CZECH REPUBLIC

SECURITIES

SUMMARY

The Czech Republic has three active stock markets – the Prague Stock Exchange (PSE), the RM-System (RMS), and the over-the-counter (OTC) market. Trading activity among the markets is fragmented, with prices of shares varying across markets. In 1997, market capitalization of the PSE stood at US$15.6 billion, but trading volumes are low. The short-term bond market has grown significantly in recent years and the derivatives market is developing rapidly. Most equity shares are held by investment and share funds created following coupon privatization in the early 1990s.

Foreign investment represents a relatively small and declining share of overall investment but influences the direction of the markets. Fragmentation of markets, lack of transparency, financial fraud, and bottlenecks in trading have sharply reduced investor confidence in the Czech equity markets in recent years.

Capital markets are regulated by the newly established Czech Securities Commission (SECOM). Unlike counterpart regulators in most other OECD countries, SECOM possesses no rule-making authority and depends on the state budget for funding. A proven track record of independence to investigate allegations of fraud and impose appropriate penalties will likely be needed before investor confidence is restored. The government is also strengthening regulations and laws governing the capital markets, such as recent amendments to the law on investment companies.

U.S. firms are present in the Czech Republic, though no U.S. firm is a member of the PSE. Most U.S. firms deal in cross-border transactions or government securities and derivatives trading, rather than the equities or corporate bond markets. The Czech government places no restriction on the establishment of foreign securities firms in the Czech Republic and foreign investors may purchase Czech equities through brokers. There are no restrictions on foreign ownership of publicly-traded securities. U.S. firms operating in the Czech Republic have not reported any instances of discriminatory treatment.

DESCRIPTION OF MARKET

The Czech Republic has three active stock markets: the PSE, the RMS, and an OTC market. The PSE has 78 members, 60 of which are shareholders. In 1996, it subdivided into three markets: an unlisted or "open" market, an intermediate market with moderate capital requirements, and the main or "central" market, the most liquid of the three markets and home to the Czech Republic's "blue chip" companies. At year-end 1997, market capitalization of shares and share certificates equaled US$15.6 billion, an 8 percent decline from a year earlier. Capitalization of bonds traded in 1997 reached US$5.5 billion. Average daily trading volume on the PSE in 1997 was US$85 million. The RMS is a network of trading "shops" where institutional or individual investors can place orders. Transactions are only completed when a counterpart is found in the same trading system. OTC trades may be made directly between firms or individuals and registered with the Ministry of Finance's Securities Center. Terms of some OTC deals are private, although many are reported to the PSE as direct trades. A fourth market, RTP, has received a license from the Ministry of Finance but has yet to begin operations. It will be based on electronic auction.

Activity among the markets is fragmented. According to published statistics, in 1997, 48 percent of shares and 19 percent of share certificates were traded on the PSE, with 24 percent and 50 percent respectively of shares and share certificates traded on the RMS, and 28 percent and 31 percent respectively by OTC trades registered with the Securities Center. Prices of shares of the same company often vary substantially across markets. The PSE more heavily dominates bond trading with a 63 percent share. Until 1996, trading in equities dominated overall trading, but in 1997 faster growth in bond trading led to a shift in the structure of the market. Demand for fixed-income funds is on the rise. Money markets are also quite active. The interbank deposit market is the most developed and liquid of these markets. The volume of transactions on the short-term bond market grew significantly in 1997. Rapid development of a derivatives market is being driven by the growing volume of crown-denominated Eurobonds.

As of July 31, 1998, there were 424 securities traders and 1,528 registered brokers operating in the Czech Republic. There is no breakdown available on the number of foreign-owned or affiliated firms. As of June 30, 1998, 103 investment funds, 150 open-end share funds, and 75 closed-end share funds operated on the markets. (An investment fund is a legal person under Czech law, unlike open-end or closed-end funds administered by investment companies.) Officials at the PSE estimate that its members are responsible for 95 percent of transactions on all markets. Individual investors are less significant in the Czech Republic than in many other markets, with most equity shares held by investment or share funds. In the recent past, shares were often traded artificially among these funds to boost equity prices and increase brokerage fee receipts by firms. An improved regulatory environment and impending bank privatization appear to have lessened this practice.

Czech equity markets in recent years have suffered from a lack of investor confidence, both domestic and foreign. The proliferation of separate markets, lack of transparency, numerous cases of financial fraud, and bottlenecks in trading have resulted in foreign and new domestic investors limiting their exposure to the Czech market. Since 1997, there have been few new issues, no new domestic bond issues, and no initial public offerings. Nevertheless, capitalization statistics are high compared to neighboring countries, given the market's initial boost from the voucher privatization process.

Trading volumes are generally much lower than in neighboring countries. Foreign investment represents a relatively small and declining share of overall investment, but often influences the direction of the market. The general weakness of the Czech equity markets has led to a shortage of capital for already highly-leveraged Czech firms, in turn hurting their competitiveness, and the growth potential of the Czech economy.

Market Regulators

SECOM opened its doors in April 1998, taking over the role of capital market watchdog from the Ministry of Finance. The new body is charged with enforcing regulations and charging fines for violations; overseeing information and disclosure requirements for issuers, investors, and brokers; and collecting data on trading. SECOM's self-proclaimed goal is to establish transparency as the norm in Czech capital markets. It has already prepared procedures for relicensing of securities dealers which are expected to improve the quality of trading on Czech capital markets. Unlike counterpart regulators in many other OECD countries, SECOM possesses no rule-making authority and depends on the state budget for funding. Its commissioners are appointed by the President, and it must cooperate with the Ministry of Finance and Czech National Bank in preparing and interpreting laws. The new authority presently suffers from severe staffing gaps.

Market fragmentation and a weak regulatory framework allowed high levels of fraudulent activity in the past. Existing statutes to enforce fiduciary responsibility and other protective measures for shareholders were widely circumvented and violations rarely prosecuted. The investment funds spawned by coupon privatization gained disproportionate influence on the incentive structure of the economy as wide dispersion of ownership led to unclear corporate governance structures. Managers (often the owners through bank-financed management buyouts) continue to face weak performance incentives, given unhealthy links among banks, investments funds, and firms. Effective policing of capital markets remains a critical issue. Many are looking to the newly-created SECOM as the first step in getting this troubled sector of the economy back on track, but SECOM's success is also highly dependent on the government's ability to introduce effective disclosure rules and prohibitions on secret and insider-trading common in other market economies. A proven track record of independence to investigate and impose appropriate penalties is needed before investor confidence can be restored.

In June 1998, the government strengthened the law on investment companies. The new amendments require closed-end funds to open within six months of the amendment's passage if the fund's shares are valued at a 40 percent or higher discount to net-asset-value. This threshold falls to 25 percent after one year. This change is expected to lead to a wide redemption of shares and consequent shrinkage in market capitalization, but should make funds more accountable to shareholders. In an effort to protect further minority shareholders, the amendments limit a fund's holdings in a single company to 11 percent of the company's assets and set new rules for transformation of investment funds into holding companies. This change could have the unintended side effect of further loosening performance incentives for some corporate managers.

Foreign Portfolio Investment

The unethical practices of brokers, lack of transparency, and ineffective regulation have reduced foreign investor confidence in the Czech stock market in recent years. Foreign investors who had been bullish on the Czech markets in the early 1990s gradually pulled out starting in 1995. Most foreign investment comes from funds structured to include Czech equities. While foreign investment comprises a relatively small share of the market, foreign investors often drive the market. Recently, foreign investors have invested heavily in short-term fixed income instruments attracted by high interest rate spreads and a positive view of future developments as the Czech currency converges toward the euro as the Czech Republic's EU accession approaches.

Czech nationals may invest directly in offshore securities markets, but must obtain a prior permit from the Czech National Bank. Restrictions on investment in offshore instruments exist for Czech investment funds, pension funds, and insurance companies.

U.S. PRESENCE IN THE MARKET

U.S. financial firms, including Merrill Lynch and several affiliates of U.S. investment banks, are widely represented in the Czech Republic. No U.S. firm, however, is a member of the PSE, though a wholly Czech Citibank subsidiary, Citibank Securities, is a member. Foreign-owned and affiliated firms represent approximately a third of the PSE's membership. U.S. securities firms established in the Czech Republic deal primarily in cross-border transactions, rather than in the domestic market. They support strategic investments, corporate privatization, and underwriting bonds for Czech companies on other international markets. U.S. securities firms participate to a limited extent in government securities, foreign exchange, and derivatives trading in the Czech Republic.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

The Czech government places no restriction on the establishment of foreign securities firms in the Czech Republic. Foreign investors may purchase Czech stocks through a broker on the PSE, through the RMS, or on the OTC market.

The Czech government has actively encouraged foreign participation in its capital markets, and U.S. and foreign financial institutions are accorded the same treatment as corresponding Czech firms. There are no discriminatory restrictions on foreign ownership of publicly-traded shares or debt instruments, nor are there any limitations on non-Czech ownership of government securities.

U.S. firms operating in the domestic market have reported no instances of discriminatory treatment.

CZECH REPUBLIC – SECURITIES

The Czech Republic is committed to liberalize its financial sector in accordance with its OECD membership obligations. The Czech Republic's GATS commitments reflect current levels of openness, and there are no limitations on national treatment regarding securities services. Market-access restrictions remain in some areas, including cross-border securities issuance and asset management.

Exchange Rates Used:

1991 (average)	29.47 CZK/US$
1996 (average)	27.14 CZK/US$
1996 (year-end)	27.33 CZK/US$
1997 (average)	31.71 CZK/US$
1997 (year-end)	34.64 CZK/US$