

ABA, Section of International Law and Practice
1993 New York Annual Meeting
Preparing and Implementing Financial Law in
Emerging Markets: Eastern Europe, the Former
Soviet Union and the Developing World
August 10, 1993

DEVELOPING THE POLISH SECURITIES MARKET

by

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I. Introduction and Market Overview 1/

In just over two years, Poland has successfully implemented a very sound and workable system of securities regulation. The centerpiece of this system is the Act on Public Trading in Securities and Trust Funds (the "Act"). Following the adoption of the Act in March 1991, the PSC was organized and the WSE reopened after a 52-year hiatus.

As of May 1993, there were 18 issues of equity securities listed on the WSE. One and three-year government bonds, each with several series, are also listed. Equities and government bonds are traded Mondays, Tuesdays and Thursdays, except that one equity listing is traded only on Thursdays as a second tier listing. 2/ In other respects, first and second tier trading procedures are essentially

1/ In June 1993, the author completed a one-year assignment in Warsaw as the U.S. Securities and Exchange Commission ("SEC") Senior Adviser to the Polish Securities Commission ("PSC"). This placement was made under the SEC's technical assistance program for Central and Eastern Europe, which is funded by the U.S. Agency for International Development. Portions of the material included in this paper have been excerpted from the author's Report and Recommendations delivered to the PSC and Warsaw Stock Exchange ("WSE").

2/ There is also a separate daily trading procedure for large blocks of government bonds. Other government bonds are traded in off-exchange markets.

the same. There is a designated specialist for each issue. Only one trading price per issue per session is established by optimum matching of buy and sell orders. Prices are subject to a limit on increases and decreases of not more than 10% from the previous session's price. Generally, the size of all orders may be reduced downward, except that small orders of thirty shares or less may be specified as all or none orders. If the rate of execution would be less than 20%, transactions may not be executed due to too great a market imbalance.

At present there is only one domestic investment fund operating in the Polish market. Pioneer First Polish Trust Fund is organized, as an open-end trust fund under the European UCITS model.

Following a reduction in interest rates, there have been substantial increases in WSE volume and share prices during the first five months of 1993. 3/ Both domestic and foreign investors have shown increased interest in the market.

3/ The WIG (market index) increased nearly 190% from December 31, 1992 through May 20, 1993. Most issues were trading at all time highs and session volume reached a record 346 billion zloties (approximately \$20 million) on May 20th. During 1992, the average monthly volume was under 200 billion zloties.

II. Regulatory Structure

PSC. Two factors significantly distinguish the PSC from the U.S. SEC model. First, the PSC has substantially less independence than the SEC. 4/ Second, the PSC's statutory mandate is substantially broader than the SEC's mandate in the areas of market development and capital markets education. 5/

One of the PSC's principal regulatory objectives is conforming the Polish securities

4/ Under the Securities Exchange Act of 1934, the SEC is organized as an independent regulatory commission with five commissioners appointed by the President and confirmed by the Senate for staggered five-year terms. Commissioners may not have outside employment and no more than three commissioners may be appointed from the same political party. In contrast, PSC members serve at the will of the Polish government. The PSC membership currently includes, in addition to a Chairman appointed by the Prime Minister at the request of the Minister of Finance and President of the National Bank of Poland, two vice chairman appointed by Prime Minister at the request of the PSC Chairman, individual representatives appointed by the Minister of Finance, Minister of Ownership Transformations (Privatization), President of the National Bank and President of the Anti-Monopoly Office, and individual members nominated by the WSE and an association of individual brokers.

5/ Under Article 7 of the Act, the PSC is directed to cooperate with government administrative bodies, the National Bank of Poland, securities market institutions, and participants in public trading in designing state economic policy with a view to promoting the development of the securities market. Also the PSC is directed to disseminate knowledge of the principles governing the operation of the securities market.

regulation model to European Community ("EC") Directives so that Poland may achieve its goal of associate, and eventually full, membership in the EC. The PSC has made significant progress toward this goal.

WSE. The WSE is organized as a nonprofit membership corporation. 6/ As a licensed exchange under the Act, its rules and regulations are subject to approval of the PSC. One of the most significant advantages of trading on the WSE is its book entry system for clearance and settlement. All securities are traded on a dematerialized basis without transfer of physical certificates. Depository and clearance and settlement functions are carried out by the National Depository of Securities ("National Depository"). The National Depository is currently a division of the WSE, but under the PSC's proposed amendments to the Act, it would become a separate legal entity owned by its members.

In the next few years, the WSE will face a number of important structural decisions. First,

6/ Although the WSE has 23 members, over 90% of the ownership still belongs to the Polish government represented by the Ministry of Privatization. Steps have recently been taken to give WSE members more voice in corporate governance.

changing to a daily trading system with continuous pricing will require a new trading model and reconsideration of current trading rules, including the role of specialists and price limits. Second, now that the mass privatization program ("MPP") has become law, the WSE and National Depository will be expected to accommodate dematerialized trading in investment certificates and shares of over 20 National Investment Funds ("NIFs") in volumes substantially in excess of the current level of trading. Finally, the WSE may face competition from over-the-counter ("OTC") markets.

III. Law Reform

Recommendations by the SEC Adviser and other securities law experts were taken into consideration by the PSC staff in drafting proposed amendments to the Act. These amendments would improve the Act in a number of areas, including:

- * Prospectus delivery requirements.
- * Issuer reporting and continuous disclosure obligations.
- * Authority to grant exemptions.
- * Examination and investigatory authority.
- * Simplification of takeover provisions.
- * A brokerage firm self-regulatory organization.

- * Provisions regarding closed-end funds.
- * Brokerage firm reporting.
- * More flexible remedies.
- * Independence of the National Depository.

IV. Market Development Issues

Is the market overregulated? Because there are few issues of stock listed on the WSE and the market capitalization represents only a small portion of Poland's GDP, some critics have suggested that the market must be overregulated. This criticism overlooks: (i) the important role of securities regulation in promoting capital formation and economic growth; (ii) the fact that securities regulation is only one of many factors necessary to foster the growth of securities markets; 7/ and (iii) the difficulties inherent in attempting to accelerate the growth of securities markets by altering the interaction of market forces which traditionally determine how and when companies are selected as candidates for public share ownership.

A sound regulatory infrastructure of securities, banking and other commercial laws is

7/ Factors such as a tax policy which encourages investment and capital turnover, and macroeconomic policies which stimulate savings and investment, are beyond the scope of this paper.

essential for the development of securities markets. If investors are not given reliable information, or if they do not believe that a securities market is a fair market, free of manipulation, they are likely to look elsewhere for investment opportunities. What the PSC and WSE have accomplished in just over two years is to put in place a basic securities market infrastructure so that investors now are beginning to invest in publicly-traded Polish securities based upon the investment merits of these issues.

It is important, however, to go beyond the general question of overregulation and consider whether there are specific requirements that unnecessarily restrict capital formation, for example, by limiting the number of brokerage firms or issuers participating in the market.

Number of Brokers. As of May 1993, there were 29 licensed brokerage firms, and 331 individual brokers who have passed the brokers' examination. However, not all persons working for brokerage firms are required to be licensed brokers and the majority of persons who receive customer orders are not licensed. The PSC's approach probably has enabled brokerage firms to begin operations and develop a customer base more quickly than if all

persons engaging in securities activities had been required to be licensed by passing an examination. Because market opportunities for financial intermediaries are limited by the small number of issuers, it is doubtful that market development has been limited by the current number of licensed brokerage firms and individual brokers. However, this situation could change in the near future in light of the MPP and other securities issues likely to increase market size, profit potential and the demand for financial intermediary services.

Number of Issuers. The more interesting question is why are there only 18 publicly-traded issuers? The most likely immediate source of publicly-traded issuers would appear to be privatization of state enterprises through share issuance. However, the Ministry of Privatization has privatized very few companies in this manner. Privatization through share issuance actually came to a standstill in 1992, but it has improved during 1993. Statements by WSE and Ministry of Privatization representatives suggest that there could be 25-30 listed issues by the end of 1993.

Two factors which may have limited the number of privatizations through share issuance include:

- (i) the availability of strategic or other

institutional investors compared to the difficulty of finding public investors with capital to purchase underwritten share offerings on a consistent basis, and (ii) the relatively low level of price/earnings ratios of WSE issuers until this year's market uptrend.

Upon analysis, listing and disclosure and reporting requirements appear not to present the regulatory burdens that some critics have suggested. 8/

Sources of Publicly-Traded Issuers. Several potential sources are likely to increase the number of public-traded issuers in the Polish market: (i) small business issuers that grow and need to access the public market for additional capital; (ij) the MPP NIFs, and state enterprises in NIF investment

8/ The WSE has recently reduced its listing requirements for second tier listings so that now a market capitalization of only 5 billion zloty (about \$300,000) and only one year of audited financial statements are required. The first tier requirements are a market capitalization of 20 billion zloty (about \$1,200,000) and three years' financial statements. Moreover, the 1991 Act on Examination and Disclosure of Financial Reports, and Auditors and their Self-Government, which is based upon an EC model, provides for a four-year phase-in period for the development of a Polish auditing profession. Commencing with the 1992 accounting year, this act requires joint stock companies, banks, state enterprises and certain other entities to present audited financial reports unless, in the case of banks and state enterprises, the Minister of Finance has exempted them from such requirements.

portfolios which may be offered publicly as one of several NIF liquidation strategies; and (iii) other issuers' securities that may soon become traded in secondary markets. 9/

Public offerings by small business issuers, may eventually provide the most promising source of new publicly-traded issuers. One of the most positive signs in the Polish economy is that almost 1.7 million private enterprises are currently registered, offering jobs to about 3.6 million persons. The share of the private sector in the total GDP is now over 40%. However, it is impossible to predict when and how many of these small businesses may eventually grow, raise capital in the public markets, and become publicly-traded. U.S. experience suggests that the process takes time and is not easily accelerated. 10/ It also

9/ These secondary markets may develop: (A) among creditors and other investors in shares issued in exchange for enterprise indebtedness under the Law on Financial Restructuring of Enterprises and Banks; (B) among employees in shares issued to employees of state enterprises under the proposed State Enterprise Covenant; and (C) among employees and NIFs under the MPP.

10/ The U.S. market for publicly-traded issuers is the world's largest, but it has taken many years of additions of public companies and growth in market valuation to reach its current size. Over 95% of all U.S. private business units are not owned by public shareholders. Generally, only the most promising companies are good candidates for
(continued...)

suggests two important points regarding the effect of securities regulation on small business financing and growth. First, there must be a sufficient exemption for nonpublic offerings of securities so that financing can be provided to small businesses without unnecessary regulatory burdens. Second, the Act should permit licensed brokerage firms to become involved in small business financing activities. 11/

V. Summary of Recommendations

The SEC Adviser's report included recommendations in the following areas.

Act's Coverage; General Fraud Prohibition.

Poland has chosen to focus its system of securities regulation on activities related to the public trading of securities. There are certain dangers inherent in limiting the regulatory umbrella to this island of activity. The Act's coverage should be broadened to give the PSC authority to prevent fraudulent securities

10/(...continued)
public offerings. Several rounds of venture capital or seed financing are often required before a company is ready for public offering.

11/ The Act already includes a liberal nonpublic offering exemption. The proposed amendments would also exempt certain offerings to existing shareholders, and would permit licensed brokerage firms to engage in exempt financing activities.

activities, public or private, by licensed or unlicensed financial intermediaries or other persons.

Rulemaking Authority. As the agency with the technical expertise in securities regulation, the PSC should have more authority to adopt regulations necessary to implement the Act in technical areas, such as prospectus disclosure requirements and insider trading.

Brokerage Firms, Brokers and Investment Advisers. The current licensing regime which the PSC administers for brokerage firms and individual brokers has worked well for purposes of getting the market started. Several changes should be considered as the securities markets grow and develop. These include: (i) expanding the range of permissible activities for licensed brokerage firms; (ii) providing an exemption from investment adviser requirements for certain activities of licensed brokers and focusing examination requirements more on legal and ethical considerations instead of academic theory; 12/ (iii) licensing by examination of all brokerage firm personnel engaging in securities activities

12/ There are currently no licensed investment advisers. The first examination will be given later this year.

but with different, in some cases less rigorous standards, depending upon the scope of an individual's securities activities; and (iv) PSC monitoring of the number of brokerage firms and broker participants to consider whether the current firm capital and individual broker examination requirements should be relaxed. 13/

Self-Regulation. Self-regulation is designed to minimize direct governmental involvement and costs of regulation by permitting industry participants to develop standards of conduct which are legal, fair and ethical. The PSC's proposed amendments to the Act provide that entities operating brokerage firms may associate in a commercial chamber. To make self-regulation work effectively, all firms should be required to join the association and the PSC should have authority

13/ The PSC's current capital requirement is 2.5 billion zloties (approximately \$150,000) for firms engaging in dealer activities. Effective December 31, 1993, the WSE proposes to make its capital requirement 3 billion zloties for member firms engaging in dealer activities. For comparison purposes, SEC requirements were recently raised to \$250,000 for firms carrying customer accounts or holding customer funds or securities. U.S. capital to indebtedness of requirements are no more than 8-to-1 for the first twelve months of operations, and 15-to-1 thereafter, whereas the current Polish requirement is roughly a 3-to-1 leverage factor. It is understood that the PSC plans to reconsider its current capital to indebtedness requirements.

to approve and require changes in the association's rules.

WSE and National Depository. Because the WSE and National Depository have responsibilities to their members, listed issuers and increasing numbers of public investors, they should have the benefit of the highest quality advice from independent sources as they undertake the transition to a more active market place offering continuous daily trading.

Exchange and OTC Markets. Some basic rules are necessary to cause brokerage firms participating in such markets to act responsibly, to enable investors and others to assess the value of the securities traded and to provide for efficient clearance and settlement procedures.

Bank Securities Activities. Most of the licensed brokerage firms are bank-affiliated, ^{14/} but the PSC does not currently require that the bank brokerage units be separate legal entities. This presents difficult examination and reporting problems from a regulatory standpoint. The PSC recognizes this issue and it should address it in

^{14/} Twenty-one of the 29 licensed brokerage firms are bank-affiliated, including 20 of the 23 WSE members and 7 of the 8 specialist firms. It is estimated that over 90% of customer accounts are maintained with bank brokerage units.

coordination with banking regulators with the objective of regulating of bank and nonbank brokerage firms on a level playing field.

Extension of Credit. The PSC should work with banking authorities to develop a law that regulates extension of credit in securities transactions by banks and others.

Underwriting and Distribution Practices. The PSC should convene a small working group of U.S. advisers to meet with their Polish counterparts and PSC and WSE representatives to make recommendations for improving Polish underwriting and distribution practices, including elimination of the current delay of over a month between completion of underwriting and listing of securities.

Financial Reporting and Disclosure. Annual reporting requirements for publicly-traded issuers are adversely affected by certain requirements in the Polish Commercial Code that delay release of audited financial statements. The private sector accounting profession, the PSC and the WSE should have more involvement in the establishment of financial reporting standards.

Enforcement and Remedies. The PSC should place more emphasis on civil and administrative remedies.

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In June 1993, Mr. Strahota completed a one-year assignment as U.S. Securities and Exchange Commission Senior Adviser to the Polish Securities Commission. During 1991-92, he was an Attorney-Fellow in the SEC's Office of General Counsel, specializing in international technical assistance matters. Mr. Strahota's professional experience includes 19 years of private practice with the law firm of Kirkland & Ellis, where he specialized in securities, corporate and partnership law, and eight years in the SEC's Division of Corporation Finance. He received B.A. and M.B.A. degrees from Cornell University and a J.D. degree from The Catholic University of America School of Law. Mr. Strahota is a member of the District of Columbia Bar and the ABA Section of Business Law.