DIAGNOSTIC STUDY OF GEORGIAN CAPITAL MARKETS

LEGAL CONTEXT

USAID GOVERNING FOR GROWTH (G4G) IN GEORGIA

16 OCTOBER 2015

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ACRONYMS

G4G	Governing for Growth in Georgia
USAID	United States Agency for International Development
ABS	Asset Backed Security
ASC	Accounting Standards Commission
CSDG	Central Securities Depository of Georgia
CMDP	Capital Markets Development Program
CMWG	Capital Markets Working Group
EBRD	European Bank for Reconstruction and Development
EU	European Union
FMI	Financial Market Infrastructures
FMSG	Financial Monitoring Service of Georgia
GoG	Government of Georgia
JSC	Joint Stock Company
IFI	International Financial Institution
IFRS	International Financial Reporting Standards
LAFA	Law on Accounting and Financial Audit
LLC	Limited Liability Company
LIF	Law of Georgia on Investment Funds
LIP	Law of Georgia on Insolvency Proceedings
LSM	Law of Georgia on Securities Markets
LOE	Law of Georgia on Entrepreneurs
LMFO	Law of Georgia on Microfinance Organizations
LPPL	Legal Person of Public Law
MMoU	Multilateral Memorandum of Understanding
MoF	Ministry of Finance of Georgia
NBG	National Bank of Georgia
NSCG	National Securities Commission of Georgia
OTC	Over the Counter
SPV	Special Purpose Vehicle
SRO	Self-Regulatory Organization

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1. EXECUTIVE SUMMARY

Present legal study of Georgian capital markets has been commissioned under USAID's Governing for Growth (G4G) in Georgia project with the aim to assess legal and regulatory framework in which Georgian capital markets operate. Legal assessments have led to conclusions and policy, legislative and regulatory level recommendations listed below.

Following issues and problems, which could be wholly or partially dealt with under legal reform/changes have been singled out:

1. Lack of long-term development strategy and/or policy for the securities markets. Absence of a long-term and clear development strategy is one of the essential weaknesses of Georgia's capital markets legal framework. As of date Government of Georgia's (GoG) Strategy 2020 is a single policy document acknowledging condition of the market, however it offers only general language and outlook for curing deficiencies.
2. Standard of securities legislation should be improved. Georgian capital markets legislation has not been studied/assessed from the perspective of its compliance with International Organization of Securities Commissions (IOSCO) Principles and Objectives of Securities Regulation. Harmonization with respective to EU legislation should also be achieved in few years. Compliance with EU legislation should be assessed in parallel to conducting IOSCO compliance to avoid duplication as well as to ensure respective changes are carefully planned and implemented in a phased manner.
3. Legal framework should be elaborate enough to ensure/promote regulator's pro-active involvement in regulation of the sector. Currently, securities regulator's functions are not sufficiently detailed. Regulator should be proactive in following and adopting such approaches to regulation, which are in line with the level of market development.
4. Lack of diversity of products on capital markets. Capital markets legal and regulatory framework in Georgia neither envisages nor promotes a range of financial products and services commonly recognized and applied in other markets. A whole range of capital market products are not adequately defined and/or treated on legal and regulatory level to enable their trading on the securities markets (securitization, derivatives, investment funds, secured or covered bonds, municipal bonds, real estate funds, pension funds, government securities).
5. Weak organized market. Being the only organized market in Georgia, Georgian Stock Exchange (GSE) has an important role in promoting capital markets activities in the country. In the absence of favorable market conditions for the organized market of securities, it could benefit from the promotion of trading through organized market.
6. Lack of interest to go public. A number and volume of private placements hints that there is general interest to issue securities, however not through public placement. Those factors affecting decision to go private, which can be cured through legal changes include registration fee for public offering which is an unreasonable burden on the issuer, tax treatment which is not favorable in comparison to other alternatives of raising capital. Further, legal framework should address unhealthy practices of issuing securities like instruments by construction and microfinance sectors and decide on potentially channeling these issuances through capital markets.
7. Lack of institutional investors. The asset management sector is an important component of capital markets. In reforming securities legislation, adequate consideration should be given to such changes which shall support and promote creation and development of institutional investors. In this regard Law on Investment Funds (LIF) clearly needs to be heavily revised or replaced by a more sophisticated piece of legislation. Its current edition undermines the concept of investment funds as an important vehicle to promote local and international investments.
8. Lack of a level playing field. Capital market products are not put on equal footing with other financial products and government securities. There is no level playing field between corporate debt instruments on one hand and government bonds or bank deposits on the other from

perspective of taxation. Going public is also more burdensome.

9. Taxation. Several tax issues need to be resolved to provide more incentives, fairness and convenience for securities transactions. Apart from leveling playing field for all securities, tax policy should consider special regime for taxation of investment funds as well as structured finance products. Further, a solution should be found for taxation of interest accrued to fixed income securities between the payment dates when sales occur between such dates. Instruction on tax exemption related to free float needs to be streamlined and re-adopted to make it applicable.
10. Questions related to transparency and quality of financial reporting. Securities legislation is quite general about reporting requirements and relies upon ensuring quality of reporting through requirement of auditing. Thus, although standards for auditing financials of licensed market participants have been improved, responsibility for oversight of audit companies is yet not assigned to any state agency or entity.
11. Missing legal concepts. Some legal concepts important for implementation of more sophisticated transactions are missing (true sale, bankruptcy remoteness, hierarchy of claims in insolvency proceedings). Issuing such securities through local or cross-border structures shall be less likely until introduction of respective changes to the legislation. Therefore, for longer term perspective, capital markets policy should consider introducing these changes.
12. Credible credit rating. In the medium and long-term, promotion of credit rating services should be considered. Due to the size and economy of issuances, international credit rating is not feasible for local issues while for some institutional investors it is very important or obligatory to invest into rated securities.

Based on the issues and problems listed above, following policy, legislative and regulatory recommendations have been suggested by the Report:

Policy Recommendations

There is a lack of elaborate and detailed long-term development strategy/policy for the securities markets in Georgia. To ensure consistency of changes to the legal framework, their substance and timing should be directly dictated by such policy/strategy document. GoG's Capital Markets Working Group (CMWG) is currently developing timebound roadmap for capital markets development in Georgia, which shall serve as a long-term strategy document to be implemented in support of the market development. From legal perspective, at minimum capital markets policy/strategy should elaborate on:

- Bringing legislation into compliance with IOSCO Principles and Objectives of Securities Regulation and Committee on Payment and Settlement Systems (CPSS-10) Principles for Financial Market Infrastructures (FMI);
- Signing of IOSCO MMoU and becoming a member of IOSCO;
- Identifying phased timeframe for harmonization with respective EU legislation;
- Considering regulation of the aspects of concentrated ownership of GSE in a manner which would ensure protection of interests of all stakeholders;
- Considering promoting trading in public securities through organized market and through market intermediaries;
- Considering alleviating capital requirements imposed on market participants;
- Widening access to trading in government securities;
- Introducing trading in currency on organized securities market;
- Introducing tax incentives in relation to public and private securities;
- Removal of registration fee for public offerings;
- Deciding on location of securities clearing and settlement function and integration with/ access to such system;

- Replacing or revising the LIF with support of sector experts;
- Considering introducing credit rating services and their regulation;
- Considering introducing relevant changes to insolvency law;
- Considering introducing legal concepts which are supportive of innovative capital market products.

Legislative Recommendations

Legislative recommendations deal with such changes to Law on Securities Market (LSM) and other pieces of legislation, which also derive from policy decisions and may include following:

- Bringing LSM into compliance with IOSCO Principles and Objectives of Regulation and CPSS-10 Principles for Financial Market Infrastructures;
- Considering EU legislation to which Georgia has committed under EU-Georgia Association Agreement even for those legislative changes which are planned for near-term implementation;
- Reflecting in LSM all policy decisions which must be preferably dealt with on the level of legislative acts rather than sub-legislative acts (regulations);
- Removing registration fee for public offering of securities from the Law on Registration Fees;
- Streamlining definitions provided in LSM and bringing them into compliance with international practices;
- Introducing tax changes leading to leveling playing field for all securities;
- Streamlining taxation of accrued interest vs capital gain tax for the securities sales between the interest payment dates;
- Replacing or revising LIF in compliance with respective IOSCO principles and relevant EU directives;
- Introducing changes to the Tax Code of Georgia to ensure fair treatment of investment funds and related income streams;
- Introducing additional qualifications for priority of claims under insolvency law;
- Introducing legal aspects supporting implementation of covered bond and Asset Backed Security (ABS) transactions;
- Introducing local credit rating services;
- Revising legislation to regulate unhealthy practices of issuing securities like instruments by micro finance organizations and construction companies;
- Considering regulation of the aspects of concentrated ownership of GSE in a manner which would ensure protection of interests of all stakeholders.

Regulatory Recommendations

Regulatory recommendations deal with changes to securities secondary legislation (sub-legislative acts) which mainly derive from LSM and include following:

- A specialized charter/provision should be elaborated for the regulator where functions and responsibilities shall be spelled out in detail and which shall ensure proactive regulation, constant oversight and monitoring of the market for new trends and necessary changes;
- Regulations should be assessed for compliance with IOSCO Objectives and Principles of Regulation and bought into compliance with these principles;
- Regulations should be brought into compliance with EU legislation in a phased manner. Near term revisions should consider EU standards as well;

- Market entry standards should be revised to allow reasonable threshold for entry of new participants on the market. Focus should be shifted to the requirements related to professional preparation of the entities/individuals;
- Initial and ongoing capital requirement should be decreased for market participants and/or replaced for ongoing prudential regulation by capital adequacy requirements to match capital requirements with the risk-taking on the market.

2. BACKGROUND AND OBJECTIVE

Recent assessments of Georgian capital markets indicate that they are almost nonexistent. Corporate debt market is underdeveloped and the government debt market is still relatively small. High-quality local issuers are unwilling to participate in the market locally, which apart from the size, is thought to reflect concern about the lack of market transparency, confidence in price discovery mechanism and its impact on borrowing costs.

The condition of Georgian capital markets is acknowledged under the Social-economic Development Strategy approved by the GoG in 2014 (GoG Strategy 2020). The document suggests several factors which contribute to underdevelopment of the local capital market and include following: (a) lack of attractiveness of debt securities for the issuers and investors due to their size and associated transaction costs; (b) absence of sufficiently sophisticated legal and regulatory mechanisms requiring refinement; (c) cost of issuing securities, which may be too high and less attractive compared to bank credit; (d) insufficient transparency of the market to attract investors, particularly foreign investors.

Objective of the present report (Report) is to diagnose the legal and regulatory framework in which Georgian capital markets operate. Results of the assessment should lead to suggestions of principle based solutions. Report is commissioned under USAID's five-year project Governing for Growth in Georgia (G4G). Under the issued Terms of Reference (ToR) the assignment envisages following tasks:

- Analysis and summarization of the provisions of selected Georgian laws and regulations impacting the capital markets and financial sector in general;
- Tracing evolution of the relevant laws, including, where necessary, performing a mapping of the amendments to those laws over time;
- Tracing evolution of transparency requirements imposed on the Georgian corporate population;
- Reviewing tax provisions impacting capital markets activities, along with the level of regulatory fees to:
    - Determine the tax treatment and fees imposed on issuers of securities;
    - Determine the tax treatment of issuers paying dividends and/or interest;
    - Determine the tax treatment of recipients of dividends and interest, separated by domestic and foreign recipients and indicating both tax percentages imposed and the withholding schemes required;
    - Compare these tax treatments to similar financial instruments such as bank deposits.
- Drafting notional amendments for discussion aimed at implementing suggested revisions to the relevant laws.

Conduct of the study under the present Report was preceded by completion of the Study of the Georgian Capital Markets (CM Report) issued in May 2015. CM Report was prepared by the Capital Markets Working Group (CMWG) formed by GoG in September 2014. It was open to public review through four rounds of thematic consultation forums held in June and July 2015. Present Report reflects on the findings and recommendations of the CM Report as well as on the views of the stakeholders who contributed to the consultations.

CM Report lays out series of recommendations aimed at curing or mitigating the deficiencies identified in the same document. List of these recommendations is appended to the Report as Annex A.1. Higher level conclusions of CM Report were the following:

- Georgia possesses all of the required ingredients to operate a healthy capital market. While additional functions may be advisable, there is no need to create new entities exists;
- In order to revive the corporate securities market, several policy missteps made in 2007 should be reversed;

- Certain aspects of the Tax Code should be adjusted to create a “level playing field” between treasury securities, bank deposits and corporate securities as investment instruments;
- The legal and regulatory system must be revised to provide a more supportive environment and also to migrate it towards EU approaches;
- There must be a strong focus on building viable content (issued securities) for the system; issuer transparency must be improved and the requirements made more proportional;
- There are steps the private sector can take to promote centrality of trading, obtain better price discovery and streamline trading; and
- There are steps the Georgian Stock Exchange (GSE), Georgian Securities Central Depository (GSCD) and National Bank of Geoorgia (NBG) can take to integrate the infrastructure and link it to cross-border systems.

Several of the listed higher level conclusions resonate with the objectives of the present Report. Conclusions of CM Report shall require consistent policy responses which should ultimately be translated into amendments to respective laws and regulations.

3. LEGAL CONTEXT

Inception of Georgian capital markets may be linked to establishment of GSE in 1999 with technical support of USAID. Most of the companies admitted for trading to GSE by the time it commenced operations in March 2000 were formerly state owned and later privatized companies settled with GSE as part of developmental scheme. Whole exercise was meant to kick off operation of the GSE with the expectation of turning quantitative efforts into a trend. Thus, when studying causal links between the dynamics of securities markets and legal framework in which it operates, admission of hundreds of companies at GSE by the time of its inception should not be taken at its merit as a sign of better times for the market. Flight of these companies from GSE in later years should be attributed to the lack of natural disposition towards the idea of being publicly traded on the organized securities market. For years there was no trade off between regulatory burden (costs, reporting) and benefits admission at GSE entailed. GSE transactions shifter to Over the Counter (OTC) market immediately upon enabling such alternative.

Therefore, in selecting a benchmark for assessment of the legal framework, it is important to look at those aspects of the market which are essential for its development and at the same time depend on, are conditioned by or directly or indirectly correlate with regulation. A number of legal conditions or preconditions are recognized as important for market development. Most fundamental of these are listed below:

- **Appropriate regulatory framework for securities, securities markets and its participant.** Regulatory framework should: (a) enable diversity of the capital market products; (b) enable efficient organization (structure) of the markets, and (c) support viability of the market allowing its participants profit from the business. Participants of the market should not be under regulated or overregulated, standards for entering and remaining on the market for the participants should correspond to the level of the market development and the need to have a diverse and adequately diversified participation of professional and intermediary firms on the market.
- **Well-developed and appropriate infrastructure for securities markets.** If the securities market is not commercially viable and sustainable, securities market infrastructure shall not develop. Commercial viability and sustainability of the market largely depends on the carefully elaborated and well-adjusted state policy and regulatory framework applicable to the market.
- **Well-developed supervision and monitoring systems furnished with sufficient authority.** To attract investors to the market, they should feel comfortable about supervision and monitoring systems in place. There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.
- **Supply of securities into the public market and investors' interest in securities investments.**
- **Foundations for creation and development of institutional investors.** The asset management sector is an important component of capital markets. The sector includes the management of funds by institutions, such as pension funds and insurance companies, and the independent management of funds for retail investors, which can be distributed as collective investment schemes (or unit trusts). The latter are particularly important, as they provide an opportunity for small investors to have access to professionally managed, diversified portfolios of assets. As institutions directing the investment decisions for investors, asset management companies are important buy-side institutions.
- **Institutionalized modern accounting standards and auditing.** Financial markets are wholly dependent on sound and reliable financial reporting. There needs to be confidence that financial reports reflect the true and fair view of a company's affairs in line with the International Financial Reporting Standards (IFRS). A coordinated effort is needed by issuers, auditors and investors to ensure that this is always an absolute priority. Markets internationally also expect that sound financial reporting will be policed by a regulator.

Present Report reflects on the listed preconditions as any deficiencies in these areas may be treated through respective adjustments to legal and regulatory framework.

4. GEORGIA'S CAPITAL MARKETS POLICY

Creation of a regulatory framework for securities, securities markets and its participants requires it to be reflective of an explicit state policy in relation to sustainable development of the market. In the absence of such policy, regulatory framework shall not be consistent. Capital markets policy and legal framework should also be consistent and reliable in long-term perspective. Once what is best for the development of the market is identified, the policy and framework should not be subject to frequent changes and/or susceptible to interests of particular stakeholders/groups.

Emergence of Georgia's securities market was marked by launching securities legislation in 1998 (Law on Securities Market of Georgia and respective package of changes) and establishment of Georgian Stock Exchange in 1999. Sector related state policy at that time was not expressed by a single formal policy document. Capital markets reform was delivered with USAID's technical assistance with the aim to increase the level of investment in Georgia (both domestic and foreign).

Absence of a clear, well-formulated and strictly enforceable capital markets policy is one of the essential weaknesses of legal framework as of the date. In the absence of a defined state policy in the sector changes that occurred to securities legislation were inconsistent. As of the day of the Report, GoG Strategy 2020 is a single policy document acknowledging condition of the market, however it offers only general language and outlook for curing identified deficiencies.

GoG Strategy 2020 declares improvement of financial intermediation as one of its top priorities to be tackled by the policy directions. These directions envisage development of non-banking financial sector which requires: (1) improvement of regulatory framework of non-banking financial institutions such as microfinance organizations (MFOs), leasing and factoring companies; (2) provision of adequate legislative framework and infrastructure for the capital markets; (3) promoting attraction of institutional investors and their operations in Georgia; (4) facilitating the development of various forms of risk capital with a view to supporting startup, small and medium businesses; (5) development of investment products and instruments; (6) development of trade and asset-based special financing instruments.

The EU-Georgia Association Agreement also serves as an essential policy reference for market development in terms of where the legislation should stand in 5 to 10 years. GoG Strategy 2020 indicates that stimulation of the non-banking credit and investment institutions shall take place in compliance with EU practices as well as through harmonization of legal acts with IOSCO principles.

GoG Strategy 2020 tasks all ministries and entities/agencies subordinated to the government of Georgia to coordinate their action plans and engage in annual reporting on compliance. As of the date, regulator of securities markets in Georgia is not subordinated to GoG and shall comply with the strategy if and when as a result of its implementation respective legislation is amended. Regulator may, and should, where necessary, engage in promoting and implementing revision of legislation, however this does not derive from GoG Strategy 2020.

5. GEORGIA'S SECURITIES LEGISLATION

Georgian securities legislation in a broader sense may be referring to a body of laws and sub-legislative acts which directly or indirectly affect capital markets. However, only number of these laws may reflect securities markets policy and have significance for the objectives of the present Report. These are the Law of Georgia on Securities Markets (LSM), Law of Georgia on Investment Funds (LIF), relevant provisions of the Tax Code of Georgia (TCG) and Law of Georgia on Insolvency Proceedings (LIP). Sub-legislative (normative) acts which directly or indirectly affect capital markets form securities secondary legislation. From these sub-legislative acts Report shall focus on regulations which derive from the directly applicable laws and mostly include regulations issued by the regulator of the sector. In this chapter Report provides overview and assessment of LSM, LIF and securities secondary legislation.

1. Law of Georgia on Securities Markets

When initially drafted under the Capital Markets Development Program, LSM was a compendium of chapters which covered various aspects of the securities markets and its participants. These chapters and articles followed policy advice provided by international experts. While securities legislation is more complex and dispersed in developed markets, structure of the LSM suggested covering all relevant directions under one act. Although, already in 1999 the draft of the law on investment funds was elaborated as a separate piece of legislation. Format and structure of LSM largely remains the same up to date.

LSM in chapters and substance

Chapter I. General Provisions

- Scope of application of the Law
- Exclusions from the scope
- Terms and definitions

Chapter II. Public Offering of Securities

- Offer and sale of securities
- Requirements for filing prospectus for registration
- Procedure of offering
- Placement report

Chapter III. Issuers of Public Securities

- Requiring periodic disclosure/reporting by companies, including audited financial statements, qualitative information and narrative descriptions of operating results
- Reporting Companies and Reporting Requirements
- Maintenance of Securities Registry
- Disclosure of significant acquisition by members of management bodies
- Responsibilities of members of reporting company management bodies to securities holders
- Confidentiality and disclosure requirements, conflict of interests
- Tender offer

Chapter IV. Public Trading in Securities

- Secondary trading on and off the stock exchange
- Trading in public securities

Chapter V. Licensing

- Qualifications and licensing of brokerage and securities registrar companies
- Qualifications and licensing of securities exchanges
- Licensing and regulation of the clearance, settlement and depository functions

Chapter VI. Regulated Participants of the Securities Markets

- Rights and obligations of the regulated participants of the market
- Additional competencies of the regulator

Chapter VII. Prohibition of Fraud and Manipulation in Securities Dealings

- Prohibition of fraudulent activities on the market
- Prohibition of abuse of insider information and insider trading

Chapter VIII. Supervision of The Securities Market

Currently provisions under this Chapter are removed, as the Regulator's competencies are originated under a different piece of legislation (Law on the National Bank of Georgia).

Chapter IX. Liability for Violation of Securities Legislation

- Administrative and criminal responsibility (sanctions) imposed for violations of securities legislation
- Types of violations and corresponding sanctions

Chronology of Changes to LSM

LSM was adopted on 14 January 1999. Current structure of LSM described above was in place originally, upon adoption of the first edition. Below is a list of features/qualifications provided in first edition of LSM:

- LSM did not cover private placements;
- State securities could be traded on the stock exchange, unless otherwise regulated by the law;
- There were 51 definitions provided by LSM (66 definitions as of the date);
- Stock exchange required mutual ownership by brokers;
- No membership without a brokerage license was allowed, no ownership without membership of the stock exchange was allowed (mutualized model);
- Secondary trading in public securities was allowed only through the stock exchange;
- Public securities only traded with participation of licensed brokerage companies;

- Securities market was regulated by an independent national regulatory body;
- Investment funds were not regulated;
- Licensed stock exchange and licensed central depository were recognized as self-regulatory organizations (subject to compliance with the required procedures for acquiring such status from the regulator);
- Securities fraud and manipulation, insider trading constituted violations of securities legislation;
- Securities violations were subject to administrative responsibility and sanctions. No criminal liability was introduced initially.

From its inception up to date LSM was amended 18 times. Some of the amendments were minor or technical, but a number of sets of these amendments caused essential changes and were *game changers* on the securities markets. Chronology of changes with brief descriptions and consequences are provided below:

1. **30.04.1999:** Explicitly excluded regulation of state securities from the scope of the LSM; Securities Commission of Georgia became “National.” Changes also dealt with remuneration of commissioners.

   Changes adopted under this set of amendments did not deliver any policy change, except that they affirmed that state securities are not and shall not be regulated under LSM.

2. **09.06.1999:** Changes dealt with assigning securities regulator with the rights to re-assign and enforce (impose) shareholder rights granted under company law (LOE); also restricted transfer of securities if the price had not been fully paid to the issuer.

   These provisions are not contained in current edition of LSM. Changes were important for investor protection, however, they can no longer be discussed. Enforcement mechanism was a precedent of securities regulator exercising powers of enforcing rights granted under the LOE.

3. **20.07.1999:** Under these changes criminal liability for violation of the securities law in aggravating circumstances was introduced and some of the commission membership issues clarified and defined.

   This amendment was important in stressing the gravity of violation of securities law and thus created additional comfort for investors. Violation of securities law in aggravating circumstances qualifies as criminal offence under current edition of LSM as well.

4. **18.07.2003:** Changes in the definition of beneficial owner under which it is clarified that concept of beneficial owner explicitly excludes nominal holder. Definition of a public security amended to also mean those securities which are held by record by more than 50 owners (instead of 100 owners defined in previous edition of the LSM); Debt security explicitly includes state debt securities (earlier edition excluded it from definition of a debt security); formulation on assigning securities national identification number refined/streamlined. Article 10 on maintenance of securities registry revised (as securities were not fully dematerialized). Corporate governance provisions strengthened. Provision that public securities transactions should be executed through brokerage companies and only through the stock exchange was strengthened. Article on dealings in public securities was amended (streamlined); regulator’s powers in relation to dealings in public securities have been expanded. Transitional provisions related to securities which have less than 100 holders and have not been admitted for trading to the stock exchange.

   2003 changes reflected market growth, as practical issues and experience had been accumulated and critical changes matured to streamline certain aspects of LSM. While this set of changes contained less critical policy level changes, it highlighted growth trend. Next changes to the LSM were introduced only after four years.

5. **27.03.2007:** Financial Institutions authorized to conduct activities on the local market without additional authorizations on Georgian territory. Notion of related party introduced. Definition of control introduced. Investment funds, central depositary and banks dealing in state securities excluded from definition of a brokerage company. 100 holders test for public securities restored. Nominal Holder’s definition streamlined. Definitions of Financial Institutions and Developing Countries introduced. Definition of a Reporting Company revised. Threshold for qualifying

acquisition of a significant share in a Reporting Company subject to disclosure has been increased from 5% to 10%. Article 18 was altered and dealings in public securities on the secondary markets allowed outside of the stock exchange and without involvement of a brokerage companies. Fixing rule introduced. Article on activities of brokerage companies revised. Additional article on restrictions imposed on Brokerage Companies added. Banks allowed to participate as intermediaries on the market directly. Licensing provisions for market participants (brokerage, registrar, stock exchange and central depository) revised and refined. Articles 25 and 26 were repealed (these dealt with the licensing of individual brokers, which was abolished under the Law on Licenses and Permits).

These were amendments that delivered significant changes as well as reversed several 2003 and original standings under LSM.

Most importantly, these changes allowed OTC trading in securities admitted for trading to GSE without participation of brokerage firms. As a result, since 2007 dealings in public securities drastically shifted to OTC market circumventing GSE as well as brokerage firms.

6. **28.03.2007:** additional Article 16[1] on Conflict of Interests and Information Disclosure added to LSM.

   This was an important change requiring members of a management body of a Reporting Company (Issuer) to disclose any dealings in the securities of the company under management.

7. **11.07.2007:** Changes reflect certain revisions refining existing definitions and provisions (also related to the public offering and rules on dissemination of the issue prospectus, on filing placement report) as well as changes related to change of the regulator: at this time NSC is temporarily replaced by the Legal Person of Public Law – Financial Monitoring Service of Georgia (FMSG). Competencies of FMSG are extended beyond those of the NSC and its functions and competencies defined in Articles of LSM.

8. **14.03.2008:** Financial Supervision Agency of Georgia (FSAG) introduced as a new regulator. Definitions and several articles streamlined. Among them, definition of an Institutional Investor introduced/streamlined. Ownership of more than one brokerage company allowed by any single person. Securities admitted to at least one foreign exchange recognized by FSAG allowed for trading on the local stock exchange without any additional regulation. Provision on membership and ownership of the stock exchange revised. Not only brokerage companies, but licensed financial institutions allowed to be the members of the stock exchange without being owners of the stock exchange. Restriction on ownership of more than 10% of the stock exchange lifted. Thus, under changes of March 2008 Georgian Stock Exchange was formally demutualized.

   Concept of ratio of free turnover of securities has been introduced for the purposes of tax exemption to denote any class of securities issued by an issuer which does not qualify as any of the following: (a) a holding of 5% or more of any one class of securities; (b) securities held by state, local self-governance body or legal person of public law; (c) securities whose beneficiary owners are members of governing body of an issuer or its employees. This definition introduced to the LSM serves as a basis for tax exemption introduced into the Tax Code of Georgia discussed in the relevant part of the Report. A new chapter on investment funds added to LSM. Notions of regulated and unregulated investment funds introduced. *Investment Fund of Institutional Investors* recognized as a type of regulated investment funds. A deadline set for introduction of new normative acts by February 15, 2009 by the FSAG to replace acts issued by the FMSG.

   2008 changes were part of the legislative package aimed at increasing global competitiveness of Georgia's financial sector (Global Competitiveness of Financial Services Act). Explanatory note available in relation to these amendments is quite general. International sources quote that the legislative package was approved by Parliament in 2008 to modernize the financial sector by: (i) establishing a single Financial Supervision Agency (FSA) for the banking and non-banking sectors (capital markets and insurance); (ii) strengthening the independence of the Central Bank, with first steps towards inflation targeting; (iii) demutualizing the stock exchange; and (iv) developing an international financial center to attract foreign funding by offering tax exemptions to large international financial companies whose activity in Georgia does not exceed 10% of their financial turnover.

Chapter on investment funds was only meant to allow/facilitate investment fund activities for the institutional investors without additional regulation and was far from the objective to sophisticate regulation of investment funds, as important vehicles for increasing securities activities on the market. This set of amendments, together with the amendments of March 2007 delivered most significant changes to the securities market and significantly altered its regulatory framework. Changes allowing for demutualization of local stock exchange(s) were meant to give access to remote foreign membership of stock exchange (GSE), facilitating access to locally traded securities for brokers licensed in any of the OECD countries without the need to establish a local subsidiary or be licensed and regulated by the FSAG (provided they did not solicit business from local residents).

9. **24.09.2009:** Under these changes NBG was introduced as a regulator of securities markets of Georgia. Several definitions were streamlined. Requirements related to the prospectus and securities placement report were streamlined.
10. **03.11.2009**: These changes dealt with reformulation of provision on alienation of the state property. This change did not reflect any policy, as the sale of state property has been excluded from the scope of regulation of LSM from the date of its inception.
11. **23.03.2010:** A new Article 20^1 added on AML and anti terrorism requirements imposed on registrars and brokerage companies in relation to opening branches outside of Georgian jurisdiction. This was a technical provision, which did not carry policy change.
12. **04.05.2010:** Changes restricted/prohibited licensed registrar from engaging in any activities, other than provision of securities registration services (unless it is at the same time a central depository), as prescribed by the license or unless performing a delegated public legal function.
13. **21.07.2010**: Change dealt with reformulation of provision on alienation of state property and was caused by amendment to law related to state property, respectively, not directly relevant for the securities legislation or securities markets policy.
14. **09.03.2011:** Article 16^1 on Conflict of Interests was revised and streamlined.
15. **01.07.2011:** Definitions on Nominal Holder of Security, Financial Institutions, Ratio of Free Turnover of Securities were further streamlined.
16. **20.12.2011:** Changes related to the requirement on presentation of information in relation to the absence of criminal records for the members of governing bodies in the process of licensing stock exchange, central depository, brokerage company and registrar.
17. **10.04.2012:** Definition of a Public Security streamlined. Definition of the term Issuer of Public Security was removed. Definition of a Reporting Company was revised and it no longer includes qualification of “security being admitted for trading to the stock exchange.” I.e. Reporting Company is a company which has issued Public Securities. This formulation no longer relies on the process of offering but instead qualifies a company as Reporting Company if the latter has issued Public Security. This change is matched with revision of the definition of a Public Security. Such editions of the two terms are legally more sound.
18. **24.07.2013:** Chapter on Investment Funds has been removed from LSM. Instead, Law of Georgia on Investment Funds was adopted on the same date.

2. Law of Georgia on Investment Funds

LIF was adopted by the Parliament of Georgia on March 27, 2013. Respective Chapter on Regulated Investment Funds was repealed from the LSM under the changes of the same date. In a little less than one year, on February 14, 2014 NBG issued an Order N22/04 on Rules and Conditions of Registration of Investment Funds with NBG (Order 22/04). Order 22/04 was preceded by a change affected to LIF on appointing NBG as an interim regulator for the investment funds until March 1, 2014 (a provision, originally missing from the law and thus silent on the regulator). LIF was amended two more times on 21 March, 2014 and 12 December, 2014 for the same purpose – to shift the deadline for NBG’s oversight authority over investment funds.

According to explanatory note to LIF, its introduction was preconditioned by the need to define different types of investment funds on legislative level, to establish rules of their formation and need for regulation of their competencies (authorizations). The declared objective of the law is to improve regulation related to formation and activities of the investment funds, to define types of investment funds, formulate their rights and obligations. By design, LIF should allow regulated investment fund activities; detailed explanations should be provided about the rules of their formation, competencies and the list of activities which are prohibited for such funds. LIF provides for the types of investment funds, namely *unit* investment fund, fund of institutional investors, stock investment fund and other types of investment funds which are regulated by the law.

LIF is a very short unsophisticated document (only 10 substantive articles) with an incomplete agenda, particularly if compared to a chapter of LSM which was almost similarly deficient. Unlike referred chapter, which recognized that both regulated and unregulated investment fund activities are allowed, LIF only allows regulated investment fund activities. Respectively, an entity which is organized as a commercial legal entity and conducts activities resembling investment fund activities (investments into financial instruments) shall not qualify as an investment fund and is prohibited from use of the term *Investment Fund* in its title/name unless it registers itself as a regulated investment fund with the regulator.

Very briefly, LIF provides for the following: (a) few definitions (8 terms); (b) types of investment funds; (c) procedure for creation of investment fund and requirements of application; (d) obligations of the investment fund; (e) requirements towards asset management companies, towards agreements on assigning management rights to them and their functions. Order 22/04 on Registration of Investment Funds is a procedural order defining conditions and procedures of registration of application of an investment fund with the regulator. Requirements imposed on registration application are provided under Article 5 of LIF, however the Order 22/04 provides for additional requirements depending on the type of the requested registration. Very importantly, Order 22/04 sets requirements in relation to the rules of the Investment Fund which should define issues and aspects such as terms and conditions of membership, placement procedures, valuation, investment policy, rights and obligations of the asset managers, rules of replacing asset manager or a depository, rules of termination of fund activities, information on risks, restrictions on investments and more. Neither LIF nor Order 22/04 qualify compilation of such information as a prospectus. Order 22/04 consists of 6 Articles and it also lacks depth and sophistication.

There is a clear confusion/overlap or discrepancy related to the terms *investment management company* and *asset management company*. LIF makes reference to license for asset management, while the only license known under Georgian legislation relates to management of non-state pension funds/schemes. An individual license for asset management is granted under insurance law and while brokerage license encompasses this activity and is allowed to manage assets of clients and pension schemes under Article 23(f) of LSM, Law of Georgia on Licenses and Permits envisages a stand alone license for asset management. Asset management license is issued by the regulator of insurance sector. Therefore, while as long as the regulator of insurance and securities market stand independent of each other, there could be a conceptual duplication. Despite this confusion, no changes or revisions have been considered to LIF, mainly due to the lack of enforcement of the law and/or mechanisms for enforcement.

LIF provides definitions of venture capital fund and private equity fund, however disregards the differences between these and other types of funds requiring different approach in regulation. Venture Capital Funds and Private Equity Funds should not be regulated by LIF. Further, LIF does not cover real estate funds, while if it was meant to serve as a single piece of legislation for governing investment practices, real estate funds should have been envisaged. Further, while it proposes unit based investment funds which actually are schemes rather than legal entities, it does not give due consideration to the specific nature of *unit* and the need to elaborate a comprehensive legal framework to enable treatment of *units* on level playing field with other publicly tradable securities. For example, a specific definition of a *unit* is not provided in LSM. Very superficially, it can fall under definition of a security, but its placement on the public securities market, in particular with GSE is completely ruled out. While in its nature *unit* is an equity like residual instrument inducing equity like risk sharing by investor, it cannot be placed on the public securities market as in such case it would require registry services. Such services are (should be) provided by specialized depositories which are not capable of maintaining records for public trading of *units*. Under current edition of sub-

legislative acts which regulate specialized depositaries, these entities provide services for non-state pension schemes only. Further, LIF defines *unit* as an equity security, however an investment fund issuing an equity security would be implying its own share. Definition of unit in Georgian may also be confused with the term denoting share in cooperatives (type of a legal entity under Georgian company law).

In assessing LIF and Order 22/04, IOSCO Principles related to Collective Investments Schemes and respective EU Directives related to Undertakings for Collective Investment in Transferable Securities (UCITS) must be applied. It is clear, that LIF should be re-written in compliance with the listed standards. IOSCO Objectives and Principles of Securities Regulation (2010) contain a dedicated Group G for principles applicable to collective investment schemes comprising five important standards (Principles 24 through 28). There are two EU Directives related to undertakings for collective investment in transferable securities: (a) Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS, Directive 2009/65/EC, as amended); and (b) Commission Directive 2007/16/EC of 19 March 2007 implementing Council Directive 85/611/EEC on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS, Directive 2007/16/EC) as regards the clarification of certain definitions. These are comprehensive instruments which require adequate assessment and consideration to avoid duplication of work and enable adoption of EU compliant law on collective investment schemes.

When LSM was introduced under the Capital Markets Development Program in 1999, it did not contain a dedicated chapter on investment funds because this topic required such level of detail, it could not be contained in the same piece of legislation. A separate draft law on investment funds was elaborated but never adopted. It would be best to use this draft as a base document which is a compilation of 33 elaborate articles and 44 pages. While it is beyond the scope of the present Report to assess quality of the referred draft, outline of the chapters and articles is provided in Annex A.2. Copy of the draft is available in electronic form.

LIF clearly needs to be heavily revised or replaced by a more sophisticated piece of legislation. Its current edition undermines the concept of investment funds as an important vehicle to promote local and international investments. Obligation to harmonize with EU and IOSCO principles should be taken into consideration as well.

3. Sub-Legislative Normative Acts (Secondary Legislation)

Secondary legislation has been reviewed, in particular, from the general viewpoint of covering IOSCO principles. Rules and regulations are also reviewed in context of the change they carried in comparison to the prior regulations in force on the same subject matter, and for the width, depth and strength of their coverage. This is relevant for the purposes of assessing the regulatory trend and the vision the regulator held about the standard and depth of regulation beginning from in 2008-2009, when in parallel to dramatic 2007-08 legislative changes new regulator (NBG) came into play, the regulator being an integrated regulator overseeing financial sector at large.

Secondary legislation is grouped and reviewed following IOSCO groups of objectives for regulation. Comments and considerations are also provided in generalized manner and in a manner, pertaining to the policy discussion. Acts are provided in chronological order under each heading and deal with securities, as defined under LSM. In recommendations which are elaborated based on the review of the below listed secondary securities legislation only specific and technical issues are addressed, which are also not exhaustive. They do not address market development strategy, related problems and matters covered by the LSM discussed in other parts of the Report.

It has been assessed back in 2001 that Georgian securities regulation fully complies with seven out of (then) thirty principles, partly complies with 18 principles, does not comply with one and is in conflict with four principles. In 2007 IMF has issued a Working Paper on Strengths and Weaknesses in Securities Market Regulation: A Global Analysis in which securities regulatory systems have been examined worldwide, Georgia included. However, conclusions provided in this study integrate findings into general comments without articulating individually issues and concerns for each country assessed.

Thus, only results of 2001 assessment can be cited to reveal status of the Georgian legislation in relation to compliance with IOSCO principles. Several changes occurred to the securities legislation since 2001. However, no recent assessment of compliance with IOSCO Principles has taken place and it is not precisely known whether post 2001 changes weighted towards improved compliance.

In general, form and at parts substance of secondary securities legislation omits certain groups of IOSCO principles. For example there is no specific secondary legislation relating to the Regulator, thus no specific regulation can be listed under Groups A and D on Regulator and Cooperation in Regulation respectively. Regulations on other groupings are listed and discussed below.

Sub-legislative acts relating to enforcement of securities regulation

- NBG Order N35/04 on Approval of the Rules on Assigning, Imposing and Executing Monetary Penalties for Violations of Securities Market Legislation, 14 February, 2012;
- NBG Order N18/01 on Approval of the Rules on Assigning, Imposing and Executing Monetary Penalties for Violating the Law on Facilitation and Prevention of Illicit Income Legalization of Georgia by Securities' Registrars and Brokerage Companies, 22 February, 2010;
- NBG Order N19/01 on Defining, Imposing and Enforcing Monetary Penalties against Founder of a Non-state Pension Scheme, Asset Management Companies and Specialized Depositaries, 22 February, 2010.

Under the principles, Regulator should have comprehensive inspection, investigation and surveillance powers, also comprehensive enforcement powers. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

Above listed regulations do not elaborate on regulator’s competencies and mechanisms of inquiry into the breaches of legislation, but rather list the sanctions which regulator may impose on a participant of the market in breach. Some of the fines remain inadequately high in comparison to the market breadth.

Sub-legislative acts relating to self-regulation

- NBG Order N171/01 on Rules on Licensing of a Central Depositary, Submission of Financial Statements, Establishment of Minimum Capital Requirements, Provision of Services by a Central Depository, 28 December, 2010;
- NBG Order N169/01 on Rules on Licensing, Submission of Financial Statements, Establishment of Minimum Capital Requirements for a Stock Exchange, 28 December, 2010.

Under Principle 9 on Self-Regulation, “where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.”

Listed regulations mainly consolidate the contents of the regulations, which it replaced. Provisions of reporting rules are imported from the old regulation, while license conditions were imported from the LSM and are quite general. No material additions or modifications have been introduced, while compliance with following IOSCO principles related to Self-Regulation and Secondary Market should be studied:

- Principle 6. The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.
- Principle 7. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.
- Principle 25. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.

- Principle 26 There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.
- Principle 27 Regulation should promote transparency of trading.
- Principle 28 Regulation should be designed to detect and deter manipulation and other unfair trading practices.
- Principle 29 Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.

While some of the principles may be less relevant for current market conditions, others need treatment on the level of LSM. Compliance with these principles will be important for the entry of a strategic investor in the business of securities exchange.

Sub-legislative acts relating to issuers

- FSAG Order N3 on Approval the Rules on Submission of Corporate Bonds' Issuance and Placement Reports, 1 July, 2008;
- FSAG Order N16 on Approval of the Rules on Defining a State official publication and Calling a Meeting of Shareholders of the Reporting Companies with less than 1% share, 3 February, 2009;
- NBG Order N21/01 on Approval of the Rules on Filing Report on Ownership of Securities in the Reporting Company by Member of Governing Body of Such Company and Rules of Disclosure of Significant Dealings in Shares or Changes of Ownership thereof of Reporting Companies, 22 February, 2010;
- FSAG Order N22 on Approval of the Rules on Defining Periodic Reporting Requirements for Reporting Companies, Exempting from Reporting Requirements, Appointing Securities Registrar for Issuers and Confidentiality of Reporting Companies, 28 December 2010;
- NBG Order N73/04 on Approval of the Rules of Requesting and Issuing Identification Number of Securities and Registration of Approved Issue Prospectus, 7 September 2011.

FSAG Order N16 essentially re-adopted replaced regulation. There was an opportunity to consider whether more convenient and authentic means of posting/publishing information on call/invitation of the shareholders to the General Meeting of Shareholders could have been selected. Legal and procedural burdens are one of the reasons why JSC's avoid having high number of shareholders (which should be typical in developed capital markets). However, as of the date of the present Report, the Georgian Legislative Bulletin (selected official publication) is also available in electronic format. Finding relevant information on shareholder meetings on this website is not too convenient, but such information is placed on regular basis.

NBG Order N21/01 on disclosure rules for acquisition of significant share in Reporting Company or its change is a consolidation of the regulations, which it replaced in 2010. No definitions are provided in the regulation. For example, no definition of a Significant Share is provided (reference is made to definitions from LSM, which also provides indirect definition requiring streamlining). In the light of the free float tax incentive, this regulation may be used to create a framework, which will support identification of the ownerships contributing to qualifying free float levels, however 5% threshold would be relevant. Further, due to the nature of the Reporting Company's securities, most of such securities may be held in nominal holding by the brokerage companies for further resale. These and other technicalities need to be addressed. Definition of a Reporting Company was wider at the time the older (replaced) regulations were adopted. It needs to be studied how this affects the objective of the regulation. Enforcement is difficult. Reporting is burdensome and non-professional owners may not be aware of the requirements. Consequences may be unfair to them (loosing voting rights on the nearest shareholder meeting for example). It is not clear how this corporate law restriction can be achieved without court injunction (this clause has been present in the old regulation as well, but unclear if ever enforced). On the other hand, reported information may be important for insider trading detection. Otherwise, it seems somewhat less relevant for the time being from public securities perspective, as some mergers and acquisitions (M&A) tactics could have been targeted. Further, this regulation should reflect Principle 14 for Issuers ("Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic

and foreign counterparts”), which it does not.

NBG Order N73/04 resolved a long standing confusion about issuing ISIN numbers for securities.

Sub-legislative acts relating to collective investment schemes

- NBG Resolution N51 on Rules on Identifying Duties of Conservation of Pension Assets of a Specialized Depositaries, 11 November, 2004;
- NSC Resolution N49 on Rules of Entering into Agreements with Specialized Depositaries, 11 November 2004;
- NSC Resolution N43 on Defining Minimum Initial Capital Requirements for Asset Management Companies, 11 November, 2004;
- NSC Resolution N48 on Rules of Licensing Specialized Depositaries, 11 November, 2004;
- NCS Resolution N46 on Conflict of Interests between Specialized Depositaries and Asset Management Companies, 11 November, 2004;
- NSC Resolution N44 on Rules of Entering into Agreement with Asset Management Companies, 11 November, 2011;
- NBG Order N22/04 on Approval the Rules and Procedures of Registration of Investment Funds at the National Bank of Georgia, 14 February, 2014.

Whole set of regulations were adopted by NSC in relation to asset management companies under the Law of Georgia on Non-state Pension Insurance (NSPI) (1998). However, NSPI defines Asset Management Company as a commercial entity managing only pension assets under the respective license. At the time of adoption of the above listed normative acts on asset management, NCSG was an integrated regulator overseeing insurance sector as well. While under LSM brokerage companies are allowed to invest pension funds, it’s unclear whether the designated license for management of pension funds envisaged by the Law on License and Permits and NSPI is sufficient to manage funds under the LIF. This is an area, which has remained unattended since adoption of the LIF. Brokerage companies are allowed to manage investments/assets under their licenses, however, LIF makes explicit reference to the license for asset management. Such formulation is only available in relation to asset managers of non-state pension collections.

Same applies to specialized depositaries for which designated normative acts are issued and they are only meant to provide services in the area of pension collection. Nothing similar is envisaged for the investment funds in general, while LIF makes explicit reference to specialized depositories, whose services are indispensable for certain types of collective investment schemes.

Sub-legislative acts relating to market intermediaries

- FSAG Order N5 on Approval of the Rules of Administrating the Securities Registrars, 8 September, 2008;
- NBG Order N33/01on Rules of Licensing, Submission of Financial Statements, Setting Minimum Capital Requirements for Securities Registrars, 9 March, 2009;
- NBG Order N34/01 on Approval of the Rules of Licensing, Defining of Minimum Capital Requirements and Submission of Financial Audit of Brokerage Companies, 9 March, 2010;
- FMSG Order N6 on Approval of the Rules of Receiving, Systemizing and Processing the Information by Brokerage Companies and its Submission to the Financial Monitoring Service of Georgia, 24 January, 2012.

Primary objectives of the securities regulation is a) protection of investors; b) ensuring fair, efficient and transparent markets and c) reduction of systemic risk. With regard to market intermediaries like brokerage companies, this translates into addressing risks related to capital, client money and public confidence. To treat these risks regulations should: a) provide for minimum entry standards for market intermediaries (Principle 29); b) set initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake (Principle 30); c) require market intermediaries to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which

management of the intermediary accepts primary responsibility for these matters (Principle 31); d) ensure existence of procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk (Principle 32).

Regulatory aims and objective described above are normally handled by the following regulatory mechanisms and instruments:

- Licensing and Supervision;
- Capital Adequacy Requirement;
- Conduct of Business Rules and Other Prudential Requirements dealing with following categories: *Integrity and Diligence; Terms of Engagement; Information about Customers; Information for Customers; Customer Assets; Market Practice; Operational Controls; Conflict of Interests; Proprietary Trading*.
- Action in the Event of Financial Failure of an Intermediary;
- Ongoing Regulatory Supervision;
- Regulation of Investment Advisory Services: *a) Such licensing which is sufficient to establish authorization to act as an investment adviser and ensure access to an up to date list of authorized advisers; b) prohibit involvement of persons who have violated securities or similar financial laws, or criminal laws during a specified time period preceding application; c) require record keeping; d) require adequate disclosures to clients; e) require rules for prevention of guarantees of future investment performance, misuse of client assets, and potential conflicts of interest; f) ensure inspection and enforcement powers.*

Minimum Entry Standards envision: (1) initial capital requirement; (2) comprehensive assessment of the applicant and all those in a position to control or materially influence the applicant that addresses *ethical attitude*, including past conduct, and appropriate proficiency requirements such as industry knowledge, skill and experience; also, include (3) an assessment of internal controls and risk management and supervisory systems in place, including relevant written policies and procedures. Under the minimum entry standards, NBG Order 34/01 covers “1”, partially meets “2” and does not address “3” above. While compliance with “3” is not targeted in the conditions of underdeveloped securities market and lack of sophisticated instruments and volumes of trading, “2” can be fully met through setting some requirements related to the skills and experience of the individuals in charge of running business, particularly to partially compensate for the need to decrease unnecessarily high capital requirements. This regulation should also elaborate on rejection of the license, withdrawal or suspension authority based on the failure to meet relevant entry requirements on an ongoing basis. Regulator should be able to prevent employment of persons (or seek removal of persons) who have committed securities violations in the past or, are otherwise unsuitable to be involved in securities business and have an influence on the company.

Regarding maintaining adequate financial resources to meet their business requirements and withstand the materialization of events of risks to which these firms are subject (capital adequacy), this is normally achieved through setting (1) initial capital and (2) capital adequacy requirements. While the initial capital is also an entry standard, capital adequacy standards are critical in fostering confidence in the financial markets and investor protection.

Initial capital requirement should be based on a capital adequacy test that addresses the risks to such firms judged by reference to the nature and amount of the business expected to be done. When adopted in 2010, under NBG Order 34/01, initial capital requirement was set at GEL 100,000. Even at that time this figure needed analysis as it seemed to be above the level that would be appropriate relative to the level of securities market capitalization and expected profitability of the brokerage companies. Furthermore, it’s not clear when and under what projections and calculations was this figure set to increase over the next several years (NBG Order 34/01 sets capital requirement for 2015 at GEL500,000). Apparently, initially the rate of increase was meant to correspond to the expected growth of the securities market and industry profitability over the same period. Due to the market conditions, this requirement should be revised, as it has already caused exit of several market participants from the market.

The ongoing capital requirement on the other hand should be directly related to the nature of the risks and the amount of business actually undertaken by the firm. This implies periodic reporting to the regulator and/or competent SRO. In this regard, capital adequacy requirements must be structured to address the full range of risks which market intermediaries are subject to, e.g., market, credit, liquidity, operational, and legal, including reputational risks. Original set of regulations addressed most of these risks. NBG Order 34/01 relinquished capital adequacy requirements. On the other hand, it also reduced frequency of reporting thus reducing costs of compliance.

NBG Order 34/01 mostly ignores Principle 31. Further, it did not annul regulation on terms of engagement between brokerage firm and its clients, but this was accomplished by the Presidential Order 110/01 of 4 August, 2010, which removed certain established standards of broker-client relations and duty of diligence.

Quality of the requirements under NBG Order 34/01 are poor and need revision. The following issues are not addressed (neither fully nor partially): Integrity and Diligence; Information about Customers; Information for Customers; Customer Assets; Market Practice; Operational Controls; Conflict of Interests; Proprietary Trading, particular requirements for investment advisory services. The coverage of all of these issues may be unnecessary, however exclusion of a need for coverage of each and any of these issues should be based on detailed analyses.

Principle 32 envisages regulator's powers and capabilities, which have not been addressed neither in the old rules nor in the new draft under review. Functions and responsibilities of the regulator are not provided under a single dedicated act.

Sub-legislative acts relating to the secondary market

- NBG Order N170/01 on Approval of the List of Recognized Foreign Securities Exchanges and Rules for Public Offering of Securities Admitted for Trading to These Securities Exchanges, 28 December, 2010.

Securities Exchanges provided in the list of NBG Order N170/01 need to be assessed according to the level of development of the corresponding capital markets, quality of regulation and market standards. Placing most of the world's securities exchanges in the list undermine the purpose of the regulation. If the approach is to allow free entry, such regulation is not adequate. Instead, if the approach is to allow only well regulated instruments, then securities exchanges should be studied at least under few general parameters. As of the date of the Report, securities exchanges of 86 countries are listed under this Order.

6. EVOLUTION OF TRANSPARENCY REQUIREMENTS

Under its scope present Report is to trace evolution of transparency requirements imposed on the Georgian corporate population. To accomplish this task, relevant provisions of LSM and sub-legislative acts and changes introduced over time have been assessed.

Following provisions of LSM deal with the reporting requirements of the issuers (Reporting Companies):

- Article 4 of LSM which lists requirements imposed on the potential issuers who plan to file for registration of securities for public offering;
- Article 11 of LSM which requires periodic reporting from the Reporting Companies (Issuers);
- Article 13 of LSM on confidentiality of information about Reporting Company.

Article 4 of LSM deals with requirements imposed on the prospectus as well as on the standards/parameters of financial reports potential issuer has to file with the regulator. Original version of LSM indicated that applicant has to file financial reports of last two years and similar information for any entity in which applicant owns more than 50%. Auditor's letter confirming it has examined applicant's reports and consent for inclusion of audited financials into the prospectus.

As of the date, since adoption of LSM, Article 4 of LSM was amended four times in 2003, 2007, 2008 and 2009. Changes of 2007 revised formulation of the relevant paragraph of Article 4 dealing with audited financial reports, however, no essential change was delivered. In 2008 Article 4 was revised and re-adopted under a new edition. These changes streamlined formulation of the relevant paragraph and enabled companies with the history of less than two years to file audited financials for the period of existence from the date of incorporation up to the date of filing application. In 2009 new edition of Article 4 was introduced again, however no changes occurred to the requirements related to presentation of audited financials.

Article 11 of LSM regulates periodic reporting requirements of Reporting Companies (Issuers). Issuers are required to provide annual, biannual and current reports. Article sets fixed dates for reporting (current reports are provided within 15 days from the occurrence of a pre-defined material event) and imposes obligation to file reports with GSE if securities are admitted for trading to GSE. Annual reports must be audited.

Article 11 of LSM was amended five times in 2003, 2007, 2008, 2009 and 2011. Changes in 2003 did not alter essence of the Article. Changes in 2007 mainly dealt with replacing fixed dates for filing reports with the number of days allowed for submission. 2008 and 2009 changes offered a new edition of Article 11, however the essential requirements of the Article were not altered. Changes were caused by change of identity of the regulator to which reports were to be filed. Similarly, paragraph 5 of Article 11 was revised in 2011 to replace identity of the regulator in relation to its authority to determine form and rules of submission of reports.

Indeed on May 25, 2009, NBG issued an Order N22 on Determining Rules of Periodic Reporting Requirements imposed on Reporting Companies, on Exemption form Reporting Requirements, on Confidentiality of Information of Reporting Companies and on Appointing Securities Registrar (Order No22).

Order N22 replicated and detailed requirements imposed under Article 11 of LSM. But most notably, it exempted Issuers whose public securities were on record held by less than 50 holders from reporting obligations. It also exempted from reporting requirements those enterprises whose securities, although admitted for trading to GSE, had not been traded for over two years.

Article 13 of LSM allows Reporting Companies to designate certain information as confidential. Changes to this Article occurred three times in 2007, 2008 and 2009. Changes were caused by change of identity of regulator. Order N22 elaborates on the rules of recognizing information as confidential by the regulator and rules of disclosure of such information upon request of the Issuer or at the discretion of the regulator.

7. TAXATION

Under its scope present Report is to review provisions of the Tax Code of Georgia (TCG) impacting capital markets activities, along with the level of regulatory fees to:

- Determine the tax treatment and fees imposed on issuers of securities;
- Determine capital gains treatment on corporate equities and bonds;
- Determine tax treatment of corporate and treasury bonds issued at discount;
- Determine the tax treatment of issuers paying dividends and/or interest;
- Determine the tax treatment of recipients of dividends and interest, separated by domestic and foreign recipients and indicating both tax percentages imposed and the withholding schemes required;
- Compare these tax treatments to similar financial instruments such as bank deposits to identify whether there is a level playing field between different types of financial instruments.

Below Report addresses each of the assignment components. Elaborations on some other aspects of taxation are provided as well.

1. Registration fees for issuance of securities

The fee charged for registration of the [public] offering of the securities does not qualify as a tax under Georgian law but constitutes a registration fee governed by the Law of Georgia on Registration Fees (LRF). Legal source of imposing a registration fee is Article 94 of the Georgian Constitution. Further, the Law of Georgia on Basis of the System of Fees defines general policy and principles of fees. Types of fees are provided under Article 5 of the Law on Basis of the System of Fees. Referred article categorizes fees into (a) general state fees and (b) local fees. Registration fee falls under the category of general state fees.

Under LRF, registration fee is defined as “mandatory payment to the state budget, paid by the legal and natural persons in the amount and manner defined by the law, for granting the right to implement an activity or for the use of product or service, or for the services performed by the state bodies”. Types of registration fees are defined under Article 7 of LRF. Fee for registration of securities offering is fixed in the amount of 0.1% of the volume of the issue. It derives from the above, that the fee are imposed either for the registration services provided by the National Bank of Georgia (as a state body/regulator) or for granting the issuer the right to offer issued securities publicly.

As of the date, there is no additional normative act regulating payment of the registration fee for offering of the securities. Payment is affected directly to the State Budget. This payment to the state budget has never been re-allocated to the regulator at a later stage. In 1999, a Presidential Order N692 on the Financial Support of the Securities Commission of Georgia envisaged financial support of the Securities Commission of Georgia through allocation of 70% of the registration fees for approval of the issue prospectus and registration services to the special account of the Securities Commission of Georgia. Remaining 30% was to enter the state budget. Registration fee at that period was fixed at 0.5% of the nominal value of the issue. This measure was envisaged for the period until adoption of the Law on Registration Fees.

Given the economy of any securities issuance in Georgia, which is already heavily discriminated against other forms of capital raising, registration fee has been a significant financial burden, often leading to decisions of potential issuers to either (a) not raise capital through issuance of securities and opt for other types of financing, or (b) not offer the issue publicly and place it through private placement. Any one of these two outcomes are detrimental to the objective of developing capital markets as in first case, securities are not issued at all, while in second case, issue circumvents public placement process which means: 1. Inability to take the issue to the secondary market and/or have it admitted for trading to the stock exchange. In such case fixing of the trades is not required either, thus the volume of trades of such securities would not be reflected in capital market activities/dynamics. 2. No publicity of the issue and thus a loss of chance to increase public awareness on capital market

activities and opportunities; 3. Lost opportunity to improve operational/financial soundness of the stock exchange through additional revenues; 4. Lost revenues for the market participants (brokerage firms, registrar).

2. Capital Gains Tax

Tax treatment of corporate equities and bonds

Georgian tax legislation conceptually treats capital gain from the sale of securities similarly to the sale of any other property. Differentiated treatment may only be identified under the exemptions from the income tax or profit tax. Both, equities and bonds fall under the definition of a financial instrument under TCG. There is no articulate differentiation provided by TCG for particular types of securities based on their legal nature. The only additional qualification related to the security for the purposes of exemption is its free negotiation. Freely negotiable security is defined by TCG as “public or debt security admitted to stock exchange’s listing for trading, ratio of free turnover of which for December 31 of the year preceding accounting year or December 31 of the accounting year, based on the information submitted by the issuer to the stock exchange, exceeds 25%.”

Income and Profit Tax Exemptions

Exemption from income tax (20%) applies to the following income of a natural person:

- capital gain received as a result of sale of security issued by international financial company;
- capital gain received as a result of the sale of freely negotiable security;
- income received in the form of interest from a debt security of state, National Bank of Georgia or international financial company. List of international financial company is determined under the Resolution of the Government of Georgia.

Exemptions from profit tax (15%) apply to the following income of a legal entity:

- profit received by international financial company as a result of financial operations and/or financial services and/or sale of securities issued by non-residents of Georgia;
- profit received as a result of sale of security issued by international financial company;
- profit received as a result of sale of freely negotiable security;
- profit received as a result of sale of debt security of state, National Bank of Georgia or international financial company and income receive in the form of interest from the funds allocated on the NBG accounts. List of international financial company is determined under the Resolution of the Government of Georgia;
- profit received by an investment fund as a result of supply of financial instrument and/or financial operation and/or financial service, if investment fund is an international financial company.

Discount

Discount is treated under the TCG as interest. Therefore, any reference to taxation of interest is directly replicable for the treatment of discount. Discount is not treated under a differentiated regime for treasury bonds. Wherever interest is exempt due to the nature of the issuer, i.e. the latter being the state, discount is treated identically, as it is considered a type of interest.

Therefore, discount of the bonds issued at discount is treated as interest. Questions related to administration of discount taxation do not arise where exemptions apply. However, for non-exempt bonds following practical issues are relevant: generally, interest is taxed at the source, upon its payment. However, when bond is placed (sold) at discount, two points in time could be eligible for taxation:

a) Moment in time, when bondholder settles for the bonds at discount (due to non-payment of the discount portion of the face (nominal) value);
b) Moment in time, when bondholder is settled for the face (nominal) value of holding, for receiving capital gain in the form of discount amount (after having held bond to maturity).

Both of these scenarios could be valid as in case (a) bondholder's interest is settled for the whole pre-defined period of holding in the form of forsaken payment, while in case (b) bondholder realizes the discount (interest) income materially (over the nominal value of the issue). While international practice may have designed a suitable solution to this situation, TCG does not specify what the rules are. Treasury bond qualifies as state security and is exempt from income and profit tax. Discount on treasury bond is exempt similarly.

3. Tax Treatment of Interest Paid on Securities

Tax Code of Georgia differentiates securities related income by type of income, i.e. TCG recognizes taxation of interest payments and dividends and regimes of taxation it imposes on these two types of income are not identical. Further, under TCG, interest payment is not differentiated based on the nature of the instrument from which it derives. Tax treatment of interest is mostly differentiated based on the payer and recipient, in the form of exemptions rather than any specific rule. Discount is also treated under the TCG as interest. Therefore, any reference to taxation of interest is replicable for the treatment of discount.

Interest is defined by Paragraph 19 of Article 8 of the TCG very widely and includes (a) insurance payments affected under pension insurance contract to insured pensioners by insuring party (insurance contributions deducted); (b) payments related to credit (loan), deposit, time deposit, bond; (c) income received from state securities and bonds, including accrued premiums and profits. Penalties for overdue payments do not qualify as interest. Obligations deriving from guarantees or surety bonds, or similar operations do not qualify as debt obligations giving basis to interest for the purposes of TCG.

Interest is generally taxed at the source under TCG. Following general and special rules apply to taxation of interest at the source or otherwise under TCG:

a) Interest paid by permanent establishment of a non-resident or by a resident, or on their behalf, is taxed at the source at the rate of 5%;

b) Interest paid by debtors to resident banks is not taxed at the source;

c) Interest received by a natural person does not count towards his/her gross income and is further not taxed;

d) Interest received from a financial institution licensed under Georgian legislation is not taxed at the source. Further, such interest income does not count towards gross income of receiving party unless such party is another licensed financial institution;

e) Interest received from *freely negotiable security* is not taxed at the source and does not count towards gross income of receiving person;

f) Interest paid by resident enterprise to the State is not taxed at the source;

g) Interest received from debt securities issued by Georgian enterprise and listed on an exchange recognized by a foreign state is not taxed at the source and is not counted towards gross income of receiving person;

h) Interest received from enterprise of Free Industrial Zone (FIZ) is not taxed at the source and does not count towards gross income of receiving person;

i) Resident legal person or permanent establishment (PE) of a non-resident (except for natural person) who is a payer of profit tax and received interest income taxed at the source, has a right to offset the tax amount paid to the budget.

Allowed deductions

As a general rule, interest payments are deductible from gross income.

4. Tax Treatment of Dividend

Dividend is defined by TCG as any income (including interest income received from preferred shares) received by a partner/shareholder from the ownership of shares as a result of distribution of profit by a legal entity to its shareholders/partners, prorated or not, to their participation in the capital. In relevance to the securities market legislation, notion of dividend is quite universal, invariably attached

to the equity ownership and thus to the stocks of a joint stock company, the only type of organizational legal form under Georgian company law able to issue equity in the form of securities qualified as such under the LSM and eligible for public offering and trading. Dividend paid by resident enterprise to a natural person, non-commercial legal entity or non-resident enterprise is taxed at the source at the rate of 5% of payable amount.

Following general and special rules apply to taxation of dividends:

a) Dividend received by persons defined by Paragraph 1 of Article 2 of the Law of Georgia on Enterprises (except for individual enterprise) is not taxed at the source and does not count towards gross income of such entity;

b) Dividend received by a resident natural person, which is taxed at the source does not count towards gross income of such person and is not subject to further taxation;

c) Dividend received by non-commercial legal entity taxed at the source is not included in gross income of such entity and shall not be further taxed;

d) Dividend paid from stocks/shares of international financial company is not taxed at the source and does not count towards gross income of receiving party;

e) Dividend received from *freely negotiable security* is not taxed at the source and does not count towards gross income of receiving party;

f) Dividend paid by resident enterprise to State is not taxed at the source;

g) Dividend received from a FIZ enterprise is not taxed at the source and does not count towards gross income of receiving person.

5. Level playing field

As discussed above, registration fee is an important factor, which influences decision-making related to either issuance of securities (over taking a loan) or nature of the issuance of securities (public vs private offering). Another important factor which influences such decision making is tax regime applicable to securities issuance.

Because bank deposit market as well as primary and secondary market for government securities shows positive trend in growth, it is important to understand how the legal environment which is supportive of these two types of financial instruments can be replicated for the typical capital markets products such as corporate debt and equity instruments. Comparing tax treatment of these instruments should be a useful exercise.

Table below provides information on tax treatment for both, issuers and recipients of securities related to income received from bank deposits, debt and equity securities and government securities.

Comparative Taxation Matrix

	Tax Treatment of Payer (Issuer)	**Tax treatment of Recipient**
Bank Deposits (with financial institutions licensed under Georgian law)	Deductible as expense? Yes, interest payment is generally deductible.	Interest income of **natural persons** or **legal entities** received from a Georgian licensed financial institution is not taxed at the source and does not count toward gross income of such person. **Non-resident natural persons** and **legal entities** are treated under the same rule. Exemption does not apply if receiver of such income is **another financial institution licensed** under Georgian legislation.
Treasury Securities	n/a	For **natural person**: income received in the form of interest from a debt security of state, national bank of Georgia [or international financial company] is exempt from income tax. For **legal entity**: profit received in the form of interest payments from state securities is exempt from profit tax. For **non-residents**: non-resident provisions on taxation of interest refer back to the general treatment of interest taxation. Therefore the above rules should apply to taxation of non-resident natural persons and legal entities. Specific provisions on taxation of interest (Article 131 of TCG) do not make any explicit references to taxation of interest from state securities. It derives from the provisions on exemption of interest income from state securities from income tax and profit tax that such income is generally exempt.
Corporate Bonds	Deductible as expense? Yes.	For **natural persons**: taxed at the source at the rate of 5%. **Exemption**: if received from *freely negotiable security*.

		For **legal entities**: taxed at the source at the rate of 5%. **Exemption**: if received from *freely negotiable security*.
Preferred Shares	Deductible as expense? No.	For **natural person**: taxed at the source at the rate of 5%. For **legal entity** (except for non-resident): not taxed at the source and does not count towards gross income of receiving person. For **non-resident**: taxed at the source at the rate of 5%.
Common Shares	Deductible as expense? No.	For **natural person**: taxed at the source at the rate of 5%. For **legal entity** (except for non-resident): not taxed at the source and does not count towards gross income of receiving person. For **non-resident**: taxed at the source at the rate of 5%.

Summary answer to the question, whether there is level playing field between bank deposits, treasury securities, corporate equities and corporate bonds is negative. TCG differentiates treatment of deposits as well as interest payments to and from/by the financial institutions. TCG differentiates treatment of interest by type of security to which they are attached. Also, different treatment is endorsed for the securities with the higher rate of the so called free float. Respective part of the Report below elaborates on the aspect in more detail.

6. Taxation of Investment Funds

Explanatory note to LIF indicates that it shall not cause any changes to either income or expense part of the state budget. Neither shall it have any effect on the level (principle of determining the amount) of fees, taxes or other levies. Therefore, it derives that whether existing tax legislation is supportive of taxation of investment fund related revenue streams, remains to be assessed based on the legislation already in effect by the time LIF was adopted. Based on the information contained in the explanatory note it derives that no differential or special tax treatment has even been considered for investment funds while it is widely recognized that such treatment is vital.

Current regime

Investors of the investment fund, if they are natural persons, are taxed at the source for the dividend or interest received from the fund as provided in the above Table on Comparative Tax Matrix. Namely, they are taxed at the source at the rate of 5%. If investors are legal entities (except for non-resident investors), they are not taxed at the source and dividend income received from the fund does not count towards gross income of receiving entity. Instead, such dividend income is only taxed when investor legal entity distributes it to its own natural person shareholders. Non-residents (both, legal entities and natural persons) are taxed at the source at the rate of 5%.

This scheme of taxation implies following:

- If a natural person invests into a security directly, without intermediation of an investment fund, his/her dividend or interest income shall be taxed at the source under the rate of 5%;
- If a natural person invests into an investment fund, and such fund invests into debt securities and receives interest income, the fund shall be taxed at the source under the rate of 5%. Later, upon distribution of profit to natural persons, investment fund shall have to withhold 5% dividend tax at the source. Thus, the interest income received by investment fund and already taxed at the source as such, shall be taxed if and when transformed into a profit and conditionally dividend, at a later stage, upon distribution to a natural person. While an investment fund is entitled to offset withheld payments against the profit tax obligation it may incur, it's clear that Georgian tax regime does not give due consideration to investment funds as a special type of investment vehicles which require more sophisticated tax treatment.

To ensure adequate treatment of investment funds and its investors the so called *tax transparency* should be ensured. Tax policy should ensure no discrimination takes place between direct investment in assets and indirect investment in those same assets via an investment fund. Further, there should be no discrimination in the tax treatment between different legal types of funds that are investing in the same assets in the same manner.

Further, LIF envisages collective investment schemes which do not constitute legal entities. Such investment schemes are maintained and managed by the asset managers and it is unclear how these shall be treated under TCG.

7. Taxation of interest vs taxation of capital gain on debt securities

Interest on debt securities accrues on daily basis and is calculated according to the terms and conditions of such securities under the selected mode of day count conversion/fraction. When securities paying interest (or discounted securities) are sold between the interest payment dates, the seller is eligible to some fraction of the coupon amount for holding security up to the date without receiving accrued interest.

Technically, interest payments are paid on due dates and tax is withheld by the issuer. On the payment date, Issuer evaluates the registered records and pays to the holders of securities who appear on the list of holders. For these purposes, issuer pays holders regardless of the date on which holders become owners of the issued securities.

The sale of security between the payment dates causes a significant tax issue as TCG does not differentiate capital gain due to sale of security for a 'dirty price', i.e. the price which in itself covers accrued interest. In other words, the difference between the actual sale/ market price of the instrument itself and the accrued interest shall be treated as a capital gain subject to entirely different rate of tax, as defined above. This has been a recurring theme for the investors of debt securities, however no solution has been introduced so far. Respectively, investors and issuers address this problem by either: (a) arranging sales only on payment dates; or (b) engaging in evaluation of accrued interest before and after the sale periods and paying holders for respective periods on payment dates. Latter is a very inconvenient way to deal with the payments, as issuer needs to identify holders between the payment terms and pay them separately. This is also a technically difficult and financially unfair solution, as the seller has to wait until the end of the period to receive the interest which accrued by the date of sale, when investment position was liquidated. Same concerns are applicable to discounted debt securities.

8. Exemption related to free float

TCG provides for exemptions from profit tax as well as dividend and interest taxes for securities which are freely negotiable. Freely negotiable security is defined as a "public or debt security admitted to stock exchange's listing for trading, ratio of *free turnover* of which for December 31 of the year preceding accounting year or December 31 of the accounting year, based on the information submitted by the issuer to the stock exchange, exceeds 25%."

Concept of *freely negotiable security* and respective tax policy to grant exemptions for such securities were introduced into Georgian legislation together with the legislative package aimed at increasing globally Georgia's financial sector in 2008. At such time TCG in force was 2004 edition. While objective of this initiative was very plausible, it has never been successful. This is confirmed by the fact that Ministry of Finance (MoF) adopted Instruction N74 on February 9, 2010. This was a period when a 2004 edition of the Tax Code was in force and Instruction N74 was meant to elaborate on application of exemptions provided by this version of the Tax Code. Respectively, all references are made to the Articles and Provisions of the Tax Code which is no longer in force. Namely, latest edition of the TCG was adopted on September 17 of the same year, i.e. 8 months later. Respectively, pursuant to the respective provisions of the Law of Georgia on Normative Acts (adopted October 22, 2009), whether or not the sub-legislative normative act has been officially repealed, it looses legal force from the date the act based on which it was adopted is declared void. Namely, Article 25 of the Law of Georgia on Normative Acts reads "A normative act which is issued based on a legislative or sub-legislative normative act which has been declared void, has no legal force, regardless of whether it has been declared legally void or not."

Thus, as of the date of the present Report Instruction N74 on Tax Exemptions related to free float securities is not in effect. Failure to replace this act with a new edition only underlines that it is not in used, otherwise, there would be interest to conduct legislative work to eliminate this huge discrepancy.

In general, to level playing field, allowing tax exemption for public securities which meet the requirement of free float is not adequate/sufficient to create motivation for issuance of such securities on the market and promoting its dispersed ownership. Because the primary problem of Georgian capital markets is that there is lack of motivation to issue securities in general, it is important to promote issuance of the securities rather than to target dispersion of their ownership. Motivating ownership of securities by critical number of investors is very important but not practicable, if the issuances do not take place because there is no level playing field for them compared to other instruments. Thus, it is important to exempt public securities from taxed in a manner, which would not discriminate them against bank deposits and state securities.

9. Tax treatment of structured finance products, derivatives

As discussed later in the Report, GoG Strategy 2020 suggests introduction of asset based special financial instruments which should also imply securitization transactions. Among other enabling legal aspects necessary for implementation of securitization transactions, very importantly certain tax aspects should also be considered. Several questions need to be answered and appropriate approach should be adopted by the tax policy to enable these transactions. Below is the list of questions which need clarifications based on which adequate tax policy may be adopted towards securitization as a form of asset based transaction:

1. What constitutes the sale of asset under the Georgian tax law?
2. Is transfer of asset taxed under Georgian tax law?
3. Shall the transfer of assets from the originator to Special Purpose Vehicle (SPV) be treated for tax purposes as a sale requiring recognition of gain or loss, or as a loan?
4. To what degree shall originator as a seller and SPV as a buyer of assets (and issuer of asset-backed securities) shall be subject to tax?
5. Is a debt instrument (bond) sold by one party to another an asset?
6. In case of the sale of debt instrument (bond), would the proceeds paid by SPV be taxed?
7. If the parent of SPV is a Georgian entity, how shall the income/profit of the parent be taxed if SPV is located in offshore jurisdiction and the income is not generated on the Georgian territory?
8. How would the servicer be taxed, if it is incorporated in Georgia? Which taxes would apply?
9. May Georgian tax authorities consider a construction of an offshore SPV as tax evasion? If so, would there be consequences?
10. How would investors who purchase the securities issued by the SPV be treated?

11. How would be components of transactions treated in case Asset Backed Security (ABS) transaction is cross-border?
12. What would be withholding rules applicable to different components of ABS transaction?
13. How would the shareholder(s) of SPV taxed?
14. What would be tax outlook towards tranched securities ranked and issued under different risk/interest rate profiles?

These are the tax issues which should be carefully examined and an articulate tax policy developed should GoG opt to promote introduction of asset based transactions into the local capital markets.

8. INSOLVENCY LAW AND SECURITIES

The principal legislation governing insolvency in Georgia is the Law on Insolvency Proceedings (LIP) adopted in 2007. Insolvency proceedings can be initiated by debtors that are cash-flow insolvent or that are under the threat of imminent insolvency. Key insolvency related legal aspects important for the legal framework of securities markets are following:

a) hierarchy of the claims and ranking of senior claims recognized contractually (and not secured) under LIP in potential bankruptcy proceedings (i.e. ability to enforce qualification of senior claims when such claims are not secured by collateral but are contractually recognized as senior to other claims);

b) bankruptcy remoteness in case of securitization transactions;

c) ability to affect true sale for the purposes of securitization transactions;

d) technicalities of participation in insolvency proceedings by the security holders or trustees.

Each of the aspects are briefly discussed below.

1. Hierarchy of Claims

LIP is quite primitive in setting the order in which claims are satisfied under insolvency proceedings. Article 40 of LIP provides for seven levels of claims and set hierarchy under which creditors of each level should expect to be satisfied in case insolvency proceedings are enforced against their debtor. Thus the order of claims is the following:

I. Costs of court and enforcement proceedings;

II. Indebtedness towards the debtor incurred after commencement of insolvency proceedings, including tax claims;

III. Costs related to appointment of a legal guardian and all costs related to performance of his/her responsibilities;

IV. All secured claims, including those claims secured in compliance with the rules established by TCG;

V. Tax indebtedness, except for those claims envisaged under IV level claims;

VI. All other recognized but unsecured claims;

VII. Late claims.

In finance, senior debt, frequently issued in the form of senior notes is debt that should take priority over other unsecured or otherwise more *junior* debt owed by the issuer. Senior debt has greater seniority in the issuer's capital structure than subordinated debt. In the event the issuer goes bankrupt, senior debt theoretically must be repaid before other creditors receive any payment. This will not hold in relation to secured debt, as notwithstanding the senior status of a debt instrument, lenders of a secured debt instrument (regardless of ranking) shall receive the benefit of the security for that instrument until they are repaid in full, without having to share the benefit of that security with any other *lenders* like bondholders/noteholders. Georgian insolvency law follows this pattern and assigns to secured claims higher ranking over unsecured claims which could be recognized as senior by the issuer. What LIP does not recognize is the additional sub-rankings which issuer may assign to its issued unsecured debt for the purposes of tranching and/or structuring instruments for different risk appetites and risk/return profiles of the issued securities. Thus, for example, LIP does not account for hierarchy in claims that may be filed by holders of senior notes, subordinated notes and mezzanine debt. All of these classes of claims fall under level VI (unsecured debt) under the hierarchy determined by LIP. Such treatment or rather failure to treat additional classes of claims under insolvency law is a significant shortcoming for the purposes of securities regulation.

2. Insolvency and Securitization

As part of the policy for development of legal framework for non-banking financial sector GoG Strategy 2020 discusses introduction and development of investment products and instruments as well as development of asset-based special financing instruments. This should imply development of legal framework for issuance of asset backed securities (ABS, securitization transaction) which require specific legal set ups and presence of certain legal concepts, which allow separation of risks from the assets. A number of questions arise when assessing legal framework applicable to securitization transactions.

Primary questions that need to be covered relate to the concept of *bankruptcy remoteness*. Securitization is premised on the ability to separate the assets to be securitized from the risk of any entity that could become subject to bankruptcy. This has two facets: (1) structuring the SPV to be *bankruptcy remote*, i.e. so that it is unlikely to commence, or have commenced against it, a bankruptcy case; and (2) structuring the SPV so that it is unlikely to be affected by the bankruptcy of the transferor of the assets. To affect securitization transaction, in particular cross-border transaction which should attract foreign investors or in which SPV is registered in foreign jurisdiction but assets are sold/transferred from a Georgian originator, it is important to enable bankruptcy remoteness of the SPV. To assess whether it is possible to establish bankruptcy remote SPV, a number of questions need to be answered:

1. Under Georgian law, what are the consequences of the bankruptcy of the Georgian parent for a local or offshore subsidiary (SPV) and its assets? Do courts have the authority to consolidate the assets? Is this authority explicit? Is there a requisite non-petition (imperative and express) language for bankruptcy remoteness?
2. What is the governing principle in case Georgian legislation is silent about bankruptcy remoteness of the subsidiary in case of the insolvency of the parent?
3. Under Georgian law, what is the consequence of the bankruptcy of the asset seller, bond seller and a borrower for the asset buyer, bond purchaser and lender respectively?
4. If the servicer is a Georgian entity what are the consequences of its insolvency for an SPV?
5. What are the consequences of bankruptcy of offshore and local subsidiary (SPV) for a Georgian parent company?

Another important legal aspect is *true sale* of assets and contingent legal issues. Conceptually, *true sale* for asset securitizations is defined as "a transfer of financial assets in which the parties state that they intend a sale, and in which all of the benefits and risks commonly associated with ownership are transferred for fair value in an arm's length transaction." To assess whether *true sale* of assets may take place under Georgian jurisdiction, following questions should be asked:

1. Under Georgian law can a transaction constitute a true sale? In other words can the sale and transfer of asset be irreversible or is there a possibility to challenge, declare void or otherwise reverse such transaction in case of an insolvency of the originator or otherwise? Can irreversibility be validly regulated under the asset sale/transfer contract?
2. Under Georgian law, if a company issues debt in the form of a security (bond) and sells this instrument, shall this be considered a sale of asset?
3. Under Georgian law is it possible to effect the assignment of receivables and security interest without notification or consent of the obligor?
4. Under Georgian law can a borrower or seller of the debt instrument (bond) set off its obligations against receivables owned to it by a third party? If so, what is the procedure?

Questions listed above would be even more relevant and pressing in case of cross border securitization transactions. To affect asset backed securitization transactions, in particular cross border transactions which should attract foreign investors or in which SPV would be registered in foreign jurisdiction, but assets are sold/transferred from a Georgian originator, it is important to enable *bankruptcy remoteness* of the SPV and *true sale* of assets.

Another set of questions brings us back to LIP and generally civil code principles:

1. Under Georgian law is there a hierarchy among creditors? Are subordination arrangements enforceable in bankruptcy proceedings?
2. Is there an explicit definition of a secured creditor?
3. What are the rights of secured creditors? What are the rights of unsecured creditors?
4. Is the holder of the debt instrument (bond) issued by an insolvent firm a creditor for the purposes of the Georgian law on bankruptcy? If yes, does such holder enjoy same rights as any other creditor?
5. What are the voidable transactions under bankruptcy proceedings? Which contracts terminate upon insolvency of one of the parties? Are there contracts which may be subject to special arrangements and regulations under the bankruptcy scheme?

To enable ABS transactions for various classes of assets under Georgian jurisdiction as a hosting jurisdiction or a jurisdiction in which one or more components of the transaction are delivered, these questions should be answered and corresponding legal solutions must be devised. As of the date of the present Report the LIP and Georgian legislation in general does not specifically recognize ABS transactions. Neither is this type of transaction recognized from tax perspective (see relevant part of the Report on taxation).

3. Trust, Trustee and Securities

Trust is a recurring theme in the securities law, as its existence is very important for delivery of certain types of capital market products which require involvement of a third party linked to the transaction under fiduciary relationship. However, the *trust* is a product of common law system and its endorsement under a civil law legal system is not just an issue of capital markets policy. Still, importance and success of the trust concept has led to several civil law jurisdictions to incorporate trusts into their civil codes.

In common law legal systems, the law of equity defines trust as an enforceable three-party fiduciary relationship whereby the first party transfers title to property to a second party who holds title in trust and for the benefit of a third party. An owner placing property into trust turns over part of his or her bundle of rights to the trustee, separating the property's legal ownership and control from its equitable ownership and benefits. While the trustee is given legal title to the trust property, in accepting the property title, the trustee owes a number of fiduciary duties to the beneficiaries. The primary duties owed include the duty of loyalty, the duty of prudence, the duty of impartiality.

Over years trusts have become very important in capital markets, particularly through pension funds and mutual funds as well as in structured finance or any other transactions which require fixation/holding of title to security on behalf of unidentifiable or changeable pool of investors. Key in this concept is the enabled beneficial ownership of the transferred assets, while title is vested with a third party (trustee). Georgian law does not recognize beneficial ownership for registered property (like real estate, vehicles). The only instance for recognition of resembling beneficial ownership under Georgian law is ownership of securities which are held by nominal holders on behalf of securities owners. Without recognition of beneficial ownership of property/assets, a whole range of legal issues, including tax issues arise. For example in case of sale of property by trustee (who holds the title to such property but is not beneficial owner) shall be recognized as sale by beneficial (registered) owner and trustee shall be taxed as such. Because real estate is subject to registered ownership, such [registered] owner is the only owner recognized as *equitable* under the Georgian law.

Trust is an important aspect in the context of covered bonds and ABS notes. Because GoG Strategy 2020 names the absence of the set up for covered bonds and ABS notes as one of the deficiencies of the market and declares intent to tackle this issue, this concept should be studied and considered.

9. CREDIT RATING

Credit ratings provide individual and institutional investors with information that assists them in determining whether issuers of debt obligations and fixed-income securities will be able to meet their obligations with respect to those securities. Credit rating agencies provide investors with objective analyses and independent assessments of companies and countries that issue such securities. GoG Strategy 2020 names absence of credit rating companies as one of the important problems on the Georgian capital markets to be dealt with. This is indeed a very important missing segment as proper assessment of risk is considered as a key ingredient of a sound financial market. GoG Strategy 2020 indicates that credit rating services should be developed, however it obviously does not and may not lay out specific measures to achieve this objective.

What may be done to promote or ensure development of this segment of the market in legal context? To facilitate a greater understanding of the function and evolution of credit rating agencies, it is useful to look into history of other more advanced markets in this regard. All three major rating agencies started with publication of the statistical and other financial information. This obviously implies that there was a critical mass of statistical and financial information through which investors needed to navigate – an environment which will be difficult to achieve in Georgia in coming years, particularly if we acknowledge, that credit rating generally deals with fixed-income instruments, a segment which is even less developed than equity market in Georgia. These companies underwent significant M&A processes and re-emerged on the market as providers of risk management, data services and finance industry trainings.

Fitch Ratings (Fitch) was founded in 1913. Fitch published financial statistics for use in the investment industry via “The Fitch Stock and Bond Manual” and “The Fitch Bond Book”. Fitch’s AAA through D rating system was introduced in 1924 and became a basis for ratings through the industry. Later it underwent mergers and acquisitions processes and also entered enterprise risk management, investor services, data services and finance industry training businesses also resulting into development of a number of software solutions. S&P is known for S&P 500 stock market index that is both, a tool for investor analysis and decision making and a U.S. economic indicator.

It is clear, that Georgian market lacks depth and dynamics to enable financially viable and sustainable local rating services. On the other hand, these services are quite critical for the market development. To name the least, appropriately designed credit ratings allow for softer capital and liquidity requirements imposed on financial institutions.

All of the leading three rating companies offer services to Georgian residents, but mostly commercial banks and very few large companies in their endeavor to tap foreign capital markets. Applying these services to the local issuances is unreasonably costly, but above all, does not add much of a value and motivation for the issuer. Without treating credit rating on regulatory level, motivation shall be absent, particularly in the naturally unfavorable conditions for development of the rating services’ segment. A viable solution could be annexing these services to an existing institution like Credit info Georgia (engaged in exchange of information on defaults on credits) or an institution of similar kind, potentially established jointly by the sector representatives as a result of policy and regulatory decision.

In elaborating on credit rating agencies, IOSCO Principle 22 (Group F) relating to credit rating agencies should be considered. Under Principle 22 “Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.”

10. PROBLEMS AND ISSUES

Appropriate regulatory framework for securities, securities markets and its participant should: a) enable diversity of the capital market products; b) enable efficient organization (structure) of the markets, and c) support viability of the market allowing its participants profit from the business. Participants of the market should not be under regulated or overregulated, standards for entering and remaining on the market for the participants should correspond to the level of the market development and the need to have adequately diversified participation of professional and intermediary firms on the market. Problems persist under each of the areas listed above on the Georgian securities markets. To make conclusions and suggest recommendations regarding legal changes it is necessary to articulate these issues and problems which either result from applicable legal and regulatory framework or could be circumvented with new regulation.

Following issues and problems, which could be wholly or partially dealt with under legal reform/changes have been singled out:

1. Lack of Long-Term Development Strategy and/or Policy for the Securities Markets

Any change to the legal framework should be a response to policy decisions adopted in relation to the sector. Absence of a long-term and clear development strategy is one of the essential weaknesses of Georgia's capital markets legal framework. As of this date, GoG Strategy 2020 is a single policy document acknowledging condition of the market, however it offers only general language and outlook for curing deficiencies. Agenda put forward in GoG Strategy 2020 is not sufficiently elaborate. There is a need for a stand alone policy paper dedicated to the capital markets in particular. Such document should have a binding nature and ensure that any changes to the legal framework are in line with its provisions. Document should also envisage steps to harmonize with EU legislation to which Georgia committed under EU-Georgia Association Agreement and comply with IOSCO Principles.

2. Standard of Securities Legislation

Georgian capital markets legislation has not been studied/assessed from the perspective of its compliance with IOSCO Principles and Objectives of Securities Regulation. Harmonization with respective EU legislation should also be achieved in few years.

Last assessment related to compliance with IOSCO principles took place in 2001. A thorough study should be conducted to ensure next changes to the legal framework take place only in compliance with the referred principles. A very general overview of the legislation demonstrates that number of principles are not met. Some groups of principles are entirely missing.

Harmonization with EU legislation should take place in next five years. Ideally compliance with EU legislation should be assessed in parallel to conducting IOSCO compliance study to avoid any duplication as well as to ensure respective changes are carefully planned and implemented in phased manner.

3. Pro-active Regulator

Normative acts governing securities regulator's functions are not sufficiently elaborate. Several components of IOSCO principles related to securities regulators are not observed. Secondary legislation governing regulator's obligations should be explicit and regulator should be proactive in following and adopting such approaches to regulation, which are in line with the level of market development. With regard to legal and regulatory changes, the role of securities regulator should be very essential while for past several years very little activity has been observed.

4. Diversity of Capital Market Products

Capital markets legal and regulatory framework in Georgia neither envisages nor promotes a range of financial products and services commonly recognized and applied in other markets. A whole range of capital market products are not adequately defined and/or treated on legal and regulatory level to enable their trading on the securities markets (securitization, derivatives, investment funds, secured or covered bonds, municipal bonds, real estate funds, pension funds, government securities). While some of the capital market products can be replicated/reconstructed through complex contractual

structures (for example securitization transaction), several legal concepts and aspects are entirely missing from the legislation (true sale, bankruptcy remoteness, hierarchy of claims in insolvency). Further, there is no level playing field for available products (treasury bills vs corporate bonds from tax perspective), which makes their availability (i.e. placement on the market) even more restricted.

Lack of products could also be caused by the limited number of adequately qualified professional participants on the markets (investment firms/brokerage companies) that would be willing to generate/support creation of innovative financial/capital products. Apart from commercial unviability of the business, regulatory capital requirements imposed on such participants have driven out several brokerage firms from the market. Same requirements render financial services offered by brokerage firms unaffordable.

Some of the potential products circumvent public securities markets entirely. Securities like real estate offerings and promissory notes issued by micro finance organizations are most notable examples. With adequate policy decisions and regulation, some of these offerings could and should be placed through the securities markets.

5. Weak Market Organization

Securities market infrastructure should have a well-founded, clear, transparent, and enforceable legal basis for each material aspect of its activities. It should also have appropriate governance and the framework for the comprehensive management of the risks. In the absence of a clear state policy and strong legal framework, capable of protecting relevant public interest considerations and objectives of the relevant stakeholders, infrastructure of securities market shall not be sound. Recent developments on the market lead to the conclusion that requirements of IOSCO FMI are not met on a number of counts. Compliance check with IOSCO Principles and Objectives of Securities Regulation and IOSCO FMI is long overdue.

Being the only organized market in Georgia, GSE has an important role in promoting capital markets activities in Georgia. To maintain a sustainable growth and development, it is important to enable GSE capture market activities which are currently outside of its domain. As a result of legal changes which took place in 2007 and 2008, most of the trades take place OTC and are reported through fixing. Allowing trading in public securities outside GSE and without brokerage firms has undermined commercial prospects of GSE and brokerage firms. This in turn has led to exit of several brokerage firms from the market (through revocation of licenses for failure to meet capital requirements) and increase of GSE's vulnerability.

6. Lack of Interest to go Public

Clearly, the public market of securities suffers more in Georgia as a number of private placements have occurred in the past and this number as well as volume significantly exceeds that of the public placements. Secondary market for the government debt is handled outside of the organized securities market and without direct access of non-bank investors. No currency is traded on the stock exchange.

Several of the above mentioned factors could be treated on policy level and through respective legal changes. There is no level playing field between private and public placements. While private placement is free of charge and fully deregulated, public placement requires payment of registration fee, going through a burdensome, time-consuming and expensive registration process. The only benefit of going public, unless the placement truly requires more than 100 investors, is the ability to admit the security to the organized market (GSE). Because trading on GSE is not liquid and its capitalization is very low, this incentive is practically non-existent. Once security is admitted to GSE for trading, trading in such securities entails obligation of fixing, which is a burden, as it entails payment of the commission fee only because security was admitted for trading to the stock exchange. Thus, while transaction costs for going public are high, this process does not warrant much of a benefit. For all of these considerations issuers are reluctant to go public.

For years real estate and microfinance sectors have circumvented capital markets through practices which very much resemble issuing securities or deposit taking but are formally qualified as promissory notes, loan agreements or real estate sales transactions respectively. Securities markets policy and legal framework should take into consideration such practices and offer a credible solution to eliminate or decrease risks associated with such “issuances” through channeling them through public issuance procedures.

7. Lack of Institutional Investors

The asset management sector is an important component of capital markets. The sector includes the management of funds by institutions, such as pension funds and insurance companies, and the independent management of funds for retail investors, which can be distributed as collective investment schemes (or unit trusts). The latter are particularly important, as they provide an opportunity for small investors to have access to professionally managed, diversified portfolios of assets. As institutions directing the investment decisions for investors, asset management companies are important buy-side institutions.

In reforming securities legislation, adequate consideration should be given to such changes which shall support and promote creation and development of institutional investors. In this regard LIF clearly needs to be heavily revised or replaced by a more sophisticated piece of legislation. Its current edition undermines the concept of investment funds as an important vehicle to promote local and international investments.

8. No Level Playing Field

Capital market products are not put on equal footing with other financial products and government securities. There is no level playing field between corporate debt instruments on one hand and government bonds or bank deposits on the other from perspective of taxation. Going public is also more burdensome.

9. Taxation

Several tax issues need to be resolved to provide more incentives, fairness and convenience for securities transactions. Apart from leveling playing field for all securities, tax policy should consider special regime for taxation of investment funds as well as structured finance products. Further, solution should be found for taxation of interest accrued to fixed income securities between the payment dates when sales occur between such dates. Instruction on tax exemption related to free float should be streamlined and re-adopted.

10. Questions Related to Transparency and Quality of Financial Reporting

Securities legislation is quite general about reporting requirements and relies on ensuring quality of reporting through requirement of auditing. Thus, responsibility for the official oversight of and enforcement of financial reporting requirements are left to the auditors and those standard imposed on quality of the auditing services. Standards for auditing financials of licensed market participants have been improved under the Law of Georgia on Accounting and Financial Audit (LAFA), however, responsibility for oversight of audit companies is yet not assigned to any state agency or entity. In contrast, international practice suggests enforcement of accounting standards by the regulator of the sector in which reports are required. Capacity for such endeavor should be available within the regulator. Evolution of transparency requirements imposed on the corporate population involved in securities markets transactions suggests that the regulator has been moving away from this function through minimizing number of those Reporting Companies (Issuers) who may be eligible for financial reporting. Assessment of compliance of reporting requirements with IOSCO principles related to the Issuers would provide adequate qualifications of relevant provisions of LSM and Order N22.

11. Missing Legal Concepts

Some legal concepts important for implementation of more sophisticated transactions are missing (true sale, bankruptcy remoteness, hierarchy of claims in insolvency proceedings). Issuing such securities through local or cross-border structures shall be less likely until introduction of respective changes to the legislation. Therefore, for longer term perspective, capital markets policy should consider introducing these changes.

12. Credible Credit Rating

In medium and long-term perspective promotion of credit rating services should be considered. Due to the size and economy of issues, international credit ratings are not feasible for local issues while for some institutional investors it is very important or it is an only option to invest into rated securities.

11. RECOMMENDATIONS

This part of the Report provides recommendations based on overview of the issues and problems above. Recommendations are grouped under three main headings: 1. Policy recommendations; 2. Legislative recommendations; 3. Regulatory recommendations.

1. Policy Recommendations

There is a lack of elaborate and detailed long-term development strategy/policy for the securities markets in Georgia. To ensure consistency of changes to the legal framework, their substance and timing should be directly dictated by such policy/strategy document. CMWG is currently developing timebound roadmap for capital markets development in Georgia, which shall serve as a long term strategy document to be implemented in support of the market development. Form legal perspective, at minimum capital markets policy/strategy should elaborate on:

- Bringing legislation into compliance with IOSCO Principles and Objectives of Securities Regulation and CPSS-10 Principles for Financial Market Infrastructures (FMI);
- Signing of IOSCO MMoU and becoming a member of IOSCO;
- Identifying phased timeframe for harmonization with respective EU legislation;
- Considering regulation of the aspects of concentrated ownership of GSE in a manner which would ensure protection of interests of all stakeholders;
- Considering promoting trading in public securities through organized market and through market intermediaries;
- Considering alleviating capital requirements imposed on market participants;
- Widening access to trading in government securities;
- Introducing trading in currency on organized securities market;
- Introducing tax incentives in relation to public and private securities;
- Removal of registration fee for public offerings;
- Deciding on location of securities clearing and settlement function and integration with/ access to such system;
- Replacing or revising the Law on Investment Funds with support of sector experts;
- Considering introducing credit rating services and their regulation;
- Considering introducing relevant changes to insolvency law;
- Considering introducing legal concepts which are supportive of innovative capital market products.

2. Legislative Recommendations

Legislative recommendations deal with such changes to LSM and other pieces of legislation, which also derive from policy decisions and may include following:

- Bringing LSM into compliance with IOSCO Principles and Objectives of Regulation and CPSS-10 Principles for Financial Market Infrastructures;
- Considering EU legislation to which Georgia has committed under EU-Georgia Association Agreement even for those legislative changes which are planned for near-term implementation;
- Reflecting in LSM all policy decisions which must be preferably dealt with on the level of legislative acts rather than sub-legislative acts (regulations);
- Removing registration fee for public offering of securities from the Law on Registration Fees;

- Streamlining definitions provided in LSM and bringing them into compliance with international practices;
- Introducing tax changes leading to leveling playing field for all securities;
- Streamlining taxation of accrued interest vs capital gain tax for the securities sales between the interest payment dates;
- Replacing or revising Law of Georgia on Investment Funds in compliance with respective IOSCO principles and relevant EU directives.
- Introducing changes to the Tax Code of Georgia to ensure fair treatment of investment funds and related income streams;
- Introducing additional qualifications for priority of claims under insolvency law;
- Introducing legal aspects supporting implementation of covered bond and ABS transactions;
- Introducing local credit rating services;
- Revising legislation to eliminate unhealthy practices of issuing securities like instruments by micro finance organizations and construction companies;
- Considering regulation of the aspects of concentrated ownership of GSE in a manner which would ensure protection of interests of all stakeholders.

3. Regulatory Recommendations

Regulatory recommendations deal with changes to securities secondary legislation (sub-legislative acts) which mainly derive from LSM and include following:

- A specialized charter/provision should be elaborated for the regulator where functions and responsibilities shall be spelled out in detail and which shall ensure proactive regulation, constant oversight and monitoring of the market for new trends and necessary changes;
- Regulations should be assessed for compliance with IOSCO Objectives and Principles of Regulation and bought into compliance with these principles;
- Regulations should be brought into compliance with EU legislation in a phased manner. Near term revisions should consider EU standards as well;
- Market entry standards should be revised to allow reasonable threshold for entry of new participants on the market. Focus should be shifted to the requirements related to professional preparation of the entities/individuals;
- Initial and ongoing capital requirement should be decreased for market participants and/or replaced for ongoing prudential regulation by capital adequacy requirements to match capital requirements with the risk-taking on the market.

APPENDIX A: TABLE OF RECOMMENDATIONS FROM CM REPORT

Recommendations by Assignment of Responsibility for Completion (Recommendation #'s tied to Table 23)	
Needed Actions by the Government and Parliament	
1.	Conduct the Approximation Amendments to the LSM and related Laws in a Phased Manner
3.	Decide on the Location and Jurisdiction of the Securities Regulator
4.	Provide for Expanded Enforcement of the LoE
5.	Place the Implementation of the Accounting and Auditing Law in the Securities Regulator
6.	Specify the Regulatory Authority of the Law on Investment Funds in the Securities Regulator
7.	Adopt Specialized Laws for Covered Bonds and Securitizations
8.	Eliminate the Offering Fee
9.	Revise and Implement the Tax Exemption for Dividends and Interest from Listed Companies
10.	Revise and Extend the Exemption to Capital Gains
11.	Adopt the Proper Tax Regime for Investment Funds
19.	Reinstitute the "Number of Shareholders Test" for the Definition of Reporting Company
20.	Adopt Tiered Reporting Requirements
23.	Institute Requirement for JSCs to Report Summary Financial Information
21.	Revise the Admitted / Listed Concepts in LoE
12.	GoG offers a Minority Percentage of Shares in State-Owned Enterprises
Needed Actions by the NBG as Regulator	
13.	NBG Determines Criteria for Rated Corporate Bonds as Repo Collateral and Haircuts
14.	NBG Determines Criteria for Rated Corporate Bonds for Capital Treatment
24.	Adopt a Best Execution Rule
18.	Determine Limitations on MFOs Issuing Securities
22.	Devise a Simplified Going Private Rule
36.	Have the Regulations Translated Officially into English and Post to NBG Website
37.	Encourage Reporting by the Infrastructure Institutions in English and Post to NBG Website
38.	Become a Signatory to IOSCO's Multilateral Memorandum of Understanding on Enforcement
39.	Become a Member of IOSCO
2.	Benchmark Georgia's Compliance with Applicable International Standards
Needed Actions by the NBG as Market Operator	
34.	Establish both Monies and Securities "Legs" with Clearstream
33.	Link the GCSD with the NBG's SSS
35.	Consider a Consolidated Depository and Registry
Needed Actions by the GSE and GSCD	
28.	Finalize the GSE Reorganization
29.	Invest in Modern IT Systems for the GSE and GSCD
26.	Increase Reporting Fees for OTC Trades by Investment Firms
25.	Adopt an 'On-Exchange Rule' Binding on Members
30.	Extend Trading Session Hours
31.	Eliminate the Pre-Pay / Pre-Deliver Rule and Lengthen the Settlement Cycle
32.	Shorten the Trade Reporting Deadline and Post in Real-time
27.	Develop a Centralized Information Center for Trades, Issuers and Securities
33.	Link the GCSD with the NBG's SSS

35.	Consider a Consolidated Depository and Registry
Needed Actions by the Donor Community	
15.	Donors offer their local currency bonds in public offerings
16.	Donors list their local currency bonds on the GSE
17.	EBRD implements lines of credit for bank purchases of corporate bonds
40.	Donors provide technical assistance for approximation effort
41.	Donors provide technical assistance for capacity building for the regulator
42.	Donors provide technical assistance for adoption of Proper IT systems
43.	Donors provide technical assistance for drafting Laws on Covered Bonds and Securitization

APPENDIX B: OUTLINE OF THE DRAFT LAW ON INVESTMENT FUNDS

Draft Law of The Republic Of Georgia On Investment Funds
06/23/1999
Stan Judd
Barents Group

CHAPTER I. INTRODUCTION
Article 1. Purpose of the Law
Article 2. Application of Other Law
Article 3. Definitions (30 terms)

CHAPTER II. INVESTMENT FUNDS
Article 4. Definition and Classification of Investment Funds
Article 5. Establishment of Joint Stock Investment Funds and Unit Investment Funds
Article 6. Sub-classification of Joint Stock Investment Funds and Unit Investment Funds
Article 7. Management of Assets
Article 8. Eligible Portfolio Securities
Article 9. Diversification
Article 10. Value
Article 11. Custody of Assets
Article 12. Auditing of Assets
Article 13. Supervisory Council
Article 14. Distribution of Profit
Article 15. Restrictions on or Concerning Regulated Investment Funds
Article 16. Restrictions on Activities of Certain Persons
Article 17. Licensing of a Joint Stock Investment Fund
Article 18. Licensing of a Unit Investment Fund
Article 19. Distribution, Redemption, or Repurchase of Redeemable Securities
Article 20. Distribution and Repurchase of Securities of Closed-end Joint Stock Investment Funds
Article 21. The Publication of Prospectus, Periodic Reports, and Other Publications and Reports
Article 22. Reorganizations
Article 23. Record Keeping

CHAPTER III. INVESTMENT MANAGERS, EVALUATORS, DEPOSITARIS
Article 24. Licensing Investment Managers
Article 25. Licensing Evaluators
Article 26. Regulating Depositaries and Licensing Brokerage Companies to be Depositaries

CHAPTER IV. POWERS OF THE COMMISSION
Article 27. Inspection of Records
Article 28. Rulemaking
Article 29. Administrative Remedies

CHAPTER V. PRIVATE RIGHT OF ACTION
Article 30. Court Action

CHAPTER VI. TRANSITIONAL PROVISIONS, RELATED LAWS AND FINAL PROVISIONS
Article 31. Licenses of Existing Joint Stock Investment Funds and Investment Management Companies
Article 32. Related Laws
Article 33. Entry into Force of the Law

APPENDIX C: TABLE OF EU DIRECTIVES AND REGULATIONS

#	Indicated under AA Agreement	Newer instrument	Approximation timeline
C. SECURITIES			
1	Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments		Directive's provisions shall be implemented within five years of the entry into force of this Agreement.
2	Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organizational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive		Timetable: that Directive's provisions shall be implemented within seven years of the entry into force of this Agreement.
3	Commission Regulation (EC) No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive		Timetable: that Regulation's provisions shall be implemented within seven years of the entry into force of this Agreement.
4	Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC		Timetable: that Directive's provisions shall be implemented within seven years of the entry into force of this Agreement.
5	Commission Regulation (EC) No 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements		Timetable: that Regulation's provisions shall be implemented within seven years of the entry into force of this Agreement.
6	Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonization of transparency requirements in relation to		Timetable: that Directive's provisions shall be implemented within seven years of the entry into force of this Agreement.

	information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC		
7	Commission Directive 2007/14/EC of 8 March 2007 laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market		Timetable: the provisions of Directive 2007/14/EC shall be implemented within seven years of the entry into force of this Agreement.
	Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes		Timetable: that Directive's provisions shall be implemented within six years of the entry into force of this Agreement. However, Georgia may consider different levels of thresholds for the investor compensation schemes and will submit a proposal to the Association Council taking into account the development of local market in Georgia, no later than five years after the entry into force of this Agreement.
	Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse)		Timetable: that Directive's provisions shall be implemented within five years of the entry into force of this Agreement.
	Commission Directive 2004/72/EC of 29 April 2004 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions and the notification of suspicious transactions		Timetable: the provisions of Directive 2004/72/EC shall be implemented within seven years of the entry into force of this Agreement.
	Commission Directive 2003/124/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation		Timetable: the provisions of Directive 2003/124/EC shall be implemented within seven years of the entry into force of this Agreement.
	Commission Directive 2003/125/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of		Timetable: the provisions of Directive 2003/125/EC shall be implemented within seven years of the entry into force of this

	the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest		Agreement.
	Commission Regulation (EC) No 2273/2003 of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards exemptions for buy-back programmes and stabilization of financial instruments		Timetable: that Regulation's provisions shall be implemented within seven years of the entry into force of this Agreement.
	Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies		Timetable: that Regulation's provisions shall be implemented within seven years of the entry into force of this Agreement.
D. UNDERTAKINGS FOR COLLECTIVE INVESTMENT IN TRANSFERABLE SECURITIES (UCITS)			
	Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)	Amended by Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions	Timetable: that Directive's provisions shall be implemented within six years of the entry into force of this Agreement.
	Commission Directive 2007/16/EC of 19 March 2007 implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions	N/A	Timetable: the provisions of Directive 2007/16/EC shall be implemented within six years of the entry into force of this Agreement.
E. MARKET INFRASTRUCTURE			
	Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements		Timetable: that Directive's provisions shall be implemented within five years of the entry into force of this Agreement.

	Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems		Timetable: that Directive's provisions shall be implemented within five years of the entry into force of this Agreement.
	Directive 2009/44/EC of the European Parliament and the Council of 6 May 2009 amending Directive 98/26/EC on settlement finality in payment and securities settlement systems and Directive 2002/47/EC on financial collateral arrangements as regards linked systems and credit claims		Timetable: the provisions of Directive 2009/44/EC shall be implemented within five years of the entry into force of this Agreement.

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