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AICEI PROCEEDINGS

"CAPITAL MARKET IN THE REPUBLIC OF MACEDONIA AND APPROXIMATION OF THE REGULATION IN THE STAGE OF THE CANDIDATE STATUS OF THE REPUBLIC OF MACEDONIA FOR EU MEMBERSHIP"

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Abstract

In the 1990s, the EU activities in the financial services sector were primarily aimed at smooth transition towards the single European currency, while the financial markets were placed in the background. After the introduction of the Euro, the issues regarding the uniformity of the financial market regulations became a top priority. A consensus was reached that greater integration of the financial markets is a key process for the success of the Euro and the monetary union, as a whole. It was unanimously agreed that a single plan of activities needs to be adopted, with a timetable for commencing the process of harmonization of the regulations, having an ultimate goal - establishment of a single European Securities Market. At the end of 2005, the new Law on Securities was enacted in the Republic of Macedonia. It was developed, besides the experts from Macedonia, by experts from the USA and the EU. Despite the opinion given in the Report of the European Commission, (which did not take into account the new solutions in the Law on Securities) it is considered that this completely new text of the Law is largely harmonized with the current EU Investment Directives, and particularly with the Market Manipulation Directive, Prospectus Directive, Transparency Directive, Directive on International Financial Reporting Standards. There are only two capital market-related laws left to be revised and harmonized with the Directive on Collective Investment Undertakings (investment funds) and Directive on Taking Up, that is the Law on Investment Funds and the Law on Taking Up Joint Stock Companies. Taking into account the EU determination to take active role in the capital market regulations of the EU member candidates, it one should expect that the process of open consultations concerning the securities market regulation be launched in 2007.

Keywords: *Financial Services, Action Plan ,Investment Directives, Integrated European Capital, Services Market*

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INTRODUCTION

In the 1990s, the EU activities in the financial services sector were primarily aimed at smooth transition towards the single European currency, while the financial markets were placed in the background[1]. After the introduction of the Euro, the issues regarding the uniformity of the financial market regulations became a top priority. A consensus was reached that greater integration of the financial markets is a key process for the success of the Euro and the monetary union, as a whole. It was unanimously agreed that a single plan of activities needs to be adopted, with a timetable for commencing the process of harmonization of the regulations, having an ultimate goal - establishment of a single European Securities Market.

In 2000, in Lisbon[2], the EU adopted the Financial Services Action Plan (FSAP) rising the key issues on harmonizing the securities market regulations in the EU member-states, with a view to uniting the capital markets by 2010.

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[1] COMMISSION OF THE EUROPEAN COMMUNITIES: "FSAP Evaluation, Part I: Process and implementation" (2005), page 2-6;

[2] COMMISSION OF THE EUROPEAN COMMUNITIES: "THE APPLICATION OF THE LAMFALUSSY PROCESS TO EU SECURITIES MARKETS LEGISLATION" Working Paper (2004)-

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KEY TRENDS IN THE DEVELOPMENT OF THE EUROPEAN FINANCIAL MARKET

The following five key trends of the EU financial markets affect the most the FSAP implementation process[3]:

1. Intensive capital market development and financing by new issues of securities. Although in the last 10 years, the EU capital market, observing all its performances, registered the most significant increase ever, it still lags behind that of the USA. As an illustration, there are approximately 5000 companies that are listed on the EU stock exchanges, while on the New York Stock Exchange and NASDAQ there are just about 6000 companies. The market capitalization of all European stock exchanges is 60% the size of the market capitalization of the New York Stock Exchange. The market capitalization of all USA stock exchanges is almost as twice as large than the GDP, while in Europe it barely reaches the GDP level;
2. The Europeization / internationalization of the capital markets;
3. Higher competitiveness and cooperation between the stock exchanges and the trade, clearing and settlement systems;
4. Higher volatility of prices of the financial assets.

The consolidation of the European stock exchanges has been the most significant process for the capital market development over the last 5 years. That process commenced with privatization of the stock exchanges and their transformation from non-profit associations of stock exchange members (brokers-dealers), into publicly owned joint-stock companies, listed on the stock exchanges. This process was strongly

page 3; Federation of European Securities Exchanges: “A EUROPEAN AGENDA FOR FINANCIAL SERVICES-FESE’s post-FSAP Priorities (2004)-page 5

[3] FINAL REPORT OF THE COMMITTEE OF WISE MEN ON THE REGULATION OF EUROPEAN SECURITIES MARKETS (2001)-page 9

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encouraged by the EU determination for further market integration, as specified by the FSAP.

The consolidation process[4] started by consolidating the Scandinavian stock exchanges led by OMX (Stockholm Stock Exchange), a dominant owner of the NOREX alliance. This trade platform includes the stock exchanges of Stockholm, Copenhagen, Oslo, Reykjavik, Helsinki, as well as the new EU member-states from the Baltic area (Tallinn, Riga and Vilnius). Soon after, the stock exchanges joined into EURONEXT, which initially welcomed the stock exchanges from Paris, Brussels and Amsterdam, and since the last year, the exchanges from Milan and Lisbon.

The London Stock Exchange is the largest exchange in Europe, and after being transformed from a non profit association of brokers-dealers into a traditional joint-stock company listed at the stock exchange, it was a constant target of other stock exchanges in the world that wanted to take it up. So far, there has been two unsuccessful attempts (OMX – Swedish Stock Exchange and Makueriry Bank from Australia) to take up the London exchange. The latest attempt made by the American Stock Exchange NASDAQ (second largest stock exchange in the world), that has already bought 19% of the London exchange stocks, was not successful. In the mean time, the largest stock exchange in the world – New York exchange and the London exchange have been negotiating for a merger, soon after the failing of the attempt of Deutche Borse (Stock Exchange) to merge with the London exchange. Soon after, Euronext started the negotiations to merge with Deutche Borse (the second and the third largest stock exchanges in Europe), and if this attempt succeeds, that stock exchange will be the largest in Europe, thus greatly contributing towards the consolidation of the capital markets in Europe.

The smaller stock exchanges from the new EU member states are still in the stage of exploring the optimal consolidation possibilities aiming to join some larger stock exchange alliances. The largest of them - the Warsaw Stock Exchange has been negotiating with Euronext, while the Budapest Stock Exchange has already been connected to the electronic stock exchange platform of Deutche Borse, ensuring direct access of the Hungarian financial intermediators and investors to the German capital

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[4] More European stock exchange web sources

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market. The Vienna Stock Exchange seeks to become a dominant trade stock exchange platform of the Southeast Europe, while the Athens Stock Exchange attempts to purchase a part of the government shares on the Bulgarian Stock Exchange.

The endeavors of the Macedonian Stock Exchange for closer ownership connection with the Athens Stock Exchange has failed, due to the delay of the negotiations (change of management of both exchanges), as well as the apparent interest of the new management of the Macedonian exchange to establish closer relations with the Ljubljana Stock Exchange and other ex-Yugoslav stock exchanges. Ljubljana exchange promoted SEI-NET, a joint information platform, including the Macedonian Stock Exchange and the exchanges from Sarajevo, Varazdin, Banjaluka and Podgorica. With an on-line exchange of information on the above-mentioned exchanges, one can expect a greater interest for investment of foreign portfolio and private investors.

The European exchange landscape is given below, showing the consolidation process of the European capital market.[5]

[5] www:fese.be

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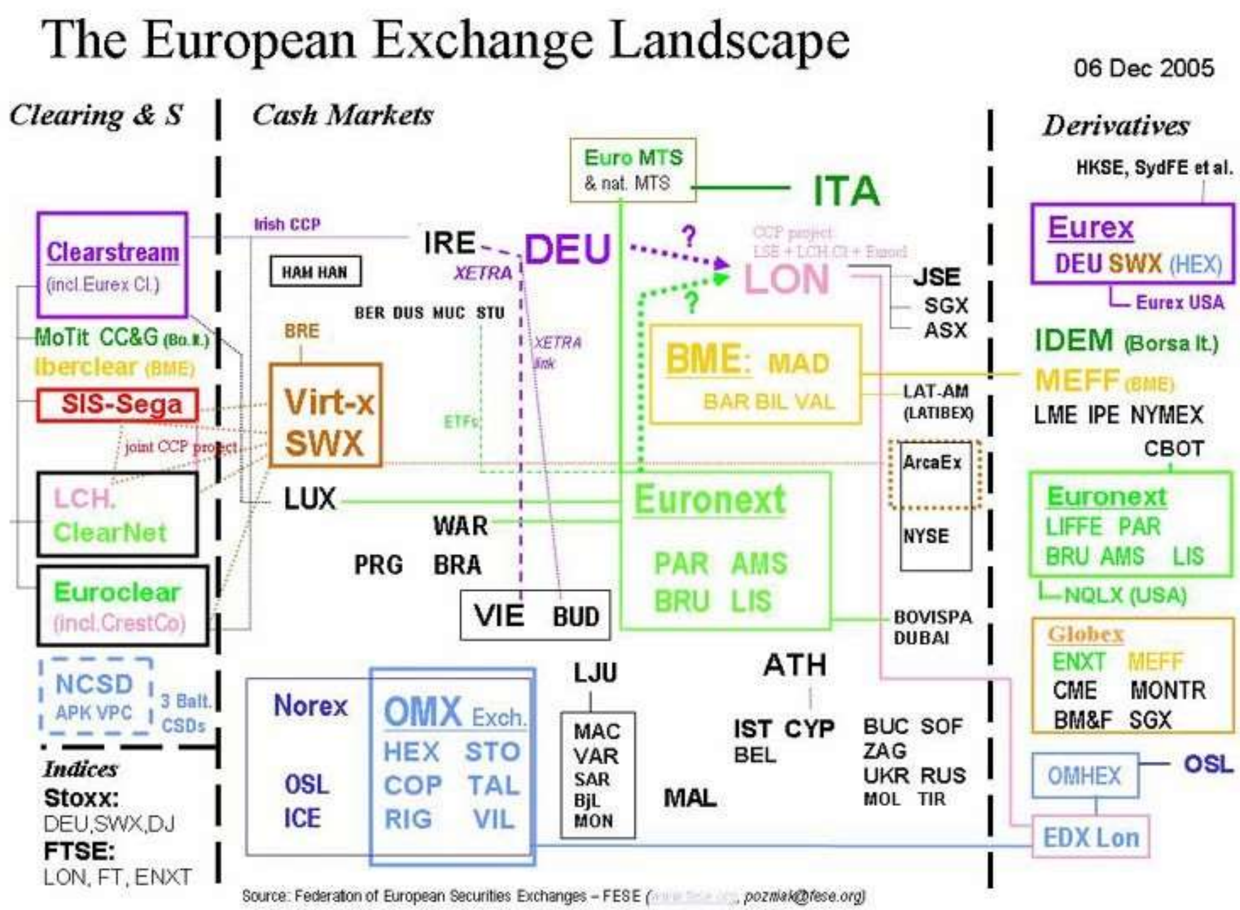

NEED FOR LAUNCHING THE FINANCIAL SERVICES ACTION PLAN

Notwithstanding the positive tendencies in the development of the European financial market in 2000, it still lags behind that of the USA (the European financial market is half the size of the US market). Some of the factors that brought about this situation follow[6]:

- Lack of those regulations, clearly accepted by the European Union, concerning the key capital market issues (contents of the prospectus, market manipulations, insider dealing, inter-state collaterals), that hindered the application of mutually recognized regulation system,

[6] FINAL REPORT OF THE COMMITTEE OF WISE MEN ON THE REGULATION OF EUROPEAN SECURITIES MARKETS (2001)-page .10-15

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- Inefficient regulation system,
- Inconsistent implementation of generally accepted investment directives, mainly due to the lack of mutual coordination in the interpretation of the regulations,
- Dysfunctional and fragmented clearing and settlement system which increased the transaction costs,
- Inappropriate system of pension system financing by funds in most of the EU member states.

We should also take into account the significant differences between the member states concerning the legal system (bankruptcy, executive procedures), tax area (different capital income taxation), political barriers (sophisticated measures for protection of national markets and local financial intermediators), different application of the corporate governance principles, competition policy, public disclosure of data on listed companies, etc. More specifically, such dysfunction was manifested in:

- Lack of harmonized leading principles covering financial services regulations;
- Non-complied application of the Investment Services Directive;
- Non-complied listing requirements;
- Unregulated application of alternative dealing systems,
- Inappropriate regulation of the collective investment undertakings (investment funds), including the pension undertakings;
- Inconsistent market manipulations control system,
- Non-complied rules for taking up companies
- Differences in application of the International Accounting Standards,
- Inconsistent settlement of disputes on various financial markets,
- Non-uniform clearing and settlement system

The above impeded the financial markets integration in many areas. That was also the main reason for initiating the FSAP development. Its implementation ensured further harmonization of the EU regulation and more efficient development of an integrated EU financial services market.

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For more efficient FSAP[7] development, a seven-member Committee was established, so called the Wise Man Committee, headed by the Belgian Baron Alexander Lamfalussy. They prepared a report specifying the key activities of the EU in the field of financial markets and services. Four new Investment Directives were adopted (Directive on Insider Dealing and Market Manipulation, Prospectus Directive, Financial Instruments Directive, Transparency Directive). These Directives allowed for:

- Adoption of a uniform contents of a prospectus of all issuers on all EU markets,
- Modernization of the quotation procedure and clear definition of the differences between approaching to quotation and approaching to dealing,
- Mutual recognition of local markets by professional investors,
- Expansion and modernization of investment rules for investment and pension funds,
- Adoption of International Accounting Standards (later renamed "International Financial Reporting Standards"),
- Single access passport of the financial trading intermediators at the regulated capital markets,
- Establishment of European Securities and Exchange Commission.

Over the next period, few other Investment Directives were amended and adopted covering other important financial system sectors (Directive on Collective Investment Undertakings, Directive on Taking Up, Directive on International Accounting Standards, Directive on Financial Collateral, Directive on Supervision of Credit and Investment Companies that Operates within Financial Conglomerates, Directive on Control of Financial E-Commerce, Directive on Liquidating Insurance Policies, Directive on Insurance Mediation, Directive on Savings Deposit Interest Taxation), as well as amendments to the Investment Directive, Directive of Presentation of Fair Values in the Accounting and Directive on Insurance Solvency Margins.

[7] Federation of European Securities Exchanges:" A EUROPEAN AGENDA FOR FINANCIAL SERVICES-FESE's post-FSAP Priorities (2004)-page 2-10

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The need for converging of the regulations and supervisory structures in EU was getting higher priority. There are 40 public institutions[8] operating on the territory of the EU, concerned with the securities market. The competences are mixed, responsibilities are different, which EU-wide, has created fragmentation and frequently, confusion. It imposed the need for elaboration of the idea for creation of a single regulator of the securities market (the European Securities and Exchange Commission), similar to the American Securities and Exchange Commission. More convergent regulatory and supervisory structures are vital for the future of the European Securities and Exchange Commission[9]. This body will be comprised of national regulators of the securities markets and will represent an independent advisory body of the European Commission. It will cooperate closely with the European Commission on all key regulatory issues of the capital and service market. By the end of 2005, 41 out of 42 measures were adopted, making up 98% of those required by the FSAP[10]. It opened a broad process of regulatory initiatives and implementation of a new regulatory process considered necessary for the purposes of following the latest innovation achievements at the securities market throughout the world. The FSAP was supposed to give the greatest contribution in the attainment of this goal.

FSAP contained key elements for integration of the European capital and financial services market. It was adopted in Lisbon, in March 2000, and in the following years it was entirely supported by the member-countries and by the national market participants and regulators. Although it was expected by be fully implemented by the end of 2005, its final implementation was postponed for 2 more years, especially due to the admission of the 10 new members.

[8] FINAL REPORT OF THE COMMITTEE OF WISE MEN ON THE REGULATION OF EUROPEAN SECURITIES MARKETS (2001)-page 16

[9] Idem, page 31

[10] COMMISSION OF THE EUROPEAN COMMUNITIES:“FSAP Evaluation, Part I: Process and implementation” (2005)-page. 5-12

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BENEFITS FROM THE INTEGRATION OF THE EUROPEAN CAPITAL AND FINANCIAL SERVICES MARKET

The integration of the European capital and financial services market will create benefits, in both micro and macro terms, to the market and the market participants and the professional participants and investors. The benefits to the EU by the establishment of an integrated European capital and financial services market[11] are given below:

1. **Improvement of the capital allocation to the EU economies**
   a) More efficient, larger and deeper capital market enables more efficient channeling of the savings to the investments,
   b) Reduction of transaction costs and higher market liquidity
   c) Greater diversification and innovation of the financial system,
   d) Greater possibilities for risks diversification;

2. **More efficient intermediation of the European savings to the investments**
   a) Higher competitiveness between financial markets and financial intermediators,
   b) Greater economy of scale and inefficiency reduction,
   c) Greater economic cohesion.

3. **Strengthening of the EU economy, making it more attractive to domestic investments**

These benefits will be shared by the EU citizens, small and medium businesses and large corporations.

For the EU citizens – the allowing of the investment and pension funds to invest in the integrated EU financial market will create funds consolidation, introduction of modern investment management technologies, administrative costs reduction and higher rate of return on investments. The investment funds in the USA are approximately 6

[11] FINAL REPORT OF THE COMMITTEE OF WISE MEN ON THE REGULATION OF EUROPEAN SECURITIES MARKETS (2001), page 73-85

times larger, on average, than the average size of the investment funds in the EU, and their market capitalization is as twice as high than that of the EU. The integrated EU financial market will allow for more flexible investment rules that are likely to encourage the improvement of the investment risk limits. The advancement of the overall macroeconomic performances of the EU, higher economic growth, productivity and employment will be an intermediate long-term effect of the above mentioned changes.

For small and medium size businesses – The integrated EU financial market will speed up the financing of small and medium size businesses in the EU, and will stimulate the employment. The EU entrepreneurial investment funds (VC firms) are only 1/5 the size of those of the USA, and their share in the financing of new innovative companies and projects is insignificant. Also, the share of the EU institutional investors in the financing of new businesses, especially the innovative technologies, is still marginal. Therefore it is highly important that uniform rules of trade, quotation, and asset management are introduced in the EU, which will trigger the process of financing the development of small and medium size businesses in EU.

For large corporations – Fragmented EU capital market creates higher capital expenses for the large corporations. These expenses are higher compared to those in the USA. This is due to the difference in the rules in the EU member states concerning this matter, including the liquidity and pricing. However, this is unfavorable for long-term projects in the field of innovative investments. It is believed that the unification of the EU financial market will be the most beneficial to the large corporations, particularly the corporate bond market and new types of debt securitization.

Encouraging competitiveness and innovations - one of the key elements in the creation of an integrated financial services market is the encouragement of competitiveness and providing free access, under equal conditions, of all financial intermediators to any financial market of the EU economy. In an integrated open European financial market, the competitiveness and innovations will launch new financial products and financial services. This is likely to reduce other expenses of the standard financial products (commercial, consumer and mortgage credits, credit cards, private equity investments etc). In such conditions, the price mechanism will be more efficient and will more realistically manifest the price trends. The liberalization of the

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telecommunication market is the best indicator for the positive effects of the competition and the creation of integrated capital and financial services market.

However, in order to derive the above benefits, the following requirements are to be fulfilled:

- Establishment of efficient, competitive, innovative and appropriately regulated EU financial services market,
- The financial intermediators should manifest their professional engagements more efficiently, meeting the needs of the institutional investors and small investors, especially in relation to risk diversification, timely information on price sensitive information, proper protection of the investors interests,
- Rigorous trade supervision and control, especially in transactions in different countries, Internet trade in securities etc.

The fulfillment of these requirements should increase the confidence of the investors in EU for its financial markets integration.

FINANCIAL SERVICES POLICY IN EU FOR THE NEXT 5 YEARS

Main objectives of the EU financial services policy in the next five years are as follows[12]:

- Consolidation of the accomplished progress towards integrated, open, competitive and cost-efficient European financial market and elimination of the remaining economic barriers in that process,
- Strengthening the market of circulation of the financial services and capital, with lowest transaction costs,
- Strengthening of the investor protection.

The new stage in the development of the single European financial services market (2005-2010) will be focused on the consolidation of the present regulation, efficient transposition of the European rules to the national legislations and permanent

[12] Idem, page 12-18

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ex-post evaluation for practical application on these rules in practice and their influence on the European financial sector.

The agenda for the last 6 years was guided by the vision that deep, liquid and dynamic financial market is likely to provide efficient allocation of capital and services allover Europe, creating benefits to both institutional and small investors. The FSAP was aimed at creating a regulation that would encourage competitiveness among the EU financial markets, equal access to the markets, stimulate the transparency, market integrity, financial stability and efficiency. Same principles apply today. However, this depends on the capability of the European institutions, regulatory bodies and the market participants, to provide consistent application of those principles in practice. In order to achieve these goals, the following needs to be addressed:

- Ongoing application of an open and transparent system of policy decision-making, with stronger consultation mechanism in place,
- Simplification and consolidation of all relevant (European and national) regulations in the financial services sector,
- Permanent cooperation with the EU member-states for consistent application of the regulations,
- Permanent evaluation of the efficiency of the application of the regulations in practice.

One of the first priorities of the EU in this domain is wrapping up of already started procedures for evaluating the efficient application of the Clearing and Settlement Directive, Solvency Directive and Payments Directive. The Directives on Rating Agencies and Financial Analysts are still to be addressed. Also, it was stated that there is no reason for further work on the details of the Directive on Taking Up. In any case, the determination remains not to propose new regulations if no economic benefit to the overall investment public is clearly manifested.

In the meantime, the EU will closely monitor the EU membership candidate countries in their fulfillment of the requirements concerning the financial services sector and will evaluate their readiness to be included in the process as full members.

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Same as with the old candidate countries, the EU will take a proactive approach and constantly urge the candidate countries to implement the current EU rules prior to the process of joining the EU.

MACEDONIAN CAPITAL MARKET AND EU MEMBER CANDIDATE STATUS

The EU regulation related to the financial services[13] includes rules for licensing, operating and supervising financial institutions in the banking, insurance, supplementary pensions, investment services and securities markets. The financial institutions can operate allover EU, in accordance with the control principle applied in the domestic country, or by establishing branches or by providing transboundary services.

As stated in the European Commission Analytical Report for the Opinion on the application of the Republic of Macedonia for EU membership[14], the legal framework of the Macedonian legislation governing the securities markets and collective investment undertakings still cannot be taken as a basis for the required harmonization.

The Republic of Macedonia has made a step forward to the approximation of its legal framework concerning financial services with ***acquis,*** while the banking supervision has improved relatively in relation to the international standards and the EU standards. However, the legislation and the respective supervisory framework, including its effectuation, should be significantly strengthened, especially in the insurance and securities market sector, which are small and underdeveloped. The Report also states that the country will have to focus further on the harmonization of its legislation with ***acquis*** for its successful implementation on a short run.

At the end of 2005, the new Law on Securities was enacted in the Republic of Macedonia. It was developed, besides the experts from Macedonia, by experts from the USA and the EU. Despite the opinion given in the Report of the European

[13] European Commission: “ANALYTICAL REPORT on the opinion on the application of the Republic of Macedonia for EU membership” (2005), page 85

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Commission, (which did not take into account the new solutions in the Law on Securities) it is considered that this completely new text of the Law is largely harmonized with the current EU Investment Directives, and particularly with the Market Manipulation Directive, Prospectus Directive, Transparency Directive, Directive on International Financial Reporting Standards. There are only two capital market-related laws left to be revised and harmonized with the Directive on Collective Investment Undertakings (investment funds) and Directive on Taking Up, that is the Law on Investment Funds and the Law on Taking Up Joint Stock Companies. Taking into account the EU determination to take active role in the capital market regulations of the EU member candidates, it one should expect that the process of open consultations concerning the securities market regulation be launched in 2007.

In this stage, we should focus on the effects of the eventual application of some of the Investment Directives prior to the accession to the EU, and especially on those referring to the equal access of all financial intermediators to the markets and the free transfer of funds abroad. Here we should benefit from the experience of the new EU member-states from Eastern and Central Europe. These countries (especially those with low liquidity on the stock exchanges) suffered fierce competition between the market intermediators, migration of domestic financial intermediators to larger stock exchanges to the Western Europe and placement of available assets of the domestic investors to the developed capital markets in Western Europe. This might adversely affect the liquidity of the already small local stock exchanges and their winding up on the long run.

In order to predict this process and minimize the negative effects, the development of domestic institutional investors (investment funds, pension funds and insurance companies) should be encouraged on time.

Macedonia witnessed the launching of two private pension funds, which, as institutional investors with increased potential, are expected to take active role on the capital market, particularly the bond market.

[14] Idem page 86-87

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Although there are a number of insurance companies in Macedonia, this market is small and there is scarce diversity of insurance services that are likely to increase their potential and make them influential on the capital market, as institutional investors.

The least developed is the area of investment funds, so-called collective investment undertakings or in the European terminology known as UCITS (Undertaking for Collective Investment in Transferable Securities)[15]. Although there is a legal framework in place (the Law on Investment Funds was passed in 2000, including the respective by-laws), no local investment fund has been established in Macedonia for the time being.

Priority for the next period will be the harmonization of the Law on Investment Funds with the two new UCITS Directives. Also, it is necessary to initiate appropriate tax incentives to encourage the local professional financial intermediators (banks and brokerage companies) to establish investment funds, either open or closed. The experiences of other countries in the region (Bulgaria, Croatia, Slovenia) show that only the development of local investment funds can trigger the development of the securities market.

[15] COMMISSION OF THE EUROPEAN COMMUNITIES: "GREEN PAPER ON THE ENHANCEMENT OF THE EU FRAMEWORK FOR INVESTMENT FUNDS" (2005), page. 7-11

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