FINANCIAL SECTOR DEVELOPMENT PROJECT

ADVISORY ASSISTANCE TO THE BANGLADESH SECURITIES AND EXCHANGE COMMISSION (SEC)

Contract #PCE-0025-Q-00-3071-00
Delivery Order #39

June 1997

Author: Molly G. Bayley

Barents Group LLC
20001 M Street, NW
Washington, DC 20036

Executive Summary

Commencing in July, 1996, the stock market in Bangladesh began a dramatic upward rise sparked by an unprecedented influx of retail investors into the stock market.

Reasons given for the sudden retail euphoria include investor's confidence in the new government and its economic growth policies, expectations of political stability, withdrawal of capital gains on bonus shares, the introduction of a quota for non-resident Bangladeshis and proposals to launch mutual funds and other investment vehicles. However, none of these reasons seems to adequately explain the remarkable surge in retail interest in the stock market.

Retail interest grew so rapidly that the stock exchanges were unable to meet the demand. As a result, an active market emerged on the "kerb" outside the exchanges where actual certificates were bought and sold for cash.

As could be expected, having risen with such rapidity and without any regard to fundamentals, the market eventually fell precipitously beginning in mid-November and continued through the month of January, 1997, with a disastrous impact on the new retail entrants into the market. In the aftermath, there were allegations of manipulation and insider trading on the stock exchanges.

The Securities and Exchange Commission (SEC) intends to take steps now which will enable it to address future episodes of market volatility more effectively. The findings and recommendations in this report are intended to direct the Commission to those reforms that can be carried out in the short term.

The market bubble highlighted systemic deficiencies in the stock market and drew attention to the critical need for regulatory reform. The trading capacity of the stock exchanges proved to be woefully deficient. The inability and unwillingness of broker members of the exchanges to handle retail customers contributed to the problem and fueled the growth of the kerb market. These systemic deficiencies in the market must be addressed in the short term.

The SEC is a very small organization by comparison to similar organizations in other developing markets. In fact, it is too small to fulfill its mandate. Because of its lack of staff, the Commission hasn't promulgated regulations or established a regulatory program in many areas where it has jurisdiction. Further, it has met overt resistance to its regulatory jurisdiction from the Dhaka Stock Exchange and its members who have significant influence in the private and public sectors.

The Commission staff must be significantly increased and its regulatory programs in all areas expanded. The Commission should use its considerable authority to compel necessary reforms at the exchanges.

Summary of Findings, Conclusions and Recommendations

Existing Laws and Mechanisms Regulating the Secondary Market

1. Require the DSE to increase the capacity for trading on the floor of the Exchange by adding additional trading booths, assigning securities to booths by volume, increasing the number of rotations securities are traded, eliminating the use of microphones, adding additional exchange staff to the trading booths to record trades, and introducing a different system for confirming transactions in order to allow traders to concentrate on trading. (Action: SEC/DSE)

2. Require the exchanges to implement small order execution systems which will allow retail customers to send orders to the floor of the exchange for automatic execution without the intervention of a broker. Include incentives for members to participate in such a system. (Action SEC/DSE)

3. Require the exchanges to take steps to increase the number of active members by selling new seats and requiring inactive members to either lease or sell their seats. Require new market entrants to agree to take on retail customers. (Action SEC/DSE)

4. Require the DSE to hire independent, professional management staff not drawn from the Council or the membership. (Action SEC/DSE)

5. Require the exchanges to establish maintenance criteria for securities listed on the exchanges, including the number of shares not held by officers and directors ("public float") and minimum trading volume, and remove from listing all securities that fail to meet the new criteria. (Action: SEC/DSE)

Regulating the Kerb Market

1. Consider legitimizing the kerb market by taking a series of gradual steps aimed at structuring the market.

Institutional Strengthening of the SEC

1. Advocate for the adoption of the proposed SEC organizational plan and for an increase in the number of staff as outlined in Annex D. (Action: SEC)

2. Expand the manual market surveillance program. (Action: SEC)

3. Take an increased number of enforcement actions to deter manipulation and insider trading, to address false and misleading information in prospectuses, to reinforce the books and records requirements for broker/dealers, and to encourage the preparation of accurate financial statements. (Action: SEC)

4. Revise the process for review and approval of IPOs by introducing a single stage process, reducing emphasis on merit regulation and ensuring full disclosure, placing the burden on the issuer company to submit appropriate certifications, and relying on underwriters and sponsors of the issue to conduct due diligence investigations in order to provide the Commission and the public with greater comfort on the accuracy of the company's assertions. In addition, cease accepting registration applications which are incomplete on their face. (Action: SEC)

CONTENTS

ANNEXES

Annex A -	List of Individuals Interviewed
Annex B -	List of Individuals In Attendance at Dinner of Charge d'affaires on February 23, 1997
Annex C -	List of Documents Reviewed
Annex D -	Proposed SEC Organization Chart, Functional Chart and Personnel Distribution
Annex E -	Expanded Guidelines for Manual Market Surveillance Program
Annex F -	SEC Document Entitled "A brief Note of the Recent Situation at the Stock Market in Bangladesh"
Annex G -	Revised Securities Act Rule 31(a)-3 of the Philippine SEC entitled "Prohibited Transactions in Securities Where Broker or Dealer and Issuer are Linked"

I. Background

Commencing in July, 1996, the stock market in Bangladesh began a dramatic upward rise fueled by unprecedented demand from retail investors which continued until November, 1996. During this period, market capitalization rose by over 256%, average daily volume increased on the Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE) by over 1000% and the Dhaka All Share Price Index rose by over 260%.

Despite the fact that 35 new securities began trading on the two Exchange between July and November, demand for stocks continued to exceed available supply.

Reasons given for the sudden retail euphoria include investor's confidence in the new government and its economic growth policies, expectations of political stability, withdrawal of capital gains on bonus shares, the introduction of a quota for non-resident Bangladeshis and proposals to launch mutual funds and other investment vehicles. However, none of these reasons seem to adequately explain the remarkable surge in retail interest in the stock market.

Small retail investors from all walks of life bought stock, at times selling valuables and liquidating other investments in order to participate in the market. It is estimated that the number of retail investors jumped three fold during the period.

The market grew so rapidly that the members of the DSE and the CSE were unable to meet the demand. As a result an active market on the "kerb" outside the DSE materialized where actual certificates were bought and sold for cash. During the peak of the market rise, as many as 25,000 people congregated in this kerb market buying and selling shares.

The stock market having risen with such rapidity and without any regard to fundamentals was bound to enter a period of correction or decline. The decline began in mid-November and continued through the month of January, 1997, with a disastrous impact on the inexperienced and naive small retail investors who had invested their life savings in the mistaken belief that the stock market could only go up.

In the aftermath, there were allegations that manipulation and insider trading on the DSE and CSE had fueled the price rise. Fraudulent share certificates were found to have been sold in the kerb market.

The SEC is concerned that this type of market phenomenon, referred to as a "bubble", could occur again in the future. It wants to take steps now which will enable it to address future episodes of market volatility more effectively.

Methodology

During a one week period at the end of February, 1997 the consultant met with the Chairman and the two Members of the SEC, all of the program officers at the SEC, officials of the DSE and CSE and several individuals in the private sector. A list of the individuals with whom meetings were held is contained in Annex A. A list of attendees at a dinner party held by the Charge d'Affaires of the U.S. Embassy is also included in Annex B. These meetings were designed to help the consultant to gain insights into the cause of the bubble and to identify deficiencies in the structure and regulation of the market which may have contributed to the bubble and to develop recommendations for change to address unrestrained rises and falls in the market in the future. As further background for the review, a large number of documents were made available to the consultant. A list of these documents is contained in Annex C.

Meetings both inside and outside the SEC enabled the consultant to briefly examine the Commission's organizational structure, the new market surveillance procedures, the process for the review of Initial Public Offerings (IPOs), the monitoring of public companies for compliance with reporting requirements, and the DSE and CSE trading and clearing operations.

The findings summarized below set forth the results of the consultant's review of these SEC functions and the operation of the Bangladesh stock market.

Summary of Findings

Before setting forth specific findings, it is important to point out that they are based on a one week visit to Dhaka. As a result, there was a limited amount of time to delve into any one area in depth. Further, not all effective laws and rules were able to be reviewed due to the fact that they are not yet translated into English or are not readily available in English. The consultant is grateful to the SEC Chairman for having made it possible to spend time with all key staff of the Commission and to the private sector individuals and representatives of donor agencies who made their time available for meetings.

II. Organization of the SEC

The SEC is a very small organization by comparison to similar organizations in other developing markets. It has eleven (11) professional staff, three of whom are the Chairman and the two Members of the Commission. It is clearly impossible for an SEC of this size to fulfill its mandate to regulate effectively the capital markets and protect the public interest.

The present Chairman joined the Commission in August, 1996 and the two Members of the Commission assumed their positions in January, 1997 when the former Members were forced to resign as a result of allegations of irregularities. This new leadership team appears to be committed to reorganizing and expanding the staff and enhancing the regulatory effectiveness of the SEC. This is an encouraging sign in light of the lack of progress to date in implementing regulatory reforms initiated through a technical assistance grant by the Asian Development Bank in 1994 and 1995.

The Commission was established by the Securities and Exchange Commission Act of 1993 and it commenced operations on early in 1994. The Commission's relative newness and small staff have contributed to limiting its regulatory effectiveness. It hasn't promulgated regulations or established a regulatory program in many areas where it has jurisdiction. Further, it has met overt resistance to its regulatory jurisdiction from the Dhaka Stock Exchange and its members who have significant influence in the private and public sectors. Given these constraints, the Commission has achieved a reasonable amount of success during its short lifetime.

Generally speaking, the primary functions of any SEC include registration of public securities offerings and continuing regulation of reporting by public companies; registration (or licensing) and regulation of intermediaries such as brokers, dealers, salesmen, authorized assistants, underwriters, etc.; oversight of exchanges and self regulatory organizations; and enforcement. The present leadership of the SEC has recognized the shortcomings in the Commission's present structure and are committed to expanding the staff and reorganizing the staff's functions into a logical framework to provide more effective regulation of the markets.

The SEC's proposed organization chart, functional chart and personnel distribution matrix which are included in Annex D reflect an appropriate reorganization of the SEC into a structure which covers all of the critical functions of an SEC. In particular, this proposed structure brings together the review of registration statements and the regulation and monitoring of on-going reporting by public companies under one Division rather than the present structure which calls for these functions to be handled separately. Similarly, it places the licensing and continuing regulation of intermediaries in one Division, whereas today they are handled by two separate Divisions. The assignment of functional responsibilities by "program" is both logical and more efficient and will help the Commission carry out its regulatory responsibilities more effectively.

The proposed organization chart also calls for the addition of a General Counsel and a Chief Financial Analyst to the Commission staff, both of which are critical positions if the Commission is to achieve its regulatory objectives. Without the expertise of a chief legal advisor and a chief accounting advisor, the Commission staff have been unable to draft and implement critical regulations and to enforce effectively the requirements relating to the filing of audited financial statements by corporations.

Finally, the proposed distribution and number of staff are reasonable given the scope and importance of the Commission's mandate to regulate the capital markets and to protect the interests of investors. The present staffing where the eight (8) officers of the Commission have no subordinate staff to assist them in carrying out their responsibilities is unworkable. Without an increase in staff as proposed in Annex D, the Commission cannot be expected by the government or the private sector to be an effective regulator.

III. Market Surveillance

Until recently, there was no market surveillance conducted at either the DSE or the CSE. In the aftermath of the bubble, the SEC established a joint team of two persons - one from SEC and one from the DSE - to conduct floor and market surveillance over trading on the DSE. Despite the fact that this was expected to be a joint activity, it is in fact being carried out by one SEC staff.

The manual market surveillance procedures being followed by the SEC are a good beginning. Each day the SEC staff member spends time in the trading booths at the DSE observing trading and looking for unusual transactions. After observing trading, the individual returns to his office where he reviews three reports. First, he reviews the list of daily transactions on the DSE for stocks that have traded more than 10% up or down without imposition of the required circuit breaker and for trades that seem unusual either in size or price. Second, he reviews the daily list of trades that have defaulted for settlement on T+2 due to delay in submission of properly endorsed certificates, non-submission of monies due or a check returned for insufficient funds. The third report he reviews is the daily Delivery Versus Payment (DVP) Report which lists trades projected to settle by DVP on T+4.

These procedures provide an initial framework for an effective manual market surveillance program. Despite the limited nature of the program it has already proven to be effective as witnessed by the remarkable reduction in the number of trades that default on settlement on T+2 since the market surveillance program began.

At the SEC Chairman's request, recommendations for expanding the present manual procedures are detailed in Annex E.

IV. Review of Initial Public Offerings

The Commission has one staff person dedicated to the review of documents pertaining to initial public offerings. This review is a two stage process where the first stage involves on average a two to three month period to determine whether the company should be allowed to apply for registration (the consent stage). At the conclusion of this first stage the company is issued a consent order which stipulates a list of standard conditions the company must meet before it can return for the second stage. Within a year of receiving the consent, the company must have met the standards and must file a draft prospectus (the approval stage) which again takes on average two to three months to be processed. If the review is successfully concluded, the company receives an approval for registration and is directed to apply for listing on both stock exchanges. If the company is not granted listing, it must return all funds received from the public within 40 days.

During both stages of the review process, the SEC scrutinizes the documents filed by the company and verifies the statements and information presented. In addition, they contact the National Bureau of Revenue to determine whether the company has paid all of its taxes and they check with the Credit Information Bureau of the Bank of Bangladesh to determine the credit status of the company. They may visit the company to inspect the facilities and they usually verify the ownership of land through public records. Many of the procedures followed by the staff constitute a "merit review" of the company to determine whether it should be granted registration status.

The information contained in the two sample prospectuses reviewed by the consultant seemed reasonably extensive, however, the risk factors were de minimis as compared to the "highlights for potential investors." The SEC staff also acknowledged that the Commission does not have the expert staff needed to review the financial statements submitted by companies to determine their compliance with international accounting principles (IAAP) as required by the 1987 rules. This is a serious concern in light of frequently expressed allegations that accountants are not knowledgeable about the IAAP and that they are not truly "independent." As a result, the Commission should consider establishing a licensing program for auditors who wish to practice before the SEC in certifying financial statements required to be filed with the Commission. Such a program would entail the development of an examination on international accounting standards and specific requirements for the preparation of financial statements as set forth in the 1987 rules. The exam would be required to be passed by all auditors wishing to be licensed by the SEC and financial statements filed by public companies with the Commission would be rejected unless certified by a licensed auditor. This program would not interfere with the existing requirements for certification as a CPA but would simply establish higher criteria for practicing before the Commission justified by the Commission's mandate to protect the interests of investors. SEC's leadership on this issue could have the beneficial result of raising auditing standards throughout Bangladesh.

The private sector has expressed two concerns with regard to the SEC's review of IPOs. First, that the registration process takes too long and, second, that the guidelines for registration issued by the Commission are too restrictive and stifle innovation. The consultant's brief review of the process gives some credence to these complaints. The Chairman of the SEC has requested recommendations on how the process can be streamlined.

The SEC's present registration process involves merit regulation which by its nature can be time consuming and slow. Merit regulation involves reviewing the merits of every offering to determine whether it should be allowed to be sold to the public. The purpose of such a review is to protect unsophisticated investors from risky investments particularly in a market where there is little or no public understanding of the stock market. The problem with the merit review process is that it assumes that the SEC is expert in all industries, is sufficiently knowledgeable to ask questions which will identify weaknesses in a particular company's operations and plans and, ultimately, is a competent judge of the merits of a particular investment. This is clearly not possible. SECs that try to carry out merit reviews are frequently troubled by the reality of their capabilities as compared to the high expectations of the public.

"Full disclosure", which has been the policy of the U.S SEC for many years and is increasingly being adopted by developing markets, is an entirely different approach to the registration process. The purpose of full disclosure is to ensure that all information important to making a decision whether to buy the stock is included in the prospectus. Under such an approach, the SEC does not pass judgement on the merits of the offering, however, it does insist on the company disclosing under a section entitled "risk factors" in the prospectus all of the negative information on the company's prospects. Additionally, the prospectus is strictly prohibited from being a sales document and is limited to setting forth factual information on the company's business and financial operations.

The concern expressed by developing markets about the full disclosure approach as compared to merit regulation is that it assumes that investors read prospectuses and are able to reach informed decisions on their own. This is a valid concern. In a fully developed market, investors are guided in their investments by salesmen employed by broker/dealers who are required by rules to "know their customers" and to recommend investments based on the customer's financial profile. Additionally, the availability of mutual funds in developed markets provide alternatives to small investors who do not want to or cannot make their own investment decisions.

In a developing market, the best approach is full disclosure coupled with some merit regulation. The underlying principle in every market should be that every company seeking to sell its securities to the public should disclose all material information on the company's financial and business operations in its prospectus and throughout its life as a public company. Implementation of this full disclosure principle is critical to ensuring the development of a fair, transparent and efficient market for the protection of investors in any country.

In order to provide unsophisticated investors in Bangladesh with additional protection, the SEC should consider applying certain merit criteria in addition to requiring full disclosure. Such matters as profitability and experience of management could be subjects of additional requirements. To the extent that these "merit criteria" are objective and within the competence of the SEC to determine, the easier they will be to administer. If they are clear and objective they will also be fairer to companies seeking registration. In order to emphasize to the public that the Commission's registration of a company does not mean that the Commission endorses the company as a good investment, the following statement or similar language could be required to appear in bold letters on the front of the prospectus:

> **The Securities and Exchange Commission has not approved these securities or determined if this prospectus is accurate or complete. Any representation to the contrary is a criminal offense and should be reported immediately to the Securities and Exchange Commission.**

The Bangladesh SEC's registration process is bogged down by many steps that fall into the category of merit regulation. Each step in the process and each information requirement should be reviewed to determine whether it is critical to determining whether the company should be granted registration. If not, then a determination should be made whether the information required is critical for an investor to determine whether to buy the stock. If the information is not needed for either of these reasons then it should no longer be required to be submitted as part of the registration process.

Secondly, all steps in the present process which lend themselves to disclosure by the issuer should be so converted. For example, in order to verify that the company owns the land that it includes in its financial statements, the company could be required to submit with its registration statement copies of the relevant land ownership records. Rather than SEC staff contacting the Credit Information Bureau to ascertain the company's credit status, the company could be required to attach a statement from the Bureau confirming its credit status. Through this procedural revision the Commission can shift the burden of providing the necessary disclosures to the company thereby streamlining the process and saving Commission staff resources.

The Commission also should collapse the IPO registration process into one stage. There does not appear to be any particular advantage to the two stage process and handling it as one will reduce the burden on both the Commission and the registrant without compromising the amount of information available to the Commission or the public.

The Commission has included in its draft IPO guidelines certifications to be submitted by the issue manager as well as the investment advisor that they have conducted a due diligence investigation and that all disclosures in the prospectus are "true, fair, and adequate". Requiring the underwriters of the issue to conduct due diligence investigations and to make such a certification provides additional protection to investors while at the same time reducing the burden on the SEC to conduct a similar investigation. The draft guidelines also require the company's officers and directors to sign a statement that they have verified the information in the prospectus and certify to its accuracy. The Commission should be able to rely on both the company's statement and the due diligence certifications in its registration process.

Because the Commission will be relying on these certifications to assure the accuracy of the prospectus, if any information in a prospectus is found to be false, misleading or otherwise in violation of the Commission's rules, the underwriters and the company should be penalized severely. This is a critical matter, particularly in light of the fact that the Commission will be doing less verification on its own motion under a streamlined registration process. Experience will dictate where the staff should continue to verify records and where it can rely exclusively on submission by the company. For example, in one case a company's statements with regard to its payment of income taxes were found to be false upon verification of the information with the Bureau of Internal Revenue. This company and its underwriters should be sanctioned and its registration statement denied. By publicizing an enforcement action of this nature, hopefully the Commission will deter other companies from submitting false and misleading information in their registration filings.

Finally, the Commission should publish clear registration requirements and thereafter refuse to accept any registration filing that fails materially to meet the requirements. SEC staff indicated that companies provide required documents on a piece meal basis and that this has the effect of prolonging Commission review. Not only does this approach waste limited Commission resources, it results in the Commission being unfairly blamed for the lengthy time it takes to process a registration.

On a totally separate matter, the Commission's rules presently dictate how the shares in a public offering should be allocated, with certain percentages given to the Investment Corporation of Bangladesh, as well as to foreign investors, small investors, overseas workers, etc. These requirements were designed to meet certain policy objectives of the government with regard to the distribution of IPOs, however, they are having certain unintended effects. Shares of an IPO which are distributed to foreign investors, the ICB and overseas nationals are likely to be held for long term investment. Thus, these shares will not be part of the floating supply of stock that is generally available for trading. The amount of shares in the floating supply of a stock often determines whether it is liquid or thinly traded. One of the problems identified as a factor in causing the bubble was an insufficient supply of stocks. Insufficient float in the stocks that are available for trading could also contribute to the lack of supply. The present required allocation of shares of IPOs should be studied to determine whether it is having the detrimental effect of reducing the floating supply in newly listed securities. If so, revisions to the allocation requirements or requiring public companies to increase the number of shares offered to the public should be implemented.

V. Supervision and Monitoring of SEC Registrants

Reporting requirements for public companies are included in the 1994 Companies Act and in the Securities and Exchange Rules of 1987. These requirements include semi-annual and annual reports and detailed guidelines for preparing financial statements in accordance with the IAAP. Reports are required to be filed with the SEC and with the stock exchanges where the company's shares are listed and sent to stockholders. However, these reports are not made publicly available at the offices of either the Commission or the exchanges.

In connection with its monitoring of corporate filings, the SEC writes each of the 191 public companies to remind them of their half-yearly filing requirement. Similarly, they write companies regarding the requirement to hold their Annual General Meeting (AGM) in accordance with the Companies Act. The SEC individual responsible for this monitoring pointed out that prior to the establishment of the Commission, more than 50% of public companies failed to hold their AGM and pay dividends. With the reminder notices, at present very few companies fail to adhere to these requirements. With this improved track record, it would be appropriate for the Commission to discontinue this practice and focus its limited resources on taking actions against the few companies that fail to take responsibility for meeting their reporting requirements.

Some concerns have been expressed about the lack of restrictions on sales by officers, directors, and 10% holders in the immediate period following the public offering. Such restrictions, better known as "lock up provisions", prohibit such persons from selling their holdings which were acquired prior to the public offering for a prescribed period of time. This protects investors from the adverse effect of sudden or heavy sales by insiders right after the stock is first publicly traded. In addition to establishing a lock up provision, the Commission should require reports of holdings by officers and directors which are presently required to be filed with the Registrar of Companies to also be filed with the Commission. This will assist the Commission to monitor for insider trading as well as to enforce the lock up provision.

As noted earlier, although corporate financial statements are required to be prepared in conformance with the IAAP, very few accountants are knowledgeable of these requirements. Since the Commission staff is also not skilled in reviewing financial statements, there is a high degree of likelihood that financial statements are not properly reflecting the current condition of public companies.

Beyond granting licenses to brokers and dealers, the Commission has not had sufficient staff to put in place a full blown program for regulating brokers and dealers. It undertakes inquiries or on-site audits of firms on an exception basis when a complaint is filed. As it expands its market surveillance program, the Commission is likely to be conducting more audits of exchange members. Since there hasn't been a regular program of broker/dealer audits, it is likely that the books and records of firms will be found to be in poor condition during initial examinations. Without accurate books and records, however, the Commission will have difficulty assembling the necessary proof to establish rule violations during investigations. Once firms have been educated by the exchanges on the books and records requirements, if a firm has inadequate books and records, serious penalties should be assessed against the broker. This kind of enforcement action will act as an incentive to firms to maintain proper books and records.

VI. Structure and Regulation of Stock Exchanges

The SEC registers exchanges and must approve all of their regulations. It has significant powers over the exchanges, including the power to remove officers and directors, if warranted.

The CSE was organized within the last two years and thus its separate professional management structure and its regulations, which are published in a bound volume, reflect significant input from the SEC. Probably as an outgrowth of the cooperative effort involved in forming the CSE, the Exchange and the SEC appear to have a healthy working relationship. All of the 71 members of the CSE are corporations and are required to have net capital of 2,500,000 taka ($58,000).

The DSE, on the other hand, has been in existence since 1954 and its management is drawn directly from the ranks of its 195 members. DSE's written rules are badly outdated, not available in published form, and do not appear to reflect current practices. Members of the DSE are required to meet the minimum capital requirement in the 1987 rules of 25,000 taka ($580). Generally speaking, the management and the governing Council of the Exchange view the SEC as an unknowledgeable meddler. They more often than not ignore the Commission's directives which poses a challenge to the Commission's authority and effectiveness. For example, several months ago the Chairman of the SEC wrote the Exchange directing that it computerize its trading system, separate the management of the Exchange from the policy-making Council and increase its membership in order to assure transparency, accountability and services. In response to the Commission's directive, the Exchange has taken steps to acquire an automated trading system but no progress has been made on either of the other equally important directives.

The SEC Chairman specifically requested the consultant's views on the issue of separation of the management of the Exchange from the governing body. The installation of highly qualified management separate from the members of the Exchange is an important step towards professionalizing the Exchange. It is critical for the exchange to understand its responsibility as a public institution to provide a fair, transparent and efficient market for the protection of investors. Only a professional management team not involved in day to day trading can implement the kind of self regulatory program that is needed to ensure the achievement of this important mission. The SEC must take every step necessary to force the DSE to hire professionals to manage the Exchange.

The other directive of the Commission that the DSE increase its membership is equally important in light of the fact that one of the causes of the bubble and the emergence of the kerb market was the inability of the DSE to handle the sudden and extraordinary influx of retail investors. One way of increasing the institutional capacity of the Exchange is through changes to its membership base.

By the Exchange's own admission, of its 195 members, only about 100 are active on the Exchange. The Exchange has an additional 55 memberships that it is considering selling in order to increase its trading capacity. Consideration is also being given to instituting a set of performance standards, including requiring a certain level of trading activity, which would have to be met in order for a member to retain its membership in the Exchange. If it is not feasible to require members who do not meet the performance criteria to sell their seats then they should be required to lease their seats to someone desiring entry to the Exchange. For all new entrants to the Exchange, whether through a leasing arrangement or through the purchase of a membership, the Exchange should require each firm to commit to handling a certain amount of retail business.

In an effort to increase the capacity of the Exchange to handle retail business, the Exchange should offer an education program on the servicing of retail clients so that members who want to do retail business but do not know how to will be better prepared to expand this aspect of their business. The Exchange should also explore changes to its fee structure in order to provide incentives to members to expand their capacity to handle retail transactions. The Exchange should also join with the SEC in educating the investing public on the stock market and how to do business with a stock broker.

Another concern the Commission has expressed is in the composition of the governing body of the exchange, or the Council in the case of the DSE. In many markets around the world, the exchanges are expanding their governing bodies to include representatives of listed companies, retail and institutional investors, and other independent individuals from the public or private sectors who bring a broader perspective to policy making at the Exchange. These changes in governance of the exchange are appropriate in light of the role and responsibilities of the exchange to provide a fair, transparent and efficient market for the protection of investors. The old style exchange which operates as an exclusive "club" is no longer accepted nor appropriate in today's global markets. The public interest must be safeguarded by broad based representation on the governing body of the exchange.

The net capital requirements of the DSE and the CSE are insufficient given the present volatile market conditions in Bangladesh. With members increasing their retail business, there is a need to provide additional financial safeguards for the protection of customer money and securities. Over the long term, the Commission should consider requiring the exchanges to provide a fund for the reimbursement of customer losses in the event of a financial default or in the case where a member has committed fraud.

Neither the CSE nor the DSE have programs for market surveillance or audits of their members' books and records, activities generally considered prerequisites of a self regulatory organization. However, both the DSE and the CSE have demonstrated a willingness to enforce their very strict settlement rules which call for banning a member from the floor if he fails to meet his payment or delivery obligations.

VII. Enforcement Activities

According to the Final Report entitled "Institutional Strengthening of the Securities and Exchange Commission in Bangladesh" prepared for the Asian Development Bank at the conclusion of a technical assistance project in 1995, "the SEC has extensive authority in relation to its objectives and that its authority is adequate in both the short and long term to enable it to carry out its legislative mandates, including its enforcement powers."

During discussions with the staff the consultant was apprised of several cases where, as a result of its monitoring activities, the Commission had fined companies who failed to pay dividends or hold their AGM as required or who failed to use funds as proposed in their prospectus. It was not learned whether the Commission has taken any actions against brokers or dealers. The staff also indicated that it has generally had cooperation from companies and broker/dealers when it requests information in connection with investigations.

The Commission appears willing to take disciplinary actions, and it has had some initial success in enforcing its rules. However, the extent of its enforcement activity has been severely limited by its small staff. This is a significant problem since rules without enforcement are meaningless. Enforcement acts as a significant deterrent to wrong doing and builds investor confidence in the market. In light of the recent bubble and the damage to public confidence in the market, there is a critical need for more enforcement actions to be taken by the Commission. Given its limited staff, the Commission must select matters carefully for investigation and enforcement action. Cases which are clear cut and will serve as a significant deterrent to future violations should be pursued. In particular actions should be taken to address false and misleading prospectuses, inaccurate or misleading financial statements, manipulation of stock prices, insider trading and failure to maintain required books and records. Commission actions should be sufficiently harsh and publicized widely in order to obtain the maximum deterrent effect.

VIII. Trading, Clearing and Settlement Procedures on the DSE

Trading in the 211 securities listed on the DSE is conducted in two "booths" commencing at approximately 10:30 a.m. each day. The securities are assigned to Booth A or B on a random basis without regard to their level of trading activity. In addition to the partner of the firm, members of the Exchange are allowed to have four authorized representatives on the floor of the Exchange. Only one representative of the firm is allowed in each of the trading booths at any one time. Trading in the booths is conducted by what is termed "open outcry" with individuals standing several rows deep behind a horseshoe configuration of tables. Two employees of the Exchange are seated at the front of the horseshoe.

One of the employees, using a microphone, calls out each security on the list of securities assigned to that booth. If there is interest in trading that security, orders are shouted out and the Exchange employee confirms the trades over the mike as they are done. The other employee records the identification of the buyer and seller and the amount and price of the trade on a log sheet. Once a log sheet is filled (each sheet holds about 10 trades) it is circulated along the tables so that the buyers and sellers can affix their signatures to their trades thereby confirming the details. Trading continues in each stock until all interest is satisfied and then the name of the next security on the list is called.

The name of each security assigned to that particular booth is read one time. If a member fails to be present in the booth at the time the security he wants to trade is called, he will have to wait until the following day to try to execute his orders.

As soon as the log sheet of executed trades is signed by buyers and sellers it is given to an employee seated nearby at a computer terminal. He enters the details of each trade on the log sheet into the terminal and a printer nearby prints out three copies of the confirmation, or "howla", for each trade, one for the buyer, one for the seller, and one for the Exchange. Subsequently, both the buyer and seller must stop by the computer section and sign each of the three copies of the "howla", again confirming the details of the trade.

Buyers and sellers must settle their trades on T + 2. Sellers must present the certificate with a Transfer Form attached which has been endorsed by the company indicating that the securities are good for transfer. Buyers must present a check made out in favor of the Exchange Clearing House. Buyers and sellers receive their certificates and payments from the Clearing House on T + 4.

Without a doubt, the DSE is the noisiest exchange that the consultant has ever visited, and that includes all of the futures exchanges and most of the stock and options and equity exchanges in the U.S. The use of the microphones in the two trading booths raises the noise level to the point that it actually hurts the eardrums. This certainly raises questions as to how the traders actually can hear what orders are being shouted out so that the best bids and offers can be satisfied. It was suggested by one individual with whom the consultant met that the members of the Exchange who are relegated to the end of the horseshoe have little chance of executing orders.

A second concern relates to the process which requires the trade log to be circulated for confirming signatures during the trading session. While it is clearly desirable to make certain that trades that are heard as being "done" by the Exchange employee are indeed agreed upon, it must be difficult for traders to trade while at the same time confirming the details of trades executed earlier. Because the signing of the "howla" forms can be accomplished at any time, presumably even after trading concludes, this procedure has less chance of disrupting trading. However, it is not clear why it is necessary to have the details of each trade confirmed twice.

While the requirement to have the transfer form endorsed by the company prior to the submission of the certificate on T + 2 undoubtedly presents problems for sellers, given the potential for fraudulent certificates to be presented for settlement, it seems advisable to continue this practice.

One of the reasons cited for the bubble and the growth of the kerb market was the inability of the DSE and the CSE to handle the sudden increase in retail demand. While this extraordinary surge in buying interest would have been a challenge to any market, the trading capacity on the DSE should be enhanced in order to respond to this level of retail interest. While the Exchange plans to install an automated trading system within the year, changes should be instituted in the short term to increase the amount of trading that can take place under the manual system. In addition, care should be taken to insure that the automated trading system installed by the Exchange does not perpetuate the constraints of the present manual system.

Steps could be taken by the Exchange to enhance its trading capacity without significant change to its trading procedures. Additional booths can be added so that the list of securities assigned to each booth will be fewer and trading can be conducted more than once in each security on each day. Also, securities should be assigned to each booth so as to ensure that very active securities are spread evenly among the booths.

Inactive securities should be de-listed from the exchange through the adoption and enforcement of maintenance listing criteria which include a minimum number of shares held by the public otherwise known as the public float (which excludes shares held by officers, directors and 10% holders) and minimum trading volume. By removing inactive securities from the exchange and thereby from the rotation list in the trading booths, the number of times that each security could be traded in any one trading day would be further increased. DSE staff raised concerns about delisting inactive securities because it could disadvantage current shareholders of those securities. However, experience has shown that the thinner the trading market in a security the more likely it is to be manipulated. For this reason alone, delisting inactive securities is advisable. It was noted that some securities which have not traded for a number of months or even years are included in the daily list of transactions with a "stale" price while other inactive securities are listed "NT" or not traded in the listing. This raised a concern whether the securities with stale prices are included in the daily all share index calculation. It would be prudent for the Commission to have an independent verification conducted of the index calculation.

The microphone should be removed from the trading booth. With a smaller number of securities assigned to each booth, the trading crowd might be diminished.

In any case, other markets where the open outcry method of trading is used, there is no need for microphones. Traders become skilled at shouting and hearing each other's bids and offers. In order to ensure that the Exchange staff capture the details of all trades executed, they could be stationed at more than one place in the crowd. This would ensure that "the highest bid or the lowest offer for an issue is given the priority on all bids or offers" as stated in the DSE brochure entitled "Introduction to the Dhaka Stock Exchange".

An alternative to circulating the log sheet among the members in the booth for confirmation during trading should be introduced. For example, if each member in the booth had an assistant who stood behind him, that person could be responsible for confirming the details of the trade outside the booth. Every effort should be made to minimize disruptions to the trading process in the booth which diminishes the capacity of traders to execute trades.

During the bubble, demand from retail customers clearly outstripped the capacity of the members of the Exchange to handle such transactions. Serious consideration should be given to introducing a process whereby retail customer orders can be delivered to the Exchange for automatic execution without any intervention on the part of the members of the Exchange. Variations on this type of small order execution system (SOES) are employed on several equity and options exchanges in the U.S.

On one of the U.S. options exchanges, orders delivered to the Exchange floor under SOES are automatically executed at the market price in the security. The buying or selling exchange member on the opposite side of the transaction, depending upon whether the customer is a seller or a buyer, is selected serially from the list of members choosing to participate in the SOES. On the DSE, such orders could be executed automatically at the opening price in the security against the account of members choosing to participate. In order to encourage participation in SOES, the Exchange could permit higher commissions to be charged on such trades and/or eliminate the usual Exchange fees. While in the U.S., SOES trades are delivered to the exchange floor electronically, this is obviously not possible in the present environment in Bangladesh. Instead, retail orders could be hand delivered by individuals to an open window at the exchange before the opening of trading on each trading day. Whatever system is designed to handle small retail orders, it must fit into the present DSE trading environment. The goal of any such system should be to enable retail customers to gain access to the floor and get their orders executed without unduly burdening Exchange members.

IX. The Kerb Market

The kerb market in Bangladesh has existed for many years, with somewhere between 50 and 100 participants. When prices in the stock market began to rise rapidly in July and August, and the members of the Exchange were unable to handle the influx of new retail customers, the kerb market suddenly exploded reaching a peak of as many as 25,000 people in October and November. The advantages of the kerb market from the point of view of retail customers is the immediacy of the transaction and no requirement to pay commission charges. The problem, of course, is the lack of transparency in transactions and no guarantee of execution at the best price. During the bubble, allegations were made that prices in the kerb market were entirely unrelated to the market on the DSE or the CSE and that some of the buyers received false or fraudulent certificates in exchange for cash.

Obviously, there is no way to determine how much trading actually takes place in the kerb market, what prices have been paid, nor even how many people have participated. In a crowd of 25,000 people, buyers and sellers meet by accident and there can be no guarantee that the highest bid and lowest offer will come together at any point in time.

The Commission has stated publicly that the kerb market is illegal in an effort to dampen public enthusiasm and to warn citizens about the dangers of trading in such an unregulated environment. It appears that the 1969 Securities and Exchange Ordinance intended to require all public companies to be listed and to require trading in such securities to be carried out only on registered stock exchanges. However, the unclear wording of subparagraphs (3) and (4) of Section 8 in the Ordinance entitled "Restrictions on dealings in securities" leaves open the question of whether transactions in listed or unlisted securities can be executed off the floor of a stock exchange.

The SEC appears to have three alternatives for dealing with the kerb market. It could ban the kerb market and require all transactions to be executed on the DSE and the CSE. It could ignore it in hopes that it will die back down to its previous size of 50 to 100 participants. Or, finally, it could take gradual steps to legitimize it.

Banning the kerb market would be exceedingly unpopular and probably unrealistic. Clearly the lack of transparency in the kerb market and the alleged abuses are troubling, however the existence of a kerb market is not bad in and of itself. Indeed, all markets, whether they be commodities or stock markets, began in the streets were buyers and sellers met to bargain and haggle over prices and deliverables.

The important thing to recognize is that the kerb market, while there were those who misused it, grew to its enormous size because members of the DSE and CSE were unable and unwilling to service the needs of the new breed of retail customer. Retail demand grew too quickly, the capacity of the brokers was severely limited, and once the market started to rise, brokers were more interested in trading for their own accounts than in handling customer orders. Cutting off retail customers' access to the market by banning the kerb market without first increasing the institutional capacity of the exchange markets would be a mistake.

The second alternative, ignoring the kerb market in hopes that it will reduce to its former size, is attractive in the short term. If the kerb market shrinks, this will be a winning strategy. If, on the other hand, another bubble in the stock market occurs, the kerb will once again grow out of all proportion, similar abuses will develop and the SEC will be held accountable. Whether the SEC declares the market illegal or not is of little interest to the public and the press who will be looking for a scapegoat. At that point, ignoring the kerb market will appear to have been a high risk strategy.

The third alternative, gradually legitimizing the kerb market, can only be accomplished over time if it is to avoid the public outcry similar to that which would occur if the market were banned. This alternative would involve a series of non-interventionist but gradual steps aimed at structuring the market and introducing some transparency for transactions. Such actions as moving the market indoors, requiring those who want to participate to sign in and wear a badge, introducing a chalk board on which transactions are recorded, establishing locations around the "floor" where buyers and sellers in specific securities could meet, and even vetting of certificates to be sold upon entry to the trading hall would begin to bring legitimacy to what in effect is an over-the-counter market. Concurrent with the gradual introduction of this informal structure, the public awareness campaign should continue to educate the public about the pitfalls and risks of participating in the kerb market.

Obviously, some of the participants in the present kerb market may refuse to move indoors or continue to participate under the new paradigm. However, if it is made clear that if they want to continue to do business off the exchange, this is the only way that will be permitted, the more ambitious and entrepreneurial of the participants will probably choose to play under the new ground rules. In that connection, it might be possible to identify individual participants in the kerb market who could play a leadership role in working with the Commission to create a new more legitimate market.

While this alternative of gradually legitimizing the kerb market may be the lowest risk and most publicly acceptable of all of the alternatives, it would require significant Commission resources to carry out. For that reason, it is probably the least realistic.

X. The Bubble

The SEC Chairman specifically requested that the consultant evaluate the Commission's actions in response to the bubble: what did they do right and what could they have done differently. In addition, he asked for recommendations of actions the Commission should take now in an effort to avoid such occurrences in the future.

First it is important to point out that the Commission is a young organization with extremely limited resources overseeing market participants who are less than cooperative. These facts coupled with a sudden surge in retail interest beyond anyone's imagination created an extremely volatile situation.

The Commission summarized the sequence of events and its actions in a document entitled "A brief note of the Recent Situation at the Stock Market in Bangladesh" which is included in Annex F. The following actions are cited in the document and are evaluated as indicated:

1. In mid-September, the SEC informed the public that it should be wary of buying the stock of 24 companies whose prices were rising rapidly despite the fact that the companies had weak fundamentals.

   Comment: In the long run, "cleaning up" the list of companies listed on the DSE by the adoption of maintenance listing criteria, including public float and minimum trading volume, and the delisting of companies that no longer meet those criteria is preferable to singling out specific companies for comment by SEC. However, given the situation, and the DSE's unwillingness to take action, the SEC had no other alternative than to put out such a warning.

2. Institution of a 10% and later a 5% circuit breaker on the DSE and CSE.

   Comment: Generally speaking it is preferable not to have the government interfere with the free flow of prices and transactions on an exchange. However, extraordinary circumstances call for extraordinary measures. It is inevitable that the market would fall at some point, and the imposition of circuit breakers may have caused a softer landing than otherwise would have occurred. In the long run, the exchanges themselves should make the determination of whether and when circuit breakers are needed. Before this responsibility can be delegated by the Commission to the DSE, however, there will have to be a significant change in the present organizational make-up of the Exchange.

3. Cases of new issues were accelerated.

   Comment: This action was obviously appropriate.

4. Brokers and dealers and their representatives were barred from becoming directors in companies listed on the stock exchanges.

   Comment: This action, while extremely controversial, was appropriate given the information on trading abuses involving traders acting in concert with listed companies. The SEC Chairman asked whether this type of prohibition exists in any other country. Since a broad survey is not available to answer this question, it is difficult to say how prevalent such prohibitions might or might not be. However, the SEC in the Philippines has had for some time a rule which prohibits a broker or dealer from executing transactions for its own account or an account of a customer in a listed security issued by a corporation where any person associated with that broker or dealer is an officer or director or controlling person of the corporation. A copy of the pertinent Philippine rule is contained in Annex G.

In addition, in a recent Senate hearing considering amendments to the Revised Securities Act in the Philippines, one Senator proposed the addition of a provision which would prohibit any broker or dealer from serving on the Board of Directors of a public company. He opined that serious abuses were frequent as a result of such interlocking relationships and that he intends to prohibit them.

5. An information campaign was launched to improve public awareness of the stock market.

   Comment: This was obviously an appropriate strategy and should be continued and expanded if possible. Hopefully the DSE and the CSE can join in this effort as their members will be the ultimate beneficiaries of a informed investing public.

6. People were warned on the illegality of trading in the kerb market.

   Comment: As a result of the abuses being perpetrated in the kerb market on innocent and naive investors, this kind of warning was appropriate. As noted above, further education on the pitfalls of the kerb market is appropriate.

7. Specific time limits were established to expedite the transfer of shares.

   Comment: Such action is frequently taken by SECs when transfer agents fail to keep up with the demand for transfers in a bull market. It was a appropriate action in this particular situation.

8. Establishment of a high powered independent Enquiry Committee to look into the allegations of manipulation and systemic deficiencies in the stock exchanges.

   Comment: This was an important step in response to the allegations. By delegating responsibility for the inquiry to an independent body, the Commission has done its best to ensure that the Committee's findings will be viewed as credible and without prejudice to any particular constituency.

In summary the Commission's responses to the bubble appear to have been carefully thought out and appropriate. Whether any of these steps should have been taken earlier in the crisis is impossible to determine.

With regard to what actions the Commission should take in order to ameliorate if not prevent a similar bubble in the future, there are several areas where the Commission should take actions in the short term in order to prepare for a future surge in retail interest in the market. The exchanges should be required to expand their trading capacity even in advance of the implementation of planned automation. This includes expanding their active membership base, increasing the handling of retail customers by members, establishing minimum float and volume requirements for securities, and providing for the direct delivery of small retail customers to the floor of the exchanges. The Commission's registration process for IPOs should be streamlined. Public and investor education should be continued and expanded to include how to do business with stock brokers. Market surveillance should be strengthened further and enforcement actions taken against exchange members, corporations and individuals who violate Commission rules.

Although many retail investors were badly hurt in the wild fluctuations in the market, there are some positive outcomes as a result of the bubble that should be recognized. First, investors are certainly more cautious in the aftermath of the bubble. Perhaps the "herd mentality" will have less effect the next time the stock market rises without regard to fundamentals. Second, with the structural and regulatory problems having been brought to the fore, the SEC has recognized the need to reorganize its staff and to appeal for a significant increase in staff. Further, it is considering instituting the reforms that were recommended as early as 1995 in the ADB Report entitled "Institutional Strengthening of the SEC." The crisis also created government and private sector support for the Commission's directives to force important changes at the DSE. Such actions previously were not possible.

The high level Enquiry Committee which the Commission established to conduct an investigation into the allegations of trading irregularities and to recommend structural and regulatory changes will add further support to the reforms already identified by the Commission as critical to building a fair and transparent capital market in Bangladesh.

XI. Recommendations

The SEC was the recipient of a comprehensive technical assistance grant from the ADB in 1994 and 1995. The recommendations for action by the Commission at the conclusion of the grant are detailed in the Final Report which was noted earlier. Most of these recommendations have not been implemented. Among the longer term changes that are required, it is critical that the Commission be made an independent regulatory agency and its staff exempted from the requirements of the civil service. This is the only way that the Commission will ever be able to pay adequate compensation to attract and retain qualified staff. Secondly, there is a pressing need to move ahead with the establishment of automated clearing and settlement facilities on the exchanges and a private sector-funded central depository. Qualifications requirements for brokers should be established and an accreditation exam instituted. As noted earlier, the SEC should also institute an exam for auditors desiring to practice before the Commission. Rules for handling customer transactions should be adopted. And the formation of additional mutual funds should be encouraged to respond to the needs of retail clients.

As noted in the introduction, the purpose of the consultant's review was to make recommendations on short term strategies which could address the structural and regulatory deficiencies which came to light as a result of the bubble. The following short term recommendations were further refined and limited to those that the Commission could reasonably be expected to carry out with its current small staff or through delegation or direction to others for action.

<u>Improve the Capacity of and Access to the Stock Market</u>

1. Require the DSE to increase the capacity for trading on the floor of the Exchange by adding additional trading booths, assigning securities to booths by volume, increasing the number of rotations securities are traded, eliminating the use of microphones, adding additional exchange staff to the trading booths to record trades, and introducing a different system for confirming transactions in order to allow traders to concentrate on trading.

2. Require the exchanges to implement small order execution systems which will allow retail customers to send orders to the floor of the exchange for automatic execution without the intervention of a broker. Include incentives for members to participate in such a system.

3. Require the exchanges to take steps to increase the number of active members by selling new seats and requiring inactive members to either lease or sell their seats. Require new market entrants to agree to take on retail customers.

4. Require the DSE to hire independent, professional management staff not drawn from the Council or the membership.

5. Require the exchanges to establish maintenance criteria for securities listed on the exchanges, including the number of shares not held by officers and directors ("public float") and minimum trading volume, and remove from listing all securities that fail to meet the new criteria.

6. Require the exchanges to explore incentives to encourage members to handle retail orders, including reduced exchange fees, and to train their members in how to handle retail accounts.

7. Ensure that the new trading systems being introduced on the exchanges will enhance trading capacity as opposed to simply automating the present trading procedures.

8. Explore the possibility of legitimizing the kerb market.

Enhance SEC Regulatory Programs

9. Advocate for the adoption of the proposed SEC organizational plan and for an increase in the number of staff as outlined in Annex D.

10. Expand the market surveillance program along the lines outlined in Annex E.

11. Until sufficient staff have been hired for a full audit program, conduct spot audits of the books and records of members of the DSE and CSE to ascertain the current state of firms' back offices and to design an effective audit program.

12. Take an increased number of enforcement actions to deter manipulation and insider trading, to address false and misleading information in prospectuses, to reinforce the books and records requirements for broker/dealers, and to encourage the preparation of accurate financial statements.

13. Revise the process for review and approval of IPOs by introducing a single stage process, reducing emphasis on merit regulation and ensuring full disclosure, placing the burden on the issuer company to submit appropriate certifications, and relying on underwriters and sponsors of the issue to conduct due diligence investigations in order to provide the Commission and the public with greater comfort on the accuracy of the company's assertions. In addition, cease accepting registration applications which are incomplete on their face.

14. Publish rules or guidelines on the following:

    - To limit the ability of officers, directors, and holders of a company's stock at the time of the initial public offering to sell their holdings for a specified period following the offering (lock up provision). Holdings might be required to remain at a minimum of 30%, for example, for a period of six months to two years. Reports on such holdings should be filed with the Registrar of Companies as well with the Commission.

    - To require the exchanges to halt trading in a stock when it is rising or falling on rumors in the market. Following the halt the exchange should contact the company and request that it make a public statement confirming or denying the rumors. Once such statement has been published, the trading halt should be lifted.

- To require listed companies to publish material announcements in two papers of general circulation.

- To require public companies to print their certificates on paper which is specially designed to prevent counterfeiting.

- To limit the use of Delivery Versus Payment (DVP) to trades that are substantial in size as defined by the rule.

- To increase the net capital requirement for brokers and dealers.

15. Require each exchange to submit a plan and timetable for implementing a full self-regulatory program including market surveillance and regular audits of their members for financial and operational soundness and sales practices compliance.

16. Cease requiring companies to list their securities on both stock exchanges. The decision on which exchange(s) to list should be left up to the company.

17. Cease sending reminder letters to public companies regarding their responsibilities for filing reports, holding their AGMs and other requirements under the 1987 rules in order to save staff time.

18. Publish in draft all rules and guidelines for public comment prior to adoption in order to ensure that Commission rules are feasible, workable, consistent with industry practice, and do not stifle innovation while at the same time meeting the regulatory needs of the Commission.

19. Establish the broad based advisory committee proposed by the Chairman to act as a sounding board and to provide support to the Commission's regulatory program.

20. Ask qualified industry participants to lead workshops on such subjects as due diligence for merchant bankers.

21. Require all exchange rules to be submitted to the Commission for approval prior to their implementation.

22. Seek out a university professor to conduct a study comparing financial statements filed by public companies against the requirements in the 1987 rules and the IAAP. Depending upon the results, publish the study and work with the accounting profession to address problems uncovered.

23. Where an exchange takes positive steps to implement or enhance its regulatory capability or programs, recognize these efforts by including their staff in training provided to SEC staff under technical assistance grants, and, to the

extent allowed by donors, to accompany SEC staff on overseas trips and internships.

24. Form an advisory committee to identify what statutory and other changes are needed to facilitate the creation of a central depository in Bangladesh.

25. In order to enhance the present capabilities of the small professional staff, provide them with personal computers.

Increase Public Awareness of the Stock Market

26. Expand the public awareness campaign to include print, media and seminars to cover not only basic facts about the stock market, but also to include what it means to be an investor, how to use a broker, the responsibilities of a public company, the pitfalls and risks of buying and selling shares in the kerb market, and the role and responsibilities of the SEC (including not endorsing IPOs). Borrow from a similar program carried out in Sri Lanka (see materials provided by USAID Administrator Richard Brown).

27. Encourage the exchanges to initiate their own public education programs by offering seminars or publishing booklets and circulars for public investors.

28. Require public companies to submit more than one copy of their annual and other reports to the Commission and the exchanges. Require the exchanges to place one copy of such reports in a reference room open to the public.

29. Hire a consultant to review the calculation of the Dhaka All Share Index to verify that companies that are not traded on any particular day are excluded from the index calculation.

ANNEX A

ANNEX A

List of Individuals Interviewed

Nasser Ahmad	Executive Director, SEC
AFM Asaduzzaman	Deputy Director, SEC
Khairul Anam Khan	Corporate Accountant, SEC
Dr. Mohammad Haroonur Rashid	Chairman, SEC
MD. Rezaur Rahman	Director, Operation Administration and Establishment, DSE
Ruksana Chowdhury	Deputy Director, Capital Issues, SEC
Emdadul Haque	Member, SEC
AGM Shasul Kamal	CEO, Chittagong Stock Exchange
M.R. Hasan	Outside Legal Counsel to Chittagong Stock Exchange
Faizuddin Ahmed	Member, SEC
Amir Khosru M. Chowdhury	M.P., Chairman, Chittagong Stock Exchange
Professor Amirul Islam Chowdhury	Vice Chancellor, Jahangirmagar U.
Zianl Hugue Khandoker	Secretary, Enquiry Committee
Md. Nurul Akin MBS	General Manager, Bank of Bangladesh
Syed Mahbubur Rashid	Company Secretary, Pioneer Insurance
Hemayet Uddin Ahmed	HMMS Consultancy Group
Amir Ul Mulk - Secretary	Banking Division, Ministry of Finance
Dr. Akbar Ali Kahn	Secretary, Finance Division, Ministry of Finance
Rezaul Karim Khan	Economist, ADB
Pierre Landell-Mills	Chief of Mission, World Bank
S.A.M.S. Kibria	Minister of Finance
G. M. Khurshid Alam	World Bank

ANNEX B

27

Final

Dinner to welcome Ms. Molly Bayley, Stock Advisor, KPMG Peat Marwick
Hosted by Charge d' Affairs i.e. Nancy Powell
Charge d' Affairs's Residence
Sunday, February 23, 1997
8: 00 p.m. dinner

****

Host	Charge d' Affairs a.i. Nancy Powell
Guests of Honor	Ms. Molly Bayley, Stock Advisor, KPMG Peat Marwick
Guests	Dr. Md Haroonur Rashid, Chairman, Security Exchange Commission
	Mr. Faizuddin Ahmed, Member, Security Exchange Commission
	Mr. Emdadul Haque, Member, Security Exchange Commission
	Mr. C. M. Murshed , Country Director , IESC/ Bangladesh
	Mr. Owaise Saadat, Manager, (Private Sector Development and Finance Unit) World Bank
	Mr. Bhanuphol Horayangura, Resident Representative, Asian Development Bank
	Mr. Rezaul Karim Khan, Economist, Asian Development Bank
	Mr. David E. Lockwood. Resident Representative, UNDP
	Mr. Quasem, President, Dhaka Chamber of Commerce & Industries
	Mr. Samson H. Chowdhury, President, MCCI
	Mr. Imtiyaz Hussain, Chairman, Dhaka Stock Exchange Ltd
	Mr. Hafeezuddin Ahmed, Country Coordinator, International Finance Corporation
	Mr. Yussuf Abdullah Harun, President FBCCI
	Prof Aminul Islam, Vice Chancellor Jahangir Nagar University

Mr. Syed Manzur Elahi, Chairman , Privatization Board

Professor Craig Baxter, President American Institute of Bangladesh Studies

American Embassy Dr. Richard Brown Director, USAID

Ms. Lisa Chiles Deputy Director, USAID

Mr. Winston Mcphie, USAID

Ms. Corry Weierbach, Economic Officer

Mr. Najmul Hussain, USAID

****

Regrets Ms. Runa Alam , MD, Peregrine Ltd, Out of country

Dr. Sohrabuddin, Deputy Governor (Research) BD Bank, Indisposed

Mr. Amir-ul-Mulk, Secretary (Banking)

Mr. S.A. Chowdhury, Managing Director, ICB

24 GUESTS ACCEPTED
4 REGRETS

As of 2/23/97 1624

ANNEX C

ANNEX C

List of Documents Reviewed

Securities and Exchange Commission "Surveillance Guidelines" (internal document)

Securities and Exchange Commission Task List for ADB, World Bank and USAID

A Brief Note of the Recent Situation at the Stock Market in Bangladesh (SEC)

Report to the World Bank, Bangladesh, of visit to establish the situation in the stock market, December 1996 prepared by Susan M. Selwyn, ISC

Bangladesh, Periodic Economic Update, October 1996, The World Bank Resident Mission

Securities and Exchange Ordinance, 1969 (as amended in 1993)

Securities and Exchange Commission Act, 1993

Guidelines on Issuance of Right Shares issued by the Securities and Exchange Commission on 11 February 1995

Amendments to Guidelines on Issuance of Right Shares dated 24 June 1996

Amendments to Guidelines on Issuance of Right Shares dated 8 July 1996

Guidelines for Raising of Capital by Greenfield Public Companies, Notification issued by the Securities and Exchange Commission on 13 June 1995

Guidelines on Initial Public Offering to Local Investors, Notification issued by the Securities and Exchange Commission on 8 February 1995

Credit Rating Companies Rules, 1996, Notification by the Securities and Exchange Commission dated 24 June 1996

Institutional Strengthening of the Securities and Exchange Commission in Bangladesh, Volumes I and II T.A. 1943-BAN, prepared for ADB by The Aries Group

Rules and Regulations 1995 of the Chittagong Stock Exchange Limited

Prospectus dated November 1996 for H.R. Textile Mills Ltd.

Prospectus dated January 1997 for Manola Perfume Chemical Industries Limited

Final Aide Memoire of the Reconnaissance Mission of the ADB for Proposed Capital Market Sector Development Program Loan dated 6 February 1997

January, 1997 Market Update for the Chittagong Stock Exchange

Letter from the Managing Director of Peregrine Bangladesh to the Finance Minister dated 14 November 1996

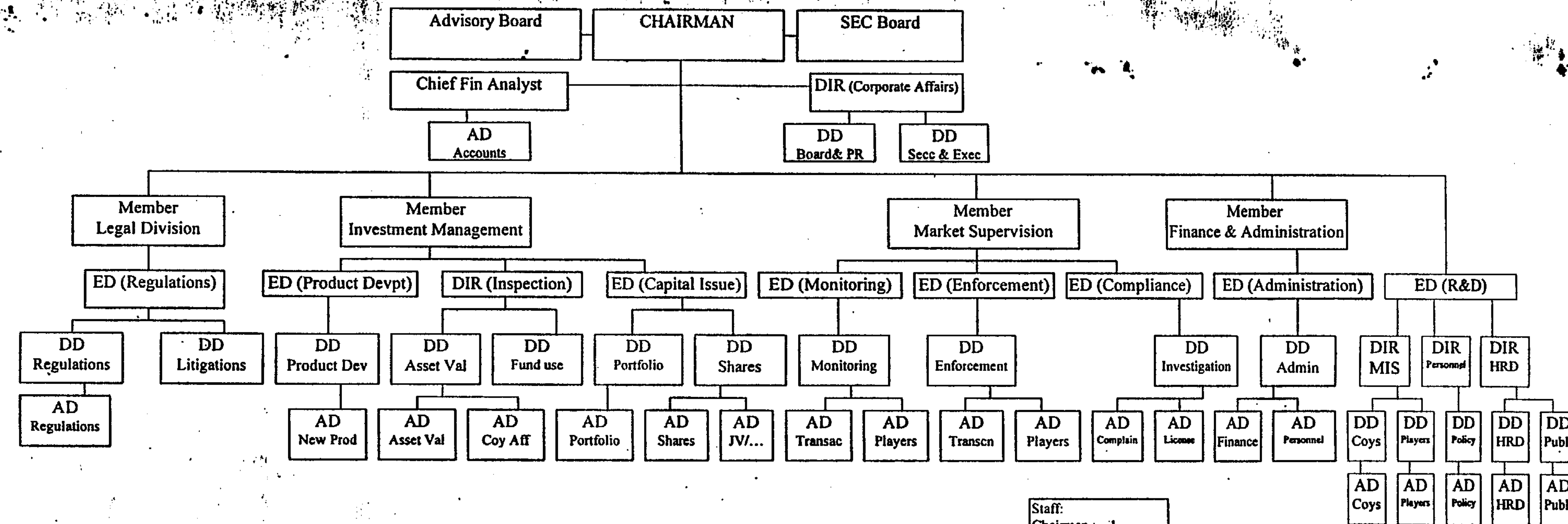
December, 1996 and January, 1997 Monthly Review of the Dhaka Stock Exchange, Ltd.
Application for Consent to Issue Share, Debenture and Other Securities by a Public Company (SEC Form Annesure-A)
Dhaka Stock Exchange Rules and Bylaws
Introduction to the Dhaka Stock Exchange (Booklet)
SEC Quarterly Review, July - September and October - December 1996
IFC Index Methodology
The Securities and Exchange Rules, 1987 issued by the Ministry of Finance on 28 September 1987
Guidelines for Issue of Capital by Public Companies, Draft dated December 17, 1996
Guidelines on Approval of Prospectus or Offer for Sale, Draft dated December 17, 1995
Functional Specifications Document for DSE Trading System, Version 3.0 dated Feb. 1997

ANNEX D

33

Annex 1)

2 March 1997



Staff:	
Chairman :	1
Members :	4
EDs+ CFA :	9
Directors :	5
DDs	: 18
ADs	: 24
	61

BEST AVAILABLE COPY

SECURITIES AND EXCHANGE COMMISSION
Functional Chart

CHAIRMAN'S OFFICE

Division : Chairman's Office; Sphere : Management of SEC

Department : Corporate Office	Chief Financial Analyst
■ SEC Board Affairs ■ Monitor operations of SEC ■ Public Relations	■ Formulate policies on Disclosures ■ Guidelines on Accounting Standards ■ develop reporting format on IPOs ■ approve Framework to enforce Audit

SERVICE FUNCTIONS

Division: Administration and Finance; Sphere: Operation of SEC

Department: Finance and Administration	Department: Personnel
■ Common Services ■ Security ■ Investment of SEC Funds ■ Annual Budget and Accounts	■ Formulate HR policy and guidelines ■ Recruitment and training of SEC Staff ■ Provide personnel support to SEC

POLICY MAKING FUNCTIONS

Division: Legal Affairs Sphere: Regulatory Framework	Division: Research and Development Sphere: Domestic & International Market
Department. Legal ■ Establish Regulatory Framework ■ Reform existing rules & regulations to meet emergent needs ■ Draft new rules for SROs to meet emergent needs ■ Provide Legal Assistance to the various Departments and litigation against SEC	Department: Research ■ Research policy initiatives ■ Impact study on regulatory program ■ Review market supervision ■ Advice on market development
	Department: MIS ■ Develop and implement MIS ■ Monitor transaction and settlement ■ Ensure reporting and compliance
	Department: HRD and Extension ■ Develop courses for Market Intermediaries ■ Educate the public ■ Train Market Actors/Investors ■ Carryout tests to give License ■ Library & Public Reference Room ■ Publish SEC Reviews/Reports

EXECUTIVE FUNCTIONS

Division: Investment Management Sphere: Issues and Institutional Funds	Division : Market Supervision Sphere: Enforcement Area of SEC
Department: Capital Issues ■ Examine and process new issues ■ Administer Guidelines on Listing ■ Examine and process Mutual Funds and Property Trusts	Department : Monitoring ■ Monitor Exchanges and Clearing Houses ■ Supervise and inspect Market Intermediaries ■ Review Rules and Practices of SROs ■ Oversight Operations of the SROs
Department: Inspection ■ Inspection of Assets to sanction IPO ■ Audit use of Public funds ■ Review policies and guidelines on Funds and Asset management	Department : Compliance ■ Receive Complaints ■ Carryout investigations ■ Report of Inspection for action
Department: Product Development ■ Develop new Financial Products/Markets ■ Prepare Guidelines for transactions of the new Financial Products in the market ■ Review/Monitor new Financial Products /Markets	Department: Enforcement ■ Ensure proper conduct of Market Intermediaries ■ Carry out prosecution and enforcement ■ Invoke suspension of Licence for breaches ■ Formulate enforcement and Licensing policies/Guidelines to meet needs.

SECURITIES AND EXCHANGE COMMISSION
Personnel Distribution

Division and Department	Executive Director	Director	Deputy Director	Assistant Director	Personal Officer	Computer Operator	Official	Skilled Staff	*Other Staff	MLSS	Total
■ Corporate Office	-	1	2	-	1	1	3	2	-	2	7
■ Chief Financial Analyst	1	-	-	1	1	-	2	1	-	1	4
■ Chairman's Office	-	-	-		1	1		2	-	2	4
Division I : Chairman's Secretariat	**1**	**1**	**2**	**1**	**3**	**2**	**5**	**5**	**-**	**5**	**15**
■ Research	-	1	1	1	2	1	4	3	-	2	9
■ MIS	1	1	2	2	2	4	5	6	-	2	13
■ HRD and Extension	-	1	2	2	1	2	5	3	-	2	10
Division II: Research and Development	**1**	**3**	**5**	**5**	**5**	**7**	**14**	**12**	**-**	**6**	**32**
■ Legal Affairs	1	-	2	1	1	2	4	3	-	2	9
■ Member's Office	-	-	-	1	1	-	1	1	-	1	3
Division III: Legal Affairs	**1**	**-**	**2**	**2**	**2**	**2**	**5**	**4**	**-**	**3**	**12**
■ Capital Issues	1	-	2	3	2	1	6	3	-	1	10
■ Product Development	1	-	1	1	1	1	3	2	-	2	7
■ Inspection	-	1	2	2	1	1	5	2	-	1	8
■ Member's Office	-	-	-	1	1	1	1	2	-	1	4
Division IV : Investment Management	**2**	**1**	**5**	**7**	**5**	**4**	**15**	**9**	**-**	**5**	**29**
■ Monitoring	1	-	1	2	2	1	4	3		2	9
■ Enforcement	1	-	1	2	1	1	4	2		1	7
■ Compliance	1	-	1	2	2	1	4	3		1	8
■ Member's Office	-	-	-	1	1	-	1	1		1	3
Division V : Market Supervision	**3**	**-**	**3**	**7**	**6**	**3**	**13**	**9**		**5**	**27**
■ Administration and Finance	1	-	1	1	2	1	3	3	28	4	38
■ Member's Office	-	-	-	1	1	-	1	1	-	1	3
Division VI : Finance & Administration	**1**	**-**	**1**	**2**	**3**	**1**	**4**	**4**	***28**	**5**	**41**
Total	**9**	**5**	**18**	**24**	**24**	**19**	**56**	**43**	***28**	**29**	**156**

*Other Staff : 18 Drivers, 1 Cash Officer, 1 Store Officer, 3 Assistant PROs, 2 Dispatch Riders, 2 Assistant Librarians, 1 Transport Officer

ANNEX E

ANNEX E

EXPANDED GUIDELINES FOR MANUAL MARKET SURVEILLANCE

The additional steps described in the attachment which are to be followed in conducting manual market surveillance are not intended to be all inclusive but rather an effective and efficient means of identifying unusual activity for further review. These steps, coupled with increasing knowledge of the stocks and the brokers that trade them as well as increasingly well honed investigative skills, will enable the staff to recognize unusual activity when it occurs.

It is likely that these steps will uncover many more instances of unusual activity than can reasonably be pursued given the staffing at the SEC. As inquiries proceed, only those situations with clear cut fact situations should be pursued beyond the initial stage. Even then it may be that not all potential instances of insider trading or manipulation will be able to be developed into full blown cases. Only the very strongest cases where the evidence is iron clad should be prosecuted.

In preparation for prosecuting cases involving securities law violations, the SEC should begin now to educate the judiciary about insider trading and manipulation and what evidence is required to prove such cases. This effort will pay off in long run. This is another reason for concentrating initially on only the stongest cases involving insider trading or manipulation.

The staff conducting the manual market surveillance program should be trained in how to conduct an investigation following the initial identification of unusual activity. They will also require training in how to assemble a strong case for prosecution of violations. Until such training can be arranged, the should rely on the guidance included in the Appendices in Volume II of the Asian Development Bank Report on the Institutional Strengthening of the SEC. After receiving formal training, staff would benefit from an internship in a well developed market surveillance program at a securities exchange.

With approproximately 200 listed stocks to review on a manual basis, the program could be carried out by three persons. One person would review the daily reports of trading and observe trading on the floor of the Exchange. After initial analysis, the first person would refer all matters for further inquiry to two additional persons who would be responsible for conducting all further investigation. Depending upon how many investigations or cases are pursued at any one point in time and how much difficulty is encountered in assembling the evidence in such cases, two persons should be sufficient to carry out this phase of the market surveillance program. Once an automated market surveillance system is available, depending upon the volume of cases uncovered, it is possible that all phases of the program could be handled by two persons.

The specifications for the automated trading system of the DSE indicated that the new system will provide the Exchange and the SEC with very extensive capabilities for researching transaction executed on the DSE. On a request basis, trading activity in a particular stock, by a particular broker, or during a selected period of time will be able to be requested to be listed out for review. What is missing from this description is a system of alerts to identify and flag unusual price and volume activity and unusual broker concentration in stocks traded on the DSE. This system of alerts should be required to be included as part of the Exchange's new trading system.

<u>Recommended Additional Steps for Manual Market Surveillance</u>

1. Review of the Report of daily transaction data from DSE.

   a. Select the top five gainers and losers for review - these are the stocks whose closing prices were up or down the largest percentage on the day. Take the following steps with regard to each of the ten stocks:

      (1) Check to determine whether there was any news on the company that day which could explain the price movement.

      (2) If news did occur, determine the time the news was released and determine whether the price moved prior to the news. Also review the trading activity in the stock for the prior day to see whether the price moved the day before the news. If the answer is yes, do further review as described below under Insider Trading.

      (3) If there is no news, look for individual aberrational trades or patterns of trades that stand out or which may have contributed to the price increase or decrease.

         A. Look for trades at increasing or decreasing prices.

         B. Large block trades that are executed at a substantial premium or discount.

         C. A single trade at the close of the market at a substantial premium or discount.

         If a single unusual trade or a pattern of unusual trading emerges, do further review as described below under Manipulation.

   b. Examine the Report for block trades. The definition of block trade can be varied by stock or, in order to facilitate the manual review, set at a level which would at the very least identify those blocks which are likely to be of concern.

      (1) Determine whether the block was executed at a price, even if at a discount or premium, which was in line with other trading in the stock.

      (2) Are block trades in this stock so unusual as to always warrant further inquiry?

(3) Was there any news on the company which caused the price to increase or decrease subsequent to the block transaction?

If a stock is selected for further review, follow the steps outlined below under Insider Trading or Manipulation, depending upon the situation.

c. Examine trades in the five stocks with the largest reported volume. Is the stock usually one of the volume leaders or is it unusual for it to have had such a large trading volume? If unusual, try to determine the reason for the activity such as company-specific or other news that might have affected trading in the stock. Was the block executed prior to the news? Are there block transactions in the stock or other trades that raise questions which warrant further inquiry? If a stock is selected for further review, follow the steps outlined below under Insider Trading or Manipulation, depending upon the situation.

d. Review all stocks that rarely trade but have a sudden flurry of activity causing the stock price to increase. If such activity occurs on two consecutive days, select the stock for more detailed review of buyers and sellers to determine whether there is any evidence of manipulation. Watch for news on the stock and then review for insider trading if appropriate.

e. Enter summary price and volume data in a PC on stocks that increase in price sufficiently to trigger the circuit breaker. If the circuit breaker is reached several days in a row, review the activity in the stock more closely for possible manipulation unless the activity can be explained by news or other outside factors.

f. Review the trading activity for the first five days that a stock is listed on the Exchange following an initial public offering. Review all unusual transactions in detail.

2. Review of the List of Settlement Failures.

a. Enter the name of the broker, the T+2 date and the reason for the failure into a PC listing to track the frequency of failures by specific brokers. Where patterns emerge, investigate further.

b. Enter the name of the stock, the T+2 date, the name of the broker and the reason for the failure into the PC to track the frequency of settlement failures in specific stocks. Where a pattern of failures emerges, review the stock and the failures more closely to determine the causes and whether there is reason for further inquiry into the problem.

c. Check this listing of settlement failures in connection with all other inquiries and investigations.

3. Review of the trades to be settled by DVP.

a. For each trade on the list, look at the trades executed in the stock for the trade date and determine whether the price or size of the trade raises questions that warrant further inquiry.

b. Create a simple PC listing of DVP trades including the name of the stock, the brokers names, the settlement date and whether settlement is still open. This listing will help track trades that are not settled in a timely fashion.

c. Inquiries should be initiated on all trades which remain unsettled for a significant period of time. Review the trading activity in the stock prior to and subsequent to the DVP trade that remains open . Is there unusual activity which warrants further inquiry for Manipulation or Insider Trading?

d. Is there a pattern of certain brokers being involved in unsettled DVP trades?

4. Further Review for Insider Trading.

a. Gather the details of trading activity in the stock for a period one or two weeks prior to the news.

b. Identify the brokers who executed purchases (in the case of favorable news) or sales (in the case of bad news) prior to the announcement. Assemble the details of the trades by broker, listing them in the PC.

c. Request each broker who handled questionable trades to furnish the names, addresses and occupations of its customers who bought or sold during the period.

d. Request the company to provide a chronology of events which led up to the announcement. See attached example of a chronology request for a merger or takeover.

e. In reviewing the chronology, narrow the period of time during which the inside information was available and identify which persons had access to the information.

f. Review the detailed information on the customers who purchased or sold stock prior to the news in connection with the information gained from the company's chronology. Look for links between the purchasers/sellers and those who had access to the news. Did the person who bought shares prior to the news sell those shares at a profit after the favorable news was announced? Are the trades "normal" for that customer, i.e. is the customer a regular purchaser or were these trades the first purchase in the stock by the customer? Try to establish a profile of the customer's buying history in the stock.

g. If the broker himself was a buyer or seller prior to the news, try to determine whether the activity is unusual for that broker in that stock.

h. Insider trading cases, absent admission on the part of the insider, are based entirely on circumstantial evidence. An iron tight case of access to the information coupled with a series of transactions that are unusual for the individual should be sufficient to prove insider trading. It is even better, of course, if the individual sold the shares after the news was announced, making a substantial profit.

5. Further review for Manipulation.

a. There are many kinds of manipulations in addition to a classic increase or decrease in the price of the stock. Other types of manipulation include pegging (executing a single transaction for purposes of creating a higher price in a stock), marking the close (executing a trade in the stock at the close of the market in order to ensure that the stock appears to have risen on the day) and executing wash sales or ficticious trades to create the impression of activity in the stock.

b. List all transactions in the stock by broker during the period of the manipulation, looking for a pattern of activity by one broker alone or in concert with another which had the effect of causing the stock to increase or decrease in price. If a single transaction was involved, with whom or for whom was the transaction executed? What effect did the transaction(s) have on the market for the stock?

c. Proof of classic manipulation generally requires establishing evidence of a series of transactions at increasing or decreasing prices for the purpose of inducing others to buy or sell the stock. Like insider trading, the evidence is usually completely circumstantial. Evidence that the suspected manipulator benefited in some way from the scheme is very helpful.

CHRONOLOGY REQUEST

Takeover And/Or Merger

1) Which company made the original decision to proceed in this matter?

2) When was this original decision made?

3) Which individuals, inside or outside of the company, knew of the original decision?

4) When, how and where was the first contact made between companies concerning this matter?

5) Which individuals, inside or outside of the companies, knew of the first contact?

6) What was determined as a result of the first contact between companies?

7) Which individuals, inside or outside the companies, were informed of the results of the first contact?

8) With reference to each subsequent contact between, or meeting of the companies, please supply information of a nature similar to that requested in Items #1 through #7 above.

9) What was the date of agreement in principle, if any, between companies?

10) Which individuals, inside or outside the companies, knew of the agreement in principle?

11) What was the date of formal agreement between companies?

12) Which individuals, inside or outside the companies, knew of the formal agreement?

13) What was the date that news of the agreement was released for public dissemination via news conference, newspapers, radio, television or any other means?

14. Please provide the name of each organization, of the types specified below, whose services were utilized in connection with this matter:

    a) Underwriter/Investment Banker
    b) Law Firm
    c) Accounting Firm
    d) Lending Institution
    e) Public Relations Firm
    f) Financial Printer
    g) Finder

44

ANNEX F

15

Annex F

A brief Note of the Recent Situation at the Stock Market in Bangladesh

01. Bangladesh has two stock exchanges, Dhaka Stock Exchange (DSE) established in 1954 where trading is still conducted in old cry-out method and Chittagong Stock Exchange, established in 1995, which is semi automated. Some of the basic data of the two stock exchanges shown at appendix A.

02. Between July '96 to mid November '96, Bangladesh stock market showed unprecedented buoyancy in terms of market capitalization, turnover and prices. Market capitalization rose by over 265%, average daily turnover increased by over 1000%, whereas All Share Price Index jumped by over 260%. The growth was attributed to, amongst others, investors' confidence in the new government, expected political and economic stability, abolition of lock-in on foreign investors, withdrawal of capital gain tax on bonus shares, introduction of quota for non-resident Bangladeshis and plan to launch mutual funds and country funds in the private sector.

03. The extraordinary boom drew large number of small investors from various walks of life. Unemployed youth, students, housewives and small traders have flocked into the market swelling the number of investors about threefold over this period. Failure of existing broker houses to extend necessary services to small investors combined with the lack of market intermediaries have led to the development of a large illegal kerb market around the stock exchanges, trading virtually under the open sky. This further boosted the price of shares.

04. From early October, the market showed highly bullish trend and in four weeks market capitalisation doubled from 3 billion dollars to about 6 billion dollars. Share price index also more than doubled (rose from 1786 on Oct. 3 to 3648 on Nov. 5 i.e., by 1962 points at DSE).

05. One of the major reasons, for rapid rise of prices of shares, amongst others, were high demand compared to supply of securities and shallowness of the market. Market is predominated by ordinary shares. There are few bonds and mutual fund securities which are also traded in the stock exchanges. Consequently, share prices rose abnormally high and was not backed by adequate earnings or assets, with potential threat to cause sudden fall in share prices, affecting investors' interest.

06. Deficiency in the institutional arrangements at the Stock Exchanges particularly Dhaka Stock Exchange (DSE), the major player in the stock market, also may have contributed to reinforce the unusually bullish market. The policy making council also is responsible for management of the stock exchange. Chairman, DSE being the CEO of DSE. The brokers of the stock exchanges, till very recently, could be the directors of the listed companies. Although there were reporting requirements regarding the change in stock holding of such directors in such companies, it has never been complied with. There is no sub-brokerage system in the securities market.

07. In the above circumstance, to sustain the market and to protect the interest of the investors the SEC/Govt took following measures:

(i) When share prices of some of the old companies, which were approved long before the SEC come into being, having weak fundamentals started rising abnormally SEC informed the DSE and the investors about the 24 such companies in mid September, so that investors could take informed decisions.

(ii) Introduced "bid limits" (generally known as circuit breaker system) to control unusual or sudden fluctuation in share prices.

46

(iii) In order to improve the supply situation in the short run, Government decided to off-load its holdings in listed companies through stock market and accelerated privatization of SOEs through stock market, wherever possible. Some of government share holdings have already been off-loaded through Stock Exchanges. From July 1996 to mid November Government off-loaded shares worth over nine crores and between mid November to end January another eight crores.

(iv) Investment Corporation of Bangladesh (ICB), since the market started sliding in mid November till the end of January, 1997 bought about 40 crores worth of shares from its own account including investors account in prudent trading.

(v) Cases of new issues have been accelerated and seven initial public offerings (IPOs) Offering, with face value of about $ 5 million dollars have gone to the market during the period of July-December, 1996.

(vi) Also to control excess demand partly caused by bank borrowings, bank loans against shares were discontinued and margin lending by Investment Corporation of Bangladesh (ICB) were suspended.

(vii) In order to protect investors' interest, prevent insider trading, unfair trade practices and conflicts of interest SEC debarred stock brokers or dealers or their representatives from becoming director in companies listed in the stock exchanges. (effective November 6, 1996)

(viii) To improve awareness of People, particularly of the ordinary small investors to the security market, information campaign was launched through Television, Radio and newspapers informing them of the fundamentals of share market and precautions to be taken in investing in the securities market and the risk of the share market particularly transacting in the kerb market, from early October.

(ix) People were warned through press on legal provision on issue and purchase of shares, Simultaneously, law enforcing authorities were directed to look into this and take necessary action.

(x) SEC set specific time-limits for signature verification , registration of transfer and splitting of shares by the companies to facilitate trade and to expedite completion of transaction

08. Circuit breaker of 10% (+/-) was applied from October 10, 1996. With a sharp fall for a day or two the market adjusted to the breaker and most of prices started hitting the ceiling and by early November bull run become fierce, breaking past records almost everyday. Hence, the circuit breaker was narrowed to 5% (+/-) effective November 4, 1996. This combined with restriction of loan facilities against share certificates started steady market corrections.

09. Since the third week of November the market prices started correction, which led to suspending of trade on a couple of days and trade become bearish. November 16, marked the peak and market capitalisation and all share price index rose to Tk. 258 billion and to 3627 points respectively. Turnover was highest 3 days before. From November 17, the All DSE Share Price Index started falling and have continued except for a few days in between. Between 16th November and 5th December the All Share DSE Price Index fell by 27% to 2667 points and market capitalization declined by 26% to Tk. 190 billion (-26%). The trade volume also declined drastically. The fall in price led to dissatisfaction among the curb-market operators and created frustration. On some days trading have been very thin. Allegation have been levelled against brokers/dealers of the Stock-Market for manipulating the price fluctuations. Consequently, there is tension between the kerb-market operators and the stock exchange members most of whom are the brokers/dealers. The kerb market operators also demanded that they be legally recognised

47

and allowed various concession and urged the Government and members of the DSE to provide price support. They have organised themselves into a number of unofficial investor's association.

10. A group of the kerb market operators staged a sit down strike in front of the Dhaka Stock Exchange and prevented any body from entering into the DSE building till their demands (i.e., supporting prices, ensuring greater transparency in trade, legal recognition to the kerb market traders) are agreed upon. As a result, trading in DSE remained closed from December, 7 to December, 9.

11. After a series of consultation between the government and members of the Stock exchange and the business community/ chambers the following measures were agreed agreed to bring back normalcy in the share market and to protect the interest of the small investors. This was announced in a press conference called by Federation of Bangladesh Chamber of Commerce and Industry (FBCCI) and attended by SEC, Government representative and stock exchanges representatives on 9th December.

(1) Revive loan facilities against share certificate which were suspended and to provide necessary loans support to ICB, the only market maker, to actively participate in the share market. ICB also would restored its margin lending facilities to its investment account holders.

(2) An appeal was made to all concerned to play their role to resume trading. The members of the stock exchange were particularly urged to actively participate in the market.

(3) To ensure transparency and fair practices in trading, a surveillance team was to be constituted comprising representatives from Securities and Exchange Commission, Stock Exchanges and Federation of Bangladesh Chamber of Commerce and Industry was established to oversee day to day trading.

(4) A high level committee was constituted to advise on the adjustment of the circuit breaker to reflect changing situation.

(5) SEC was to pursue vigorously its monitoring and supervision with a view to prevent manipulation and corrupt practices- if necessary to set up of enquiry committee to bring the manipulators to book.

(6) The DSE was requested to expedite automation, effect separation of policy from management and conduct regular audit of the stock exchange operations.

The market resumed operation, alongwith operation in the kerb market and the level of transactions have been improving although the turnover were low. The share price index at DSE went up for a few days, but started going down again, while CSE also registered small decline.

In pursuance to above announcement: (a) a Committee to review and advice on adjustment of Circuit Breaker was constituted with Finance Secretary in the Chair with SEC, DSE & President FBCCI, w.e.f. 11.11.96. (b) a surveillance team formed w.e.f. 11.11.1996 with representatives of SEC and DSE to keep daily watch on the DSE trading floor. FBCCI, although earlier promised to nominate its member in the surveillance team later declined. (c) SEC formed a high powered independent Enquiry Committee to look into the allegation for manipulation and systemic deficiencies in the stock exchanges w.e.f. December 27, 1996. FBCCI earlier agreed to nominate a representative in the Enquiry Committee but they later declined (d) SEC relaxed the Circuit Breaker for post-book closure adjustment for 3 days, and the general circuit breaker was further relaxed from 5% (+/-) to 10% (+/-) w.e.f. January 01, 1997. (e) Restricts on bank borrowing against shares were withdrawn and ICB margin lending was resumed immediately.

11. About US $200-250 million (Tk 1000 crores) were stuck to the primary market for subscribing to IPOs (Initial Public Offerings)floated during the period of late November to 3rd week of December. IPOs have remained very attractive to investors and during the last six months the IPOs have been subscribed by over 15 times of the offer on an average. December being book closing time has also contributed to the low supply of funds. These also contributed to low demand and fall in price in the share market in the month of December.

12. It came down to 2241 on 28th December and the kerb market operators threatened to go on strike in front of the Dhaka Stock Exchange and close down operation of DSE. However, trade continued but the turnover was low. CSE index went down from its peak of 1730.53 on November 16 to 1157 on 30th December, 1996

13. During the week of 28th December to 2nd January with 5 trading days, index went up by 209 points to 2450 and prices rose by 7.97%. However, from the following week of 4th January the price started declining again. Since then the prices showed generally downward trend. However, the fluctuation have been moderate.

14. 12. During the month of January the DSE Price Index went down by 571 points to 1879, week ending on January 30, 1997. The market capitalization also went down drastically so also the volume and turnover from the peak of 196 billion to 147 billion. During January it further went ? down to 765 as on 30 January.

15. About 20% of the issues both in DSE and CSE remained non-traded from 7 days to over 30 days. At this stage the circuit breaker has been relaxed fro 3 days in case of those securities that has remained inactive over 30 days w.e.f. February 01, 1997.

16. Opinion about circuit breaker is mixed. The member/broker of the stock exchanges are in favour of total removal of circuit breaker or leave it to the DSE. The small investors generally are in favour of circuit breaker as they felt that it has served them well during down trend. Ramadhan have always been a period of lean transaction in the stock market.

17. DSE index at the close of January 1996 was 751 and average daily turnover during January 1996 in DSE was Tk. 29 million compared to that of the average daily turnover of Tk. 60 million in DSE in January 1997, which is double that of the turnover a year ago. Since the complete relaxation of circuit breaker for 3 days with respect to issues which remained non-traded for over 30 days the volume and turnover has increased in both the bourses. The turnover on 15th an 16th January has been around 10 crores, which is approximate of the same order as the average trade in August/September 1996. This showed that the market is returning its normal transaction level.

ANNEX G

50

RSA Rule 31 (a)-3 Prohibited Transactions in Securities Where Broker or Dealer and Issuer are Linked

(a) No broker or dealer shall deal in or otherwise buy or sell, for its own account or for the account of customers, securities listed on an Exchange issued by any corporation where any stockholders, director, associated person or salesman, or authorized clerk of said broker or dealer is at the time holding office in said issuer corporation as a director, president, vice-president, manager, treasurer, comptroller, secretary or any other office of trust and responsibility, or is a controlling person of the issuer.

(b) Every broker or dealer covered by paragraph (a) hereof shall submit to the Commission within ten (10) days after every annual stockholders' meeting of the issuer corporation, an inventory of the long position on the issue concerned held for its own account and for the account of its customers.

(c) Any violation of these rules shall subject the offending person to a fine of not more than Fifty thousand (₱50,000) Pesos and a suspension appropriate to the egregiousness of the violation as the Commission shall determine.

(d) Any broker or dealer, any stockholder, director, associated person, salesman, or authorized clerk of said broker or dealer who shall be found to have employed another person to act in his stead or as his dummy in the board or management of any company whose shares are listed in the exchange thereby allowing the broker or dealer to deal on or otherwise buy or sell securities of said company, shall be jointly and severally liable with the broker or dealer under paragraph (c) hereof in addition to the sanctions provided for under Section 61 of the Revised Securities Act.