings of shareholders under applicable corporate law. Both of these activities began in November and continued into the first half of December 1998.

12. Move of Guarantee Fund from RSE to LCD

Barents Advisors drafted and delivered to the Presidents of the LCD and RSE a basic plan for transferring the existing settlement guarantee fund from the RSE to the LCD. The institutions were reticent to make such a transfer and preferred the requirement for the RSE fund as it existed in the law. Under these circumstances, the Barents Advisors recommended that the LCD guarantee take the form of an insurance policy.

13. Technical Assistance in Securities Borrowing and Lending

At the request of the Latvian Central Depository, a Barents Advisor provided extensive assistance in the area of securities borrowing and lending throughout 1998. This assistance (which was specifically requested by the LCD President) developed a template based on the general template for defining, evaluating, developing, and delivering new products and services. This template was distributed to senior management of the LCD and RSE in November.

Further, the LCD provided the Barents Advisor with the detailed business requirements for the securities lending and borrowing program. The Advisor reviewed this material in November and provided comments to the LCD. The object of this exercise was to reinforce application of the concepts found in the template.

D. Public Education and Professional Development

1. Public Education Program

A Barents Advisor arrived in mid-October 1998 and began work on the Public Education initiative in the Task Order. In this regard, the Barents Advisor worked closely with the Barents Latvian Training Specialist to prepare her for the role of supporting and maintaining the focus of the Capital Markets Education Task Force (CMETF) vis-à-vis the objectives set forth in the Task Order. The CMETF was convened on November 19 (at the SMC) and December 2 (at LASA) and the Public Relations Department Director at RSE was elected to the post of CMETF Chair.

The CMETF agreed to provide support for the following initiatives, which target different audiences, to educate Latvian citizens regarding the nation's capital markets: first, Junior Achievement (JA-Latvia) participated in the development of a module for teachers to instruct high school students in preparation for their participation in a stock market game sponsored by JA-Latvia. Each of the CMETF participants contributed background materials that could be incorporated into the teaching module that JA-Latvia had been drafting. Second, a Television Program was developed on the subject of the capital markets, which was intended to reach a broad cross-section of the Latvian population. The Program's format might track an earlier (and very successful) program sponsored by the Latvian Privatization Agency and would be broadcast on public television. Third, an Investor Brochure was prepared which was aimed at a broad cross-section of the Latvian population. Fourth, Practitioner Conferences were to be developed.

a. Stock Market Game with Junior Achievement-Latvia

During January and February 1999, a key activity was work on the teaching manual for the high school Stock Market Game. The first draft of the teaching manual was sent to the RSE, LCD, SMC and LASA for comments. The student teaching module was reviewed by the task force members and returned to Junior Achievement to incorporate the comments and produce a final product.

A working meeting between the educators and securities market institutions was held on April 10 clarifying the viewpoints on basic principles involved in the text. In May work continued on completion of the teaching module for the stock market game. The final editing and approval of the teaching module for the stock market game was completed in the month of June.

The final printed version of the teaching module for the stock market game, developed in conjunction with Latvian Junior Achievement, was completed in late July in time for the new school year. The teaching retreat for the teachers was held by Latvian Junior Achievement during the month of August. As a result, the Stock Market game was ready for use when the Secondary School year opened in September 1999.

b. Television Programs

An official letter was received from Rolands Tjarve, general director of the Latvian Television, and confirmed allocation of airtime for the television program on securities market. Two shows were completed and televised in July: the first program concentrated on the Riga Stock Exchange and the second dealt with issues related to the Latvian Central Depository as the focus of the program. Two additional shows were done in August: the third show in the series dealt with the role of the SMC and the fourth dealt with the activities of real investors, large and small, and news regarding privatization. The CMETF found financing to continue the series and it continued beyond the period of AID support.

c. Investor Information Brochures

During the month of April 1999, the work on the text of investor brochure was completed and approved by the CMETF participants. Based on the developed work schedule, pre-testing of the brochure in a Focus Group was conducted and submitted to the management of the securities market institutions for the final approval. In May, the investor brochure was completed and printed.

The Brochure had a wide distribution during the month of June. The main goal of distribution strategy was to find distribution channels that would most effectively cover the whole territory of Latvia. The investor survey that was conducted pointed out that there was a greater interest in securities in the cities outside Riga. There were two main channels selected for the distribution outside Riga: (1) the network of public libraries, and (2) local municipalities.

With regard to distribution channels in Riga, each participant organization (RSE, LCD, SMC and LASA) displayed this educational aid at its premises and used it in publicity activities. In addition, brochures were transferred to the Riga City Council building and to two major banks – the Latvian Savings bank and Unibanka.

Market Research Questionnaire. Finally, in addition to the other four tasks, a market research questionnaire exploring the views, perception, knowledge and interest level of potential investors (the information target group was defined by the CMETF participants as individuals earning more than Ls 121 per family member) was developed and approved in April. The market survey was conducted in the second week of May.

The report of the investor survey was also completed during May. This report has proved very useful in analyzing the willingness and ability of Latvian citizens to participate in the Latvian Capital Market. The report showed the obvious, that most citizens do not have funds to invest. But it also shows that increased public education and information about the stock market is needed and wanted. In addition, it showed that when investors were inclined to invest they wanted "blue chip" Latvian shares, thus demonstrating the need for further privatization of the major Latvian corporations.

d. Professional Seminars

The decision on seminars for market participants was made to provide for two seminars:

- ◆ A seminar on debt securities scheduled for May 27, 1999; and
- ◆ A seminar on due diligence scheduled for June 17, 1999.

2. Accounting Education Program

a. International Auditing Standards for LASA Members

Barents consultants began preparation of a course on International Auditing Standards to be presented to Latvian accountants in conjunction with LASA. A Barents Advisor developed course materials and an instructor's guide for the presentation of a course on International Auditing Standards. This material was translated into Latvian for a course that began in early July 1998. This course was jointly sponsored by USAID/Barents and the Latvian Association of Sworn Auditors. The Latvian Association of Sworn Auditors (LASA) handled most administrative details and provided a classroom at its office; however, due to the high demand, the course was moved to a large classroom at the University of Latvia in downtown Riga.

Barents retained a Latvian sworn auditor and member of LASA to be the instructor for this course. By mutual agreement with the President of LASA (Ms. Snadra Vilcane), participation in the course was limited to LASA members. Ms. Vilcane had projected participation by at least fifty (50) LASA members. Actual participation on the opening night amounted to approximately sixty-five (65). The number grew to about eighty (80) LASA members.

b. International Accounting Standards for Public Sector Employees

On April 20, 1998, a Barents Advisor launched a training program on IAS at the Ministry of Finance on Mondays. This training program covered the substance of all international accounting standards that would be relevant in Latvia. This course resulted from a request by Ms. Valentina Andrejeva, State Secretary of the Ministry of Finance, to upgrade the professional knowledge of government accountants/financial personnel. As a result, participation in this course was limited to public sector employees. On July 20, 1998, Barents concluded the thirteen-week training course on International Accounting Standards at the Latvian Ministry of Finance. More than 30 individuals (including several SMC staff) attended these training sessions.

c. For Credit Course in IAS at Riga Business School

On May 19 and 20, 1998, a Barents Advisor commenced teaching a for-credit course at the Riga Business School on International Accounting Standards. Given the level of interest, the course was taught in two sections on consecutive evenings each week. Approximately 60 students enrolled. These two courses were concluded with final exams on August 11 and 12, 1998.

d. Training the Trainers

In this regard, the Barents Adviser, on April 22, also met with the Latvian Sworn Accountant who was the trainer and a LASA Board member who is also the Barents staff accountant to discuss overall ideas on a Train the Trainers program. It was agreed that they would put this on the agenda of the Board meeting of the Sworn Auditors Association. Further, meetings were held to discuss details of courses appropriate for Continuing Professional Education needs of Sworn Auditors. It was agreed that the Director of the Education Center should be requested to co-ordinate the program once Barents decided on funding availability. The proposed trainers would be LASA members.

LASA, with the assistance of Barents Group, began the presentation of accounting training courses in International Accounting Standards in August and September 1999, conducted by LASA trainers. The costs of the courses were shared, with LASA paying for the room, course materials and other expenses, while Barents provided the trainers. The courses have been extremely well attended with an average of 100 persons attending each course. LASA charged the attendees for the courses and the courses to be provided in the future will provide LASA with a means of self-funding which will greatly contribute to its sustainability. The courses are the beginning of series of courses to be provided by LASA in the future to train the Latvian accounting profession in international practices in accounting and thus raise the level of the accounting profession in Latvia.

e. Specialized Courses

In addition, a Barents Advisor on May 15, 1998, delivered a day-long workshop at the University of Latvia in Riga on the accounting treatment of Leasing and Factoring transactions under International Accounting Standard 17, Accounting for Leases (as revised in 1997). This workshop was developed in co-operation with Ms. Vilma Paupa, Dr. oec., Head of the University of Latvia's Department of Accounting and Business Analysis.

3. Intermediaries and Industry Education Program

a. Internal Controls and Risk Management for Intermediaries

On July 21-22 and 23-24, 1998, Barents Advisors delivered seminars on Internal Controls and Risk Management, respectively. These seminars were conducted at the RSE and attendance was restricted to persons working in a regulatory capacity with the RSE, LCD, SMC, the Bank of Latvia (BOL), or the State Insurance Inspectorate. A total of nine SMC staff participated in the seminars on Internal Control or Risk Management on July 21 and 22, respectively.

b. Organization and Functions of a Broker/Dealer

On July 29, 1998, Barents Advisors delivered a daylong seminar on the Organization and Functions of a Broker-Dealer.

c. Broker/Dealer Financial Reporting

On July 30, a Barents Advisor delivered a half-day seminar on broker-dealer financial reporting. It should be noted that Ms. Kulesova, Director of the Department of Intermediaries, and Mr. Artis Smits of the SMC participated as instructors in the July 30 seminar on broker-dealer financial reporting. Their participation was important to convey to practitioners certain weaknesses that have been identified in the financial filings made earlier that year. (Beginning in 1998, the SMC has required licensed broker-dealers and bank securities departments to make quarterly filings with the SMC. Hence, the comments provided by Ms. Kulesova and Mr. Smits were quite relevant for the practitioners.)

IV. Project Impacts and Concerns

A. Strengths and Contributions

The Latvian Capital Markets Project made some extremely important contributions to the development of the financial markets.

1. Latvian Financial Accounting Standards Board

The Project was extremely successful in establishing a vehicle in Latvia for the adoption of financial accounting standards in accordance with IAS. The previous system that required the approval of too many agencies, including the highest body of the Executive Branch, proved to be too unwieldy and subject to interference. There was a great deal of resistance to the adoption of IAS in Latvia from accountants who had been trained in the older Soviet accounting system. Since the independence of Latvia from the USSR, the accounting structure has been mainly fiscally oriented to provide a means of measuring the revenue to the State. It was not geared to provide financial information in a format that would be useful to investors and managers in evaluating the company's performance.

The solution found by the project allows the continuance of the fiscally based accounting, but at the same time allows for the establishment of Official Latvian Financial Accounting Standards based on International Accounting Standards which provide a degree of regularity and certainty for those companies that follow the IAS system, such as banks, mutual funds and companies on the first list at the Riga Stock Exchange.

2. Increased Regulatory Effectiveness at SMC

When the Capital Markets Project commenced its activities, the Latvian Securities Market Commission ("SMC") had just begun its full-fledged operations. The Project was able to provide timely assistance to the SMC in its early stages with advice on

organization and legislative changes needed to make the SMC more effective. The SMC management recognized the value of many of these recommendations and was able to obtain a greater degree of autonomy and authority for the SMC to conduct its activity.

In addition, the basic skills of the staff were greatly improved by the work of the Barents advisors who worked with the staff. The staff was generally willing and interested to learn new techniques of regulation and apply them to local circumstances.

In addition, the SMC had a forward-looking view toward automation of its activities and the extent to which it could bolster an institution with a relatively small staff. The Project was able to assist the SMC in obtaining sufficient IT resources to create a data base and surveillance system which were vital to the development of the SMC's regulatory capabilities.

3. LCD - Enhanced Functions to Improve Viability

The LCD was extremely responsive to the assistance provided. It had a clear vision of its current abilities and areas in which it needed additional technical assistance for future growth. Although its operations were already advanced, the LCMP was able to assist the LCD in providing new services, such as securities borrowing and lending, corporate shareholder democracy services (proxy services) and arbitration. In addition, the LCMP significantly assisted the LCD in avoiding problems from Y2K and in setting up a disaster recovery plan.

4. RSE - Enhanced Operational and Regulatory Functions

The RSE initially did not request any help from the LCMP in reviewing or assisting its operations. However, after evaluating the assistance given to the LCD, the RSE requested and received assistance in the areas of Y2K analysis, developing new products/services, and enforcement of exchange rules. The RSE was thus able to conduct expanded surveillance of the market and had the disciplinary procedures to conduct a trial and sanction violators of its rules. In a related vein, the GSE was provided with specific recommendations for rules, and training to implement an arbitration mechanism to resolve commercial disputes, whether member-to-member or member-to-customer. Finally, from a business standpoint, the RSE was well equipped to handle changes in the market environment and to take the lead on initiatives such as the integration of the Baltic Markets into the Nordic Markets.

5. Strengthening Private Sector Capital Market Knowledge - Professional and General

Barents training programs significantly increased the skill levels of the SMC and the surveillance capacity of the RSE. The Public Education program had a wide impact on the knowledge level of the Latvian populace in regard to the efforts of the capital markets and its institutions. Most importantly, the LASA accounting training programs had a significant effect on furthering the education of Latvian accountants in regards to

International Accounting Standards and furthering the adoption of a mechanism for the promulgation of Latvian accounting standards based on IAS.

B. Issues and Concerns

1. Low Levels of Capital Market Activity

The most significant problem facing the Latvian capital markets is the very low level of activity on the Riga Stock Exchange and the OTC market. The RSE was doing well until the Russian crisis in the spring of 1998, resulting from Russian allegations of mistreatment of Russian citizens living in Latvia and the annual march of Latvian SS veterans. The market suffered a precipitous decline at that time when large amounts of foreign capital left the market, from which it has never recovered. The later Russian Bond Crisis of August 1998, cut off a small recovery in the market, but was not the cause of the decline.

Of particular importance, the market did not recover when other emerging markets began to recover in 1999. A number of reasons have been put forth to explain the failure of the Latvian market to recover. First, few companies have attempted to use the capital market to raise capital for their activities, resulting in the lack of new securities on the market. In addition, it has been argued that there are few products on the market due to inadequate privatization of the largest and most liquid Latvian companies. Moreover, even if privatized, the argument is made that due to the small size of the Latvian market, it would not be possible for the market to grow to any size. Finally, recognition began to develop among the market participants that a low level of safeguards existed for minority shareholder rights. This factor, in turn, discourages portfolio investors or venture capitalists from investing in Latvian companies.

The market participants began to address these problems by tackling the legislative issue first as to making necessary changes in the corporate law. By the end of the project, this effort to affect the drafting of the new Commercial Code had progressed significantly. The size of the market could only be solved by entry into a larger market and Latvia has taken significant strides towards joining the EU, which would also provide a counterweight to Russian pressure. More specifically, the RSE began negotiations with the Stockholm Exchange regarding entry into the Nordic system. At the end of the project, this was still being evaluated for its advantages to the Latvian economy and the RSE.

2. Investigatory Powers of SMC

A second cause of concern for the effectiveness of the regulation of the Latvian capital markets revolved around the investigatory powers of the SMC. The SMC did not have the power to review individual accounts at a bank brokerage department due to bank secrecy provisions in the banking law, nor did it have the power to require the production of documents and testimony from non-registered natural persons. The result was a severe weakness in its power to investigate violations of the securities law, such as market

manipulation and insider trading, and sanction persons who had committed such violations.

The solution to the bank secrecy issue will probably be found in the creation of a Consolidated Financial Regulator of the SMC, the Insurance Inspectorate and the Examination Department of the National Bank. As a result, an investigation by the Securities Department of the Consolidated Regulator should not be hampered by the secrecy provisions applying to other institutions. However, the final law for the Consolidation will need to be reviewed for the specific provisions relating to such a situation. As to its other investigatory powers, the law will need to be expanded to give the SMC or the Consolidated Regulator more authority to investigate violations, particularly by violations persons/entities that are not licensed by the Consolidated Regulator

3. Funding of Financial Supervision

The SMC or Consolidated Regulator will face serious shortages in funding as is common in all countries. However, the law has been changed to allow the SMC to have alternative forms of funding, which will depend on the health of the market to implement. Nonetheless, finding adequate funding and salaries for SMC personnel will be a continual problem for the SMC.

V. Conclusion

The Latvian capital markets institutions are adapting to new market conditions as well as can be expected. The institutions are well managed with forward-looking, market-oriented leaders. The assistance given by the USAID Latvian Capital Markets Project significantly assisted the institutions in meeting the demands of the new post-Russian crisis market conditions.

** All deliverables were provided to USAID with the project's monthly reports. Given their size, they are not included with this document.