

## The Pragma Corporation

Lithuanian Capital Market  
Development Project  
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### MEMORANDUM

To: Aldas Kriauciunas (USAID -- Vilnius, Lithuania)

From: James P. Ryan, (Project Manager)

Cc: Beverly E. Low (USAID -- Washington, DC)  
Jacques DeFay (Pragma -- Virginia)  
Pragma -- Vilnius Office File (Diana Sokolova)

Re: **Status Report for the Month of October 1997** -- Lithuanian Capital Markets  
System Project

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#### I. INTRODUCTION

This memorandum represents The Pragma Corporation's ("Pragma") monthly status report for October 1997, in conjunction with its implementation of the Lithuanian Capital Markets System--Market and Regulatory Development Project (hereinafter "Project") funded by the United States Agency for International Development (hereinafter "USAID"). The primary purpose of this report is to provide USAID with a status of Project deliverables as set forth in the USAID task order and Pragma's work plan.

#### II. PROFESSIONAL STAFFING

During October, Pragma continued the services of a short term adviser, Donald Buddenbohn, to provide expert assistance to the Lithuanian Securities Commission ("LSC") regarding international accounting standards. Don Buddenbohn has been working with Dr. Arvydas Paskevicius in the area of standardized accounting of investment companies and the methodology of calculating asset valuations. He has conducted the review of broker-dealer financial reporting using the third quarter reports of the firms. In addition, he has completed an impact analysis regarding changes in capital requirements, which are scheduled to be effective December 31, 1997, see Exhibit # 8 enclosed. The new capital requirements will determine the number of broker-dealers, who

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will continue to be market participants. Buddenbohn is now drafting a proposed rule defining the timely filings of broker-dealer financial statements.

James Ryan, a short term adviser, has been extended in order to become interim project manager until November 20, 1997, and to continue to work with the clients<sup>1</sup> on the NAFB's Ethical Code, the proposed margin rule and training seminars, and the development of inspection manuals, modules and procedures for both the NAFB and the LSC, see Exhibits # 9 and 10 enclosed.

### III. AREAS OF CONCENTRATION

During the month of October, Pragma focused its attention on the following areas:

Zilvinas Zinkevicius continues to work with all four of the clients with discussions or drafting amendments to various laws to include The Law on Public Trading in Securities, The Law on Stock Companies, The Law on Privatization of State and Municipal Property, Rules on Tender Offers and Rules on Identification of Insider Trading. Exhibits # 1 and 2 are memorandums addressed to the Chairman of the LSC regarding Company Law and Public Trading in Securities.

Dr. Arvydas Paskevicius continues his work with the Division of Investment Companies of the LSC regarding the valuation of property holdings and the financial statements of investment companies. Conformity of the above with both international accounting standards and European Union Directives is the intent, and he is consulting with interested commentators such as auditors, accountants and academia. Dr. Paskevicius is conducting a seminar "The Fiscal Policy of The Lithuanian Government", Exhibit # 3 enclosed.

Skirmantas Rimkus continues to work on The Capital Adequacy Rule, which is in its public commentary period. He continues to draft and translate new or amended sections, comments and schedules, Exhibits # 4 and 5 enclosed. The rule has a projected effective date of December 31, 1997, and Skirmantas is developing the new capital adequacy statements to be used monthly or quarterly. He translated the proposed margin rule and assisted in the Pragma training seminar on margin accounts.

Vita Markeviciute is working with Jurga Dermontaite on presentations on the WWW "Bullish on Lithuania" of the Lithuanian companies that are ready for research and fundamental analysis. A copy of the Vilnius Vingis report is enclosed as Exhibit # 6. Vita continues her efforts in the training and preparation of Certified Financial Analysts candidates. Both Vita and Jurga are working on the draft of the law covering pension funds, which law has recently been formally assigned to the LSC by the Lithuanian Government for administrative and enforcement responsibility.

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<sup>1</sup> Pragma's four clients are the Lithuanian Securities Commission ("LSC"), the National Stock Exchange of Lithuania ("NSEL"), the Central Securities Depository of Lithuania ("Central Depository"), and the National Association of Finance Brokers ("Brokers Association").

Gediminas Reciunas works with the LSC on the underwriting rules, and the rules covering issuance of corporate debt. He researches and advises on such topics as underwriting agreements, best efforts distributions and due diligence. He continues his research on the proposed rule covering the segregation of clients' funds including amendments to the Enterprise Bankruptcy Law. He is working for the Commission on portfolio management, his memorandum to the LSC is enclosed as Exhibit # 7.

#### IV. STATUS OF DELIVERABLES<sup>2</sup>

- (1) *Completed*—The Margin Seminars;
- (2) *Completed*--The Capital Rule Impact Analysis;
- (3) *Completed*--A Research Report on Vilniaus Vingis, a Public Company;
- (4) *In Progress*--The Capital Adequacy Rule;
- (5) *In Progress*--Securities Portfolio Management;
- (6) *In Progress*—The Examination Module.

In addition, copies of the weekly work status reports are attached to this memorandum.

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<sup>2</sup> Work product, where applicable, evidencing completion of deliverables is attached to this memorandum in the numerical order in which they are set forth below.

## MEMORANDUM

To: Virgilijus Poderys, the Chairman  
the Commissioners

From: Žilvinas Zinkevičius, the Pragma Corporation

Date: October 6, 1997

Subject: **Concerning draft amendments and supplements to Articles 4, 10, 11, 13, 16, 17, 18, 20, 21, 25, 26, 27, 32, 34, 38, 43, 48, and 49 of the Company Law**

According to this draft of the Law which was prepared by the Government of the Republic of Lithuania (hereinafter - Draft), the companies are provided with a possibility to issue special shares. The main characteristic features of special shares and their differences from shares of other types and classes are the following:

1. Certain decisions at the general shareholders meeting may be passed only in the event holders of special shares vote "for".
2. Upon liquidation of a company, the asset value allotted to special shares must be paid off in cash, the amount of which is equal to the par value of the special shares (Article 3 of the Draft).
3. Holders of special shares have no right to dividend (Article 5 of the Draft).
4. Holders of special shares have the right to appoint an expert (group of experts) to examine the company's activities and accounting documents (Article 8 of the Draft).
5. The company which has issued special shares must form the Board (Article 10 of the Draft).
6. A person who represents special shares has the right to initiate a general meeting (Article 14 of the Draft).
7. A person who has been appointed into the Board by a person representing special shares may not be recalled from members of the Board without the agreement of the person representing special shares (Article 16).
8. A person representing special shares shall delegate one person into the Board who cannot be recalled without his agreement (Article 17).
9. Certain decisions of the Board may be passed only in the event a person appointed to the Board by a person representing special shares votes "for" (Article 19).

There are a few more proposals concerning amendments and supplements to the Law on Public Companies which are not directly related to the status of special shares.

Although it is hard to evaluate the Draft being unaware of the objectives of the authors, some general observations can be presented.

Firstly, while giving the evaluation to the Draft, Article 22 (supplement to Art. 38 of the Law on Public Companies) should be analysed as it sets forth the procedure for the issuance of special shares.

Par. 1 of this Article provides that "the rights of a special share or shares may be granted to [ ] a state or municipality share or shares in the company in which the state or the municipality holds no less than 2/3 of votes by right of ownership at a general shareholders meeting". Yet, par. 2 of the same Article provides that "the period of validity of special shares shall be determined at a general meeting and . . . shall be specified in the minutes of the general meeting or the company's by-laws". The question arises whether the status of special shares will be retained in the event they are issued for a period of 2 years by a company in which the state holds no less than 2/3 of votes, but a year later that part diminishes. Pursuant to par. 2 it will, pursuant to par. 1 it will not.

If the authors of the Draft have in mind that the status of special shares is valid only within the company, in which the municipality or state holds no less than 2/3 of votes by right of ownership at a general meeting of shareholders, this idea is unacceptable. Pursuant to the Draft, shareholders holding 2/3 of votes in the company at the same time have all other rights attaching to special shares, namely, without the agreement of such a shareholder no decision can be passed at the general shareholders meeting, he will be able to appoint the majority into the company's Supervisory Council or Board and will have all the rights of a shareholder's initiative (to call a general meeting, to appoint experts, etc). One of the merits of the Draft (for holders of state or municipality shares) is that, according to Articles 17 and 19 of the Draft, the state or municipality which holds the majority of votes can be represented by one person, thus escaping the necessity to appoint a few representatives of the municipality or the state to one managing body. On the other hand, this problem might be resolved by minor amendments to the law, for instance, by providing that regulations of the Supervisory Council or Board be approved by a general shareholders meeting and setting forth that certain decisions of the Supervisory Council or Board be passed only upon unanimous vote.

The idea could sound more motivated if, upon the issue of special shares, their status would be retained even if the state or municipality share in the company decreases. In that case the first paragraph of Article 38 to be supplemented to the Company Law as proposed in the Draft should run as follows: "The rights of a special share or shares may be granted to any share or shares of the state or municipality in a company by the decision of a general meeting of shareholders."

It is little feasible that at this stage of the discussion of the Draft it will be changed in essence. However, even in this case it is to be amended because of the discrepancies listed below:

1. Article 1 of the Draft (the amendment to par.1 of Article 4 of the Company Law) can be passed only after the new Law on Privatisation of the State and Municipality Property comes into power.

2. Article 2 of the Draft is not accurate. I cannot understand how it is possible to have an exact pro rata allocation of rights and obligations among the companies which appear after the reorganisation of a company by way of splitting (the more so by merger). Most probably, they have in mind that the agreement of the representative of a special share is necessary in approving any project of the company reorganisation, except the change of the type of the company (e.g. when a public company is reorganised into a closed stock company or vice versa).

3. Pursuant to Article 3 of the Draft (the amendment to par.8 of Article 11 of the Company Law), the subordination of satisfying the claims of holders of special shares is not clearly defined. Such a wording could mean that after the claims of the company's

creditors and the claims of preference share holders are satisfied, the holders of special shares are paid in cash the amount equal to the par value of the special shares and then the claims of holders of ordinary shares are met. I wonder if that is exactly what is meant.

4. Article 4 of the Draft (the amendment to item 6 of par. 2 of Article 13 of the Company Law) requires respective amendments to par. 3 of Article 12 of the Company Law.

5. Article 7 of the Draft (the amendment to par. 3 of Article 16 of the Company Law) needs editorial amendments. A question rises what laws are born in mind in the statement "Such a voting right is granted only on issues provided for in a special law regulating the activities of the companies in that branch of economy". The second statement in Article 7 of the Draft contradicts the third one.

6. While giving a generally positive evaluation to Article 8 of the Draft (the amendment to par. 8 of Article 16 of the Company Law which defines the status of an expert is to escape examinations carried by "fictitious" and dependent experts), there is still a question concerning the wording of "having higher education in that field", which might be treated in several ways. For instance, according to this wording the examination of a company in energy sector may be entrusted to a specialist in energy who does not have the necessary knowledge in finance or law. Or on the contrary, a qualified financier may be prohibited from examining a company because of the lack of knowledge in the specific field of a company's activities. An expert should be also independent of the persons appointing him/her. I think that in all cases a company's activities and accounting documents could be examined by an independent auditor.

7. Article 12 of the Draft (the amendment to item 3 of par.3 of Article 19. of the Company Law) is not grounded. The general meeting has the right to decide upon the suitability of members of the Board it has elected and remove them from office. In the event the amendment is meant to grant the right to the general meeting to directly dismiss the Board that the Supervisory Council has elected, the amendment should be spelled out in a more exact way, at the same time amendments to other articles of the Company Law will be necessary. In all cases a state or municipality representative who holds more than  $\frac{1}{2}$  of shares in the company has the right to initiate the call of a general meeting and supplement its agenda, therefore, he/she can initiate the discussion of the suitability of a member of the Board for the occupied position without the proposed amendment to the Law.

8. The wording of Article 13 of the Draft (the amendment to par.4 of Article 20 of the Company Law) "have  $\frac{1}{2}$  plus 1 of all votes of shareholders participating at the meeting when decisions are passed by simple majority of votes, and  $\frac{2}{3}$  plus 1 of all votes of shareholders participating at the meeting when decisions are passed by  $\frac{2}{3}$  of votes" is "mild" but inaccurate because it defines a constantly changing number of votes. It could be simpler to read the paragraph as follows: "Decisions on issues relevant to the status of the special shares shall be deemed passed where a representative of special shares votes "for"." Other articles of the Draft could be worded accordingly (par. 19 of Article 2, etc.).

9. Article 16 of the Draft may be applied the same comments as Article 12.

10. The purpose of Article 18 of the Draft is not clear. An employment agreement must be drawn with any person who has regular labour relationship in a company. Maybe, the idea is that a limited employment agreement must be drawn with a member of the Board who has no other position in the company?
11. It is not clear why Article 18 of the Draft (supplement to items 10 and 11 of par. 2 of Article 27) sets forth different terms for appeal to court. From the wordings of items 10 and 11 of par. 2 of Article 27 that are proposed one can understand that a member of the Board who resigns may fail to transfer to the company the rights and obligations established by an enterprise he has founded, while the following items provide for a possibility to demand the transfer of these rights in a court procedure. The amendments to the law do not provide for the cases when an "analogous enterprise" is being founded by a person(s) connected with a member of the Board or head of the administration or when said person(s) participate in the activities of that enterprise.
12. Besides the discrepancies in Article 22 of the Draft mentioned, the contradiction between par. 1 which sets forth that the status of a special share shall be decided by the decision of the general meeting and par.2 which provides (in my opinion, erroneously) that such a status shall be granted by the Government of the Republic of Lithuania or the municipality (these institutions will authorise their representatives to vote accordingly in order to have the necessary decision of the general meeting passed). Being unfamiliar with the concrete draft laws of the "special economic activities", it is not clear in what concrete cases, in which field and on what issues shares will be granted the status of "special". A question arises how the status of special shares may be granted in the event of liquidation of a company, for instance, where the decision to liquidate the company is passed, i.e. its liquidator is appointed, while all the other members of the managing bodies (including the general meeting) have lost their powers to manage the company (par.2 of Article 11 of the Company Law).
13. Article 23 of the Draft (par.4 of Article 43 of the Company Law) is redundant as the new draft of the Law on Privatisation of the State and Municipality Property (its Article 19) does not provide for any special order of increasing the authorised capital. In the event the amount payable to the state or municipality for the transfer of the control in the company is not agreed upon, 1/3 of votes will simply veto the decision to increase the authorised capital. (I consider the provision of the Draft Law on Privatisation of the State and Municipality Property that the "acquirer of the control" shall pay for the new issue to the company, and the company shall transfer part of the proceeds from the issue into the account of the privatisation fund wrong. The "acquirer of the control" should directly pay to the state or municipality).
14. I do not agree with the provision of Article 24 of the Draft (amendment to par. 3 of Article 48 of the Company Law) because it cannot be based either on legal or economic considerations.

15. The Draft provides that the term of validity of a special share may be limited (Article 22 of the Draft), but the order of their conversion (into ordinary nominal or other shares) is not foreseen.

This Memorandum does not touch upon the issue of a more general character, namely, whether in principle it does not violate the rights of the companies and their shareholders. As only the state or the municipality can be a holder of special shares (an individual shareholder who owns 2/3 of votes in a company will not be able to "ensure" his future by issuing special shares), the question of equality before the law may be questioned.

As the time presses, some of the criticised articles of the Draft are not supported with alternatives. They will be prepared if requested.

## MEMORANDUM

To: Virgilijus Poderys, Chairman of the LSC  
Commissioners

From: Žilvinas Zinkevičius, Pragma Corporation

Subject: Comments on Article 8 of the Law on Public Trading in Securities

### Concerning Article 8 of the Law on Public Trading in Securities of the Republic of Lithuania and the concept of secondary public trading in securities

In the Law on Public Trading in Securities (hereafter - Law) the concept "through an intermediary of public trading in securities" is used in two senses: in Article 2, while defining public trading in securities, it means a characteristic feature of public trading whereas in Article 8 it is a way of public trading. This fact alone makes the current text of Article 8 of the Law inconsistent and inaccurate. Here are my arguments in support of such a critical observation with regard to Article 8 of the Law:

1. First of all, it is necessary to evaluate item 1 of Article 8 which provides that "secondary public trading in securities shall be carried out only through intermediaries of public trading in securities". In this item the concept "through intermediaries of public trading in securities" means a way of trading and cannot be taken as a feature of public trading. Taking this into account and paraphrasing item 1 of Article 8 (including all features of public trading in securities from item 19 of Article 2 of the Law, except "through intermediaries of public trading in securities"), it could run as follows: in cases when secondary public trading in securities means offer, allotment or transfer of securities or offering securities to the public through advertisements and/or offering securities to more than 50 persons, it shall be carried out only through intermediaries of public trading. That means that any person may, without an intermediary, conclude any transaction concerning any securities in the event he/she finds a purchaser or seller of securities "privately", by offering securities to fewer than 50 people.
2. Item 2 of Article 8 sets forth the cases when **public** trading in securities must be carried out on a stock exchange. Yet, according to the understanding of secondary trading in securities as given in item 1 of Article 8, instances when a transaction must be concluded on an exchange would be very rare and practically voluntary. Only in case a person cannot directly find a purchaser or seller of securities and the transaction is to be concluded with securities of an issuer that meets the requirements of item 2 of Article 8 is he/she obligated to place the order on an exchange through a broker because the secondary public trading of any other type (through advertising or by offering securities to more than 50 people) is prohibited.
3. The obligation for some legal persons to conclude security transactions through intermediaries of public trading in securities is stipulated in item 4 of Article 8. I would like to draw your attention that this item provides for the order of concluding "non-public" in their essence transactions (the concept of secondary public trading in

securities is not used in this item), which is inconsistent with the objective of Article 8 as given in the title of the Article, namely, to regulate secondary **public trading** in securities. The most frequent argument is that it is the provisions of item 4 of Article 8 of the Law that promote trading in securities on the exchange. The arguments are as follows: (1) as item 4 of Article 8 requires, **some legal persons must conclude transactions of purchase or sale of securities through intermediaries of public trading in securities**, (2) pursuant to the definition provided in item 19 of Article 2 of the Law, **conclusion of a transaction through an intermediary of public trading in securities means public trading in securities** (I find this statement doubtful), (3) **in the cases set forth in item 2 of Article 8 secondary public trading in securities must be carried out on the exchange**. However, a different interpretation is also possible: (1) as item 4 of Article 8 requires, **some legal persons must conclude transactions of purchase or sale of securities through intermediaries of public trading in securities**, (2) as the concept of “through an intermediary of public trading in securities” in item 1 of Article 8 means a way of trading but not a feature of public trading in securities, **conclusion of a transaction “through an intermediary” does not mean public trading in securities**, (3) as pursuant to item 2 of Article 8 only secondary public trading in securities must be carried out on the exchange, following the requirements of item 4 of Article 8 **some legal persons must conclude transactions of purchase or sale of securities through intermediaries of public trading in securities, but not on the exchange**.

I am inclined to think that transfer of securities through an intermediary is a way of trading but not a feature of public trading in securities as not every transfer of securities while using the services of an intermediary is public (see the example below). Pursuant to said considerations, I propose:

In item 19 of Article 2 offer, allotment or transfer of securities through intermediaries of public trading in securities should be deleted from the list of features of public trading in securities. In that case, features of public trading in securities as proposed in the current amendments to the Law would be the following: offer, allotment, transfer of securities or offering to transfer securities through advertising or in any other manner and /or offering securities to more than 100 persons. I propose to introduce an additional feature of offering to transfer securities to an indefinite number of persons, which, in my opinion, would define the placement of a customer’s order to be executed on the central market of the exchange (or in the future, on another organised market).

Pursuant to the objective of this Law, Article 8 should regulate only public trading in securities. Therefore, Article 8 should suffice to provide that secondary public trading in securities shall be carried out only by intermediaries of public trading in securities. According to the proposed interpretation, an act when a person places the order to purchase or sell securities with a brokerage firm does not in itself mean secondary public trading in securities as such a person has not yet offered to transfer securities either publicly or through advertisements or to more than 100 persons or to an indefinite number of persons.

The choice of a public way of secondary trading will depend on the brokerage firm: in the event a customer’s order can be best executed on the exchange, the order will be placed on the exchange, in other cases, however, for example, in the sales of a block of shares, a better execution price may be received off the exchange, in a block transaction

to a concrete investor, i.e. non-publicly (as a private placement), which will not be prohibited by the Law (as Principle 6 of the Code of Ethics of Intermediaries of Public Trading in Securities provides, a member of the Association shall, upon the receipt of a customer's order to purchase or sell securities, apply his efforts to find the best market and execute a customer's order in the best way).

In the event such amendments to the Law are passed, practically that would mean that each person (both physical and legal) could personally look for a purchaser of the securities he/she intends to sell or for a seller of the securities he/she wants to purchase. He would go to an intermediary of public trading in securities only voluntarily and only if offers he/she personally received did not satisfy his/her needs. The fact that a person would go to an intermediary of public trading in securities would not mean that a transaction will be executed on the exchange either. In certain cases a broker may conclude a block transaction off the exchange. Due to these reasons, the amendments proposed may be unacceptable for some market participants and for some capital market institutions.

Certainly, provisions of item 5 of Article 8 which are to be applied if there is an attempt to establish an organised OTC market and those of item 6 should remain unchanged.

All proposed amendments to the Law run as follows:

*(item 19, Article 2) public trading in securities means offering, trading (distribution), transfer of securities or offering publicly to transfer securities through advertising or in any other manner and (or) offering securities to more than 100 persons and (or) offering securities to an indefinite number of persons;*

#### **Article 8. Secondary Public Trading in Securities**

- 1. Secondary public trading in securities shall be carried out only through intermediaries of public trading in securities.*
- 2. Rules of secondary trading off the stock exchange shall be established by the Securities Commission.*
- 3. Persons who, pursuant to this Law, conclude a transaction of the secondary trading in an issuer's listed securities on over-the-counter market in cases, in the order and at the time established by the Securities Commission must specify the number of securities transferred in the transaction and the price per security.*

In the event the Securities Commission believes that it is necessary to promote trading in securities through intermediaries of public trading in securities and on the National Stock Exchange in a mandatory fashion, I would propose to supplement Article 8 of the Law with the following provision:

*The Securities Commission, taking into account the size of an issuer and the volume of trading of its securities, shall establish, supplement or change the list of issues which can be traded only publicly.*

Based on this formulation, public trading in securities designated by the Securities Commission would be mandatory to all physical and legal persons as well as to brokerage firms. In reality that would mean that, as long as the Securities Commission does not adopt the rules regulating public trading in securities off the exchange, all

transactions would be required to be concluded on the National Stock Exchange. At the same time, such a provision would prohibit direct transactions on the Exchange because they would not be in compliance with the new concept of public trading in securities. I consider it an advantage of the new wording as due to a large spread in price the fact that commercial banks register their securities transaction as a block transaction on the National Stock Exchange following the requirements of item 4 of Article 8 does not mean that they conclude the transaction at the best price possible. At the same time the problem of the so-called "unlicensed intermediaries" is solved, because they would not be able to buy securities from the "special list" off the exchange.

Otherwise, the amended version of Article 8 of the Law may impede repo transactions, sales of blocks of shares or the sales by a physical person of a very small amount of securities. The Securities Commission should consider carefully as to the exemptions when secondary public trading in securities is not required. In order to have a legal basis to establish such exemptions, Article 8 should be supplemented with a sentence:

*While approving of the special list, the Securities Commission may provide general exemptions when secondary public trading is not mandatory.*

LITHUANIA SEMINAR  
24.10.1997

**LITHUANIA SEMINAR**

Date Friday 24.10.1997  
Time 11.15 - 15.30  
Place Kokkola Health Care Institute  
Terveystie 1, Kokkola

**PROGRAM**

11.15 - 12.00 Lunch in the students' restaurant

12.00 **Introduction and welcome**  
Central Ostrobothnia Polytechnic  
Chairman of the Development Committee,  
Johan Karjaluooto

**Aims and objectives of the seminar**  
M.Sc. (Econ), Head of the unit Asia,  
Russia and Baltic countries, Hannele Teir

12.15 **Education and Science in Lithuania**  
Doctor Anatolijus Rimkevicius,  
Vilnius Gedimino Technikos Universitas

13.00 **Perspectives of Lithuanian Business and Economy**  
Professor Aleksandras Rutkauskas,  
Vilnius Gedimino Technikos Universitas

13.45 Coffee break

14.15 **The Investment Situation in Lithuania**  
Professor Arvydas Paskevicius, International  
Business College, Vilnius University

15.00 Case study

15.30 Conclusion

**LIETTUA SEMINAARI**

Päivä perjantai 24.10.1997  
Aika 11.15 - 15.30  
Paikka Kokkolan sosiaali- ja terveysalan oppilaitos  
Terveystie 1, Kokkola

**OHJELMA**

11.15 - 12.00 Lounas oppilaitoksen ravintolassa

12.00 **Tilaisuuden avaus**  
Keski-Pohjanmaan ammattikorkeakoulun  
neuvottelukunnan puheenjohtaja  
Johan Karjaluooto

**Seminaarin tarkoitus**  
Lehtori Hannele Teir, ammattikorkeakoulun  
Venäjä ja muun lähialueyhteistyö -tiimin vetäjä

12.15 **Education and Science in Lithuania**  
Doctor Anatolijus Rimkevicius,  
Vilnius Gedimino Technikos Universitas

13.00 **Perspectives of Lithuanian Business and Economy**  
Professor Aleksandras Rutkauskas,  
Vilnius Gedimino Technikos Universitas

13.45 Kahvitauko

14.15 **The Investment Situation in Lithuania**  
Professor Arvydas Paskevicius, International  
Business College, Vilnius University

15.00 Case study

15.30 Tilaisuuden päättäminen

Seminaari on englanninkielinen.

**The Conformity of the Draft Rule on the Capital Adequacy for Lithuanian Brokerage Firms with the EU Directive 93/ 6/ EEC "On the Capital Adequacy of Investment Firms and Credit Institutions" and Other Related Directives**

Prepared by Skirmantas Rimkus, the Pragma Corporation

No	The Lithuanian Draft of the Capital Adequacy Rule	The EU Directive 93/ 6/ EEC on the Capital Adequacy (CAD) and other directives referred to
1.	<p>par. 1.1 The Capital Adequacy Rule sets forth capital adequacy requirements for category A, B, and C brokerage firms and the order of their calculation</p>	<p>Does not fully conform</p> <p>The CAD applies to credit and financial institutions. A credit institution means an undertaking whose business is to receive deposits from the public and to grant credits for its own account (that is the main definition of a credit institution).</p> <p>The CAD may be not applied where 1) the amount of the trading book of this institution does not exceed 5% of its income from all of its activities; 2) the amount of its trading book positions does not exceed ECU 15 million; 3) the trading volume of the trading book does not exceed 6% of all income and the total of all trading book positions does not exceed ECU 20 million.</p> <p>The CAD is not applied to the firms which only accept and execute a client's orders but do not hold the client's monies or securities and which are not responsible for the client's failure to settle the transaction (there are no such firms in Lithuania).</p>
2.	<p>par. 1.3 The financial accounting carried out in the firm and the financial statements are the basis for calculation of capital adequacy. Par. 8.2.5 and 8.2.6 concerning "marking to market". Other paragraphs</p>	<p>Conforms</p> <p>The CAD provides that the trading book positions of an institution must be marked to market every day. The non- trading book positions must be reported at the lower acquisition cost or market value at the end of the accountable period. Credit institutions to which the CAD is not applied (see No1 above) are not required to mark their trading book positions to market every day.</p> <p>Profit or loss, which is received after the trading book positions are calculated (unrealized profit (loss)), must be recognized and reflected in the Profit (Loss) Statement for a certain period. (The value of the collateral must be marked to market every day in order to ensure that the value of the collateral does not fall below the value of the extended loan, but the result of the re-calculation is not recognized in the Profit (Loss) Statement. In this case accrued interest</p>

		increases the value of the extended loan.
3.	Chapter 2	<p>Does not fully conform</p> <p>The CAD does not treat such long-term assets as land and buildings as illiquid assets to the amount they are pledged to another institution for liabilities. Then these assets are treated as pledged and are applied 8% of the risk weighting (liquidity adjustment). Thus, the Lithuanian requirement is more stringent as long-term assets are completely excluded from liquid capital.</p> <p>The CAD allows not to include material holdings in a credit or finance institution if such investment is made temporarily, in order to help that institution, and the supervising institutions are notified about it (e.g. the SC).</p>
4.	Chapter 2 The definition of the Trading Book	<p>Conforms</p> <p>The CAD gives practically the same definition, only some additional conditions are added.</p>
5.	Chapter 2 The definition of the market value	<p>Does not fully conform</p> <p>The CAD provides that all positions must be marked to market every day as set forth for each type of risks, i.e. position, counterparty and settlement, foreign exchange risks. Where these positions do not have readily available market prices, the firm must use the evaluation methods approved by the Commission.</p> <p>When new instruments are introduced to Lithuanian securities market, new methods of determining the market price will have to be established.</p>
6.	Paragraphs 3.1, 3.2 The establishment of the capital adequacy requirement	Fully conforms
7.	Paragraph 3.3 The structure of liquid own capital	<p>Does not fully conform</p> <p>"Own funds" are defined in CAD 89/299 "Own Funds of Credit Institutions". This Directive is also applied to investment firms. But where the CAD is applied to a firm, the definition to be used is the one given in the CAD. The CAD primarily determines the structure of own funds, and all requirements are calculated in relation to own funds. In the Lithuanian draft of the Capital Adequacy Rule the structure of liquid own capital conforms with the defined own funds with some slight exceptions. They are the result</p>

		of the British influence as the Rule was prepared following the capital rules passed in Great Britain, where the capital requirements are a bit more stringent than the CAD provides.
8.	Paragraphs 3.6 and 3.7. The - expenditure requirement and its establishment	Conforms In general, the expenditure requirement as defined in the Rule is in conformity with the CAD. Yet, the CAD does not prescribe the procedure for its calculation as precisely as was selected for the purposes of this Rule. In order to leave less room for interpretation, the British experience was used, and items of expenditure to be deducted while determining annual audited expenses were clearly set forth.
9.	Paragraphs 3.12 - 3.15 Limits on preference shares and the amount of subordinated loans	Conforms In the CAD these limits are defined a little differently. The Lithuanian Rule follows the experience of Great Britain.
10.	Chapter 4. Position Risk Requirement (PRR)	Does not fully conform The main differences are: 1) the Lithuanian Rule provides for more stringent risk weightings of the PRR; 2) in the Rule the risk management of short positions is not addressed at all; 3) in the Rule there is no established procedure for hedging risky positions; 4) the Lithuanian Rule does not provide for the PRR calculation in case of underwriting; 5) there is no provision concerning risk concentration; 6) the Lithuanian Rule does not divide the position risk into specific or general, as is done in the CAD.
11.	Chapter 5 Counterparty settlement requirement (CRR) and risk	Does not fully conform The main differences: 1) In the CAD the CRR is divided into two parts, i.e. counterparty and settlement risks are calculated separately, while in the Lithuanian Rule there is no such division and only one requirement is calculated; 2) provisions in the Lithuanian Rule are simplified and more stringent; 3) the Lithuanian Rule does not provide for the amount of accrued interest to be calculated while establishing the market value of borrowed, lent, or pledged securities in case of securities lending, borrowing, repurchase and reverse repurchase

		agreements.
12.	Chapter 6 Large Exposure Requirement (LER)	<p>Does not fully conform</p> <p>The LER is to be calculated pursuant to Directive 92/121/EEC "Monitoring and Control of Large Exposures in Credit Institutions". While calculating capital adequacy, however, the CAD must be followed, in which certain corrections are made with regard to the LER Directive.</p> <p>The differences between the CAD and the Lithuanian Capital Rule are as follows:</p> <ol style="list-style-type: none"> <li>1) the Lithuanian Rule provides only for the methodology of determining the LER for long positions. If short positions were allowed, the value of long positions would decrease;</li> <li>2) there is no methodology to establish the LER in case of securities underwriting;</li> <li>3) the calculation of the LER as given in the CAD is more flexible. That is due to the differences among the countries which have to apply it. The concrete requirements must be set forth in each country individually;</li> <li>4) the CAD does not stipulate the methodology of the LER calculation. In the Lithuanian Rule this methodology is based on the British experience.</li> </ol>
13.	Chapter 7 Foreign Exchange Requirement (FER)	<p>Conforms</p> <p>However, the order of calculating open positions in the CAD is more detailed (broader), and more financial instruments are described. Besides, the CAD allows the competent institutions to establish the alternative methods for the FER calculation, which have to meet the criteria set forth in the CAD.</p> <p>In the Lithuanian Rule the order of calculating the FER is given in very simple terms. Yet, some problems may appear in case of certain concrete instruments.</p>
14.	Chapter 8 Principles of accounting for the purposes of this Rule	<p>Does not fully conform</p> <p>First, the CAD does not set forth the principles of accounting. The principles of accounting and reporting for financial institutions are provided in Directive 86/635/EEC.</p> <p>The principles of accounting as given in the Lithuanian Rule are quite acceptable, because they provide for the accounting procedures for certain business operations. A few fundamental principles of internal control are also provided, which are similarly set forth in the CAD.</p>
15.	Paragraph 9.3	Does not fully conform

	Submission of reports to the SC	<p>First of all, the CAD provides that the competent institutions must ensure that an investment firm follow all regulations concerning internal control, administration and accounting procedures.</p> <p>An investment firm, which provides such investment services that require the initial own capital of the size of ECU 730000 (the Lithuanian "A" category firms) must submit all reports on capital adequacy at least once a month.</p> <p>An investment firm, which provides such investment services that require the initial own capital of the size of ECU 125000 (the Lithuanian "B" category firms, though not exactly) must submit all reports on capital adequacy at least once every quarter.</p> <p>An investment firm, which provides such investment services that require the initial own capital of the size of ECU 50000 (the Lithuanian "C" category firms, not exactly) must submit all reports on capital adequacy at least once in half a year.</p> <p>An investment firm, which provides such investment services that require the initial own capital of the size of ECU 730000 or ECU 125000 (the Lithuanian "A" and "B" category firms) must submit consolidated or sub-consolidated reports on capital adequacy every 6 months.</p>
16.		<p>The CAD provides that the country's competent institutions establish procedures for the supervision of an investment firm together with its subsidiaries, i.e. consolidated balance sheets are required. In Lithuania there is no established order of consolidation. Therefore, the Lithuanian Rule does not require that.</p>
17.	Statement of Capital Adequacy Calculation	<p>The CAD does not provide for the forms of capital adequacy statements or requirements for these forms. Only a few general statements are given of what an investment firm must report to the competent institutions.</p>

## The List of Participants of the Discussion on the Capital Adequacy Rule

October 16, 1997

Speakers: Skirmantas Rimkus (Pragma Corporation), Liucija Naudžiūnienė (LSC, Market Regulation), Arvydas Jelinskas (Commissioner), Saulius Pečiulis (NAFB)

- |     |                        |                              |
|-----|------------------------|------------------------------|
| 1.  | Jaskelevičius Žilvinas | BH "Apyvarta"                |
| 2.  | Pridotkas Almantas     | - BH "Leodana"               |
| 3.  | Pacanskas Vaidas       | BH "Finbaltus"               |
| 4.  | Varanavičius Valdas    | BH "Finbaltus"               |
| 5.  | Lekevičius Algimantas  | BH "Aukšinė Karūna"          |
| 6.  | Valančiauskas Ramūnas  | BH "Finansų Spektras"        |
| 7.  | Aušra Pilipavičiūtė    | Bank Mekmes                  |
| 8.  | Rudys Edmantas         | BH "Vilfima"                 |
| 9.  | Šeikis Darius          | BH "Eugenijus ir Partneriai" |
| 10. | Steponavičiūtė Jūratė  | BH "Eugenijus ir Partneriai" |
| 11. | Kubilienė Vida         | BH "Pfeiffer and Galland"    |
| 12. | Gakijūnas Jonas        | BH "Viva Moneta"             |
| 13. | Karmazinienė Dalia     | BH "Naugvilda"               |
| 14. | Tvarijonienė Violeta   | BH "Naugvilda"               |
| 15. | Žiburys Julius         | BH "Sinkus"                  |
| 16. | Žiškienė Irma          | BH "Spekonis ir Gastonas"    |
| 17. | Bernatavičienė Jelena  | BH "Mendes Prior Europe"     |
| 18. | Jelenskis Leonidas     | BH "Baltijos VP"             |
| 19. | Daublys Haroldas       | NAFB                         |
| 20. | Šulnis Darius          | BH "Finasta"                 |
| 21. | Mekšrūnas Vidas        | BH "VIVUM"                   |
| 22. | Ganina Renata          | the Securities Commission    |
| 23. | Garnevičienė Rasa      | the Securites Commission     |
| 24. | Ryan James             | the Pragma Corporation       |
| 25. | Buddenbohn Donald      | the Pragma Corporation       |
| 26. | Maskaliūnienė Nijolė   | the Pragma Corporation       |



"VILNIAUS VINGIS" electronics by Vita Markeviciute and Jurga Dermontaite  
Public Company UTENOS GERIMAI by Vita Markeviciute and Jurga Dermontaite

## "VILNIAUS VINGIS" *electronics*

Company : PC "Vilniaus Vingis"  
Director General: Vaclovas Sleinota  
Address: 176 Savanoriu St., Vilnius, Republic of Lithuania  
Tel.: (3702) 237 770  
Fax: (3702) 237 393

Registration date: February 25, 1994  
Authorised capital: 45,615,525 LTL  
Main business: Manufacturer of Deflection Yokes  
Number of employees: About 2,000

Last traded price: 3.39 LTL (97/10/20)  
Market capitalisation: 30,927,325.95 (97/10/17)  
Face value: 5 LTL  
Price range (Jan.-Aug.): Low 2 LTL (07/01/97)  
High 8 LTL (22/01/97)  
P/E: 9.6 (97/10/17)

### Short history

The company "Vilniaus Vingis" was founded in 1956. In the former Soviet Union it was the largest electronic company, unique in its range of production. Vilniaus Vingis has a 30 - year - old history of designing and manufacturing electronic components for television sets, monitors and radios, and has retained the leading position in this branch of electronics in Lithuania. The plant was privatised in 1994, mostly by local Lithuanian investors. The authorised capital of the company is LTL 45.6 million (USD 11.4 million). In July 1997, the Estonian investment company "Tallinvest" acquired 30.3% of the company's outstanding shares and became the largest holder of its shares. The second largest shareholder is the state of Lithuania, which owns 23% (see Figure 2).

### Manufacturing

"Vilniaus Vingis" specialises in producing:

- deflection yokes for colour TV sets and computer monitors;
- fly back transformers for television screens;
- high and low voltage transformers for radio and TV sets, and;
- special purpose technological equipment, devices and tools

In 1989, the company bought a licence from RCA for manufacturing deflection yokes and a licence from SANYO for the production of high voltage transformers. Deflection yokes make up approximately 70% of the company's production, transformers total about 17%, and other products comprise 11% (see Table 1).

Table 1

	1994		1995		1996		1997E	
	units (m)	%	units (m)	%	units (m)	%	units (m)	%
Deflection yokes	1.817	65.024	1.863	70.11	2	71.46	2.9	70.14
transformes	0.52	25.448	0.57	16.47	0.7	17.31	1	22.29
magnetic convergence units	0.3	1.37	1.58	7.28	1.83	6.98	1.8	4.63
air heaters	0.006	1.42	0.013	2.31	0.009	1.32	0.01	1.06
other products	n.a.	7.015	n.a.	3.83	n.a.	2.93	n.a.	1.88

Source: Memorandum'96 of "Vilniaus Vingis"

The graph below (Fig. 1), illustrates the increase in the volume of deflection yoke production and sales every year.

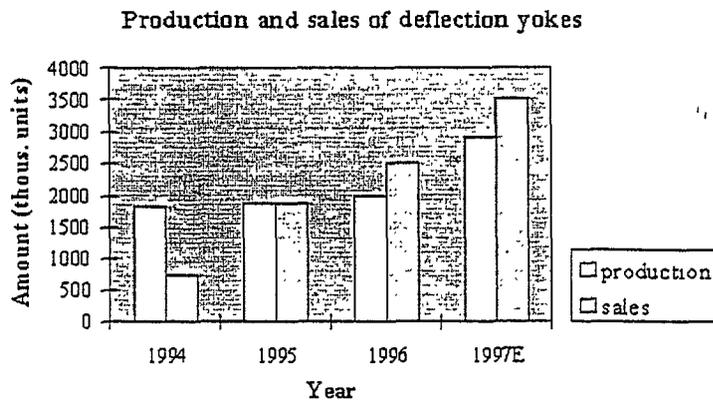


Figure 1

### Realization

The products of "Vilniaus Vingis" are traded not only in Lithuania but also in CIS countries, Latvia, Estonia and Western Europe (mostly in Germany). In 1996, total sales amounted to LTL 47.1 million. During the first half of 1997 this figure was LTL 28.3 million, a 28% increase over than during the same period in 1996. Although the primary consumer of its products is PC "Ekranas", a television screen producer in Panevezys, Lithuania, the sales for new consumers is steadily increasing. For instance, in 1996, 80% of the company's production (74% during the first half of the year) was sold to "Ekranas" while during the same period in 1997 at part comprised at only 55% (see Table 2). In 1995, "Vilniaus Vingis" signed a contract with the South Korean company "Samsung" EB GmbH which is working in Berlin selling deflection yokes. Every year the contract is renewed. In 1996 "Samsung" bought about 13.7% of the Lithuanian company's production. This year, orders from Samsung have tripled when two new products were introduced. "Vilniaus Vingis" intends to sign a long-term contract with "Philips" (Spain) which has given a positive evaluation to the quality of deflection yokes.

Table 2

Country	1996, Ist half (%)	1997, Ist half (%)
Lithuania	74	55
CIS	13	17
Germany (SAMSUNG)	12	26
Other countries	1	2

### Main competitors

PC "Vilniaus Vingis" holds a monopoly in Lithuania in production of deflection yokes, yet it has competitors in CIS countries and some Western countries, namely PC "Zond", PC "Anod", PC "Radiant" in Russia and Brest Electromechanical plant (Byelorussia). However, these TV component producers currently operate at only 10-20% of their total capacity. They compete by a low price of their products, their weakest point being quality. The most important competitors in the Western market are "Elfema" (Germany) and "SPEM" (Portugal). Both companies supply deflection yokes to "Samsung EB" in Berlin. Although "Vilniaus Vingis" is competitor to them in quality and

reliability, "Elfema" and "SPEM" are characterised by a better organised logistics. Vilniaus Vingis have no possibility of competing with these two companies by lower prices because the prices of "SPEM" are identical to those of "Vilniaus Vingis", and those of "Elfema" are even lower. On the other hand, a highly qualified team of constructors of "Vilniaus Vingis" is capable of promptly solving different issues of innovations, this was ensuring swift adaptation to any new trends in the production of television sets. Moreover, the company anticipates a quality certificate ISO 9002 to be granted in September, which will open new possibilities for competition on the international market.

Other competitors of "Vilniaus Vingis" are "Eldor", "Termal" (Turkey), "Philips" (England).

## Financial analysis

Table 3

	01 01 96	01 07 96	01 01 97	01 07 97
Long term assets(LTL)	23,621,986	27,266,759	27,998,888	31,080,695
Current assets(LTL)	15,854,576	15,422,789	17,299,217	19,744,517
Total assets(LTL)	38,987,803	42,741,975	45,423,282	51,526,855
Stocks(LTL)	10,811,016	10,423,515	10,897,609	12,575,037
Current liabilities(LTL)	4,050,107	5,850,381	8,856,315	16,549,410
Owners equity(LTL)	21,870,564	23,891,557	36,215,128	34,539,699
Authorised capital(LTL)	14,579,950	24,367,665	31,795,525	31,795,525
Sales(LTL)	36,767,951	22,134,028	47,073,637	28,276,630
Net profit	-3,389,732	-477,007	4,418,704	-1,675,429
<b>INDICES</b>				
Net profit margin(%)	-9.22	-2.16	9.39	-5.93
Current ratio	3.91	2.64	1.95	1.19
Quick ratio	1.25	0.85	0.72	0.43
D/E	0.78	0.79	0.25	0.49
ROE(%)	-15.50	-2.00	12.2	-4.85
ROA(%)	-8.69	-1.12	9.73	-3.25
TAT	0.94	0.52	1.04	0.55

During the first half of this year, the company's assets increased by LTL 6.1 million, which is by 1.6 times higher than during the same period in 1996. The company invested into production LTL 4.2 million, i.e. by 83.1% more than during the same period in 1996.

In the first half of 1996 the sales of products amounted to LTL 6.1 million, more by 28% than during the first half of the previous year;

In 1996, the company received LTL 4.4 million in net profit, but during the first half of 1997 it suffered a loss of LTL 1.6 million, which exceeds the same indicator of 1996 by 3.5 times. The loss of LTL 1.6 million was caused by a number of factors, such as the drop in the currency rate of German Mark, the growing cash turnover which resulted in extra expenses on borrowing from banks, indebtedness to suppliers for materials and others.

## Ownership structure

Table 4

Shareholders	Jun'1997	%	July'1997	%
Government	2,129,657	33.49	2,129,657	23.34
Hansapank, Ltd Estonia, Tallinn	1,333,478	20.96	1,333,478	14.62
Three investment companies:				
IC "Trikotazo investicija"	279,744	4.44	279,744	3.07
IC "Vilinvest"	279,744	4.44	279,744	3.07
IC "Nekilnojamās turtas"	279,744	4.44	279,744	3.07
New Century Holdings	251,154	3.90	251,154	2.75
Tallinnvest	-	-	2,764,000	30.29
Others	1,805,584	28.39	1,805,584	19.79
Total:	6,359,105	100.00	9,123,105	100.00

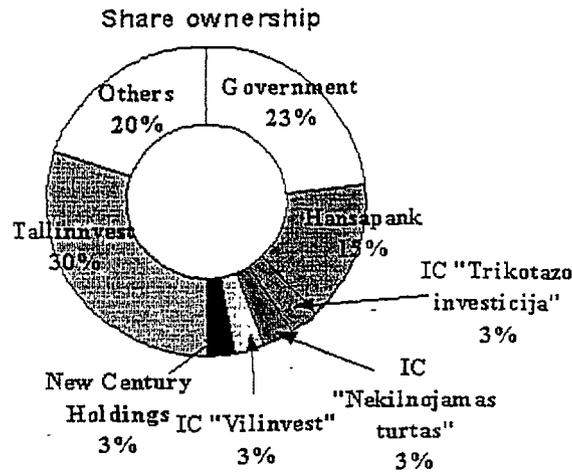


Figure 2

In July 1997 "Vilniaus Vingis" distributed a new issue of shares valued at 13,860,000 LTL and increased its authorised capital to 45,615,525 LTL. The new issue of "Vilniaus Vingis" was acquired by Estonian investment company "Tallinvest" and the Lithuanian FBF "Suprema" acting as an intermediary for them. The subscriber owns 30.3% of the authorised capital and has become the major shareholder of the company. "Hansapank" holds 15%, while the state-owned part of the capital has been reduced from 33.49% to 23%.

#### Trading on the Stock Exchange

- \* "Vilniaus Vingis" was listed on the A list of the NSEL in 1996 but its shares have been traded since May of 1995.
- \* Face value of the share - 5 LTL
- \* In 1996 maximum share price was 2.00 LTL and min share price was 0.9 LTL.
- Through the first seven months of 1997, maximum share price was 8.00 LTL (22/01/97) and minimum price was 2.00 LTL (07/01/97)
- \* Last traded price was 4.2 LTL (05/09/97)
- \* Price fluctuation rate in 1997 is shown in Fig. 3:

### Price fluctuation rate

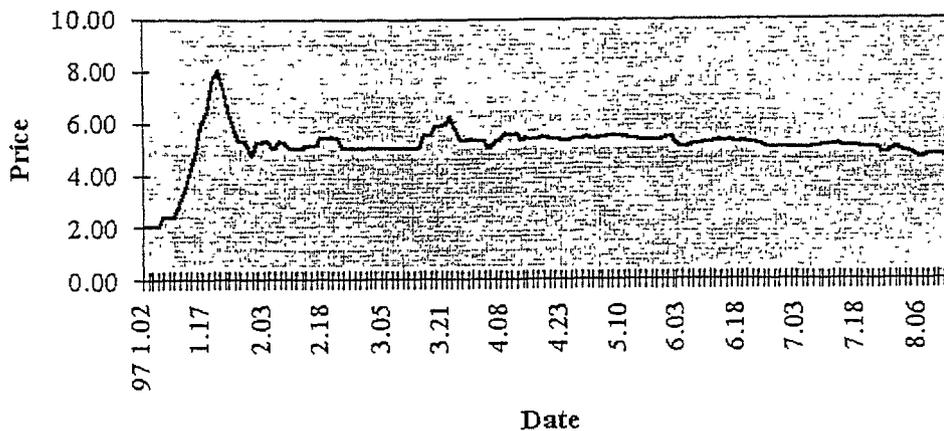


Figure 3

## MEMORANDUM

To: Securities Commission  
Central Securities Depository of Lithuania  
National Association of Financial Brokerage Firms  
National Stock Exchange

Copy: James Ryan

From: Gediminas Rečiūnas

Re: Securities portfolio management

Date: October 7, 1997.

The present memorandum concludes a legal investigation of securities portfolio management agreements, which currently intermediaries of public trading in securities offer to their clients. Conclusions drawn on the basis of analysis of the effective legal acts and the agreements in question are rather preliminary, and their appropriateness will be approved or denied in the course of further discussions with the Securities Commission and market participants.

Currently some financial brokerage firms employ a rather peculiar portfolio management procedure, i.e. they make up a single securities portfolio for a group of clients instead of offering separate portfolios for each individual clients. Such procedure is more inherent to investment funds, rather than to portfolio management by a financial brokerage firm.

In general, currently valid legal acts set forth certain requirements to management of securities portfolio by investment funds, including diversification of portfolio. Besides, an investment fund invests funds collected from the shareholders not directly but through a investment management and consulting firm, while safe keeping of the portfolio is transferred to a custodian. Such segregation of functions enhances safety of the securities portfolio.

Whereas, in case of financial brokerage firm, there are no diversification requirements or risk reducing segregation of functions set forth with respect to the securities portfolio management. Consequently, an investor, having entrusted management of securities portfolio to the financial brokerage firm, is placed in a position where he has to protect his interests himself, i.e. to instruct brokers on formation of the portfolio as well as management and liquidation of the portfolio, etc. Therefore it is evident, that only bigger investors will be able to properly protect their interests.

Moreover, management of securities portfolio for smaller investors can hardly be profitable for a financial brokerage firm due to relatively higher costs. Besides, it is hardly possible, that small investors could afford or had enough expertise to develop their own investment strategies. The aforesaid could result in a situation when financial brokerage firms will manage portfolios of bigger investors exclusively, while smaller investors would have to become shareholders of investment funds. In the absence of investment funds in Lithuania, the gap is filled in by financial brokerage firms. Still, in the best interests of shareholders, formation of common portfolio for a group of clients should not be tolerated.

Another group of problems with respect to management of investment portfolios is related to powers granted to financial brokers. Currently used agreements often include a provision that a broker shall act in the best interests of the clients and he is also granted an almost unlimited freedom in management of the securities portfolio of the client at his own discretion. This kind of problem is inherent in the very nature of agreements. As a rule, they are based on agency, and the agent (FBF) directly creates rights and obligations to the principal (client). It is but natural, that the client, seeking to protect his own interests, shall try to come up with as accurate as possible instructions for the agent. Though agreements on which broker-client relationship is currently based provide for almost unlimited rights of the brokers in taking decisions regarding investments.

Portfolio management agreements based on commission agency could make an acceptable alternative for the same agreements based on ordinary agency. Pursuant to such agreements brokers would acquire rights and obligations with respect to third persons and on the basis of the agreement would transfer the securities (or cash for the sold securities) after the order is executed. In this case the client has an obligation to take over only what has been properly carried out against the order or he can refuse to accept the execution of the order, and in order to make the client approve his actions the broker will have to justify the execution of the order. Whereas in case of representation, the client will have to prove that the order was not properly executed and only in case of success he will be able to seek recovery of losses from the broker.

The above analysis reveals that portfolio management agreement may be of two types. The agreement on commission agency basis is more favourable for the client while financial brokerage firms favour portfolio management agreement based on ordinary agency. In the latter case instructions to brokers should be issued extremely carefully.

In relation to portfolio management agreement based on commission agency, procedure of placing of commission orders needs to be examined. Evidently the broker shall place orders in his own name, thus he will be able to combine (join) securities sale/purchase orders for several clients and later transfer them to each client. (Whereas in the case of agreement based on ordinary agency, orders are to be placed in the name of each individual client). Requirement for the broker

to note the name of the client for whom the securities are sold/purchased on the order placed in the broker's name is believed to facilitate control over the procedure.

The above considerations reveal that investment management and consulting firms could also have a right to manage the accounting of securities making up the portfolio, though for this purpose Par. 2 of Art. 14 of the Law on Public Trading in Securities needs to be supplemented.

As to personal securities accounts handled on commission agency basis, having examined the effective legal acts, I have not found any provisions that prevent existence of such accounts. Personal securities account is opened for a client in his name and the securities therein are deemed his ownership (code 11).

As it has been mentioned, in case the securities portfolio is managed by a financial brokerage firm, the agreement may be either ordinary agency or commission agency based. Though in case an intermediary is introduced between the client and the financial brokerage firm, namely investment management and consulting firm, portfolio management agreement based on commission agency seems to be much more appropriate mainly for the following essential reason: investor is related by contractual obligations to the investment management and control firm only, and he deprived of possibility to influence the choice of financial brokerage firm, through which the order will be handled. Thus it appears more logical that the investment management and consulting firm assumes rights and duties with respect to third persons and later transfers the acquired securities or cash funds to its clients pursuant to the portfolio management agreement.

One way or another, actual activity of some of the intermediaries in public trading is not in line with (is contrary to) these theoretical considerations. Actually an investment management and consulting firm represents the investors, it acts in their name and on their account, it is also granted broad authorisation to take decisions regarding investment. Although the agreements include provisions regarding responsibility of the investment management and consulting firm with respect to the investor for passing unacceptable decisions, singling out of the investment management and a consulting firm into a separate legal entity reduces the intermediaries' risk as well as probability of recovery of damage incurred by investors.

It becomes obvious that interests of clients of investment management and consulting firms are much more subject to violation, thus for the sake of their protection it seems to be logical to set forth a requirement, that investment management and consulting firm can manage the securities portfolio only on commission agency basis.

Speaking of improvement of the legal basis for securities portfolio management, the current Law on Public Trading in Securities needs to be considered. There is

some uncertainty as to what accounting is to be carried out by the investment management and consulting firms (Par.2 Art.15), and for what reason they are precluded from managing personal securities accounts (Par.2 Art.28).

Another problematic issue is the joint responsibility of the investment management and consulting firm and FBF. Although in general welcome, practical implementation of this provision will cause certain difficulties. Evidently, a broker will have to check the orders only formally, i.e. to verify their legality, and financial brokerage firm should not evaluate the appropriateness of execution of orders. In an opposite case financial brokerage firms would perform the same functions as an investment management and consulting firms, which would entirely eliminate the necessity for existence of the latter as a separate legal entity. Thus, a broker, given a possibility to check the orders only formally, should not be deemed jointly responsible for the investment decisions made by an investment management and consulting firms which to a great extent are at the risk of the latter.

Commenting on drafting the rule on the securities portfolio agreement, I will limit myself to only one remark. The draft rule seems to lack general provisions on the legal nature of the agreement and obligations of the parties, though these are essential provisions underlying the agreement and individual requirements.

When the Securities Commission and the market participants have discussed the basic provisions, the Pragma consultants will avail themselves in preparation of draft rules and typical portfolio management agreement (in case it is decided such is needed).

# THE PRAGMA CORPORATION

Lithuanian Capital Market  
Development Project  
Stock Exchange Building  
Ukmergės 41, Suite 514  
2662 Vilnius, Lithuania  
Tel: (370 2) 72 48 26, 72 15 19  
Fax: (370 2) 72 49 42

October 28, 1997 2:35PM

## Fax Cover Sheet

To: Mr. Aldas Kriauciunas, Director, OER  
Company: USAID/Vilnius  
Fax Number: 22 29 54  
From: Donald Buddenbohn  
Re: Capital Adequacy of Financial Brokerage Firms

Number of Pages Including this Cover Sheet: 5

### Message:

# THE PRAGMA CORPORATION

Lithuanian Capital Market  
Development Project  
Stock Exchange Building  
Ukmergės 41, Suite 514  
2662 Vilnius, Lithuania  
Tel: (370 2) 72 48 26, 72 15 19  
Fax: (370 2) 72 49 42

October 28, 1997 2:26PM

## MEMORANDUM

**To:** Aldus Kriauciunas, Director, OER

**Company:** USAID/Vilnius

**From:** Donald Buddenbohn

**Phone #:** (370 2) 72 39 41

**Re:** Capital Adequacy of Financial Brokerage Firms

**C/C:** Virgilijus Poderys , Chairman Lithuanian Securities Commission  
Jacques DeFay, Pragma/USA  
Dow Heard, Pragma Corporation/Moscow  
James Ryan, Pragma Corporation/Vilnius  
Diana Sokolova, Pragma Corporation/Vilnius (Office Copy)

### Message:

Attached are two summaries, one for "A" and one for "B" firms, of the capital adequacy analyses and a memorandum of observations concerning the capital adequacy calculations.

**The Pragma Corporation**  
**U.S.A.I.D. Capital Markets Consultants**  
Phones/Faxes: (370 2) 72 49 42

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**To:** Aldas Kriauciunas, Director, OER  
**Fax Number:** 222 954  
**From:** Pragma Corporation-Jim Ryan  
**Date:** October 21, 1997  
**No. of Pages:** 17 (including this one)  
**Subject:** Capital Adequacy of Finance Brokerage Firms

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Aldas,

The memo and spread sheet reports the capital positions of the Finance Brokerage Firms as of September 30, 1997. It is an advance copy in that the memo will be translated and sent to the four "clients" by the end of the week.

If you have questions, give me a call.

Jim Ryan

## CAPITAL ADEQUACY OF FINANCIAL BROKERAGE FIRMS

A financial brokerage firm satisfies the Capital Adequacy test when its Liquid Own Capital equals or exceeds its Capital Adequacy requirement. Its Capital Adequacy is the highest of the following three determinations:

1. Minimum Initial Own Capital established by the Securities Commission's Rule on Initial Own Capital, Resolution No 5,
2. The sum of the financial brokerage firm's position risk, counterparty and settlement risk, large exposure risk and foreign exchange risk requirements as provided for by the Securities Commission's draft Rule on Capital Adequacy and Capital Adequacy Calculation Statement,
3. The financial brokerage firm's expenditure requirement as provided for by the Securities Commission's draft Rule on Capital Adequacy and Capital Adequacy Calculation Statement.

In view of the imminent large increase in the Minimum Initial Capital requirement as of January 1, 1998 and the recent circulation for comment by the Securities Commission of the Capital Adequacy Calculation Statement, it is important to determine if financial brokerage firms satisfy to these requirements.

Using the financial statements that financial brokerage firms submitted to the Commission as of September 30, 1997, a calculation of their Capital Adequacy was made as of that date. The Commission received Balance Sheets and Statements of Operation from 12 Category "A" and 19 Category "B" firms. Two other Category "A" and two other Category "B" firms submitted Balance Sheets only. No firms, Category "A" or "B", submitted Appropriation Account Statements. Two Category "A" firms did not submit any financial statements. No firms submitted any detailed information on accounts receivable, investments or trading accounts.

Because of the absence of information, it was not possible to be thorough or completely accurate with all calculations. Without Appropriations Account Statements, it was not possible to verify amounts that seemed erroneous. Without information on ageing of accounts receivable, investments and trading positions and the quality and kinds of investments and trading positions, it was not possible to make some necessary calculations. Nevertheless, some meaningful observations were possible, which are presented in the attached analyses.

I think that the calculations of the Expenditure Requirement are reasonably accurate. Nine of the 11 Category "A" firms who submitted Statements of Operation meet the requirement easily. One firm, Finasu, missed it narrowly and the other, Baltfina, missed it by approximately 37,000 litas. Fifteen of the 19 Category "B" firms who submitted Statements of Operation meet the requirements. Four Category "B" firms, Lusu Tarpininkas, Mojus, More Mejorum and Sinkus came up short of their requirement by between 4,000 to 21,000 litas.

The Minimum Initial Own Capital requirement of Resolution No 5 on January 1, 1998 will be 270,000 ECU for Category "A" firms and 36,000 ECU for Category "B" firms. Using the conversion rate on September 30, 1997, the requirements would be 1,201,284 and 160,171 litas, respectively.

There was some information that was not available for a totally accurate calculation of Liquid Own Capital, but generally, it seems to be a realistic approximation.

Only three Category "A" firms, Finasta, Mifonda and Vilfima, meet the requirements of the Minimum Initial Own Capital test. Finasta narrowly meets this test by only approximately 8,000 litas. The next closest to meeting the requirement is Alterna, which misses by approximately 301,000 litas. If the Minimum Initial Own Capital requirement were reduced to 75%, or 900,963 litas, as the National

Association of Financial Brokers has suggested, no additional firms would meet the test, but three firms, Alterna, Balticum and Naugvilda, would come within 50,000 litas. All Category "A" firms, except Finansu and Baltfina, would meet the Minimum Initial Own Capital requirement of 160,171 litas for Category "B" firms.

Only one Category "B" firm, Palacio, meets the requirement of the Minimum Initial Own Capital test. If the requirement were reduced to 75%, or 120,128 litas, three additional firms, Pragma, Vertybiu Fondas and Viva Moneta, would meet the test and another three, Achemos, Ermitentas and Finvesta, would come within 20,000 litas of meeting it.

Because so much information is missing, it was not possible to calculate the test for the sum of the firms' position risk, counterparty and settlement risk, large exposure risk and foreign exchange risk requirements. This test may prove to be the most difficult for the financial brokerage firms to meet and we may find that one or more of the three Category "A" and one Category "B" firms that met the Minimum Initial Own Capital test may not meet this test.

LITHUANIAN CATEGORY "A" BROKERS  
LIQUID OWN CAPITAL AND OTHER CALCULATIONS  
AS OF SEPTEMBER 30, 1997

Source of Data	Alterna	Baltina	Balticum	Baltijos	Diskontas	Elmarket	Finansu	Finasta	Kazeno	Lithun Maklenai	Maqistra	Mendes	Mifonda	Naugvilda	Suprema	Vilfima	
<b>A. Initial own capital:</b>																	
1 Total nominal value of ordinary share capital and preference non-cumulative share capital	A.I Capital B/S	420,000	701,400	700,000	850,000	507,000	458,700	450,000	1,400,000		470,057	645,100	320,000	1,700,000	833,500		2,150,000
2 Share premium	A.II Capital B/S			1,200			(40)					160,000					
3 Reserves, except revaluation reserve	A.IV Capital B/S	220,790				1,217		34	20,803		726	6285	74	386			120,001
4 Audited profit (loss) brought forward	A.V 2 Capital B/S	13,477	(68,813)	(7,646)	(30,946)	22,754	(4,747)	5,407	88,993	(18,559)	-245,554	753		5,978			1,403,920
5 Current period audited profit	XIII P&L	343,940	4,997	426,256	3,953	102,454	10,305	24,496	14,564	9,411	-30079	107		11,883			3,397,218
6 Current period loss	XIII P&L												(20,239)				
11 A.Total initial own capital (1 +2.+3 +4.+5.-6 )		998,207	637,584	1,119,810	823,007	633,425	464,218	479,937	1,524,360	0	461,635	375,752	480,934	1,679,761	851,747	0	7,071,139
<b>B. Original own funds:</b>																	
12 Investments in own shares	A.IV.2.1 Assets B/S																
13 Value of intangible assets	A.I+A.II Assets B/S		438	4,730			1,700	1,628		10,232		3,210	1,066				8,617
14 B.Total original own funds (11.-12.-13 )		998,207	637,146	1,115,080	823,007	633,425	462,518	478,309	1,524,360	0	451,403	375,752	477,724	1,678,695	851,747	0	7,062,522
<b>C. Own funds:</b>																	
15 Nominal value of cumulative preference shares	?																
16 Long term subordinated debt	D I 1.1 Liab B/S																
17 Revaluation reserves	A.III Capital B/S	46	44,760					4,280		3,643							
18 C.Total own funds (14 +15 +16 +17 )		998,253	681,906	1,115,080	823,007	633,425	462,518	478,309	1,528,640	0	455,046	375,752	477,724	1,678,695	851,747	0	7,062,522
<b>D. Liquid own capital:</b>																	
19 Short term subordinated debt	D.II.1 Liab. B/S																
20 Interim net trading book profit	?																
21 Liquidity adjustment	?																
22 Illiquid assets	A.III+B I+C Assets B/S	98,647	715,675	222,985	184,904	19,274	15,665	422,877	319,145	22,819	80539	107,444	46,749	148			3,211,871
23 Total liquid own capital (18 +19 +20 -21.-22.)		899,606	(33,769)	892,095	638,103	614,151	446,853	55,432	1,209,495	0	432,227	295,213	370,280	1,631,946	851,599	0	3,850,651
Minimum Initial capital as of January 1, 1998	Sec Comm Res # 5	1,201,284	1,201,284	1,201,284	1,201,284	1,201,284	1,201,284	1,201,284	1,201,284	1,201,284	1,201,284	1,201,284	1,201,284	1,201,284	1,201,284	1,201,284	1,201,284
75% of minimum initial capital as of January 1, 1998		900,963	900,963	900,963	900,963	900,963	900,963	900,963	900,963	900,963	900,963	900,963	900,963	900,963	900,963	900,963	900,963
<b>Other Requirements:</b>																	
<b>Expenditures.</b>																	
Services, works and research	II.2 P&L			648,168	98,195	603,389	9,488	235,861		86,844	25597	67,194		786			1,001,666
Operating expenses	IV. P&L		8,292		33,265		105,651	164,663				235,694		41,546			2,242,010
Other operating expenses	VI.2 P&L		43				1,610	1,827,581						320			32,196
Income Taxes	XII P&L		2,041	90,316	1,615	30,896	2,030	3,682	1,539					6,385			905,986
Total		0	10,376	738,484	133,075	634,285	117,167	169,955	2,064,981	0	90,688	25,597	302,888	0	49,037	0	4,181,858
Above Total Annualized		0	13,800	982,184	176,990	843,599	155,832	226,040	2,746,425	0	120,615	34,044	402,841	0	65,219	0	5,561,871
Expenditure requirement	1/4 of above	0	3,450	245,546	44,247	210,900	38,958	56,510	686,606	0	30,154	8,511	100,710	0	16,305	0	1,390,468
<b>Paragraph 3.12 of Cap. Adeq. Rule:</b>																	
Cumulative preference shares	Row 15, above	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Long term subordinated debt	Row 16, above	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Revaluation reserves	Row 17, above	46	44,760	0	0	0	0	0	4,280	0	3,643	0	0	0	0	0	0
Total		46	44,760	0	0	0	0	0	4,280	0	3,643	0	0	0	0	0	0
Original own funds (above total not to exceed this)	Row 14, above	998,207	637,146	1,115,080	823,007	633,425	462,518	478,309	1,524,360	0	451,403	375,752	477,724	1,678,695	851,747	0	7,062,522
<b>Paragraph 3.13 of Cap. Adeq. Rule:</b>																	
Cumulative preference shares	Row 15, above	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Long term subordinated debt	Row 16, above	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Total		0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
50% of original own funds (above total not to exceed this)	50% of row 14, above	499,104	318,573	557,540	411,504	316,713	231,259	239,155	762,180	0	225,702	187,876	238,862	839,348	425,874	0	3,531,261
<b>Paragraph 3.14 of Cap. Adeq. Rule:</b>																	
Short term subordinated debt	Row 19, above	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
200% of original own funds (above not to exceed this)	200% of row 14, above	1,996,414	1,274,292	2,230,160	1,646,014	1,266,850	925,036	956,618	3,048,720	0	902,806	751,504	955,448	3,357,390	1,703,494	0	14,125,044

LITHUANIAN CATEGORY "B" BROKERS  
LIQUID OWN CAPITAL AND OTHER REQUIREMENTS  
AS OF SEPTEMBER 30, 1997

	Source of Data	Palaicio	Pfeiffer & Gaillard	Pragema	Sinkus	Spekonis & Gastonas	Slakne-vicienes	Verslo benrdai	Vertybiu Fondas	Vilniaus Kapitalo Rinka	Viva Moneta	
<b>A. Initial own capital:</b>												
1	Total nominal value of ordinary share capital and preference non-cumulative share capital	A.I Capital B/S	110,000	151,259	60,000	104,000	70,000	65,653	60,000	135,000	220,000	180,000
2	Share premium	A.II Capital B/S		80						500		
3	Reserves, except revaluation reserve	A.IV Capital B/S		11,733	8,737	60,496			933		7,254	
4	Audited profit (loss) brought forward	A.V 2 Capital B/S	14,679	(1,367)			20,058	6,430		2,429	11,395	(2,456)
5	Current period audited profit	XIII P&L	53,911		92,081	48,105	18,778		111		587,739	1,967
6	Current period loss	XIII P&L		(11,867)				(616)		(869)		
11	A.Total initial own capital (1 +2 +3 +4 +5 -6)		178,590	149,838	160,818	212,601	108,836	71,467	61,044	137,060	826,389	179,511
<b>B. Original own funds:</b>												
12	Investments in own shares	A.IV.2.1 Assets B/S		4,996	847	1,094	400					556
13	Value of intangible assets	A.I+A.II Assets B/S										
14	B Total original own funds (11 -12 -13)		178,590	144,842	159,971	211,507	108,436	71,467	61,044	137,060	826,389	178,955
<b>C. Own funds:</b>												
15	Nominal value of cumulative preference shares	?										
16	Long term subordinated debt	D.I 1 1 Liab B/S					1,000					
17	Revaluation reserves	A.III Capital B/S										
18	C Total own funds (14 +15 +16 +17)		178,590	144,842	159,971	211,507	109,436	71,467	61,044	137,060	826,389	178,955
<b>D. Liquid own capital:</b>												
19	Short term subordinated debt	D.II 1 Liab B/S										
20	Interim net trading book profit	?										
21	Liquidity adjustment	?										
22	Illiquid assets	A.III+B.I+C Assets B/S	17,122	119,367	18,759	119,958	38,217	20,164	29,758	6,868	763,272	38,118
23	Total liquid own capital (18 +19 +20 -21.-22)		161,468	25,475	141,212	91,549	71,219	51,303	31,286	130,192	63,117	140,837
<b>Minimum initial capital as of January 1, 1998</b>												
75% of minimum initial capital as of January 1, 1998												
	Sec. Comm. Res. # 5		160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171
			120,128	120,128	120,128	120,128	120,128	120,128	120,128	120,128	120,128	120,128
<b>Other Requirements:</b>												
<b>Expenditures:</b>												
	Services, works and research	II 2 P&L	71,396			258,357		28,410	14,829		65,004	
	Operating expenses	IV. P&L		54,553	43,580	53,778			584	30,625		6,891
	Other operating expenses	VI.2 P&L		4,503		19,014			741			288
	Income Taxes	XII P&L	17,485		37,611	6,005				162	11,330	
	Total		88,881	59,056	81,191	337,154	0	28,410	16,154	30,787	76,334	7,179
	Above Total Annualized Expenditure requirement	1/4 of above	118,212	78,544	107,984	448,415	0	37,785	21,485	40,947	101,524	9,548
			29,553	19,636	26,996	112,104	0	9,446	5,371	10,237	25,381	2,387
<b>Paragraph 3.12 of Cap. Adeq. Rule:</b>												
	Cumulative preference shares	Row 15, above	0	0	0	0	0	0	0	0	0	0
	Long term subordinated debt	Row 16, above	0	0	0	0	1,000	0	0	0	0	0
	Revaluation reserves	Row 17, above	0	0	0	0	0	0	0	0	0	0
	Total		0	0	0	0	1,000	0	0	0	0	0
	Original own funds (above total not to exceed this)	Row 14, above	178,590	144,842	159,971	211,507	108,436	71,467	61,044	137,060	826,389	178,955
<b>Paragraph 3.13 of Cap. Adeq. Rule:</b>												
	Cumulative preference shares	Row 15, above	0	0	0	0	0	0	0	0	0	0
	Long term subordinated debt	Row 16, above	0	0	0	0	1,000	0	0	0	0	0
	Total		0	0	0	0	1,000	0	0	0	0	0
	50% of original own funds (above total not to exceed this)	50% of row 14, above	89,295	72,421	79,986	105,754	54,218	35,734	30,522	68,530	413,195	89,478
<b>Paragraph 3.14 of Cap. Adeq. Rule:</b>												
	Short term subordinated debt	Row 19, above	0	0	0	0	0	0	0	0	0	0
	200% of original own funds (above not to exceed this)	200% of row 14, above	357,180	289,684	319,942	423,014	216,872	142,934	122,088	274,120	1,652,778	357,910

LITHUANIAN CATEGORY "A" BROKERS  
 LIQUID OWN CAPITAL AND OTHER CALCULATIONS  
 AS OF SEPTEMBER 30, 1997

	<u>Alterna</u>	<u>Baltfina</u>	<u>Balticum</u>	<u>Ballijos</u>	<u>Diskontas</u>	<u>Elmarket</u>	<u>Finansu</u>	<u>Finasta</u>	<u>Kazeno</u>	<u>Lithun Makleriai</u>	<u>Magistra</u>	<u>Mendes</u>	<u>Mifonda</u>	<u>Naugvilda</u>	<u>Suprema</u>	<u>Vilfima</u>
Liquid own capital	899,606	(33,769)	892,095	638,103	614,151	446,853	55,432	1,209,495		432,227	295,213	370,280	1,631,946	851,599		3,850,651
Minimum initial capital as of January 1, 1998	1,201,284	1,201,284	1,201,284	1,201,284	1,201,284	1,201,284	1,201,284	1,201,284		1,201,284	1,201,284	1,201,284	1,201,284	1,201,284		1,201,284
Capital Adequacy Excess (Deficit)	(301,678)	(1,235,053)	(309,189)	(563,181)	(587,133)	(754,431)	(1,145,852)	8,211		(769,057)	(906,071)	(831,004)	430,662	(349,685)		2,649,367
75% of minimum initial capital as of January 1, 1998	900,963	900,963	900,963	900,963	900,963	900,963	900,963	900,963		900,963	900,963	900,963	900,963	900,963		900,963
Capital Adequacy Excess (Deficit) @ 75%	(1,357)	(934,732)	(8,868)	(262,860)	(286,812)	(454,110)	(845,531)	308,532		(468,736)	(605,750)	(530,683)	730,983	(49,364)		2,949,688
Minimum initial capital for "B" firms as of January 1, 1998	160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171		160,171	160,171	160,171	160,171	160,171		160,171
Capital Adequacy Excess (Deficit) using "B" firm requirement	739,435	(193,940)	731,924	477,932	453,980	286,682	(104,739)	1,049,324		272,056	135,042	210,109	1,471,775	691,428		3,690,480
Expenditure requirement		3,450	245,546	44,247	210,900	38,958	56,510	686,606		30,154	8,511	100,710		16,305		1,390,468
Expenditure Requirement Excess (Deficit)		(37,219)	646,549	593,856	403,251	407,895	(1,078)	522,889		402,073	286,702	269,570		835,294		2,460,183

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LITHUANIAN CATEGORY "B" BROKERS  
LIQUID OWN CAPITAL AND OTHER REQUIREMENTS  
AS OF SEPTEMBER 30, 1997

	<u>Achemos</u>	<u>Depozitas</u>	<u>Emitentas</u>	<u>Eugenijus &amp; Partnenai</u>	<u>Fiksas</u>	<u>Finvesta</u>	<u>Inltuva</u>	<u>Lusu Tar- pininkas</u>	<u>Mojus</u>	<u>More Mejonum</u>	<u>Obligacija</u>	<u>Palalcio</u>	<u>Pfeiffer &amp; Galland</u>	<u>Pragema</u>	<u>Sinkus</u>	<u>Spekonis &amp; Gastonas</u>	<u>Stakne- vicienes</u>	<u>Verslo benrdai</u>	<u>Vertybiu Fondas</u>	<u>Vilniaus Kapitalo Rinka</u>	<u>Viva Moneta</u>
Liquid own capital	115,723	15,369	112,850	48,801	16,968	101,390	63,744	3,427	(880)	18,863	19,436	161,468	25,475	141,212	91,549	71,219	51,303	31,286	130,192	63,117	140,837
Minimum initial capital as of January 1, 1998	160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171	160,171
Capital Adequacy Excess (Deficit)	(44,448)	(144,802)	(47,321)	(111,370)	(143,203)	(58,781)	(96,427)	(156,744)	(161,051)	(141,308)	(140,735)	1,297	(134,696)	(18,959)	(68,622)	(88,952)	(108,868)	(128,885)	(29,979)	(97,054)	(19,334)
75% of minimum initial capital as of January 1, 1998	120,128	120,128	120,128	120,128	120,128	120,128	120,128	120,128	120,128	120,128	120,128	120,128	120,128	120,128	120,128	120,128	120,128	120,128	120,128	120,128	120,128
Capital Adequacy Excess (Deficit) @75%	(4,405)	(104,759)	(7,278)	(71,327)	(103,160)	(18,738)	(56,384)	(116,701)	(121,008)	(101,265)	(100,692)	41,340	(94,653)	21,084	(28,579)	(46,909)	(68,825)	(88,842)	10,064	(57,011)	20,709
Expenditure requirement	28,935	5,841	75,504	29,658		38,332	1,182	9,199	2,694	21,415	1,466	29,553	19,636	26,996	112,104		9,446	5,371	10,237	25,381	2,387
Expenditure Requirement Excess (Deficit)	86,788	9,528	37,346	19,143		63,058	62,562	(5,772)	(3,574)	(2,552)	17,970	131,915	5,839	114,216	(20,555)		41,857	25,915	119,955	37,736	138,450

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October 27, 1997

**OBSERVATIONS ON CAPITAL ADEQUACY OF  
LITHUANIAN FINANCIAL BROKERAGE FIRMS**

I thought it would be helpful to make some observations about the results of the analyses of Capital Adequacy of Financial Brokerage Firms, as of September 30, 1997, which was presented in a report dated October 21, 1997.

The analyses indicate that only three "A" firms one "B" firm meet the minimum initial own capital test, while another three "B" firms come somewhat close to meeting it. Because of lack of information, I could not calculate the sum of position risk, counterparty and settlement risk, large exposure risk and foreign exchange risk, which is a requirement that could also be very difficult for the firms to meet.

I believe the capital adequacy calculations in the analyses were liberal in favor of the financial brokerage firms and allowed inclusions in capital adequacy that would be excluded in a more thorough and accurate calculation. Nevertheless, it is clear that it is going to be impossible, without additional capital, for more than a few firms to be in compliance with capital adequacy requirements by January 1, 1998, when the minimum initial own capital increases to 270,000 ECU for "A" firms and 36,000 for "B" firms.

The suggested reduction in the January 1, 1998 minimum initial own capital requirement by the National Association of Financial Brokers to 75%, still would not allow any additional "A" brokers to meet the requirement and I would not recommend that. Reducing the requirement would, at best, delay compliance to the European Directives and conceivably could have more lasting undesirable effects. The lower the requirements, the less protection there will be for investors. Less protection for investors will mean less investors and market activity.

It is also very important that Lithuanian financial brokerage firms be accepted into the European and other international communities so that cross border trading with established economies is accomplished. This will not happen until Lithuanian financial brokerage firms comply with European Communities Council Directives. These Directives specify the requirements for capital adequacy, which include minimum initial own capital. The Lithuanian draft Rule on Capital Adequacy Requirements for a Licensed Financial Brokerage Firm and Capital Adequacy Calculation Statement follow these Directives and when they are adopted and adhered to by financial brokerage firms will eventually put them in compliance with European Directives.

## Seminar on Margin Accounts on October 1, 1997

Speaker: **James Ryan**, translator: Nijolė Maskaliūnienė

### Participants:

- |                         |                                       |
|-------------------------|---------------------------------------|
| 1. Margarita Vidutienė  | Commissioner, LSC                     |
| 2. Arvydas Jalinskas    | Commissioner, LSC                     |
| 3. Aurelija Gasiūnienė  | Head of Corporate Finance Department  |
| 4. Liucija Naudžiūnienė | Head of Market Regulation Department  |
| 5. Irma Lazickienė      | Head of Investment Company Department |
| 6. Nijolė Gerdvilytė    | Investment Company Department         |
| 7. Kęstutis Juras       | Corporate Finance Department          |
| 8. Jolanta Kairienė     | Market Regulation Department          |
| 9. Rasa Garnevičienė    | Market Regulation Department          |
| 10. Darius Krukonis     | Market Regulation Department          |
| 11. Skirmantas Rimkus   | Pragma Corporation                    |
| 12. Vita Markevičiūtė   | Pragma Corporation                    |
| 13. Arvydas Paškevičius | Pragma Corporation                    |

## The List of Participants of the Seminar on Margin Accounts

October 16, 1997

Speaker: James Ryan (the Pragma Corporation); interpreter: Nijolė Maskaliūnienė

- |     |                        |                              |
|-----|------------------------|------------------------------|
| 1.  | Jaskelevičius Žilvinas | BH "Apyvarta"                |
| 2.  | Urbanas Valdas         | BH "Prome investment"        |
| 3.  | Pacanskas Vaidas       | - BH "Finbaltus"             |
| 4.  | Varanavičius Valdas    | BH "Finbaltus"               |
| 5.  | Lekevičius Algimantas  | BH "Auksinė Karūna"          |
| 6.  | Valančiauskas Ramūnas  | BH "Finansų Spektras"        |
| 7.  | Tumosaitė Jurga        | Stock Exchange               |
| 8.  | Tauras Vaidotas        | BH "Vilfima"                 |
| 9.  | Šeikis Darius          | BH "Eugenijus ir Partneriai" |
| 10. | Steponavičiūtė Jūratė  | BH "Eugenijus ir Partneriai" |
| 11. | Kubilienė Vida         | BH "Pfeiffer and Galland"    |
| 12. | Gakijūnas Jonas        | BH "Viva Moneta"             |
| 13. | Karmazinienė Dalia     | BH "Naugvilda"               |
| 14. | Tvarijonienė Violeta   | BH "Naugvilda"               |
| 15. | Steponkus Giedrius     | BH Elmarket Finansai"        |
| 16. | Žiškienė Irma          | BH "Spekonis ir Gastonas"    |
| 17. | Kupšys Kęstutis        | BH "Mendes Prior Europe"     |
| 18. | Žabolis Alvydas        | BH "Vilfima"                 |
| 19. | Buddenbohn Donald      | the Pragma Corporation       |
| 20. | Daublys Haroldas       | NAFB                         |

**INTERVIEW MODULE:**

Finance Brokerage Firm  
Date of Examination  
Names of the LSC examiners

Yes / No Comment NA

Person(s) interviewed  
Company position  
Registration

- Has the firm a diagram of organizational responsibility ?
- Does it describe supervisory responsibilities ?
- Does it list the Board of Directors ?
- Is there a description of other affiliated companies and address the possible control relationship(s) ?
- Request a list of the FBF's shareholders.
- Is there a control relationship between an issuer and anyone affiliated with the firm ? Use 10% as control ownership.
- Request a list of securities agents.
- Request a list of branch offices.
- Describe the FBF's business as a % of gross revenues in three major categories.
- Does the FBF carry discretionary accounts ?
- Does the FBF accept third party accounts ?
- Does the FBF anticipate capital additions or withdrawals within the next twelve months ?
- Does the FBF anticipate other substantial changes within the next twelve months ?
- Describe the FBF's advertising during the last year.
- Describe the FBF's involvement in any of the following:
  - Restrictions
  - Lawsuits
  - Injunctions
  - Complaints / Arbitration's
  - Regulatory Investigations





If not, describe the independent quotation source used by the FBF. Yes / No Comment WP / NA

Describe the testing of the above quotation source.

Are there exceptions to the FBF positions that are a charge to Capital ?

Did the FBF fail to take the charge in their Capital Computation ?

**Independent Audit**

Yes / No Comment WP / NA

Has an independent audit been completed ?

Did the FBF file the audit with the LSC ?

**Financial Notification:**

Has the FBF given a notice of capital or recordkeeping problems ?

Describe the notification.

Was notification given promptly ?

Did notification accurately describe the event ?

Was adequate action taken promptly to correct the problem ?  
such an event ?

**Financial Reporting:**

Yes / No Comment WP / NA

Does the FBF file monthly reports promptly and accurately ?

Does the FBF file quarterly reports promptly and accurately ?

Does the FBF file an annual report promptly and accurately ?

**Registrations:**

Does the FBF have a procedure to review the backgrounds and qualifications of new agents ?

Are notifications made to LSC promptly regarding agents ?

Are agents' files maintained ?

**Sales Practices:**

Yes / No Comment WP / NA

**Supervision:**

Has the FBF adopted procedures to supervise its activities ?

Has the FBF adopted procedures to supervise its agents activities ?

Do the procedures seem adequate ?

Have copies of the procedures been given to the associates ?

Has the FBF designated persons responsible for supervision ?

Are there documents and evidence of supervision ?

Is there evidence of branch office supervision ?

Does the FBF have a Compliance Officer ?

Does the Compliance Officer report to the Executive Officers ?

Is there a customer compliant file or register ?

List complaints unresolved more than three months old.

**Advertising:**

Does the FBF have an advertising file ?

Does the FBF file the advertisements with LSC ?

**Customer Accounts:**

Does the FBF maintain customer account files ?

Is there evidence of supervisory approval of new accounts ?

**Discretionary Accounts:**

Yes / No   Comment   WP / NA

- Does the FBF permit discretionary accounts ?
- Is there a standard discretionary agreement signed by the client and the person exercising the authority ?
- Are discretionary accounts approved in writing by a supervisor ?
- Are discretionary trades approved in writing by a supervisor ?
- Are there indications of improper trading activity ?
- Has the FBF exercised diligence prior to opening the accounts ?
- Are the accounts subject to extraordinary review to detect and prevent abuses ?

**Suitability:**

- Does the FBF have adequate controls over investment recommendations ?
- Are recommendations consistent with the customers' objectives, resources, and expertise ?
- Are customer accounts periodically and adequately reviewed to prevent compliance problems ?
- Are the procedures adequate and are exceptions noted ?

**Research / Sales Literature / Promotional Material**

- Are materials approved by supervisory personnel ?
- Are the materials filed for approval with the LSC prior to use ?
- Are files maintained by the FBF ?

**Exit Interview:**

- Note the date of the exit interview ?
- FBF personnel present
- LSC personnel present
- Summary of preliminary LSC findings.
- Summary of FBF personnel comments.

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**REGULAR EXAMINATION WORKPAPERS**

Diagram of Organization	Interview-1
Board of Directors List	Interview-2
Shareholders List	Interview-3
List of Securities Agents	Interview-4
List of Branch Offices	Interview-5
Bank Statements	Financial-1
Balance Sheet	Financial-2
Operational Statement	Financial-3
Capital Statement	Financial-4
Capital Adequacy Statement	Financial-5
Customer Bank a/c Statement	Customer-1
Clearing Statement as of audit date	Clearing-1
Deposit'y Statement as of audit date	Clearing-2
Reconciliation of Clearing Statement	Clearing-3
Reconciliation of Depository Positions	Clearing-4
Listing of FBF Positions	Clearing-5
The Audit	Audit-1
Financial Notification	Notice-1
Financial Reporting	Reports-1
Supervision Procedures	SP-1
Customer Complaints	SP-2
List of Complaints	SP-3
Advertising	Adv-1
Accounts	Acct-1
Discretionary Agreement	Acct-2
Suitability	Suit-1
Research	Research-1
Sales Literature	Sales-1
Promotional Material	Promo-1
Exit Interview	Exit-1

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MEMORANDUM

To: Securities Commission  
Central Securities Depository of Lithuania  
National Association of Financial Brokerage Firms  
National Stock Exchange

Copy: James Ryan

From: Gediminas Rečiūnas

Re: Securities portfolio management

Date: October 7, 1997.

The present memorandum concludes a legal investigation of securities portfolio management agreements, which currently intermediaries of public trading in securities offer to their clients. Conclusions drawn on the basis of analysis of the effective legal acts and the agreements in question are rather preliminary, and their appropriateness will be approved or denied in the course of further discussions with the Securities Commission and market participants.

Currently some financial brokerage firms employ a rather peculiar portfolio management procedure, i.e. they make up a single securities portfolio for a group of clients instead of offering separate portfolios for each individual clients. Such procedure is more inherent to investment funds, rather than to portfolio management by a financial brokerage firm.

In general, currently valid legal acts set forth certain requirements to management of securities portfolio by investment funds, including diversification of portfolio. Besides, an investment fund invests funds collected from the shareholders not directly but through a investment management and consulting firm, while safe keeping of the portfolio is transferred to a custodian. Such segregation of functions enhances safety of the securities portfolio.

Whereas, in case of financial brokerage firm, there are no diversification requirements or risk reducing segregation of functions set forth with respect to the securities portfolio management. Consequently, an investor, having entrusted management of securities portfolio to the financial brokerage firm, is placed in a position where he has to protect his interests himself, i.e. to instruct brokers on formation of the portfolio as well as management and liquidation of the portfolio, etc. Therefore it is evident, that only bigger investors will be able to properly protect their interests.

CERTAIN, SELECTED  
WEALTHIER  
SIGNIFICANT

Moreover, <sup>the</sup> management of <sup>a</sup> securities portfolio for smaller investors can hardly be profitable for a financial brokerage firm due to relatively higher costs. Besides, it is hardly possible, that small investors could afford or had enough expertise to develop their own investment strategies. The aforesaid could result in a situation when financial brokerage firms will manage portfolios of bigger investors exclusively, while smaller investors would have to become shareholders of investment funds. In the absence of investment funds in Lithuania, the gap is filled in by financial brokerage firms. Still, in the best interests of shareholders, <sup>the</sup> formation of common portfolio for a group of clients should not be tolerated.

Another group of problems with respect to management of investment portfolios is related to powers granted to financial brokers. Currently used agreements often include a provision that a broker shall act in the best interests of the clients and he is also granted an almost unlimited freedom in management of the securities portfolio of the client at his own discretion. This kind of problem is inherent in the very nature of agreements. As a rule, they are based on agency, and the agent (FBF) directly creates rights and obligations to the principal (client). It is but natural, that the client, seeking to protect his own interests, shall try to come up with as accurate as possible instructions for the agent. Though agreements on which broker-client relationship is currently based provide for almost unlimited rights of the brokers in taking decisions regarding investments.

GENERAL PART 12

Portfolio management agreements based on commission agency could make an acceptable alternative for the same agreements based on ordinary agency. Pursuant to such agreements brokers would acquire rights and obligations with respect to third persons and on the basis of the agreement would transfer the securities (or cash for the sold securities) after the order is executed. In this case the client has an obligation to take over only what has been properly carried out against the order or he can refuse to accept the execution of the order, and in order to make the client approve his actions the broker will have to justify the execution of the order. Whereas in case of representation, the client will have to prove that the order was not properly executed and only in case of success he will be able to seek recovery of losses from the broker.

The above analysis reveals that portfolio management agreement may be of two types. The agreement on commission agency basis is more favourable for the client while financial brokerage firms favour portfolio management agreement based on ordinary agency. In the latter case instructions to brokers should be issued extremely carefully.

In relation to portfolio management agreement based on commission agency, procedure of placing of commission orders needs to be examined. Evidently the broker shall place orders in his own name, thus he will be able to combine (join) securities sale/purchase orders for several clients and later transfer them to each client. (Whereas in the case of agreement based on ordinary agency, orders are to be placed in the name of each individual client). Requirement for the broker

*[Handwritten mark]*

to note the name of the client for whom the securities are sold/purchased on the order placed in the broker's name is believed to facilitate control over the procedure.

The above considerations reveal that investment management and consulting firms could also have a right to manage the accounting of securities making up the portfolio, though for this purpose Par. 2 of Art. 14 of the Law on Public Trading in Securities needs to be supplemented.-

As to personal securities accounts handled on commission agency basis, having examined the effective legal acts, I have not found any provisions that prevent existence of such accounts. Personal securities account is opened for a client in his name and the securities therein are deemed his ownership (code 11).

As it has been mentioned, in case the securities portfolio is managed by a financial brokerage firm, the agreement may be either ordinary agency or commission agency based. Though in case an intermediary is introduced between the client and the financial brokerage firm, namely investment management and consulting firm, portfolio management agreement based on commission agency seems to be much more appropriate mainly for the following essential reason: investor is related by contractual obligations to the investment management and control firm only, and he deprived of possibility to influence the choice of financial brokerage firm, through which the order will be handled. Thus it appears more logical that the investment management and consulting firm assumes rights and duties with respect to third persons and later transfers the acquired securities or cash funds to its clients pursuant to the portfolio management agreement.

One way or another, actual activity of some of the intermediaries in public trading is not in line with (is contrary to) these theoretical considerations. Actually an investment management and consulting firm represents the investors, it acts in their name and on their account, it is also granted broad authorisation to take decisions regarding investment. Although the agreements include provisions regarding responsibility of the investment management and consulting firm with respect to the investor for passing unacceptable decisions, singling out of the investment management and a consulting firm into a separate legal entity reduces the intermediaries' risk as well as probability of recovery of damage incurred by investors.

It becomes obvious that interests of clients of investment management and consulting firms are much more subject to violation, thus for the sake of their protection it seems to be logical to set forth a requirement, that investment management and consulting firm can manage the securities portfolio only on commission agency basis.

Speaking of improvement of the legal basis for securities portfolio management, the current Law on Public Trading in Securities needs to be considered. There is

some uncertainty as to what accounting is to be carried out by the investment management and consulting firms (Par.2 Art.15), and for what reason they are precluded from managing personal securities accounts (Par.2 Art.28).

Another problematic issue is the joint responsibility of the investment management and consulting firm and FBF. Although in general welcome, practical implementation of this provision will cause certain difficulties. Evidently, a broker will have to check the orders only formally, i.e. to verify their legality, and financial brokerage firm should not evaluate the appropriateness of execution of orders. In an opposite case financial brokerage firms would perform the same functions as an investment management and consulting firms, which would entirely eliminate the necessity for existence of the latter as a separate legal entity. Thus, a broker, given a possibility to check the orders only formally, should not be deemed jointly responsible for the investment decisions made by an investment management and consulting firms which to a great extent are at the risk of the latter.

Commenting on drafting the rule on the securities portfolio agreement, I will limit myself to only one remark. The draft rule seems to lack general provisions on the legal nature of the agreement and obligations of the parties, though these are essential provisions underlying the agreement and individual requirements.

When the Securities Commission and the market participants have discussed the basic provisions, the Pragma consultants will avail themselves in preparation of draft rules and typical portfolio management agreement (in case it is decided such is needed).

**The Conformity of the Draft Rule on the Capital Adequacy for Lithuanian Brokerage Firms with the EU Directive 93/ 6/ EEC "On the Capital Adequacy of Investment Firms and Credit Institutions" and Other Related Directives**

Prepared by Skirmantas Rimkus, the Pragma Corporation

No	The Lithuanian Draft of the Capital Adequacy Rule	The EU Directive 93/ 6/ EEC on the Capital Adequacy (CAD) and other directives referred to
1.	<p>par. 1.1 The Capital Adequacy Rule sets forth capital adequacy requirements for category A, B, and C brokerage firms and the order of their calculation</p>	<p>Does not fully conform</p> <p>The CAD applies to credit and financial institutions. A credit institution means an undertaking whose business is to receive deposits from the public and to grant credits for its own account (that is the main definition of a credit institution).</p> <p>The CAD may be not applied where 1) the amount of the trading book of this institution does not exceed 5% of its income from all of its activities; 2) the amount of its trading book positions does not exceed ECU 15 million; 3) the trading volume of the trading book does not exceed 6% of all income and the total of all trading book positions does not exceed ECU 20 million.</p> <p>The CAD is not applied to the firms which only accept and execute a client's orders but do not hold the client's monies or securities and which are not responsible for the client's failure to settle the transaction (there are no such firms in Lithuania).</p>
2.	<p>par. 1.3 The financial accounting carried out in the firm and the financial statements are the basis for calculation of capital adequacy. Par. 8.2.5 and 8.2.6 concerning "marking to market". Other paragraphs</p>	<p>Conforms</p> <p>The CAD provides that the trading book positions of an institution must be marked to market every day. The non- trading book positions must be reported at the lower acquisition cost or market value at the end of the accountable period. Credit institutions to which the CAD is not applied (see No1 above) are not required to mark their trading book positions to market every day.</p> <p>Profit or loss, which is received after the trading book positions are calculated (unrealized profit (loss)), must be recognized and reflected in the Profit (Loss) Statement for a certain period. (The value of the collateral must be marked to market every day in order to ensure that the value of the collateral does not fall below the value of the extended loan, but the result of the re-calculation is not recognized in the Profit (Loss) Statement. In this case accrued interest</p>

		increases the value of the extended loan.
3.	Chapter 2	<p>Does not fully conform</p> <p>The CAD does not treat such long-term assets as land and buildings as illiquid assets to the amount they are pledged to another institution for liabilities. Then these assets are treated as pledged and are applied 8% of the risk weighting (liquidity adjustment). Thus, the Lithuanian requirement is more stringent as long-term assets are completely excluded from liquid capital.</p> <p>The CAD allows not to include material holdings in a credit or finance institution if such investment is made temporarily, in order to help that institution, and the supervising institutions are notified about it (e.g. the SC).</p>
4.	Chapter 2 The definition of the Trading Book	<p>Conforms</p> <p>The CAD gives practically the same definition, only some additional conditions are added.</p>
5.	Chapter 2 The definition of the market value	<p>Does not fully conform</p> <p>The CAD provides that all positions must be marked to market every day as set forth for each type of risks, i.e. position, counterparty and settlement, foreign exchange risks. Where these positions do not have readily available market prices, the firm must use the evaluation methods approved by the Commission.</p> <p>When new instruments are introduced to Lithuanian securities market, new methods of determining the market price will have to be established.</p>
6.	Paragraphs 3.1, 3.2 The establishment of the capital adequacy requirement	Fully conforms
7.	Paragraph 3.3 The structure of liquid own capital	<p>Does not fully conform</p> <p>“Own funds” are defined in CAD 89/299 “Own Funds of Credit Institutions”. This Directive is also applied to investment firms. But where the CAD is applied to a firm, the definition to be used is the one given in the CAD. The CAD primarily determines the structure of own funds, and all requirements are calculated in relation to own funds. In the Lithuanian draft of the Capital Adequacy Rule the structure of liquid own capital conforms with the defined own funds with some slight exceptions. They are the result</p>

		of the British influence as the Rule was prepared following the capital rules passed in Great Britain, where the capital requirements are a bit more stringent than the CAD provides.
8.	Paragraphs 3.6 and 3.7. The – expenditure requirement and its establishment	Conforms In general, the expenditure requirement as defined in the Rule is in conformity with the CAD. Yet, the CAD does not prescribe the procedure for its calculation as precisely as was selected for the purposes of this Rule. In order to leave less room for interpretation, the British experience was used, and items of expenditure to be deducted while determining annual audited expenses were clearly set forth.
9.	Paragraphs 3.12 - 3.15 Limits on preference shares and the amount of subordinated loans	Conforms In the CAD these limits are defined a little differently. The Lithuanian Rule follows the experience of Great Britain.
10.	Chapter 4. Position Risk Requirement (PRR)	Does not fully conform The main differences are: 1) the Lithuanian Rule provides for more stringent risk weightings of the PRR; 2) in the Rule the risk management of short positions is not addressed at all; 3) in the Rule there is no established procedure for hedging risky positions; 4) the Lithuanian Rule does not provide for the PRR calculation in case of underwriting; 5) there is no provision concerning risk concentration; 6) the Lithuanian Rule does not divide the position risk into specific or general, as is done in the CAD.
11.	Chapter 5 Counterparty and settlement risk requirement (CRR)	Does not fully conform The main differences: 1) In the CAD the CRR is divided into two parts, i.e. counterparty and settlement risks are calculated separately, while in the Lithuanian Rule there is no such division and only one requirement is calculated; 2) provisions in the Lithuanian Rule are simplified and more stringent; 3) the Lithuanian Rule does not provide for the amount of accrued interest to be calculated while establishing the market value of borrowed, lent, or pledged securities in case of securities lending, borrowing, repurchase and reverse repurchase

		agreements.
12.	Chapter 6 Large Exposure Requirement (LER)	Does not fully conform The LER is to be calculated pursuant to Directive 92/121/EEC "Monitoring and Control of Large Exposures in Credit Institutions". While calculating capital adequacy, however, the CAD must be followed, in which certain corrections are made with regard to the LER Directive. The differences between the CAD and the Lithuanian Capital Rule are as follows: 1) the Lithuanian Rule provides only for the methodology of determining the LER for long positions. If short positions were allowed, the value of long positions would decrease; 2) there is no methodology to establish the LER in case of securities underwriting; 3) the calculation of the LER as given in the CAD is more flexible. That is due to the differences among the countries which have to apply it. The concrete requirements must be set forth in each country individually; 4) the CAD does not stipulate the methodology of the LER calculation. In the Lithuanian Rule this methodology is based on the British experience.
13.	Chapter 7 Foreign Exchange Requirement (FER)	Conforms However, the order of calculating open positions in the CAD is more detailed (broader), and more financial instruments are described. Besides, the CAD allows the competent institutions to establish the alternative methods for the FER calculation, which have to meet the criteria set forth in the CAD. In the Lithuanian Rule the order of calculating the FER is given in very simple terms. Yet, some problems may appear in case of certain concrete instruments.
14.	Chapter 8 Principles of accounting for the purposes of this Rule	Does not fully conform First, the CAD does not set forth the principles of accounting. The principles of accounting and reporting for financial institutions are provided in Directive 86/635/EEC. The principles of accounting as given in the Lithuanian Rule are quite acceptable, because they provide for the accounting procedures for certain business operations. A few fundamental principles of internal control are also provided, which are similarly set forth in the CAD.
15.	Paragraph 9.3	Does not fully conform

	Submission of reports to the SC	<p>First of all, the CAD provides that the competent institutions must ensure that an investment firm follow all regulations concerning internal control, administration and accounting procedures.</p> <p>An investment firm, which provides such investment services that require the initial own capital of the size of ECU 730000 (the Lithuanian "A" category firms) must submit all reports on capital adequacy at least once a month.</p> <p>An investment firm, which provides such investment services that require the initial own capital of the size of ECU 125000 (the Lithuanian "B" category firms, though not exactly) must submit all reports on capital adequacy at least once every quarter.</p> <p>An investment firm, which provides such investment services that require the initial own capital of the size of ECU 50000 (the Lithuanian "C" category firms, not exactly) must submit all reports on capital adequacy at least once in half a year.</p> <p>An investment firm, which provides such investment services that require the initial own capital of the size of ECU 730000 or ECU 125000 (the Lithuanian "A" and "B" category firms) must submit consolidated or sub-consolidated reports on capital adequacy every 6 months.</p>
16.		<p>The CAD provides that the country's competent institutions establish procedures for the supervision of an investment firm together with its subsidiaries, i.e. consolidated balance sheets are required. In Lithuania there is no established order of consolidation. Therefore, the Lithuanian Rule does not require that.</p>
17.	Statement of Capital Adequacy Calculation	<p>The CAD does not provide for the forms of capital adequacy statements or requirements for these forms. Only a few general statements are given of what an investment firm must report to the competent institutions.</p>

## MEMORANDUM

To: Members of the Securities Commission

Cc: James Ryan

From: Gediminas Rečiūnas

Subject: Clients' Funds Accounts

Date: August 15, 1997

Mr. James Ryan has prepared a proposal concerning a segregation of clients' funds into a separate bank account. The purpose of my memorandum is to discuss the possibilities of practical implementation of such a proposal within the legal system of Lithuania.

According to para. 1 of Article 13 of the Law on Public Trading in Securities, "brokerage firms must conduct separate accounting of their own securities and the securities and cash funds of their clients". In order to implement this requirement the Securities Commission has passed the Rule on Clients' Monies and Securities Accounts in which a sub-account is required to be opened by a brokerage firm for its clients.

As is mentioned in Mr. Ryan's Memorandum, a sub-account does not guarantee a real segregation and custody of the clients' funds in the event of a financial difficulty or failure of a FBH or a bank (in case of bankruptcy, etc.). Therefore, a proposal is to require a FBH to open a separate bank account for custody of the clients' monies.

A separate bank account could ensure that the clients' monies be subject to no claim, either made by a commercial bank or any other person, for recovery of a FBH's debts.

Furthermore, the purpose<sup>1</sup> of a separate bank account is to guarantee not only a segregation of the clients' monies from the funds of the FBH but also a segregation of these funds from the bank assets (the funds may not be reflected on the bank's balance sheet). The bank account agreement is regulated by Article 469 of the Civil Code, yet this Article does not provide for ownership relations. For this reason provisions of other chapters of the Civil Code are to be applied. It is not recommended that a client's account agreement be based on the same consideration as a loan agreement (Chapter 28 of the Civil Code) because according to a loan agreement the creditor transfers cash to the debtor's **ownership**. The transfer into ownership means a possibility for the bank to lend this money and, accordingly, does not ensure the safety of a FBH's clients' funds in the event of failure of the commercial bank. Therefore, I would recommend that a clients' account agreement of a FBH be based on Chapter 36 which sets forth the custody. *5 (245703) 192 A/E*

A FBH's clients' account agreement based on custody shall make it possible to guarantee that the custodian (bank) have no right to use the property under its custody unless the agreement provides otherwise (Art. 437 (3) of the Civil Code), and clients of

the FBH will acquire a general partial ownership of the money in the account unless the agreement provides otherwise (Art. 444 of the Civil Code).

In order to protect clients' funds, liabilities based on agreements will not be sufficient. The mechanism of financial control of the banks must be implemented as well (through standards limiting the risks of banking activities, i.e. by deducting the funds under a bank's control on the basis of a custodian agreement from the bank's capital). That measure will make it possible to control, at least indirectly, whether the bank meets its obligations with regard to the agreement of a FBH's clients' cash account.

Moreover, Article 439 of the Civil Code provides that in the event a custodian is an organisation, custody being one of its business activities (Art. 25 (9) of the Law on Commercial Banks sets forth that a bank may accept clients' monies for custody), it shall be exempt from liability for the loss, shortage or damage only in the event of *force majeure*. Consequently, the bank will be responsible for taking care that the client's account be subject to no claims of any creditors of the FBH.

The basis for a FBH to open its clients' cash account shall be a proposed amendment to para. 1 of Article 13 of the Law on Public Trading in Securities, while the discretion of a finance broker to handle the funds in these accounts shall be determined in the agreement with each client separately.

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One more aspect mentioned in Mr. Ryan's Memorandum is the impact of the Law on Enterprise Bankruptcy on the proposed account of clients' monies. It must be pointed out that the Law on Enterprise Bankruptcy does not specifically provide for a segregation of property which belongs to other persons by the right of ownership in custody of a company under bankruptcy from the property of this company, therefore special laws must be analysed .

Having supplemented para. 1 of Article 13 of the Law on Public Trading in Securities as indicated below, in the event of bankruptcy of a FBH, clients' funds must be segregated from the FBH's property and may not be subject to any claims of the FBH's creditors.

In the event a custodian type of a client's account is chosen, in case of bankruptcy of a bank<sup>1</sup> in which said account is opened, the funds in the clients' account will be segregated and therefore will not be used to satisfy the claims of the bank's creditors.

To sum it up, in order to set forth a requirement to open a special bank account for clients' funds, the following steps should be taken:

**First**, amend para. 1 of Article 13 of the Law on Public Trading in Securities by establishing an additional requirement that a FBH deposit the funds that belong to its clients by the right of ownership in a separate bank account opened in the name of the FBH and based on a custodian agreement which shall be subject to no claims under the FBH's debts.

**Second**, amend and supplement the Rule on Clients' Monies and Securities Accounts coordinating it with the Bank of Lithuania. In this case there may be no question as to the competence of the Central Bank to participate in adoption of the legal documents of

the type, because the amendments in this legal document must be agreed by all institutions involved.

In the event the Securities Commission agrees to the proposals presented in this Memorandum, the consultants of the Pragma Corporation might assist in preparation of the draft amendments to these legal documents.

The Pragma Corporation

Lithuanian Capital Market  
Development Project  
Stock Exchange Building  
Ukmerges 41, Suite 514  
2662 Vilnius, Lithuania

MEMORANDUM

To: Virgilijus Poderys; Chairman, Lithuanian Securities Commission

From: James P. Ryan

Cc: Kevin J.P. O'Hara  
Jacques DeFay ( The Pragma Corporation-USA )  
Diana Sokolova ( Office File )

Re: The Rule on Clients Monies and Securities Accounts

Date: July 28, 1997

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The purpose of this memorandum is to advise the Lithuanian Securities Commission regarding the adoption of a rule concerning the safeguarding of client fund and securities while such property is under the control of Finance Brokerage Houses.

**Funds:**

At the present time, Finance Brokerage Houses are required to open a separate bank account for customer funds. The account may be used only for the collection of funds for securities purchases and commissions paid by the client, the payment of funds for securities sold, dividends paid to the client or other charges paid by the client. Finance Brokerage Houses are prohibited from using the funds in the clients' separate bank account for their own purposes.

In Decision No. 31 dated 7 October 1993 ( copy attached ) the Board of the Bank of Lithuania states, "brokerage houses must open a separate sub-account in their bank account, and deposit in it all sums of money belonging to their clients." In addition the decision states that " the brokerage house must in its account make a separate accounting of the funds of each client, specifying all income and expenses belonging to him."

However, in the event of a financial difficulty or a failure of a Finance Brokerage House, it is possible that customer funds could be seized by the bank. In order to prevent this situation in the U.S., The Customer Protection Rule was adopted, SEC Rule 15c3-3 ( certain paragraphs attached ). In it, paragraph (f) Notification of Banks requires the following:

1. broker-dealers are required to maintain a Special Bank Account;

2. broker-dealers are required to obtain and maintain in its records written notification from the bank that the funds are being held for the exclusive benefit of customers of the broker-dealer in accordance with the regulations of the Commission and are being kept separate from any other account maintained by the broker-dealer with the bank;

3. the broker-dealer shall have a written contract with the bank that the cash shall at no time be used directly or indirectly as security for a loan to the broker or dealer by the bank and, shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank.

### **Securities:**

The Customer Protection Rule requires under paragraph (b)(1) that “a broker or dealer shall promptly obtain and thereafter maintain the possession and control of all fully-paid securities carried by a broker or dealer for the account of customers.

Further paragraph (b)(2) allows an amount of latitude for the “normal business delays” which may occur and cannot be controlled by the broker-dealer. This section of the rule is as follows:

“a broker or dealer shall not be deemed to be in violation of the provisions of paragraph (b)(1) regarding control of customer securities if, solely as the result of normal business operations, temporary lags occur between the time when a security is required to be in the control of the broker or dealer and the time it is placed under its control, provided that the broker or dealer takes timely steps in good faith to establish prompt control. The burden of proof shall be on the broker or dealer to establish that the failure to obtain control of securities carried for the account of a customer as required by paragraph (b)(1) is merely temporary and solely the result of normal business operations including same day receipt and redelivery ( turnaround ), and to establish that he has taken timely steps in good faith to place the securities in its control.

Control is defined under The Customer Protection Rule, and part of the definition could be used in Lithuania as the custody of a depository, clearing agency, or custodian bank which the Lithuanian Securities Commission upon application shall designate as a satisfactory control location for securities. These securities should be free of any right, charge, security interest, lien, or claim of any kind.

### **Recommendation**

The Pragma staff recommends that the Lithuanian Securities Commission adopt such a rule with the above characteristics in order to protect the funds and securities of the general investing public. Finally, the Lithuanian insolvency laws should be reviewed to determine that the above protection would be available to clients in the event of a failure of a Finance Brokerage House.

Customer property.doc

TO: JIM RYAN

SEPTEMBER 30, 1997

FROM: DON BUDDENBOHN

RE: COMMENTS OF PROFESSIONALS RECEIVED ON INVESTMENT  
COMPANIES' FINANCIAL STATEMENTS FORMAT

Attached are the two comments received in September, 1997 from professionals regarding the investment companies' financial statements format. These comments were solicited from securities industry institutions and professionals. Additional comments are anticipated in October, 1997. It is planned that all comments will be summarised and presented to the Ministry of Finance and the Lithuanian Securities Commission.

Association of Investment Companies  
A.Bučas, President  
Received on September 22, 1997

## COMMENTS ON PROCEDURES FOR PREPARATION OF FINANCIAL STATEMENTS OF INVESTMENT COMPANIES

### 1.2. Composition of Financial Statements

The Balance-sheet and the Statement of Net (own) assets actually report the same data. Combining them into one statement would provide the same information.

The "Statement of Operations" could be called "Profit/Loss Account", as the subsequent "Appropriation Account" is not called "Statement on Performance Appropriation". Compilers and users of the financial statements are accustomed to the title "Profit/Loss Account", thus there is hardly any reason to change the name.

If we acknowledge that "Statement of Net Assets" is equivalent to the "Balance-Sheet", the "Statement of Changes in Net Assets" would have to be called "Cash Flow Statement".

The Explanatory Note should be called Notes to the Financial Statements, having in mind that explanations of some of the entries of the financial statements should have numbered notes set forth in the Notes to Financial Statements.

### 1.4. On Application of IAS.

Parts 1.1 and 1.4. contradict each other, thus it is not appropriate to apply all the principles specified under 1.4.1.-1.4.11 to the financial statements. The same information could be conveyed by the last paragraph of 1.4.11. and a commentary that investment companies may (or they are recommended) carry out the accounting in accordance with the IAS, though they have to file the specified documents to the Tax authorities. In the event of contradiction between the IAS and LAP (Lithuanian Accounting Principles) it might happen that statements prepared in accordance with the IAS will differ from the tax statements, even though both are based on the same principles.

### 1.5. On Filing and Announcement of Statements

It is nor clear which statements are to be approved by the general meeting of shareholders. If the accounting prepared in accordance with the IAS is true and correct (see 1.4.11), it would be advisable to submit it to the shareholders for approval and announce it publicly. The financial statements deliberated herein could be submitted to the institutions specified under 1.5.6., though the

primary purpose of the statements is to submit them to the tax authorities. In case an investment company limits itself to preparation of prepares tax statements only, statements submitted to the shareholders will be identical to those submitted to the state institutions. Though in case the general meeting of the shareholders is entitled to approve the consolidated statements of the investment holding company, is it worthwhile to additionally file the tax statements?

Few auditors shall agree to approve the tax reports prepared pursuant to the legal acts specified under 1.1., if the tax statements distort the financial statements prepared by the investment companies.

On the consideration of the above, different procedures should be applied to compiling, filing, approval and public announcement of financial statements and tax statements.

## 1.6. On Concepts Used

### 1.6. Concepts

Item 1.6.4. Definition of market value is in contradiction to the principles of conservatism specified in 1.4.1. Auditors for sure will refuse to approve of the investments accounted for on this principle. "Asset Appraisal Methodology" (approved by the Government of the Republic of Lithuania, on February 14, 1996, Resolution No. 244), underlying the "Methodology of Calculation the Net (Own) Assets" states (item 5): Assets shall be appraised (i.e. the methodology shall be applied) in cases defined in item 4 of the Assets Appraisal Principles approved by the Government of the Republic of Lithuania on March 28, 1995, Resolution No.440 "On Appraisal of Assets". The item 4 of the General Principles states: "The object of asset appraisal (otherwise, the principles shall be applied while appraising) may be movable and immovable property (except securities)". Thus neither the above indicated methodology, nor the principles have been designed or are applicable to the statements for the tax authorities. More over so they can not be applied to financial accounting based on IAS system.

1.6.5. Is the FIFO principle actually appropriate to the accounting of securities? FIFO in its essence is the principle of accounting of the material short-term assets (reserves, raw materials, etc.). Closed-end investment funds and especially investment holding companies may have a considerable number of long-term investments the value and number of which may be subject to significant changes in time. Even in the case of an investment fund (where the bulk of investments are short-term) may be the average values would be more appropriate, as they can reflect the gains and losses incurred more accurately.

Besides, commission fees and other expenses are essentially operational expenses of the period and can hardly be capitalised in the investment. This will depend upon the nature of agreements with the securities market intermediaries and other factors.

1.6.8. According to the principle of conservatism (1.4.1.) unrealised increase may not even occur. Decrease may occur quite often, but the way it is reflected in the accounting may be appropriate to investment funds only, but not to closed-end investment funds and Investment Holding Companies. Besides, unrealised outcome is not relevant from the standpoint of taxes, thus it should be discussed whether it must be included in the accounting.

#### 4. Appropriation Account

The concept "Types of profit" is not suited for the purpose of the statements. We suggest to call it "Various income", as essentially it is the income that is subject to taxation, not the profit.

#### 5. Statement of Changes in Net Assets.

Investment companies, closed-end investment funds and investment holding companies should be required to submit differentiated Statements of Changes in Net Assets. Major differences should reflect the principles of the value of investment and the method of reflecting changes of investment on the other side of the balance-sheet. May be the item "Unrealised profit/loss" should be named "Change in value reserve", and it could be reported in the balance-sheet instead of in the "Statement of Operations". This arrangement would make the investment holding companies more convenient and more consumer-orientated. Recognised income and costs could be transferred into the Statement of Operations, as standard income and expenses which incurred in respective period.

#### 9. Explanatory Note

Explanatory Note could be more expanded and the number of entries in the statements should be reduced.

#### SUMMARY OF PROPOSALS

A. The accounting system could be much simplified if presented in accordance with the scheme:

Profit/Loss Account - Statement of Net Assets - Cash Flow Statement.

B. Accounting should not be confused with the accounting principles.

C. Accounting should be differentiated for the investment funds and the investment holding companies.

1.6.1. Investment appraisal issue needs further consideration.

Investment Stock Company  
"Investicijos Fondas"  
Vice President Vaidas Savukynas  
Received: September 15, 1997

## COMMENTS ON PROCEDURES FOR PREPARATION OF FINANCIAL STATEMENTS OF INVESTMENT COMPANIES

### 1.2. Composition

The Balance-sheet and the Statement of Net (own) assets actually report the same data. Joining them into one statement would provide the same information.

The profit/loss account could be not the "Statement of Operations", as the subsequent "Appropriation Account" is not called the "Statement of Operation Appropriation".

When we acknowledge that "Statement of Net Assets" is equivalent to the Balance-Sheet, then "Statement of Changes in Net Assets" should then be called the "Cash Flow Statement".

The Explanatory Note should be issued as "Comments to the Financial Statements".

### 1.4. Principles

Parts 1.1. and 1.4. contradict each other, thus it is not reasonable to apply all the accounting principles specified under items 1.4.1. - 1.4.11. The last paragraph of 1.4.11. and explanation, that an investment company may carry out the financial accounting in accordance with IAS, but must submit the statements submitted to tax authorities (tax reports). The audited financial statements prepared in accordance with IAS may not be different from statements for tax authorities which are compiled on the basis on the same principles.

### 1.5. Notification

Items 1.5.1.-1.5.8. What statements are to be approved by the general meeting of shareholders? In the event the accounting prepared in accordance with the IAS is true and correct (see 1.4.11), may be it is better to approve it and make public. If the general meeting of the shareholders is to approve the consolidated accounts, is it worth submitting the tax reports for approval?

Few auditors shall agree to approve the tax reports prepared pursuant to the legal acts specified under 1.1., if the tax statements distort the financial statements prepared by the investment companies.

Supposing that the Balance- Sheet is equivalent to GA, it should be according to the procedure established in the by-laws. The same concerns other statements.

#### 1.6. Concepts

Item 1.6.4. Definition of market is in contradiction to the principles of conservatism specified in 1.4.1. Auditors for sure will refuse to approve the investments accounted for on this principle. "Asset Appraisal Methodology" (approved by the Government of the Republic of Lithuania, on February 14, 1996, Resolution No. 244), underlying the "Methodology of Calculation the Net (Own) Assets" states (item 5): Assets shall be appraised (i.e. the methodology shall be applied) in cases defined in item 4 of the Assets Appraisal Principles approved by the Government of the Republic of Lithuania on March 28, 1995, Resolution No.440 "On Appraisal of Assets". The item 4 of the General Principles states: "The object of asset appraisal (otherwise, the principles shall be applied while appraising) may be movable and immovable property (except securities)". Thus neither the above indicated methodology, nor the principles have been designed or are applicable to the statements for the tax authorities. More over so they can not be applied to financial accounting based on IAS system.

1.6.5. Is FIFO really appropriate for securities accounting? In the case of investment companies average values would be much more appropriate. Besides, commission fees and other expenses are essentially operational expenses of the period and can hardly be capitalised in the investment.

1.6.8. According to the principle of conservatism (1.4.1.) unrealised increase may not even occur. Decrease may occur quite often, but the way it is reflected in the accounting may be appropriate to investment funds only, but not to closed-end investment funds and Investment Holding Companies. Besides, unrealised outcome is not relevant from the standpoint of taxes, thus may be it should not be included in the accounting.

#### 4. Appropriation Account

The concept "Types of profit" is not suited for the purpose of the statements. We suggest to call it "Various income", as essentially it is the income that is subject to taxation, not the profit.

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Investment companies, closed-end investment funds and investment holding companies should be required to submit differentiated Statements of Changes in Net Assets. Major differences should reflect the principles of the value of investment and the method of reflecting changes of investment on the other side of the balance-sheet. May be the item "Unrealised profit/loss" should be named "Change in value reserve", and it could be reported in the balance-sheet instead of in the "Statement of Operations". This arrangement would make the investment holding companies more convenient and more consumer-orientated. Recognised income and costs could be transferred into the Statement of Operations, as standard income and expenses which incurred in respective period.

#### 9. Explanatory Note

More explanations could be given in the Explanatory Note and the number of entries in the statements should be reduced.

#### SUMMARY OF PROPOSALS

- A. The accounting system could be much simplified if presented in accordance with the scheme:  
Profit/Loss Account - Statement of Net Assets - Cash Flow Statement.
- B. Accounting should not be confused with the accounting principles.
- C. Accounting should be differentiated for the investment funds and the investment holding companies.
- D. Investment appraisal issue needs further consideration.

TO: JIM RYAN

October 2, 1997

FROM: DON BUDDENBOHN

RE: USAID REPORT FOR THE MONTH OF SEPTEMBER, 1997

**WEEK: September 8 to 12, 1997**

Much of week consisted of orientation, meeting staff, meeting counterparts, obtaining computer and getting software. Met with Arturas Keleras, President of the Central Securities Depository, Rimantas Busila, Director General of the National Stock Exchange, Romas Matiukas, President of the National Association of Financial Brokers and Arvydas Jelinskas, Securities Commission Commissioner of Market Regulation. Introduced myself at meeting of Virgilijus Poderys, Chairman of the Securities Commission and his Commissioners. Met with Dow Heard, potential future Chief of Party of the Pragma project. Began reviewing security industry legislation and proposed legislation. Began familiarisation process with proposed financial statements for investment companies.

**WEEK: September 15 to 19, 1997**

Continued familiarisation process of proposed financial statements for investment companies. Began critiquing financial statements of investment companies and recommending improvements. Began critiquing and recommending improvements in English version of instructions for preparing financial statements of investment companies. Reviewed Lithuanian Law on Investment Companies and other relevant legislation. Reviewed European Communities Council Directives as they relate to investment companies. Met with USAID Project Manager, Aldas Kriauciunas regarding status of the project and administrative matters.

**WEEK: September 22 to 26, 1997**

Continued reviewing, critiquing and recommending improvements in English version of instructions for preparing financial statements of investment companies. Met with following professionals, who were solicited for comments on the proposed financial statement format for investment companies, to hear and review their comments: Vaidas Savukynas, Vice President of Investicijos Fondas, Dr. Algirdas Bucas, Vice President of Invalda and Mr. Dalikas, an independent auditor from Kaunas. Reviewed written comments of Mr. Savukynas and Mr. Bucas. Met with Gintautas Deveikis, Director of the Accounting Methodology Department of the Ministry of Finance, along with Margarita Vidutiene and Irmina Judickaite, Commissioners of the Securities Commission and Dr. Arvydas Paskevicius of Pragma to review the proposed financial statement format for investment companies. Received a positive reaction from Mr. Deveikis with an indication of likely approval of the Ministry of Finance with relatively minor changes. Met with Arturas Keleras, President of Central Depository and Vitalija Kvedaraite, Head of Training, Inspection and Accounting Research at the Depository on their comments on the proposed Rule on Books and Records.

**TWO DAYS: September 29 and 30, 1997**

Reviewed proposed Rule on Capital Adequacy Requirements in preparation for review of broker financial statements due from brokers on October 15, 1997. Reviewed material on valuation of investment securities for investment companies to prepare for improvement suggestions for valuation procedures. Began review of proposed Rule on Books and Records. Met with Darius Krauciunas of Price Waterhouse to hear and review his comments on the proposed financial statement format for investment companies.

## The Pragma Corporation

Lithuanian Capital Market  
Development Project  
Stock Exchange Building  
Ukmerges 41, Suite 514  
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Tel: (370 2) 72 48 26  
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### MEMORANDUM

To: Aldas Kriauciunas (USAID -- Vilnius, Lithuania)

From: Donald M. Buddenbohn (Financial Analyst)

Cc: Beverly E. Low (USAID – Washington, DC)  
Jacques DeFay (Pragma – Virginia)  
Pragma – Vilnius Office File (Diana Sokolova)

Re: **Status Report for the Month of November 1997** – Lithuania Capital Markets  
Development Project

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#### I. INTRODUCTION

This memorandum represents The Pragma Corporation's ("Pragma") monthly status report for November 1997 in conjunction with its implementation of the Lithuanian Capital Markets Development Project (hereinafter "Project") funded by the United States Agency for International Development (hereinafter "USAID"). The primary purpose of this report is to provide USAID with a status of Project deliverables as set forth in the USAID task order and Pragma's work plan.

#### II. PROFESSIONAL STAFFING

Donald Buddenbohn, a short term adviser, has been extended until December 12, 1997. Mr. Buddenbohn, is providing expert assistance to the Lithuanian Securities Commission ("LSC") regarding International Accounting Standards and European Communities Council Directives. Donald Buddenbohn, during November, prepared the draft of the Rule on Internal Control of Licensed Financial Brokerage Firms (Exhibit #1) and the draft of the Rule on Reports To be Made By Financial Brokerage Firms (Exhibit #2). He wrote the Memorandum Regarding Accounting and Financial Statement Presentation for Investment Companies and Financial Brokerage Firms (Exhibit #3) to help the LSC Chairman, the Commissioners and their staff to understand current accounting issues. He also prepared a report for the LSC Chairman prioritizing additional work that needs to be done by an accountant (Exhibit #4).

James Ryan, a short term adviser, was extended in order to become interim project manager until November 20, 1997, and to continue to work with the clients<sup>1</sup> on the National Association of Financial Broker's ("NAFB") Ethical Code, the proposed margin rule and training seminars, and the development of inspection manuals, modules and procedures for both the NAFB and the LSC. He reviewed the Examination Model with the staff of the Department of Market Regulation of the LSC. He completed his work on November 20, 1997. His Trip Report is attached (Exhibit #5).

### III. AREAS OF CONCENTRATION

During the month of November 1997, Pragma focused its attention on the following areas:

Zilvinas Zinkevicius continues to work with all four of the clients with discussions or drafting amendments to various laws and rules to include The Law on Public Trading in Securities, The Law on Stock Companies, The Law on Investment Companies, Pension Fund Law and the proposed Rule on Insider Trading Identification.

Dr. Arvydas Paskevicius continues his work with the Division of Investment Companies of the LSC, Ministry of Finance, Lithuanian Central Depository (LCD) and financial brokerage firms regarding financial statements and taxation of investment companies. Conformity of the above with both International Accounting Standards and European Communities Council Directives is the intent, and he is consulting with interested commentators such as auditors, accountants and academia. He chaired the meeting of financial brokerage firms concerning the establishment of investment companies (List of Attendees-Exhibit #6).

Skirmantas Rimkus worked on The Capital Adequacy Rule, which was passed by the LSC in November. He prepared a report, "Some Proposals Concerning the Activities of a Financial Brokerage Firm According to the EU", comparing the Rule on Initial Own Capital to European Directives (Exhibit #7). He worked with financial brokerage firms in preparation for drafting the Rule on Accounting and Financial Statements. In addition, he began work on the Rule on Accounting and Financial Statements.

Vita Markeviciute is working with Jurga Dermontaite on presentations on the internet world wide web site "Bullish on Lithuania"; a site dealing with Lithuanian companies that are ready for research and fundamental analysis. They are currently working on a research report on the hotel LIETUVA. Vita continues her efforts in the training and preparation of Certified Financial Analysts candidates. Both Vita and Jurga are working on the draft of the law covering pension funds, which was recently formally assigned to the LSC by the Lithuanian Government for administrative and enforcement responsibility.

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<sup>1</sup> Pragma's four clients are the Lithuanian Securities Commission ("LSC"), the National Stock Exchange of Lithuania ("NSEL"), the Central Securities Depository of Lithuania ("Central Depository"), and the National Association of Finance Brokers ("Brokers Association").

Gediminas Reciunas spent part of the month reviewing amendments to the Companies Act. He had numerous meetings with the staff of the LSC, the LCD and financial brokerage firms on model investment management contracts of investment funds and portfolio management for investment management and consulting firms. He began drafting a rule for portfolio management. He also had meetings with the LCD staff to discuss conversion of private companies to public companies, and agreements among shareholders on the price of shares of a company.

#### IV. STATUS OF DELIVERABLES<sup>2</sup>

- (1) *Completed*--The Capital Adequacy Rule
- (2) *In Progress*--Rule on Securities Portfolio Management
- (3) *In Progress*--The Examination Module
- (4) *In Progress*--Rule (Guidelines) on Internal Control of Licensed Financial Brokerage Firms
- (5) *In Progress*--Rule on Reports to be Made by Financial Brokerage Firms
- (6) *In Progress*--Rule on Insider Trading Identification
- (7) *In Progress*--Rule on Tender Offers
- (8) *In Progress*--Pension Fund Law
- (9) *In Progress*--Rule on Accounting and Financial Statements

In addition, copies of the weekly work status reports are attached to this memorandum.

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<sup>2</sup> Work product, where applicable, evidencing completion of deliverables is attached to this memorandum in the numerical order in which they are set forth below.

Draft

December 5, 1997

Prepared by: Donald Buddenbohn

## **RULE ON INTERNAL CONTROL OF LICENSED FINANCIAL BROKERAGE FIRMS**

Pursuant to item 1. paragraph 2 of Article 32 of the Law on Public Trading of Securities requiring the Securities Commission to prepare rules regulating the activities of intermediaries of public trading in securities, this rule requires that all Financial Brokerage Firms (FBF) establish and maintain, at all times, effective systems of internal control. that will result in transactions (as well as events and conditions) being recorded, processed, summarised and reported consistent with management's assertions embodied in the financial statements, which are fairly presented in conformity with generally accepted accounting principles. The internal control system must be designed to provide reasonable assurance of the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

Draft

December 5, 1997

Prepared by: Donald Buddenbohn

## GUIDELINES FOR INTERNAL CONTROL OF LICENSED FINANCIAL BROKERAGE FIRMS

The Lithuanian Securities Commission's ("Commission") Rule on Internal Control of Licensed Financial Brokerage Firms ("the Rule") and the European Communities Council Directive 93/22 on Investment Services in the Securities Field ("the Directive"), both require that financial brokerage firms ("firms") have adequate internal controls.

The Lithuanian Securities Commission's Rule on Internal Control of Licensed Financial Brokerage Firms "requires that all Financial Brokerage Firms establish and maintain, at all times, effective systems of internal control, that will result in transactions (as well as events and conditions) being recorded, processed, summarised and reported consistent with management's assertions embodied in the financial statements, which are fairly presented in conformity with generally accepted accounting principles".

Article 12 of the European Communities Council Directive 93/22 on Investment Services in the Securities Field provides that "Each home Member State shall draw up prudential rules which investment firms shall observe at all times. In particular, such rules shall require that each investment firm have sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing, and adequate internal control mechanisms ...".

The Commission is issuing these Guidelines to assist firms in establishing and maintaining internal controls in compliance with the Rule and the Directive.

### 1 DEFINITION

The International Auditing Standard, Section 8400, on Risk Assessment and Internal Control defines '*internal control system*' as "all the policies and procedures (internal controls) adopted by management of an entity to assist in achieving management's objectives of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of accounting records, and the timely preparation of reliable financial information."

### 2 SCOPE

In determining the scope and nature of effective internal control, a firm FBF must consider all relevant factors including the size of the business; the organisation and ownership characteristics; the diversity and complexity of operations; the nature, volume, size and frequency of transactions; the methods of transmitting, processing, maintaining, and accessing information; the degree of centralisation and the methods of data processing.

### 3 COMPONENTS

A firm FBF must ensure that all of the components of internal control are established and

maintained, including:

### 3.1 *Control Environment.*

Control environment is the foundation for all other components of internal control, providing discipline and structure. It includes the FBF management's overall attitude and commitment to establishing and maintaining appropriate internal controls. The control environment means the overall attitude, awareness and actions of directors and management regarding the internal control system and importance in the entity. The control environment has an effect on the effectiveness of the specific control procedures. A strong control environment, for example, one with tight budgetary controls and an effective internal audit function, can significantly complement specific control procedures. However, a strong environment does not, by itself, ensure the effectiveness of the internal control system. Factors reflected in the control environment include:

- 3.1.1 The function of the board of directors and its committees.
- 3.1.2 Management's philosophy and operating style.
- 3.1.3 The entity's organisational structure and methods of assigning authority and responsibility.
- 3.1.4 Management's control system including the internal audit function and personnel policies and procedures.

### 3.2 *Risk assessment.*

Risk assessment, for financial reporting purposes, is the identification, analysis and management of risks relevant to the preparation of financial statements. Part of risk assessment and control is to minimise the risk of losses to the business from irregularities, fraud or error and to identify such matters, so that prompt remedial action may be taken by management.

### 3.3 *Control activities.*

Control activities are the policies and procedures that help ensure necessary actions are taken to address risks so that the firm's objectives can be achieved. These include:

- 3.3.1 *Performance reviews.* These include reviews of actual financial performance versus budgets, forecasts and prior period performance.
- 3.3.2 *Information processing.* These include general and application controls to check accuracy, completeness and authorisation of transactions. General controls apply to mainframe, minicomputer and end-user environments and include controls over data centre operations, system software acquisition and maintenance and application system development and maintenance. Applications controls apply to the processing of individual applications.
- 3.3.3 *Physical controls.* These encompass the physical security of assets, including adequate safeguards such as secured facilities, over access to assets and records; authorisation for access to computer programs and data files and periodic counting, comparison and reconciliation with amounts shown on control records. These controls extend to assets belonging to third parties for which the firm is accountable.
- 3.3.4 *Segregation of duties.* This entails assigning different people the responsibilities of authorising transactions, recording transactions and maintaining custody of assets in order to reduce the opportunities of one person being in a position to

both perpetrate and conceal errors or irregularities in the normal course of performing their duties.

### 3.4 *Information and communication.*

The information system, relevant to financial reporting, which includes the accounting system, consists of the methods and records established to record, process, summarise, and report transactions (as well as events and conditions) and to maintain accountability for related assets, liabilities, and own funds equity. An information system encompasses methods and records that:

- 3.4.1 Identify and record promptly all valid transactions and commitments in sufficient detail to permit proper classification for financial reporting the appropriate account.
- 3.4.2 Determine that all transactions and commitments entered into are within the scope of authority of the firm FBF or individual acting on behalf of the firm FBF.
- 3.4.3 Ascertain that it is reasonable to believe that all transactions and commitments entered into are within the scope of authority of the counterparty or any individual acting on behalf of the counterparty.

**Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.**

- 3.4.4 Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- 3.4.4 Determine the time period the transactions occurred to permit recording of transactions in the proper accounting period.
- 3.4.5 Organise documentation of and establish controls over all liabilities.
- 3.4.6 Present properly the transactions and related disclosures in the financial statements.

Communication involves providing an understanding of roles and responsibilities pertaining to internal control over financial reporting. Communication takes such forms as policy manuals, accounting and financial reporting manuals and memoranda.

### 3.5 *Monitoring.*

Monitoring is the process that assesses the quality of internal control over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. Ongoing monitoring activities must be built into the normal recurring activities of a firm FBF and include regular management and supervisory activities.

## 4 **ADDITIONAL INTERNAL CONTROL PROCEDURES** An FBF shall ensure that the following additional internal control procedures are established:

- 4.1 Determine that transactions are executed in accordance with management's general or specific authorisation.
- 4.2 In so far as is reasonably practicable, limit and monitor the extent to which employees are permitted to engage in personal account dealings.

- 4.3 Provide a means to determine that a customer's interests are not prejudiced by conflicts of interest between the firm FBF and its customer or between one customer and another customer.
- 4.4 Provide for physical and accounting separation of firm FBF funds and securities from customer funds and securities.

Draft

November 21, 1997

***RULE ON REPORTS TO BE MADE BY FINANCIAL BROKERAGE FIRMS***

1 *For the purposes of this Rule:*

- 1.1 *Capital Adequacy Calculation Statement* shall mean the statement prepared by a financial brokerage firm in compliance with the Rule on Capital Adequacy Requirement;
- 1.2 *generally accepted accounting principles* shall mean the technical methods that encompass the conventions, rules, and procedures necessary to define accepted accounting practices at a particular time;
- 1.3 *audit* shall mean the examination that an independent accountant performs in order to express an opinion on the fairness with which the financial statements of a financial brokerage firm present, in all material respects, the financial position, results of operations, changes in financial position and cash flows in conformity with generally accepted accounting principles;
- 1.4 *liquid own funds* shall be defined in accordance with subparagraph 3.3.4 of the Rule on Capital Adequacy Requirement;
- 1.5 *capital adequacy requirement* shall mean the requirement imposed by the Rule on Capital Adequacy Requirement;
- 1.6 *independent accountant* shall mean an accountant who is duly licensed, in good standing, by the Lithuanian Institute of Audit and Accounting, who is without bias with respect to his/her financial brokerage firm client since otherwise he/she would lack that impartiality necessary for the dependability of his/her findings, however excellent his/her technical proficiency may be;
- 1.7 *material inadequacy* shall mean a defect in the accounting system, internal accounting controls or financial statement presentation, the magnitude of which, in the light of surrounding circumstances and known facts, makes it probable that the judgement to a reasonable person relying on information received through these defective means would have been changed or influenced by the defect. In financial statements this can relate to form, arrangement and content and their appended notes, including, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the basis of amounts set

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forth;

- 1.8 *free credit balance* shall mean funds in a customer's account available for use by the customer for the purchase securities, to apply against service charges or for withdrawal;
- 1.9 *national securities exchange* shall be defined in accordance with paragraph 2, Article 20 of the Law on Public Trading in Securities;
- 1.10 *auditing scope* shall mean the procedures deemed necessary in the circumstances to achieve the objective of the audit. The procedures required to conduct an audit is determined by the auditor having regard to the requirements of International Standards of Auditing, the Lithuanian Securities Commission (Commission), other relevant professional bodies, legislation, regulations and where appropriate, the terms of the audit engagement and reporting requirements;
- 1.11 *accountant's report* shall mean the statement made by an independent accountant that identifies the financial statements he/she has audited, the scope of the audit and his/her opinion as to the fairness of their presentation;
- 1.12 *adverse opinion* shall mean an independent accountant's opinion that states that the financial statements do not present fairly the financial position or the results of operations or the changes in financial position or cash flows in conformity with generally accepted accounting principles;
- 1.13 *disclaimer* shall mean a statement by an independent accountant when the possible effect of a limitation of an auditing scope is so material and pervasive that the independent accountant has not been able to obtain sufficient appropriate audit evidence to express any opinion;
- 1.14 *qualification, or qualified opinion*, shall mean a statement by an independent accountant that he/she concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation of auditing scope is not so material and pervasive as to require an adverse opinion or disclaimer of opinion. A qualified opinion will be expressed as being 'except for' the effects of the matter to which the qualification relates;
- 1.15 *unqualified opinion* shall mean a statement by an independent accountant that the financial statements audited by the independent accountant present fairly, in all material respects, the financial position, results of operations and cash flows of an entity in conformity with generally accepted accounting principles;
- 1.16 *generally accepted auditing standards* shall mean the measures of the quality of the performance of procedures and objectives to be attained by use of the procedures undertaken. They concern themselves with the

auditors professional qualities and the judgement exercised by him/her in the performance of his/her audit and in his/her report;

1.17 *internal accounting control* shall mean a process designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations;

1.18 *interim work* shall mean audit work done prior to the balance sheet date such as testing which may permit early consideration of significant matters effecting year-end financial statements (for example, related party transactions, changed conditions, recent accounting pronouncements, and financial statement items likely to require adjustment). In addition, much of audit planning, including obtaining an understanding of internal control, assessing control risk and application of substantive tests to transactions can be conducted prior to the balance sheet date;

1.19 *illiquid assets* shall be defined in accordance with paragraph 2 of the Rule on Capital Adequacy Requirement;

1.20 *initial capital* shall be defined in accordance with paragraph 2 of the Instruction on the Requirement for Initial Own Capital of Financial Brokerage Firms as approved by Resolution 5 of the Commission.

2 *Filing of monthly and quarterly reports, pursuant to paragraph 6, Article 13 of the Law on Public Trading in Securities (the Law)*

2.1 This paragraph 2.1 shall apply to every financial broker firm (firm) licensed pursuant to Article 16 of the Law.

2.1.1 Every Category A firm, pursuant to the Instruction on the Requirement for Initial Own Capital of Financial Brokerage Firms as approved by Resolution 5 of the Commission, shall file with the Market Regulation Department of the Commission, a Balance Sheet, Income Statement, Statement of Change in Financial Position, Statement of Cash Flows and Capital Adequacy Calculation Statement within 15 days after the end of each month.

2.1.2 Every Category B and C FBF, pursuant to the Instruction on the Requirement for Initial Own Capital of Financial Brokerage Firms as approved by Resolution 5 of the Commission, shall file with the Market Regulation Department of the Commission, a Balance Sheet, Income Statement, Statement of Change in Financial Position, Statement of Cash Flows and Capital Adequacy Calculation Statement within 15 days after the end of each calendar quarter.

2.1.3 Upon receiving written notice from the Commission, a firm who receives such notice shall file monthly or at such times as shall be specified, a Balance Sheet, Income Statement, Statement of Change in Financial Position, Statement of Cash Flows, Capital Adequacy Calculation Statement and such other financial or operational information as shall be required by the Commission.

2.2 The reports provided for in this paragraph 2 shall be considered filed when received at the Commission's principal office in Vilnius. All reports filed pursuant to this paragraph 2 shall be deemed to be confidential.

2.3 Upon written application by a firm to the Commission, the Commission may extend the time for filing the information required by this paragraph 2. The Commission shall maintain a record of each extension granted.

### 3 *Report Filed Upon Termination of Firm*

3.1 If a licensed firm ceases to be a firm in good standing, such firm shall, within two business days after such event, file with the Market Regulation Department of the Commission a Balance Sheet, Income Statement, Statement of Change in Financial Position, Statement of Cash Flows and Capital Adequacy Calculation Statement as determined by the standards set forth in paragraphs 2.1.1 and 2.1.2 of this section as of the date of such event. These financial statements shall be filed at the Commission's principal office in Vilnius. Provided, however, that such financial statements need not be made or filed if the Commission, upon written request or upon its own motion, exempts such firm, either unconditionally or on specified terms and conditions, from such requirement. Provided, further, that the Commission may, upon request of the firm, grant extensions of time for filing the financial statements specified herein for good cause shown.

3.2 Attached to the financial statements required by subparagraph 3.1 of this paragraph shall be an oath or affirmation that to the best knowledge and belief of the individual making such oath or affirmation the information contained in the financial statements is true and correct. The oath or affirmation shall be made before a person duly authorised to administer such an oath or affirmation. If the firm is a sole proprietorship, the oath or affirmation shall be made by the proprietor; if a partnership, by a general partner; or if a corporation, by the chief executive officer, or in his/her absence, by the person authorised to act in his/her place.

3.3 For purposes of this paragraph 3, any firm shall be deemed to have ceased to be a firm in good standing when the firm's license has been revoked or suspended, or it has directly or through any associated person sold or entered into an agreement for the sale of the firm which would on consummation thereof result in termination of the firm..

### 4 *Customer Statements*

- 4.1 *Who must furnish the statements.* Every firm shall file with the Commission at its principal office in Vilnius and shall send to its customers the statements prescribed by subparagraphs 4.2 ~~and 4.3~~ of this paragraph 4.
- 4.2 *Audited statements to be furnished.* The following statements shall be furnished as required by subparagraph 4.1 within 15 days after the date of the general shareholders' meeting:
- 4.2.1 A Balance Sheet with appropriate notes prepared in accordance with generally accepted accounting principles which shall be audited if the financial statements furnished in accordance with paragraph 5 of this rule are required to be audited;
  - 4.2.2 A footnote containing a statement of the amount of the firm's liquid own capital and its capital adequacy requirement, computed in accordance with the Rule on Capital Adequacy Requirements. Such statement shall include summary financial statements of subsidiaries consolidated, where material, and the effect thereof on the liquid own capital and capital adequacy requirement of the firm.
  - 4.2.3 If in connection with the most recent annual audited financial statements pursuant to this section, the independent accountant commented on any material inadequacies in accordance with paragraphs 12 and 13 of this section, there shall be a statement by the firm that a copy of such financial statements and comments are currently available for the customer's inspection at the principal office of the Commission in Vilnius; and
  - 4.2.4 A statement indicating that the Balance Sheet of the most recent annual audited financial statements of the firm are available for examination at the principal office of the firm, and at the Commission.
- 4.3 *Unaudited statements to be furnished.* The statements shall contain the information specified in subparagraphs 4.2.1 and 4.2.2, and shall be furnished not later than 15 days after the date as of which the statements are prepared, as follows:
- 4.3.1 In the case of Category A firms, pursuant to subparagraph 4.2 of the Instruction on the Requirement for Initial Own Capital of Financial Brokerage Firms as approved by Resolution 5 of the Commission, as of the last calendar day of each month.
  - 4.3.2 In the case of Category B and C firms, pursuant to subparagraph 4.2 of the Instruction on the Requirement for Initial Own Capital of Financial Brokerage Firms as approved by Resolution 5 of the

Commission, as of the dates three months, six months and nine months from the date of the annual audited financial statements required to be furnished pursuant to subparagraphs 4.1 and 4.2.

4.4 *Definition of "customer"*. For purposes of this paragraph 4, the term "customer" includes any person other than (i) a general, special or limited partner or director or officer of a firm, or (ii) any person to the extent that such person has a claim for property or funds, whether it be contract, agreement or understanding, or by operation of law, is part of the capital of the firm or is subordinated to the claims of creditors of the firm, for or with whom a firm has effected a securities transaction in a particular month, which month shall be either the month preceding the Balance Sheet date or the month following the Balance Sheet date in which the statement is sent. The term "customer" also includes any person for whom the firm carries a free credit balance in the month in which customers are determined for purposes of this paragraph 4.

## 5 *Annual Filing of Audited Financial Statements*

5.1 Every licensed firm pursuant to Article 16 of the Law shall file annually, on a calendar or fiscal year basis, financial statements which shall be audited by an independent accountant. Financial statements pursuant to this paragraph 5 shall be as of the same fixed or determinable date each year, unless a change is approved in writing by the Commission.

5.2 A firm succeeding to and continuing the business of another firm need not file financial statements under this paragraph as of a date in the fiscal or calendar year in which the succession occurs if the predecessor firm has filed financial statements in compliance with this paragraph as of a date in such fiscal or calendar year. *delete*

5.3 A firm which is a member of a national securities exchange and has transacted business in securities solely with or for other members of a national securities exchange, and has not carried any margin account, credit balance or security for any person who is defined as a "customer" in paragraph 4.4 of this section, shall not be required to file a report under this paragraph. *delete*

5.4 The annual audited financial statements shall include a Balance Sheet, Income Statement, Statement of Change in Financial Position and a Statement of Cash Flows.

5.5 A Capital Adequacy Calculation Statement shall be filed with the annual audited financial statements.

5.6 The annual audited financial statements shall be filed within 15 days after the general shareholders' meeting.

5.7 Two copies of the annual audited financial statements shall be filed at the

Commission's principal office in Vilnius.

6 *Nature and form of reports*

- 6.1 The annual audited financial statements filed pursuant to paragraph 5 of this rule shall be audited by an accountant who shall in fact be independent and shall give an opinion covering them.
- 6.2 Attached to the financial statements shall be an oath or affirmation that, to the best knowledge and belief of the person making such oath or affirmation, (i) the financial statements and schedules are true and correct and (ii) neither the firm, nor any partner, officer, or director, as the case may be, has any proprietary interest in any account classified as that of a customer. The oath or affirmation shall be made before a person duly authorised to administer such oaths or affirmations. If the firm is a sole proprietorship, the oath or affirmation shall be made by the proprietor; if a partnership, by a general partner or if a corporation, by a duly authorised officer.
- 6.3 All financial statements filed pursuant to paragraph 5 shall be public, except that if the Balance Sheet is bound separately from the balance of the annual audited financial statements filed pursuant to subparagraph 5.4, the balance of the annual audited financial statements shall be deemed confidential, except that they shall be available for official use by any official or employee of Lithuania, by national securities exchanges and registered national securities associations of which the firm is a member, and by any other person to whom the Commission authorises disclosure of such information as being in the public interest.

7 *Qualification of accountants*

- 7.1 The Commission will not recognise any person as a independent accountant who is not duly licensed, in good standing, by the Lithuanian Institute of Audit and Accounting.
- 7.2 An independent accountant must satisfy the Commission that he/she has the necessary knowledge and experience to act as an auditor for the firm concerned.

8 *Designation of accountant*

- 8.1 Every firm which is required by paragraph 5 of this section to file annual audited financial statements shall file no later than one month before the end of each year a statement with the Commission's principal office in Vilnius. Such statement shall indicate the existence of an agreement dated no later than 45 days before the end of each year, with an independent accountant covering a contractual agreement to conduct the firm's annual audit during the following year.

- 8.2 The agreement may be of a continuing nature, providing for successive yearly audits, in which case no further filing is required. If the agreement is for a single audit, or if the continuing agreement previously filed has been terminated or amended, a new statement must be filed by the required date.
- 8.3 The statement shall be headed "Notice pursuant to Rule on Reports to Be Made by Financial Brokerage Firms" and shall contain the following information:
- 8.3.1 Name, address, telephone number and registration number of firm;
  - 8.3.2 Name, address and telephone number of independent accountant;
  - 8.3.3 The audit date of the firm for the year covered by the agreement. *last day of fiscal year*
- 8.4 Notwithstanding the date of filing specified in subparagraph 8.1, every firm shall file the notice provided for in this paragraph 8 within 30 days following the effective date of registration as a firm.

9 *Engagement letter*

- 9.1 Each firm must ensure that its independent accountant appointed under these rules has set out his/her rights and duties in a written engagement letter which shall be signed by the firm and its independent accountant.
- 9.2 Each firm must ensure that the engagement letter gives its independent accountant the rights and duties set out below, both in relation to the firm and, on a consolidated basis.
- 9.2.1 The right at all times to the accounting and other records of the firm and all other documents relating to its business;
  - 9.2.2 The right to require from the firm such information and explanations as it thinks necessary for the performance of its duties;
  - 9.2.3 The duty to submit an opinion or disclaimer on the firm's annual financial statements;
  - 9.2.4 The duty to carry out such investigations as considered necessary in order to form an opinion on the firm's annual financial statements;
  - 9.2.5 The duty to submit a letter to the firm commenting on internal controls or that he/she has no comments on internal control;
  - 9.2.6 The duty to include with any qualification of the independent

accountant's opinion a statement specifying the relevant requirements and the reasons why the opinion is qualified.

- 9.3 Each firm must retain a copy of the engagement letter required under this rule.

## 10 *Independence of Accountant*

- 10.1 An accountant who is duly licensed, in good standing, by the Lithuanian Institute of Audit and Accounting, who is without bias with respect to the financial brokerage firm he/she is auditing shall be deemed to be independent.

- 10.2 An accountant shall not be considered independent, if he/she is:

10.2.1 An officer, appointed representative or employee of the firm;

10.2.2 A controller of the firm; *delete*

10.2.3 A person who is a partner of, or in the employment of, <sup>an</sup> a person listed in 10.2.1 ~~or 10.2.2~~ above;

10.2.4 Any individual whose close relative is one of the persons in 10.2.1 to 10.2.3; ?

10.2.5 A body corporate of which the firm or a connected company of the firm or any person listed in 10.2.1 to 10.2.4;

10.2.6 Any person disqualified by the Commission.

## 11 *Replacement of accountant*

- 11.1 A firm shall file a notice which must be received by the Commission's principal office in Vilnius, not more than 15 days after:

11.1. 1 The firm has notified the accountant whose opinion covered the most recent financial statements filed under paragraph 5 of this rule that his services will not be utilised in future engagements; or

11.1. 2 The firm has notified an accountant who was engaged to give an opinion covering the financial statements to be filed under paragraph 5 that the engagement has been terminated; or

11.1. 3 An accountant has notified the firm that they would not continue under an engagement or give an opinion covering the financial statements to be filed under paragraph 5; or

11.1. 4 A new accountant has been engaged to give an opinion covering the financial statements to be filed under paragraph 5 without any

notice of termination having been given to or by the previously engaged accountant.

Such notice shall state (a) the date of the notification of the termination of the engagement or engagement of the new accountant as applicable and (b) the details of any problems existing during the 24 months (or the period of the engagement, if less) preceding such termination of a new engagement relating to any matter of accounting principles, financial statement disclosure, auditing scope or procedure or, compliance with rules of the Commission, which problems, if not resolved to the satisfaction of the former accountant, would have caused him/her to make reference to them in connection with his/her report on the subject matter of the problems. The problems required to be reported in response to the preceding sentence include both those resolved to the former accountant's satisfaction and those not resolved to the former accountant's satisfaction. Problems contemplated by this rule are those which occur at the decision making level, that is, between principal financial officers of the firm and personnel of the accounting firm responsible for rendering its report. The notice shall also state whether the accountant's report on the financial statements for any of the past two years contained an adverse opinion or a disclaimer of opinion or was qualified as to uncertainties, audit scope, or accounting principles, and describe the nature of each such adverse opinion, disclaimer of opinion, or qualification. The firm shall also request the former accountant to furnish the firm with a letter addressed to the Commission stating whether he agrees with the statements contained in the notice of the firm and, if not, stating the respects in which he does not agree. The firm shall file three copies of the notice and the accountant's letter, one copy of which shall be manually signed by the sole proprietor, or general partner or duly authorized officer, as appropriate, and by the accountant, respectively.

## 12 *Audit objectives*

- 12.1 The audit shall be made in accordance with generally accepted auditing standards and shall include a review of accounting systems and internal accounting controls, including appropriate tests thereof for the period since the prior examination date. The audit shall include all procedures necessary under the circumstances to enable the independent accountant to express an opinion on the Balance Sheet, Income Statement, Statement of Change in Financial Position, Statement Of Cash Flows, and Capital Adequacy Calculation Statement under the Rule on Capital Adequacy Requirement. The scope of the audit and review of the accounting system and internal controls shall be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination in (a) the accounting system; (b) the internal accounting controls; and (c) the practices and procedures whose review is specified in 12.1.1 and 12.1.2 of this paragraph would be disclosed. Additionally, as specific objectives, the audit shall include reviews of the practices and procedures followed by the client:

12.1.1 In making the calculation of capital adequacy under the Rule on Capital Adequacy Requirement; and

12.1.2 In complying with the requirement for prompt payment for securities under the Rule for Margin Accounts

12.2 A material inadequacy in the accounting system, internal accounting controls and practices and procedures referred to in paragraph 12.1 which is expected to be reported under these audit objectives includes any condition which has contributed substantially to or, if appropriate corrective action has not been taken, could reasonably be expected to (i) inhibit a firm from promptly completing securities transactions or promptly discharging their responsibilities to customers and other firms or creditors; (ii) result in material financial loss; (iii) result in material misstatements in the firm's financial statements; or (iv) result in violations of the Commission's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in paragraphs 12.2 (i), (ii), or (iii) of this section.

### 13 *Extent and Timing of Audit Procedures*

13.1 The extent and timing of audit procedures are matters for the independent accountant to determine on the basis of his review and evaluation of existing internal controls and other audit procedures performed in accordance with generally accepted auditing standards and the audit objectives set forth in paragraph 12 above. In determining the extent of testing, consideration shall be given to the materiality of an area and the possible effect on the financial statements and schedules of a material misstatement in a related account. The performance of auditing procedures involves the proper synchronisation of their application and thus comprehends the need to consider simultaneous performance of procedures in certain areas such as, for example, customer and firm confirmation in connection with verification of securities positions.

13.2 If, during the course of the audit or interim work, the independent accountant determines that any material inadequacies exist in the accounting system, internal accounting controls, or otherwise defined in paragraph 12.2 of this section, then the independent accountant shall call it to the attention of the chief financial officer of the firm, who shall have a responsibility to inform the Commission by facsimile notice within 24 hours thereafter as set forth in paragraphs 19.7 and 19.8 of this section. The firm shall also furnish the accountant with a copy of said notice to the Commission by facsimile within said 24 hour period. If the accountant fails to receive such notice from the firm within said 24 hour period, or if the accountant disagrees with the statements contained in the notice of the firm, the accountant shall have a responsibility to inform the Commission by report of material inadequacy within 24 hours thereafter as set forth in paragraph 19.8 of this section. Such report from the accountant shall, if

the firm failed to file notice, describe any material inadequacies found to exist. If the firm filed the notice, the accountant shall file a report detailing the aspects, if any, of the firm's notice with which the accountant does not agree.

14 *Accountant's report, general provisions*

14.1 *Technical requirements.* The accountant's report shall: (i) be dated; (ii) be signed manually; (iii) indicate the city ~~and state~~ where issued; and (iv) identify without detailed enumeration the financial statements and schedules covered by the report.

14.2 *Representations as to the audit.* The accountant's report shall: (i) state whether the audit was made in accordance with generally accepted auditing standards; and (ii) designate any auditing procedures deemed necessary by the accountant under the circumstances of the particular case which have been omitted, and the reason for their omission.

Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required under this rule.

14.3 *Opinion to be expressed.* The accountant's report shall state clearly the opinion of the accountant: (i) in respect of the financial statements and schedules covered by the report and the accounting principles reflected therein; and (ii) as to the consistency of application of accounting principles, or as to any changes in such principles which have a material effect on the financial statements.

14.4 *Exceptions.* Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.

15 *Accountant's report on material inadequacies*

15.1 The firm shall file concurrently with the annual audit report a supplemental report by the accountant describing any material inadequacies found to exist or found to have existed since the date of the previous audit. The supplemental report shall indicate any corrective action taken or proposed by the firm in regard thereto. If the audit did not disclose any material inadequacies, the supplemental report shall so state.

16 *Extensions and Exemptions*

16.1 The Commission may extend the period under paragraph 5 of this section for filing annual audited financial statements. The Commission shall maintain a record of each extension granted.

16.2 On written request, the Commission may grant an extension of time or an exemption from any of the requirements of this rule either unconditionally or on specified terms and conditions.

17 *Notification of change of fiscal year*

17.1 In the event any firm finds it necessary to change its fiscal year, it must file with the Commission's principal office in Vilnius a notice of such change.

17.2 Such notice shall contain a detailed explanation of the reasons for the change. Any change in the filing period for the audit report must be approved by the Commission pursuant to paragraph 5.1 of this section.

18 *Filing requirements*

18.1 For purposes of filing requirements as described in this rule, such filing shall be deemed to have been accomplished upon receipt at the Commission's principal office in Vilnius.

19 *Notification Provisions for Firms.* This paragraph shall apply to every firm licensed by the Commission pursuant to Article 16 of the Law.

19.1 Every firm whose liquid own capital declines below their capital adequacy requirement pursuant to the Rule on Capital Adequacy Requirement shall give notice of that occurrence that same day in accordance with paragraph 19.8 of this section. The notice shall specify the firm's capital adequacy requirement and its current liquid own capital. If a firm is informed by the Commission that it is, or has been, in violation of the Rule on Capital Adequacy and the firm has not given notice of the capital deficiency under this section, the firm, even if it does not agree that it is, or has been, in violation of the Rule on Capital Adequacy, shall give notice of the claimed deficiency, which may specify the firm's reasons for its disagreement.

19.2 Every firm whose liquid own capital declines below 110% of their capital adequacy requirement pursuant to the Rule on Capital Adequacy Requirement shall give notice promptly (but within 24 hours) after the occurrence in accordance with paragraph 19.8 of this section.

19.3 Every firm whose total value of its illiquid assets exceeds 25% of its initial capital plus interim profit or loss account shall give notice promptly (but within 24 hours) after the occurrence in accordance with paragraph 19.8 of this section.

19.4 Every firm whose unsecured borrowings exceed its initial capital, unless the loans (a) are subordinated loans; or (b) arise from money borrowed to finance the purchase of investments to the extent that the firm's

position in those investments is a long position, shall promptly give notice (but within 24 hours) after the occurrence in accordance with paragraph 19.8 of this section.

- 19.5 Every firm that has reason to believe that a counterparty with which it has entered into a repurchase, reverse repurchase, securities lending, securities borrowing, sale and buy back and sale back agreement has defaulted on its obligations, shall promptly give notice (but within 24 hours) after the firm becomes aware of the situation in accordance with paragraph 19.8 of this section.
- 19.6 Every firm who fails to make and keep current the books and records required by the Rule on Books and Records, shall give notice of this fact that same day in accordance with paragraph 19.8 of this section, specifying the books and records which have not been made or which are not current. The firm shall also transmit a report in accordance with paragraph 19.8 of this section within 48 hours of this notice stating what the firm has done or is doing to correct the situation.
- 19.7 Whenever any firm discovers, or is notified by an independent accountant, pursuant to paragraph 13.2 of this section, of the existence of any material inadequacy as defined in paragraph 12 of this section, the firm shall:
  - 19.7.1 Give notice in accordance with paragraph 19.8 of this section, of the material inadequacy within 24 hours of such discovery or notification and
  - 19.7.2 Transmit a report in accordance with paragraph 19.8 of this section within 48 hours of the notice stating what the firm has done or is doing to correct the situation.
- 19.8 Every notice or report required to be given shall be given or transmitted to the principal office of the Commission in Vilnius. For purposes of this section, 'notice' shall be given or transmitted by facsimile transmission. The report required by paragraphs 19.6 or 19.7.2 of this section may be transmitted by overnight delivery.

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November 26, 1997 5:48PM

## MEMORANDUM

To: Chairman Virgilijus Poderys  
Commissioners of the LSC

From: Donald Buddenbohn

C/C: Aldas Kriaučiūnas, USAID  
Rimantas Busila, National Stock Exchange  
Arturas Keleras, Lithuanian Central Depository  
Romas Matiukas, National Association of Finance Brokers  
Jacques DeFay, The Pragma Corporation/USA  
Diana Sokolova, Pragma Corporation/Vilnius (Office Copy)

November 25, 1997

## MEMORANDUM REGARDING ACCOUNTING AND FINANCIAL STATEMENT PRESENTATION FOR INVESTMENT COMPANIES AND FINANCIAL BROKERAGE FIRMS

### OVERVIEW

Accounting matters that have been of concern to the Commission have been the general accounting and financial statement presentation of Investment Companies and Financial Brokerage Firms. In this regard, Investment Companies and Financial Brokerage Firms are very different and need to be dealt with in accordance with their own individual characteristics.

To determine appropriate rules and guidelines to be used for these enterprises, in so far as accounting and financial statement presentation is concerned, we have to consider (a) the Lithuanian Law on the Principles of Accounting, (b) International Accounting Standards and (c) European Communities Council Directives. Additional guidance can be gained from accounting principles and standards of the United States and, in so far as the securities industry is concerned, from the English Securities and Futures Authority (SFA) and the United States Securities and Exchange Commission (SEC).

## BACKGROUND

I understand that it is the ultimate intent of the Commission to be in compliance with European Directives and International Accounting Standards. To be in compliance with both of these at the same time is generally not a problem since they are most often in harmony with each other. One problem is that International Accounting Standards are not translated into Lithuanian, although many securities industry laws and Commission rules have been written in accordance with the European Directives. The bigger problem right now is being in compliance with these and the Law on the Principles of Accounting. Even though this Law states that accounting shall be carried out in pursuance of International Accounting Standards and European Directives, it is, at times, incomplete in that regard, and inconsistent and in conflict with those Standards and Directives.

Also, the financial statement format part of the Law on the Principles of Accounting is rigid and inflexible in that it is designed for all businesses enterprises. It is also intended, as I understand, to provide government information it needs for income taxes and perhaps, statistical data. Some businesses, such as financial services and investment firms, are very specialised and require accounting and financial statement presentation that is representative of their business activities. In addition, in the United States and England, the SEC and SFA respectively, in the interest of protecting investors, have their own accounting and financial reporting requirements for financial services and investment firms. These provide for more detailed financial reporting and additional information beyond that required by generally accepted accounting principles, but at the same time they are in harmony with those principles.

## INVESTMENT COMPANIES

In Lithuania we have been talking about two kinds of investment companies. One is a holding company and the other an open end fund, also known as a mutual fund. Holding companies in Lithuania have arisen as a result of the privatisation program. For the most part, I believe, they are companies holding large blocks, often controlling blocks, of a small group of privatised companies.

Open end fund are very different from holding companies. They are characterised by redeemable shares and generally, have many small investors, a portfolio of many different securities and provide for reinvestment of dividends.

Work was done to modify the financial statement format that is part of the Law on the Principles of Accounting. This was done with the intent of retaining the basic format, but also to make them more applicable and informative for both holding companies and open end funds at same time. This met with only limited success because they are very different kinds of companies and the new statement format is still somewhat rigid and inflexible. Let's take a look at the two kinds of companies independently.

### HOLDING COMPANIES

Holding companies present a unique problem in several respects. It is thought that all investment companies that came into existence as a result of privatisation are in fact holding companies. A lot is not known about them because most either do not report any financial information or report incomplete or inaccurate information, especially in regard to investments which may have little or no market activity, which is needed to establish a realistic market price.

In the United States, holding companies are not under the purview of the SEC

(except for registration). It probably is not practical to consider excluding them from the responsibility of the Commission in Lithuania at this time, since they represent a part of the securities industry as a result of privatisation.

In the United States, holding companies basically follow rules of generally accepted accounting principles, especially for consolidated financial statements. There are no such rules for consolidated financial statements at this time in Lithuania. I understand that the Ministry of Finance has consolidation rules under consideration, but that they have neither the staff nor the budget to deal with them now. It would be a big step forward if holding companies' financial statements could be consolidated in accordance with International Accounting Standards and European Directives.

In the absence of consolidated statements, I think it is important for the Commission to learn as much as possible about these holding companies, in particular about their investments and the liquidity of their investments. Actually, the unmodified financial statement format may be the best way to try to gather this information, since they are already in place. Also, the Commission may consider issuing directives to these holding companies to collect pertinent financial information.

#### OPEN END FUNDS

It is my understanding that there are not now any open end funds in Lithuania. But, I believe there is growing interest in having these available as a means of investment. So, it seems, they should be provided for. Open end funds are a very simple concept and accounting and financial reporting is straight forward. Usually, investments represent 95% or more of assets, income is all from investments and expenses are largely management fees and administration.

The modified financial statement is an improvement for the open end funds, but it would be even better if they were less rigid and more flexible. Consideration should be given to providing a separate rule for accounting and financial reporting of open end funds to have more meaningful and useful financial statements which are also in conformity with European Directives. If this is done, it may be necessary for open end funds to also provide financial statements in the format prescribed by the Law on the Principles of Accounting to satisfy that Law and tax and other requirements of the Ministry of Finance.

#### FINANCIAL BROKERAGE FIRMS

Financial brokerage firms are very different from investment companies and generally, much more complicated. Their activities may include trading in various different kinds of investment instruments, executing of trades, clearing and settling security transactions, underwritings, lending customers' money on margin accounts, investment advising, business planning and others as well. It is important that accounting and financial statement presentation of financial brokerage firms reflect accurately all their different specialised activities.

European Directives 78-660 on Annual Accounts of Certain Types of Companies and 86-635 on Annual Accounts and Consolidated Accounts of Banks and Other Financial Institutions do a very good job of defining the content and layout of financial statements of financial brokerage firms. It is these Directives that Skirmantas Rimkus will use as a primary source of reference in preparing the Accounting Rule. This should result in much more meaningful and useful financial statements

which are also in conformity with European Directives. If this is done, it may be necessary for financial brokerage firms to also provide financial statements in the format prescribed by the Law on the Principles of Accounting to satisfy that Law and tax and other requirements of the Ministry of Finance.

November 27, 1997

**ADDITIONAL WORK NEEDED ON THE LITHUANIAN CAPITAL MARKETS PROJECT**  
by Mr. Buddenbohn

The additional work requested by the Securities Commission and other clients, is, in my opinion, important and necessary and should be worked on in early 1998. They are outlined below in order of priority, with comments and an estimated time to complete.

<u>PROJECT</u>	<u>COMMENTS</u>	<u>TIME</u>
1. Continue overseeing and assisting in development of Accounting Rules and the definition of the content and arrangements of financial statements for brokers based on International Accounting Standards and European Directives.	Skirmantas Rimkus of the Pragma staff will begin working on this soon. We have already had a couple of planning meetings. This a long and complex task and for these reasons Skirmantas should be overseen by someone experienced with brokerage accounting and brokerage financial statements. The two European Directives that are being used as models, are a total of 42 pages.	3 to 4 weeks
2.. Complete writing revision to Rule on Margin Accounts and assist the Commission in its implementation.	I plan to start this in November or December but will not be able to complete it before I leave Lithuania. It is a difficult, complex and important rule. The original rule was not written so much as a rule; it was more like a description. Also, it needs to be harmonized with the European Directives.	2 to 3 weeks
3. Write Rule on Subordinated Borrowing and assist Commission in its implementation.	I was asked by the Commissioner of Market Regulation about this Rule. It has never been written, but would be important as another means for brokers to finance their businesses, which may keep some alive right now.	Com- bined with 5, below 2 to 3 weeks
4. Write Rule on Aggregate Indebtedness and assist Commission in its implementation.	I was asked by the Commissioner of Market Regulation about this Rule. It has never been written, but is important for the protection of customers. Both the Sec and the European Directives provide such a rule.	See 4, above

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|-----|---|---|--------------|
| 5.  | Rewrite Rule on Books and Records and assist the Commission and the Depository in its implementation.   | The original rule was written more as a description than as a rule. The portion for the Depository needs to be separate or an additional rule.  | 3 to 4 days  |
| 6.  | Develop pricing valuation standards and practices for investment companies' and brokers' investments and brokers' trading position.   | This is a sticky problem for the Lithuanian capital markets that no one wants to address, but is essential for fair presentation of financial statements of investment companies, brokers and investment managers. The problem is all the investments and trading positions that have very low or no trading volume.  | 1 week       |
| 7.  | Assist the Commission in Implementing the Capital Adequacy Calculation Requirement, which becomes effective on January 1, 1998. Assist the Commission in working with brokers who do not meet capital adequacy tests. | When the Capital Adequacy Rule goes into effect on January 1, 1998 (calculation and brokers statements due January 15, 1998) , simultaneously with the tripling of initial capital requirements, there will be a major disqualification of most brokers, leaving only a very few. The Commission will need someone knowledgeable with the Rule at that time to deal with objections from brokers that are very likely to occur. | 3 to 5 days  |
| 8.  | Work with and assist in training of brokers in preparation of financial statements and computation of capital adequacy.   | Brokers have little or no training in preparation of financial statements (other than statements for tax inspectors) and in calculation of capital adequacy.  | 1 to 2 weeks |
| 9.  | Overview audit engagements to ensure that audited financial reports of brokers are completed in accordance with International Auditing Standards.   | The Commission's staff has very little experience (practically none) in auditing brokers. Audits will become even more involved as the capital adequacy rule and accounting rule become effective.  | 1 to 2 weeks |
| 10. | Assist in training of inspection officials (auditors) of the Commission and Depository in International Auditing Standards.   | See 8., above. Same is true for Depository relative to the rule on books and records.   | 1 to 2 weeks |
| 11. | Summarize and prepare commentary for Commission and Ministry of Finance on comments received from accounting professionals regarding the accounting and financial statement formats for investment companies.         | We solicited the comments and we received them. Some were quite substantive, but not included in the revisions to the procedures for preparation of investment companies' financial statements. The comments are somewhat complex, but should be presented to the Commission and Ministry of Finance for their consideration in the future. It would be a mistake and insensitive not to present them.                          | 3 to 4 days  |
| 12. | Participate in Ad Hoc working group, as presented by the President of the   | I was requested by the President of the Depository and Commissioner of  | As           |

Depository, to make recommendations to improve and further develop the current system of securities and cash accounting of Depository.

Market Regulation to participate in this group, which I agreed to. They needed have not had any meetings to date.

**The Pragma Corporation**

**Lithuanian Capital Market  
Development Project  
Stock Exchange Building  
Ukmerges 41, Suite 514  
2662 Vilnius, Lithuania  
Tel: ( 370 2 ) 72 15 19, 724826  
Fax: ( 370 2 ) 72 49 42**

**MEMORANDUM**

To: Aldas Kriauciunas, USAID-Vilnius, Lithuania

From: James Ryan

Cc: Beverly E. Loew (USAID-Washington, DC)  
Virgilijus Poderys (Lithuanian Securities Commission)  
Edmundas Mikuuciauskas (Lithuanian Securities Commission)  
Arvydas Jalinskas (Lithuanian Securities Commission)  
Luicija Naudziuniene (Lithuanian Securities Commission)  
Rimantas Busila (National Stock Exchange)  
Arturas Keleras (Lithuanian Central Depository)  
Romas Matiukas (National Association of Finance Brokers)  
Jacques DeFay (The Pragma Corporation--USA)  
Diana Sokolova (Office File)

Re: The Trip Report from James Ryan

Date: November 20, 1997

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**The Pragma Corporation**  
**U.S.A.I.D. Capital Markets Consultants**  
**Vilnius, Lithuania**  
**Phone/Fax: (370 2) 72 49 42**

- **Trip Report**  
**Lithuanian Capital Markets Project**

Name of Consultant: James P. Ryan

Date of Visit: June 16, 1997 through November 20, 1997

Clients: Lithuanian Securities Commission ( "the Commission" ), the National Stock Exchange of Lithuania ( "the Exchange" ), the Central Securities Depository of Lithuania ( "the Depository" ) and the National Association of Finance Brokers ( "Brokers Association" ).

Purpose of the Trip: To advise the above clients as a Capital Market Specialist. Served as the interim Chief of Party in addition to continuing as an Advisor from September 15 through November 20, 1997.

Deliverables:

1. Draft of the Code of Ethics for the Brokers Association;
2. Draft of the Rules on Books and Records of Financial Brokerage Houses for the Commission;
3. Capital Adequacy Impact Analysis for the Commission;
4. Draft of Capital Adequacy Computation;
5. Draft of the Margin Account Rule for the Commission;
6. The Margin Rule Seminars for the Commission;
7. The Draft of the Rule on Clients' Funds and Securities for the Commission;
8. The Examination Manual and Modules;
9. Draft of the Hypothecation Rule for the Commission.

Description of Attachments:

Attachment A: James Ryan / Vilnius Disc;  
Attachment B: Books and Records Rule Proposal;  
Attachment C: The Brokers Association Code of Ethics;  
Attachment D: Capital Adequacy Computation;  
Attachment E: Customer Property Proposal;  
Attachment F: The Margin Rule Proposal: Definitions;  
Attachment G: Examination Manual;  
Attachment H: Capital Impact Analysis;  
Attachment I: Hypothecation Rule Proposal;

Attachment J: Interview Module;  
Attachment K: Margin Rule Proposal;  
Attachment L: September Monthly Report;  
Attachment M: October Monthly Report;  
Attachment N: Examination Module;  
Attachment O: Seminar Material for Margin Accounts;  
Attachment P: 1998 Work Plan.  
Attachment Q: The Weekly Reports for James Ryan

Contact Persons: Virgilijus Poderys, Chairman of the Commission;  
Edmundas Mikuciauskas, Deputy Chairman of the Commission;  
Arvydas Jalinskas, Commissioner  
Liucija Naudziuniene, Head of Market Regulation Department;  
Rimantas Busila, Director of the Exchange;  
Arturas Keleras, President of the Depository;  
Romas Matiukas, President of the Brokers Association;  
Dow Heard III, Chief of Party for the Pragma Corporation.  
Mohammad Fatoorechie, Vice President of the Pragma Corporation  
Jacques DeFay, Vice President of the Pragma Corporation

Next Steps: Both the Commission and the Brokers Association have made progress in the writing and the adoption of rules. To continue the process of providing assistance in this area, the following will require attention:

- the Brokers Association's Code of Ethics must be implemented with an examination program and an enforcement procedure;
- the Commission's capital rules and financial reporting rules must be implemented with an examination program and an enforcement procedure;
- the Commission and the Brokers Association must develop an experienced staff to conduct the above examinations and enforcement actions;
- the examination manuals and modules should be fine tuned to the realities and needs of the Lithuanian marketplace;
- because of the installation of the new market system, the development of new rules, surveillance procedures, and enforcement activities will be of critical importance.

# THE PRAGMA CORPORATION

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## MEMORANDUM

**To:** Aldas Kriauciūnas  
**Company:** USAID - Vilnius, Lithuania

**From:** Dow H. Heard  
Chief of Party, The Pragma Corporation

**Phone:** 72 49 42

**Re:** **Status Report for the Month of December 1997 -**  
Lithuania Capital Markets Development  
Project CONTRACT EPE-I-00-95-00040-00; Task Order 05

**C/C:** Beverly Loew (USAID - Washington, D.C)  
Mohammed Fatoorechie (Pragma - Virginia)  
The Pragma Corporation - Vilnius Office File (Diana Sokolova)

### Project Description

The Pragma Corporation ("Pragma") is implementing the Lithuania Capital Markets Development Project ("Project") funded by the United States Agency for International Development ("USAID"). The Project is to provide legal and regulatory development assistance to the Lithuanian Securities Commission ("Commission") and organisational development to the National Stock Exchange of Lithuania ("NSEL"), the Central Securities Depository and the National Association of Finance Brokers of Lithuania ("Association"). In addition, the Project is providing assistance in the procurement of software and operations capabilities to support an order-driven, continuous trading stock exchange.

### Professional Staffing

During December 1997, Dow H. Heard, Chief of Party, arrived to provide expert legal assistance to the counterparties. In addition, Bill Gorman began performing a short term assignment to draft the RFP for the acquisition of the software for the Exchange. Mr. Gorman arrived on December 18, 1997 and departed on January 13, 1998.

### Areas of Concentration

During December 1997, the primary focus of the team was to introduce Mr. Heard to the counterparties and to continue the work of Don Buddenbohn, a short term advisor.

Mr. Heard met with all counterparty heads and participated in a presentation by NASD to the Association and the Exchange on a proposed trading system. In addition, he began reviewing questions on the Inside Trading Rules and Investor Advisor fees. Mr. Buddenbohn provided expert assistance regarding International Accounting Standards and European Council Directives dealing with broker - dealers. Mr. Buddenbohn completed a draft Rule on Reports to Be Made by Financial Brokerage Firms. (Attachment "A"). He also completed a Rule on Internal Control of Licensed Financial Brokerage Firms (Attachment "B") and draft Guidelines for Internal Control of Licensed Financial Brokerage Firms (Attachment "C"). Included herein is Mr. Buddenbohn's Trip Report dated December 9, 1997 (Attachment "D").

Mr. Bill Gorman arrived to begin work on the RFP for the acquisition of the Exchange's automated trading system. He had meetings with all counterparties and their staff. He made presentations to the Association, significant members of the broker - dealer community in Lithuania, and to the Exchange. After reviewing the trading regulations and technical aspects of the Exchange, Mr. Gorman commenced drafting the important Project task of the Bid documents.

During December, Arvydas Paskevicius met with the Ministry of Finance and the State Insurance Supervisory Authority. These meetings dealt with the effect of Taxation on the unit investment trust legislation and with proposed pension fund legislation. In addition, meetings were held with the brokerage community concerning open-end investment companies. Dr. Paskevicius also worked on the procedures for preparing financial statements for investment holding companies.

Mr. Heard and Mr. Zinkevicius worked on draft rules for Insider Trading and "non-profit" pension funds. Changes were proposed to certain sections of the Law on Stock Companies.

Mr. Gediminas Reciuonas completed a draft rule on portfolio management for investment companies and worked on amendments to the Law on Stock Companies. Also, he began working on the rules relating to management of securities accounts by brokers and on portfolio management.

Mr. Skirmantas Rimkus worked with Mr. Buddenbohn on the initial drafts of the new reporting forms. He also worked on financials for brokerage firms including: balance sheet, off balance sheet items, profit (loss) statements, shareholders equity changes statement and cash flow statement.

Ms. Vita Markeviciute coordinated the forthcoming kick-off session of the Certified Financial Analysts course with the Financial Services Volunteer Corp. In addition, our staff made several presentations for and updated the Lithuanian market website, "Bullish on Lithuania".

#### Status of Deliverables

1. Completed: Draft Rule on Insider Trading
2. Completed: Draft Rule on Reports to Be Made by Financial Brokerage Firms

3. Completed: Draft Rule on Internal Control of Licensed Financial Brokerage Firms
4. Completed: Draft Guidelines for Internal Control of Licensed Financial Brokerage Firms
5. In Progress: Draft Rule on Securities Portfolio Management Agreement (On Discretionary Accounts) for Investment Management and Consulting Firms
6. In Progress: Rule on Tender Offers
7. In Progress: Pension Fund Law
8. In Progress: Rule on Accounting and Financial Statements
9. In Progress: Amendments to Law on Public Trading in Securities

Anticipated Issues for Next Month

During January 1998, it is planned that the draft RFP for the purchasing of the software for the automated trading system will be completed. This major goal of the Project will entail working with all counterparties and ascertaining the best form for the technical specifications.

**Draft**

November 13, 1997

Prepared by: Donald M. Buddenbohn

**RULE ON REPORTS TO BE MADE BY FINANCIAL BROKERAGE FIRMS**1 *For the purposes of this Rule:*

- 1.1 *Capital Adequacy Calculation Statement* shall mean the statement prepared by a financial brokerage firm in compliance with the Rule on Capital Adequacy Requirement;
- 1.2 *generally accepted accounting principles* shall mean the technical methods that encompass the conventions, rules, and procedures necessary to define accepted accounting practices at a particular time;
- 1.3 *audit* shall mean the examination that an independent accountant performs in order to express an opinion on the fairness with which the financial statements of a financial brokerage firm present, in all material respects, the financial position, results of operations, changes in financial position and cash flows in conformity with generally accepted accounting principles;
- 1.4 *liquid own funds* shall be defined in accordance with subparagraph 3.3.4 of the Rule on Capital Adequacy Requirement;
- 1.5 *capital adequacy requirement* shall mean the requirement imposed by the Rule on Capital Adequacy Requirement;
- 1.6 *independent accountant* shall mean an accountant who is duly licensed, in good standing, by the Lithuanian Institute of Audit and Accounting, who is without bias with respect to his/her financial brokerage firm client since otherwise he/she would lack that impartiality necessary for the dependability of his/her findings, however excellent his/her technical proficiency may be;
- 1.7 *material inadequacy* shall mean a defect in the accounting system, internal accounting controls or financial statement presentation, the magnitude of which, in the light of surrounding circumstances and known facts, makes it probable that the judgement of a reasonable person relying on information received through these defective means would have been changed or influenced by the defect. In financial statements this can relate to form, arrangement and content and their appended notes, including, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the basis of amounts set forth;
- 1.8 *free credit balance* shall mean funds in a customer's account available for use by the customer for the purchase securities, to apply against service charges or for withdrawal;
- 1.9 *national securities exchange* shall be defined in accordance with paragraph 2, Article 20 of the Law on Public Trading in Securities;
- 1.10 *auditing scope* shall mean the procedures deemed necessary in the circumstances to achieve the objective of the audit. The procedures required to conduct an audit is determined by the auditor having regard to the requirements of International Standards of Auditing, the Lithuanian Securities Commission (Commission), other relevant professional bodies, legislation, regulations and where appropriate, the terms of the audit engagement and reporting requirements;

- 1.11 *accountant's report* shall mean the statement made by an independent accountant that identifies the financial statements he/she has audited, the scope of the audit and his/her opinion as to the fairness of their presentation;
- 1.12 *adverse opinion* shall mean an independent accountant's opinion that states that the financial statements do not present fairly the financial position or the results of operations or the changes in financial position or cash flows in conformity with generally accepted accounting principles;
- 1.13 *disclaimer* shall mean a statement by an independent accountant when the possible effect of a limitation of an auditing scope is so material and pervasive that the independent accountant has not been able to obtain sufficient appropriate audit evidence to express any opinion;
- 1.14 *qualification*, or qualified opinion, shall mean a statement by an independent accountant that he/she concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation of auditing scope is not so material and pervasive as to require an adverse opinion or disclaimer of opinion. A qualified opinion will be expressed as being 'except for' the effects of the matter to which the qualification relates;
- 1.15 *unqualified opinion* shall mean a statement by an independent accountant that the financial statements audited by the independent accountant present fairly, in all material respects, the financial position, results of operations and cash flows of an entity in conformity with generally accepted accounting principles;
- 1.16 *generally accepted auditing standards* shall mean the measures of the quality of the performance of procedures and objectives to be attained by use of the procedures undertaken. They concern themselves with the auditors professional qualities and the judgement exercised by him/her in the performance of his/her audit and in his/her report;
- 1.17 *internal accounting control* shall mean a process designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations;
- 1.18 *interim work* shall mean audit work done prior to the balance sheet date such as testing which may permit early consideration of significant matters effecting year-end financial statements (for example, related party transactions, changed conditions, recent accounting pronouncements, and financial statement items likely to require adjustment). In addition, much of audit planning, including obtaining an understanding of internal control, assessing control risk and application of substantive tests to transactions can be conducted prior to the balance sheet date;
- 1.19 *illiquid assets* shall be defined in accordance with paragraph 2 of the Rule on Capital Adequacy Requirement;
- 1.20 *initial capital* shall be defined in accordance with paragraph 2 of the Instruction on the Requirement for Initial Own Capital of Financial Brokerage Firms as approved by Resolution 5 of the Commission.
- 2 *Filing of monthly and quarterly reports, pursuant to paragraph 6, Article 13 of the Law on Public Trading in Securities (the Law)*
- 2.1 This paragraph 2.1 shall apply to every financial broker firm (firm) licensed pursuant to Article 16 of the Law.
- 2.1.1 Every Category A firm, pursuant to the Instruction on the Requirement for Initial Own Capital of Financial Brokerage Firms as approved by Resolution

5 of the Commission, shall file with the Market Regulation Department of the Commission, a Balance Sheet, Income Statement, Statement of Change in Financial Position, Statement of Cash Flows and Capital Adequacy Calculation Statement within 15 days after the end of each month..

- 2.1.2 Every Category B and C FBF, pursuant to the Instruction on the Requirement for Initial Own Capital of Financial Brokerage Firms as approved by Resolution 5 of the Commission, shall file with the Market Regulation Department of the Commission, a Balance Sheet, Income Statement, Statement of Change in Financial Position, Statement of Cash Flows and Capital Adequacy Calculation Statement within 15 days after the end of each calendar quarter.
- 2.1.3 Upon receiving written notice from the Commission, a firm who receives such notice shall file monthly or at such times as shall be specified, a Balance Sheet, Income Statement, Statement of Change in Financial Position, Statement of Cash Flows, Capital Adequacy Calculation Statement and such other financial or operational information as shall be required by the Commission.
- 2.2 The reports provided for in this paragraph 2 shall be considered filed when received at the Commission's principal office in Vilnius. All reports filed pursuant to this paragraph 2 shall be deemed to be confidential.
- 2.3 Upon written application by a firm to the Commission, the Commission may extend the time for filing the information required by this paragraph 2. The Commission shall maintain a record of each extension granted.

### 3 *Report Filed Upon Termination of Firm*

- 3.1 If a licensed firm ceases to be a firm in good standing, such firm shall, within two business days after such event, file with the Market Regulation Department of the Commission a Balance Sheet, Income Statement, Statement of Change in Financial Position, Statement of Cash Flows and Capital Adequacy Calculation Statement as determined by the standards set forth in paragraphs 2.1.1 and 2.1.2 of this section as of the date of such event. These financial statements shall be filed at the Commission's principal office in Vilnius. Provided, however, that such financial statements need not be made or filed if the Commission, upon written request or upon its own motion, exempts such firm, either unconditionally or on specified terms and conditions, from such requirement. Provided, further, that the Commission may, upon request of the firm, grant extensions of time for filing the financial statements specified herein for good cause shown.
- 3.2 Attached to the financial statements required by subparagraph 3.1 of this paragraph shall be an oath or affirmation that to the best knowledge and belief of the individual making such oath or affirmation the information contained in the financial statements is true and correct. The oath or affirmation shall be made before a person duly authorised to administer such an oath or affirmation. If the firm is a sole proprietorship, the oath or affirmation shall be made by the proprietor; if a partnership, by a general partner; or if a corporation, by the chief executive officer, or in his/her absence, by the person authorised to act in his/her place.
- 3.3 For purposes of this paragraph 3, any firm shall be deemed to have ceased to be a firm in good standing when the firm's license has been revoked or suspended, or it has directly or through any associated person sold or entered into an agreement for the sale of the firm which would on consummation thereof result in termination of the firm..

### 4 *Customer Statements*

- 4.1 *Who must furnish the statements.* Every firm shall file with the Commission at its principal office in Vilnius and shall send to its customers the statements prescribed by

subparagraphs 4.2 and 4.3 of this paragraph 4.

- 4.2 *Audited statements to be furnished.* The following statements shall be furnished as required by subparagraph 4.1 within 15 days after the date of the general shareholders' meeting:
- 4.2.1 A Balance Sheet with appropriate notes prepared in accordance with generally accepted accounting principles which shall be audited if the financial statements furnished in accordance with paragraph 5 of this rule are required to be audited;
  - 4.2.2 A footnote containing a statement of the amount of the firm's liquid own capital and its capital adequacy requirement, computed in accordance with the Rule on Capital Adequacy Requirements. Such statement shall include summary financial statements of subsidiaries consolidated, where material, and the effect thereof on the liquid own capital and capital adequacy requirement of the firm.
  - 4.2.3 If in connection with the most recent annual audited financial statements pursuant to this section, the independent accountant commented on any material inadequacies in accordance with paragraphs 12 and 13 of this section, there shall be a statement by the firm that a copy of such financial statements and comments are currently available for the customer's inspection at the principal office of the Commission in Vilnius; and
  - 4.2.4 A statement indicating that the Balance Sheet of the most recent annual audited financial statements of the firm are available for examination at the principal office of the firm, and at the Commission.
- 4.3 *Unaudited statements to be furnished.* The statements shall contain the information specified in subparagraphs 4.2.1 and 4.2.2, and shall be furnished not later than 15 days after the date as of which the statements are prepared, as follows:
- 4.3.1 In the case of Category A firms, pursuant to subparagraph 4.2 of the Instruction on the Requirement for Initial Own Capital of Financial Brokerage Firms as approved by Resolution 5 of the Commission, as of the last calendar day of each month.
  - 4.3.2 In the case of Category B and C firms, pursuant to subparagraph 4.2 of the Instruction on the Requirement for Initial Own Capital of Financial Brokerage Firms as approved by Resolution 5 of the Commission, as of the dates three months, six months and nine months from the date of the annual audited financial statements required to be furnished pursuant to subparagraphs 4.1 and 4.2.
- 4.4 *Definition of "customer".* For purposes of this paragraph 4, the term "customer" includes any person other than (i) a general, special or limited partner or director or officer of a firm, or (ii) any person to the extent that such person has a claim for property or funds, whether it be contract, agreement or understanding, or by operation of law, is part of the capital of the firm or is subordinated to the claims of creditors of the firm, for or with whom a firm has effected a securities transaction in a particular month, which month shall be either the month preceding the Balance Sheet date or the month following the Balance Sheet date in which the statement is sent. The term "customer" also includes any person for whom the firm carries a free credit balance in the month in which customers are determined for purposes of this paragraph 4.

## 5 *Annual Filing of Audited Financial Statements*

- 5.1 Every licensed firm pursuant to Article 16 of the Law shall file annually, on a calendar or fiscal year basis, financial statements which shall be audited by an independent accountant. Financial statements pursuant to this paragraph 5 shall be as of the same

fixed or determinable date each year, unless a change is approved in writing by the Commission.

- 5.2 A firm succeeding to and continuing the business of another firm need not file financial statements under this paragraph as of a date in the fiscal or calendar year in which the succession occurs if the predecessor firm has filed financial statements in compliance with this paragraph as of a date in such fiscal or calendar year.
- 5.3 A firm which is a member of a national securities exchange and has transacted business in securities solely with or for other members of a national securities exchange, and has not carried any margin account, credit balance or security for any person who is defined as a "customer" in paragraph 4.4 of this section, shall not be required to file a report under this paragraph.
- 5.4 The annual audited financial statements shall include a Balance Sheet, Income Statement, Statement of Change in Financial Position and a Statement of Cash Flows.
- 5.5 A Capital Adequacy Calculation Statement shall be filed with the annual audited financial statements.
- 5.6 The annual audited financial statements shall be filed within 15 days after the general shareholders' meeting.
- 5.7 Two copies of the annual audited financial statements shall be filed at the Commission's principal office in Vilnius.

#### 6 *Nature and form of reports*

- 6.1 The annual audited financial statements filed pursuant to paragraph 5 of this rule shall be audited by an accountant who shall in fact be independent and shall give an opinion covering them.
- 6.2 Attached to the financial statements shall be an oath or affirmation that, to the best knowledge and belief of the person making such oath or affirmation, (i) the financial statements and schedules are true and correct and (ii) neither the firm, nor any partner, officer, or director, as the case may be, has any proprietary interest in any account classified as that of a customer. The oath or affirmation shall be made before a person duly authorised to administer such oaths or affirmations. If the firm is a sole proprietorship, the oath or affirmation shall be made by the proprietor; if a partnership, by a general partner or if a corporation, by a duly authorised officer.
- 6.3 All financial statements filed pursuant to paragraph 5 shall be public, except that if the Balance Sheet is bound separately from the balance of the annual audited financial statements filed pursuant to subparagraph 5.4, the balance of the annual audited financial statements shall be deemed confidential, except that they shall be available for official use by any official or employee of Lithuania, by national securities exchanges and registered national securities associations of which the firm is a member, and by any other person to whom the Commission authorises disclosure of such information as being in the public interest.

#### 7 *Qualification of accountants*

- 7.1 The Commission will not recognise any person as a independent accountant who is not duly licensed, in good standing, by the Lithuanian Institute of Audit and Accounting.
- 7.2 An independent accountant must satisfy the Commission that he/she has the necessary knowledge and experience to act as an auditor for the firm concerned.

#### 8 *Designation of accountant*

- 8.1 Every firm which is required by paragraph 5 of this section to file annual audited

- 10.2.1 An officer, appointed representative or employee of the firm;
- 10.2.2 A controller of the firm;
- 10.2.3 A person who is a partner of, or in the employment of, an person listed in 10.2.1 or 10.2.2 above;
- 10.2.4 Any individual whose close relative is one of the persons in 10.2.1 to 10.2.3;
- 10.2.5 A body corporate of which the firm or a connected company of the firm or any person listed in 10.2.1 to 10.2.4;
- 10.2.6 Any person disqualified by the Commission.

#### 11 *Replacement of accountant*

- 11.1 A firm shall file a notice which must be received by the Commission's principal office in Vilnius, not more than 15 days after:
  - 11.1.1 The firm has notified the accountant whose opinion covered the most recent financial statements filed under paragraph 5 of this rule that his services will not be utilised in future engagements; or
  - 11.1.2 The firm has notified an accountant who was engaged to give an opinion covering the financial statements to be filed under paragraph 5 that the engagement has been terminated; or
  - 11.1.3 An accountant has notified the firm that they would not continue under an engagement or give an opinion covering the financial statements to be filed under paragraph 5; or
  - 11.1.4 A new accountant has been engaged to give an opinion covering the financial statements to be filed under paragraph 5 without any notice of termination having been given to or by the previously engaged accountant.

Such notice shall state (a) the date of the notification of the termination of the engagement or engagement of the new accountant as applicable and (b) the details of any problems existing during the 24 months (or the period of the engagement, if less) preceding such termination of a new engagement relating to any matter of accounting principles, financial statement disclosure, auditing scope or procedure or, compliance with rules of the Commission, which problems, if not resolved to the satisfaction of the former accountant, would have caused him/her to make reference to them in connection with his/her report on the subject matter of the problems. The problems required to be reported in response to the preceding sentence include both those resolved to the former accountant's satisfaction and those not resolved to the former accountant's satisfaction. Problems contemplated by this rule are those which occur at the decision making level, that is, between principal financial officers of the firm and personnel of the accounting firm responsible for rendering its report. The notice shall also state whether the accountant's report on the financial statements for any of the past two years contained an adverse opinion or a disclaimer of opinion or was qualified as to uncertainties, audit scope, or accounting principles, and describe the nature of each such adverse opinion, disclaimer of opinion, or qualification. The firm shall also request the former accountant to furnish the firm with a letter addressed to the Commission stating whether he agrees with the statements contained in the notice of the firm and, if not, stating the respects in which he does not agree. The firm shall file three copies of the notice and the accountant's letter, one copy of which shall be manually signed by the sole proprietor, or general partner or duly authorised officer, as appropriate, and by the accountant, respectively.

#### 12 *Audit objectives*

- 12.1 The audit shall be made in accordance with generally accepted auditing standards and shall include a review of accounting systems and internal accounting controls, including appropriate tests thereof for the period since the prior examination date. The audit shall include all procedures necessary under the circumstances to enable the independent accountant to express an opinion on the Balance Sheet, Income Statement, Statement of Change in Financial Position, Statement Of Cash Flows, and Capital Adequacy Calculation Statement under the Rule on Capital Adequacy Requirement. The scope of the audit and review of the accounting system and internal controls shall be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination in (a) the accounting system; (b) the internal accounting controls; and (c) the practices and procedures whose review is specified in 12.1.1 and 12.1.2 of this paragraph would be disclosed. Additionally, as specific objectives, the audit shall include reviews of the practices and procedures followed by the client:
- 12.1.1 In making the calculation of capital adequacy under the Rule on Capital Adequacy Requirement; and
- 12.1.2 In complying with the requirement for prompt payment for securities under the Rule for Margin Accounts
- 12.2 A material inadequacy in the accounting system, internal accounting controls and practices and procedures referred to in paragraph 12.1 which is expected to be reported under these audit objectives includes any condition which has contributed substantially to or, if appropriate corrective action has not been taken, could reasonably be expected to (i) inhibit a firm from promptly completing securities transactions or promptly discharging their responsibilities to customers and other firms or creditors; (ii) result in material financial loss; (iii) result in material misstatements in the firm's financial statements; or (iv) result in violations of the Commission's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in paragraphs 12.2 (i), (ii), or (iii) of this section.
- 13 *Extent and Timing of Audit Procedures*
- 13.1 The extent and timing of audit procedures are matters for the independent accountant to determine on the basis of his review and evaluation of existing internal controls and other audit procedures performed in accordance with generally accepted auditing standards and the audit objectives set forth in paragraph 12 above. In determining the extent of testing, consideration shall be given to the materiality of an area and the possible effect on the financial statements and schedules of a material misstatement in a related account. The performance of auditing procedures involves the proper synchronisation of their application and thus comprehends the need to consider simultaneous performance of procedures in certain areas such as, for example, customer and firm confirmation in connection with verification of securities positions.
- 13.2 If, during the course of the audit or interim work, the independent accountant determines that any material inadequacies exist in the accounting system, internal accounting controls, or otherwise defined in paragraph 12.2 of this section, then the independent accountant shall call it to the attention of the chief financial officer of the firm, who shall have a responsibility to inform the Commission by facsimile notice within 24 hours thereafter as set forth in paragraphs 19.7 and 19.8 of this section. The firm shall also furnish the accountant with a copy of said notice to the Commission by facsimile within said 24 hour period. If the accountant fails to receive such notice from the firm within said 24 hour period, or if the accountant disagrees with the statements contained in the notice of the firm, the accountant shall have a responsibility to inform the Commission by report of material inadequacy within 24 hours thereafter as set forth in paragraph 19.8 of this section. Such report from the accountant shall, if the firm failed to file notice, describe any material inadequacies found to exist. If the firm filed the notice, the accountant shall file a report detailing the aspects, if any, of the firm's notice with which the accountant does not agree.

14 *Accountant's report, general provisions*

14.1 *Technical requirements.* The accountant's report shall: (i) be dated; (ii) be signed manually; (iii) indicate the city and state where issued; and (iv) identify without detailed enumeration the financial statements and schedules covered by the report.

14.2 *Representations as to the audit.* The accountant's report shall: (i) state whether the audit was made in accordance with generally accepted auditing standards; and (ii) designate any auditing procedures deemed necessary by the accountant under the circumstances of the particular case which have been omitted, and the reason for their omission.

Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required under this rule.

14.3 *Opinion to be expressed.* The accountant's report shall state clearly the opinion of the accountant: (i) in respect of the financial statements and schedules covered by the report and the accounting principles reflected therein; and (ii) as to the consistency of application of accounting principles, or as to any changes in such principles which have a material effect on the financial statements.

14.4 *Exceptions.* Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.

15 *Accountant's report on material inadequacies*

15.1 The firm shall file concurrently with the annual audit report a supplemental report by the accountant describing any material inadequacies found to exist or found to have existed since the date of the previous audit. The supplemental report shall indicate any corrective action taken or proposed by the firm in regard thereto. If the audit did not disclose any material inadequacies, the supplemental report shall so state.

16 *Extensions and Exemptions*

16.1 The Commission may extend the period under paragraph 5 of this section for filing annual audited financial statements. The Commission shall maintain a record of each extension granted.

16.2 On written request, the Commission may grant an extension of time or an exemption from any of the requirements of this rule either unconditionally or on specified terms and conditions.

17 *Notification of change of fiscal year*

17.1 In the event any firm finds it necessary to change its fiscal year, it must file with the Commission's principal office in Vilnius a notice of such change.

17.2 Such notice shall contain a detailed explanation of the reasons for the change. Any change in the filing period for the audit report must be approved by the Commission pursuant to paragraph 5.1 of this section.

18 *Filing requirements*

18.1 For purposes of filing requirements as described in this rule, such filing shall be deemed to have been accomplished upon receipt at the Commission's principal office in Vilnius.

19 *Notification Provisions for Firms.* This paragraph shall apply to every firm licensed by the Commission pursuant to Article 16 of the Law.

19.1 Every firm whose liquid own capital declines below their capital adequacy requirement

pursuant to the Rule on Capital Adequacy Requirement shall give notice of that occurrence that same day in accordance with paragraph 19.8 of this section. The notice shall specify the firm's capital adequacy requirement and its current liquid own capital. If a firm is informed by the Commission that it is, or has been, in violation of the Rule on Capital Adequacy and the firm has not given notice of the capital deficiency under this section, the firm, even if it does not agree that it is, or has been, in violation of the Rule on Capital Adequacy, shall give notice of the claimed deficiency, which may specify the firm's reasons for its disagreement.

- 19.2 Every firm whose liquid own capital declines below 110% of their capital adequacy requirement pursuant to the Rule on Capital Adequacy Requirement shall give notice promptly (but within 24 hours) after the occurrence in accordance with paragraph 19.8 of this section.
- 19.3 Every firm whose total value of its illiquid assets exceeds 25% of its initial capital plus interim profit or loss account shall give notice promptly (but within 24 hours) after the occurrence in accordance with paragraph 19.8 of this section.
- 19.4 Every firm whose unsecured borrowings exceed its initial capital, unless the loans (a) are subordinated loans; or (b) arise from money borrowed to finance the purchase of investments to the extent that the firm's position in those investments is a long position, shall promptly give notice (but within 24 hours) after the occurrence in accordance with paragraph 19.8 of this section.
- 19.5 Every firm that has reason to believe that a counterparty with which it has entered into a repurchase, reverse repurchase, securities lending, securities borrowing, sale and buy back and sale back agreement has defaulted on its obligations, shall promptly give notice (but within 24 hours) after the firm becomes aware of the situation in accordance with paragraph 19.8 of this section.
- 19.6 Every firm who fails to make and keep current the books and records required by the Rule on Books and Records, shall give notice of this fact that same day in accordance with paragraph 19.8 of this section, specifying the books and records which have not been made or which are not current. The firm shall also transmit a report in accordance with paragraph 19.8 of this section within 48 hours of this notice stating what the firm has done or is doing to correct the situation.
- 19.7 Whenever any firm discovers, or is notified by an independent accountant, pursuant to paragraph 13.2 of this section, of the existence of any material inadequacy as defined in paragraph 12 of this section, the firm shall:
- 19.7.1 Give notice in accordance with paragraph 19.8 of this section, of the material inadequacy within 24 hours of such discovery or notification and
- 19.7.2 Transmit a report in accordance with paragraph 19.8 of this section within 48 hours of the notice stating what the firm has done or is doing to correct the situation.
- 19.8 Every notice or report required to be given shall be given or transmitted to the principal office of the Commission in Vilnius. For purposes of this section, 'notice' shall be given or transmitted by facsimile transmission. The report required by paragraphs 19.6 or 19.7.2 of this section may be transmitted by overnight delivery.

Draft

December 5, 1997

Prepared by: Donald Buddenbohn

## **RULE ON INTERNAL CONTROL OF LICENSED FINANCIAL BROKERAGE FIRMS**

Pursuant to item 1, paragraph 2 of Article 32 of the Law on Public Trading of Securities requiring the Securities Commission to prepare rules regulating the activities of intermediaries of public trading in securities, this rule requires that all Financial Brokerage Firms (FBF) establish and maintain, at all times, effective systems of internal control, that will result in transactions (as well as events and conditions) being recorded, processed, summarised and reported consistent with management's assertions embodied in the financial statements, which are fairly presented in conformity with generally accepted accounting principles. The internal control system must be designed to provide reasonable assurance of the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

Draft

December 5, 1997

Prepared by: Donald Buddenbohn

## GUIDELINES FOR INTERNAL CONTROL OF LICENSED FINANCIAL BROKERAGE FIRMS

The Lithuanian Securities Commission's ("Commission") Rule on Internal Control of Licensed Financial Brokerage Firms ("the Rule") and the European Communities Council Directive 93/22 on Investment Services in the Securities Field ("the Directive"), both require that financial brokerage firms ("firms") have adequate internal controls.

The Lithuanian Securities Commission's Rule on Internal Control of Licensed Financial Brokerage Firms "requires that all Financial Brokerage Firms establish and maintain, at all times, effective systems of internal control, that will result in transactions (as well as events and conditions) being recorded, processed, summarised and reported consistent with management's assertions embodied in the financial statements, which are fairly presented in conformity with generally accepted accounting principles".

Article 12 of the European Communities Council Directive 93/22 on Investment Services in the Securities Field provides that "Each home Member State shall draw up prudential rules which investment firms shall observe at all times. In particular, such rules shall require that each investment firm have sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing, and adequate internal control mechanisms ...".

The Commission is issuing these Guidelines to assist firms in establishing and maintaining internal controls in compliance with the Rule and the Directive.

### 1 DEFINITION

The International Auditing Standard, Section 8400, on Risk Assessment and Internal Control defines '*internal control system*' as "all the policies and procedures (internal controls) adopted by management of an entity to assist in achieving management's objectives of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of accounting records, and the timely preparation of reliable financial information."

### 2 SCOPE

In determining the scope and nature of effective internal control, a firm must consider all relevant factors including the size of the business; the organisation and ownership characteristics; the diversity and complexity of operations; the nature, volume, size and frequency of transactions; the methods of transmitting, processing, maintaining, and accessing information; the degree of centralisation and the methods of data processing.

### 3 COMPONENTS

A firm must ensure that all of the components of internal control are established and maintained, including:

#### 3.1 *Control Environment.*

Control environment is the foundation for all other components of internal control, providing discipline and structure. The control environment means the overall attitude, awareness and actions of directors and management regarding the internal control system and importance in the entity. The control environment has an effect on the effectiveness of the specific control procedures. A strong control environment, for example, one with tight budgetary controls and an effective internal audit function, can significantly complement specific control procedures. However, a strong environment does not, by itself, ensure the effectiveness of the internal control system. Factors reflected in the control environment include:

- 3.1.1 The function of the board of directors and its committees.
- 3.1.2 Management's philosophy and operating style.
- 3.1.3 The entity's organisational structure and methods of assigning authority and responsibility.
- 3.1.4 Management's control system including the internal audit function and personnel policies and procedures.

### 3.2 *Risk assessment.*

Risk assessment, for financial reporting purposes, is the identification, analysis and management of risks relevant to the preparation of financial statements. Part of risk assessment and control is to minimise the risk of losses to the business from irregularities, fraud or error and to identify such matters, so that prompt remedial action may be taken by management.

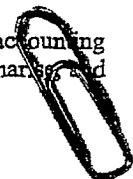
### 3.3 *Control activities.*

Control activities are the policies and procedures that help ensure necessary actions are taken to address risks so that the firm's objectives can be achieved. These include:

- 3.3.1 *Performance reviews.* These include reviews of actual financial performance versus budgets, forecasts and prior period performance.
- 3.3.2 *Information processing.* These include general and application controls to check accuracy, completeness and authorisation of transactions. General controls apply to mainframe, minicomputer and end-user environments and include controls over data centre operations, system software acquisition and maintenance and application system development and maintenance. Applications controls apply to the processing of individual applications.
- 3.3.3 *Physical controls.* These encompass the physical security of assets, including adequate safeguards such as secured facilities, over access to assets and records; authorisation for access to computer programs and data files and periodic counting, comparison and reconciliation with amounts shown on control records. These controls extend to assets belonging to third parties for which the firm is accountable.
- 3.3.4 *Segregation of duties.* This entails assigning different people the responsibilities of authorising transactions, recording transactions and maintaining custody of assets in order to reduce the opportunities of one person being in a position to both perpetrate and conceal errors or irregularities in the normal course of performing their duties.

### 3.4 *Information and communication.*

The information system, relevant to financial reporting, which includes the accounting system, consists of the methods and records established to record, process, summarise and



report transactions (as well as events and conditions) and to maintain accountability for related assets, liabilities, and own funds. An information system encompasses methods and records that:

- 3.4.1 Identify and record promptly all transactions and commitments in sufficient detail to permit proper classification for financial reporting.
- 3.4.2 Determine that all transactions and commitments entered into are within the scope of authority of the firm or individual acting on behalf of the firm.
- 3.4.3 Ascertain that it is reasonable to believe that all transactions and commitments entered into are within the scope of authority of the counterparty or any individual acting on behalf of the counterparty.
- 3.4.4 Determine the time period the transactions occurred to permit recording of transactions in the proper accounting period.
- 3.4.5 Organise documentation of and establish controls over all liabilities.
- 3.4.6 Present properly the transactions and related disclosures in the financial statements.

Communication involves providing an understanding of roles and responsibilities pertaining to internal control over financial reporting. Communication takes such forms as policy manuals, accounting and financial reporting manuals and memoranda.

### 3.5 *Monitoring.*

Monitoring is the process that assesses the quality of internal control over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. Ongoing monitoring activities must be built into the normal recurring activities of a firm and include regular management and supervisory activities.

## 4 ADDITIONAL INTERNAL CONTROL PROCEDURES:

- 4.1 Determine that transactions are executed in accordance with management's authorisation.
- 4.2 In so far as is reasonably practicable, limit and monitor the extent to which employees are permitted to engage in personal account dealings.
- 4.3 Provide a means to determine that a customer's interests are not prejudiced by conflicts of interest between the firm and its customer or between one customer and another customer.
- 4.4 Provide for physical and accounting separation of firm funds and securities from customer funds and securities.

## TRIP REPORT

### LITHUANIAN CAPITAL MARKET DEVELOPMENT PROJECT

DATE: December 9, 1997 -

LENGTH OF CONTRACT: September 6 to December 11, 1997

NAME OF CONSULANT: Donald Buddenbohn

PURPOSE OF TRIP: Create financial statement forms for investment companies in accordance with European Communities Council Directives. Develop capital adequacy calculation rules. Develop accounting rules in accordance with International Accounting Principles. Perform other tasks as assigned.

### WORK PERFORMED

#### INVESTMENT COMPANIES

Helped design financial statement format and write Procedure for Preparation of Financial Statements of Investment Companies. Edited English version of Procedures for Preparation of Financial Statements of Investment Companies. Visited and received comments from investment companies, accounting professionals and Ministry of Finance on new financial statement format and Procedures for Preparation of Financial Statements of Investment Companies.

#### RULE ON BOOKS AND RECORDS

Reviewed and critiqued Central Depository's comments on proposed Rule on Books and Records with Depository's staff. Presented a written report of observations (deliverable) regarding the comments to the President of the Depository and his staff.

#### CAPITAL ADEQUACY

Calculated capital adequacy of all financial brokerage firms as of September 30, 1977. Prepared a report (deliverable) to the Securities Commission Chairman and the Market Regulation Department providing details of the calculations and an analysis of the impact on financial brokerage firms. Prepared an additional report, Observations on Capital Adequacy of Lithuanian Financial Brokerage Firms, (deliverable) for the Chairman and the Market Regulation Department, providing further analysis of the impact on financial brokerage firms.

RULE ON INTERNAL CONTROL OF LICENSED FINANCIAL BROKERAGE FIRMS

Wrote the Rule on Internal Control of Licensed Financial Brokerage Firms (deliverable). Reviewed with the Commissioner and Department Head of Market Regulation. Rewrote the Rule (deliverable) to include changes requested by the Department of Market Regulation. Wrote Guidelines for Internal Control of Licensed Financial Brokerage Firms (deliverable).

RULE ON REPORTS TO BE MADE BY FINANCIAL BROKERAGE FIRMS

Wrote the Rule on Reports to Be Made by Financial Brokerage Firms (deliverable).

MEMORANDUM REGARDING ACCOUNTING AND FINANCIAL STATEMENT PRESENTATION FOR INVESTMENT COMPANIES AND FINANCIAL BROKERAGE FIRMS

Wrote the Memorandum Regarding Accounting and Financial Statement Presentation for Investment Companies and Financial Brokerage Firms (deliverable) to help provide the Securities Commission Chairman and his staff with a better understanding of current issues concerning accounting and financial statements of holding companies, open end investment funds and financial brokerage firms.

SEPARATE FINANCIAL STATEMENTS FOR DIFFERENT KINDS OF FIRMS

Through repeated recommendations, along with members of Pragma's local staff, to allow financial statement presentation in a manner consist with the nature of the business being conducted by holding companies, open end investment funds and financial brokerage firms, obtained approval from the Securities Commission and Ministry of Finance to proceed in this direction for each of these three types of companies. This will allow financial statements to be prepared in accordance with European Communities Council Directives and International Accounting Standards, instead of the same or similar formats for all companies required for income tax purposes.