FOREIGN INVESTORS
COUNCIL IN LATVIA

Position Paper No 3

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Position Paper on Capital Markets Development

1. Executive Summary

Sound capital markets and effective regulation are critical in encouraging capital formation in Latvia. Actions taken to pursue these objectives must also ensure that investors and consumers are adequately protected. Improvements in capital markets and their regulation will help restore confidence in the financial system and promote economic recovery.

It is estimated that increasing the development of Latvia's capital markets (e.g. to the level of Estonia's) would result in an increase of at least 1.8 percentage points in the annual growth rate of Latvia's real GDP per capita, thereby closing the income gap between the two countries by one third in 5 years and generating an additional EUR 120 million in tax revenue per year.

2. Recommendations

The recommendations have been prepared with a focus on the following three main policy pillars:

- **Infrastructure** (Stock exchange [NASDAQ OMX Riga], Latvian Central Depositary [LCD], FKTK);
- Processes for the Participation of **Investors** (banks, individuals, corporates and funds);
- Processes for the Participation of securities **Issuers.**

Infrastructure:

1. Improvement of Corporate Governance (CG) in State-owned Enterprises (SOE):

- Research and incorporate in the State Ownership Policy international best practice of CG in SOEs;
- Reduce political interference by establishing governance structures where line ministries would not have a direct ownership interest in their SOEs;
- Reestablishment and then selection of competent members of Supervisory Councils, including the requirement to involve independent directors (supervisory council members), ie., at least two independent professionals should be represented in supervisory councils of the SOEs;
- Adopt a Transparency Policy based on international best practice, setting SOEs' disclosure requirements similar to those for listed companies.

2. Increasing private ownership in State-owned Assets / Privatization

- Establish and communicate a clear strategy and plan to increase private ownership in State-owned assets describing:
    - A list of State-owned assets under consideration;
    - Options and proposed solutions for increasing private equity in State-owned assets;
    - Proposed timetable for planned activities;
- Ensure transparency and consistency through:
    - Using best international practices;
    - Assigning independent advisors and involving international institutions (eg EBRD,

IMF and World Bank) to monitor and advise the capital attraction process;
    - Considering initial public offerings (IPOs) on the Stock exchange and financial reporting (quarterly, half-yearly);
- Ensure that a wide range of investors are attracted by:
    - Involving international investment banks in the process;
    - Providing timely and well prepared information to the general investor community;
    - Communicating the potential investment opportunities to brokers, pension funds, wealth management companies, large market players and others in the industry;
    - Analyst coverage (i.e. the companies are periodically analyzed by specialists from investment banks);
- Invest proceeds raised from listing State-owned assets into investment funds to add to the liquidity and depth of capital markets.

3. Improvement of Enforcement

- Establish specialization of judges on financial markets rules and regulations, as well as international market practice, by providing training and technical assistance;
- Entrench and further develop the current practice of involving consultative bodies and representatives from sectors directly concerned (including, where applicable, NGOs) in the preparation of draft legislative documents or amendments to such documents;
- Establish separate courts specifically to hear commercial and capital markets disputes, which would also provide for an effective fast track procedure;
- Require that parliament passes legislation governing courts of arbitration, thereby raising standards and reducing the number of courts of arbitration to a minimum. Encourage interested parties (NASDAQ OMX Riga, LCD) to support a specialist (department of a) court of arbitration to consider capital markets cases, as a credible alternative to the courts system;
- Maintain shareholders' registers in independent accountable bodies (LCD, other) to better protect shareholders' rights;
- Amend corporate legislation in order to give greater certainty and clarity to issuers and holders of financial instruments with contingent rights (such as options, convertible bonds, etc.).

Investors:

1. *Attract long term institutional investors, incl. Latvian pension fund money*
    - To align with Estonia and Lithuania, have EUR as the default currency for trading and clearing of securities investments on NASDAQ OMX Riga;
    - Establish one empowered competence centre (State Development Bank) for Public Private Partnership (PPP) projects and sell participation in PPP infrastructure projects via international auctions;
    - Ensure the long-term commitment of state funds to the privately-managed venture capital industry.

2. *Develop and strengthen the local retail investor base*
    - Reduce transaction costs of investing in shares relative to other assets (e.g. real estate) Reduce tax administration for retail investors in securities listed on NASDAQ OMX Riga;
    - Require that a certain percentage (10% - 25%) of the shares of each medium or large state or municipal company which is selected for privatization are sold on the Stock Exchange for cash to retail investors;
    - 10% of shares of privatized state and municipal owned companies could be allocated to employees as part of their remuneration package;
    - Issue Latvian government inflation bonds available for purchase by retail investors.

Issuers:

- Incentives for investment funds and pensions funds to invest in companies listed on NASDAQ OMX Riga (eg, improved rules on disclosure and transparency, corporate governance, reduced capital gains tax, etc);
- Introduce tax incentives for issuers who operate in Latvia and are listed or partially listed in Latvia (please see FICIL Tax Position);
- Easier access to export guarantees for larger issuers;
- Consolidate all state and municipal property in several strong companies that would be governed centrally under transparent and professional management bodies;
- Establish and communicate the government's policy on the sale of the remaining state and municipal property, both short- and long-term, aiming to support privatisation models that would attract new participants to the Capital Market in Latvia.

3. Rationale

Corporate Governance is one of the key elements that foreign investors assess before making their investment decision in any specific country. Development or under-development of corporate governance is highly correlated with the risk of the investment. Good corporate governance is critical in respect to shareholder rights which in turn is one of the basic and fundamental requirements of any investor.

Separation of the administration of the SOEs from the line ministries would:

- Reduce the political interference;
- Create a level playing field where line ministries would not have a direct interest (as an owner) in limiting the competition in order to protect their SOEs. On the contrary, as one of its key obligations, ministries should facilitate competition in a specific sector. This is a very important factor to facilitate FDI.

Reestablishment of the supervisory councils (boards) and/or Audit Committee, Remuneration Committee and Nomination Committee create efficient control and management of the SOEs. Latvia is perhaps one of the few countries in the World that does not have supervisory councils for their SOEs. When the decision was made to abolish SOE councils, the intentions were clearly good, however the chosen and current solution was definitely not good.

Centralized management of the SOEs would improve the efficiency of their financial oversight as well as ensuring that the management of the SOEs' business activities is done on commercial grounds.

The Transparency Policy should set clear requirements on the availability of information on the SOEs, including quarterly reports, publishing information on the changes of a business that have material impact on the company, improving the information availability in the annual reports, revealing information about the management of the company, managers' experience, remuneration, internal controls, etc.

Increasing Private Equity in State-owned Assets provides such benefits as:

- Additional investments when other finance sources are limited (eg. credit traditionally provided by banks and foreign institutions);
- Increased efficiency of business processes and business management quality and access to the experience of private equity houses;
- Achieving critical trading mass for further attraction of investors;
- Development of the stock market would significantly improve access to additional finance sources;
- Employment opportunities;

- Increase in tax revenues;
- A more transparent business environment.

Positive experience should be used from other countries:

- Poland performed successful IPOs of its largest state enterprises through the Warsaw Stock Exchange (WSE) and managed to:
    - Increase liquidity of the securities;
    - Increase management effectiveness;
    - Retain control over strategically important companies;
    - Ensure high transparency;
    - Distribute 10% of the newly listed shares to the employees of the state owned companies, thus helping distribute the wealth, ensure public acceptance of the IPOs and attract a broad base of individual investors through promotion of IPOs of state-owned companies;
- Subsequently the IPO of the largest state companies and banks led to rapid development of WSE, which in turn encouraged:
    - The establishment of an exchange regulated market for SMEs.
    - The development of the market for corporate, municipal and treasury bonds;
    - Increased interest for IPOs in the Polish market amongst privately held companies;
    - Significant increase in its market capitalisation;
    - Ability in attracting additional finance sources;
- Additional key success factors for the development of WSE:
    - Strong market institutions and promoted corporate governance among issuers;
    - Pension funds in Poland invest up to 40% of their assets in the equities of the companies listed on the regulated market;
    - Broaden the investor base (individual investors account for ca. 20% of shares trading);
    - Relatively large internal market;
    - Ability to compete with the London Stock Exchange and other exchanges for the biggest CEE companies;
    - Poland's resilient economy.

- Romania involved international institutions (IMF and World Bank) as controlling entities to change the Increasing Private Equity model in use because of corruption and deadlocks in the privatisation and economic transition process.

- In many jurisdictions, courts of arbitration act as an effective alternative forum for dispute resolution to the normal court system. They can act much more quickly and they can have a higher standard of judges hearing cases, as they are free to engage industry specialists as judges. Unfortunately the current arbitration system in Latvia does not act as an effective supplement to the courts and is largely discredited.

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