Capital Market Integration and MiFID Implementation: the Bulgarian Experience

Knowledge and Advisory Services on Financial Market Integration and the Implementation of the Markets in Financial Instruments Directive (MiFID) in EU Candidate and New Member States[1]

Public Disclosure Authorized

June, 2011

Financial and Private Sector Development Department
Central Europe and the Baltics Country Department
Europe and Central Asia Region
World Bank

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Abbreviations:

BALII	Bulgarian association of investment intermediaries
BIS	Bank for International Settlements
BME	Bolsas y Mercados Españoles
BNBGSSS	Bulgaria's National Bank Government Securities Settlement System
BOP	Balance of Payments
BSE	Bulgarian Stock Exchange
CDAD	Central Depository AD, an organization in Bulgaria providing settlement of corporate securities
CEESEG	Central and Eastern Europe Stock Exchange Group
CSD	Central Securities Depository
EC	European Commission
ECB	European Central Bank
EGMI	Expert Group on Market Infrastructures
EU	European Union
FDI	Foreign Direct Investment
FESE	Federation of European Stock Exchanges
FSAP	Financial Sector Assessment Program
FSAP	Financial Services Action Plan
FSC	Financial Supervision Commission
FTSE	Financial Times and London Stock Exchange
GDP	Gross Domestic Product
IMF	International Monetary Fund
IPO	Initial Public Offering
MiFID	Markets in Financial Instruments Directive
MoF	Ministry of Finance
NASDAQ OMX	National Association of Securities Dealers Automated Quotations Aktiebolaget Optionsmäklarna/Helsinki Stock Exchange
NYSE	New York Stock Exchange
OTC	Over-The-Counter
RM	Regulated Market
SPV	Special Purpose Vehicle
SIX	Swiss Infrastructure and Exchange
WDI	World Development Indicators

Table of Contents

Tables

Figures

I EXECUTIVE SUMMARY: CAPITAL MARKET INTEGRATION AND MIFID IMPLEMENTATION: THE BULGARIAN EXPERIENCE

1. This note aims to assess the implementation of MiFID in Bulgaria, provide an initial view on the impact it had on the Bulgarian securities markets, and draw lessons from the experience.

2. **Bulgaria entered the European Union (EU) and adopted MiFID at the cusp of a global crisis that hit central Europe particularly hard.** MiFID implementation in Bulgaria began along with other EU countries on November 1st 2007, less than a year after Bulgaria had entered the union. Important changes for the local market were the introduction of the passport, which allows intermediaries to operate throughout Europe under the local license, a more competitive environment for trading venues as shares listed on the regulated market (RM) shares can be traded anywhere in Europe, and greater role for home supervisor.

3. **The crisis had a severe impact on the Bulgarian capital market in terms of prices, depth and liquidity.** Market capitalization dropped from 51 in 2007 to 15 percent of GDP in 2010, mostly driven by a sharp drop in the valuation of listed firms, and liquidity dropped with annual trading amounting to only 5 percent of market capitalization in 2010. These developments have overshadowed the capital markets in the period.

4. **MiFID has had a very modest impact on market development and structure since initiation.** The Bulgarian Stock Exchange (BSE) remains the only trading venue in Bulgaria, as is the case in most other EU Member States, but with the difference that although Bulgarian companies gained access to a variety of trading venues in Europe, most of the trading in BSE-listed shares still occurs in Bulgaria. Due to the small size of Bulgarian companies, there has not been much interest from the pan-European venues, as most of the MiFID competition in Europe has been concentrated on the blue chips[2]. The small domestic market is still served by a large number of intermediaries as it was before the introduction of MiFID, focused on operations on the domestic market. Whereas other forms of international financial integration has been significant, including foreign direct investments (FDI), foreign borrowing and domestic on lending by foreign owned banks, and direct lending by European banks into Bulgaria, foreign interest in the Bulgarian capital market has been modest. Perhaps the most important aspect of this integration has been the presence of foreign banks facilitating investments abroad and investment banking services to companies in Bulgaria.

[2] A stock in a company with a national reputation for quality, reliability and the ability to operate profitably in good and bad times.

5. **The modest international integration raises the question of how to best achieve the benefits of MiFID, and international integration of the BSE can be a part of the answer, but clearing, settlement, and depository functions are equally important.** The EU Single Market underpinned by MiFID and the rest of the Financial Services Action Plan aims to provide access to a wider pool of capital for Bulgarian companies, investment firms, market operators and investors. However, the Single Market has thus far generated modest benefits for small capital markets such as that of Bulgaria. One solution might be to integrate Bulgaria's market more closely with bigger and more established capital markets, and in that context plans are underway for a strategic sale of the BSE to a strong international exchange. Local intermediaries, too small to make direct use of their MiFID rights to compete abroad, would gain immediate access to more and bigger trading venues, but would also face greater competition. Listed firms, despite predominantly small size, would gain more visibility and therefore practical access to a greater investor base. Local investors would gain easier access to a larger market through the local intermediaries. The BSE as part of the bigger international player will be better placed to face competition from other European exchanges and multilateral trading facilities (MTF). The right choice of partner is beyond the scope of this report. A regional approach to analyzing this question is proposed not only because other countries in the region face a similar question, but also because Bulgaria's optimal choice depends on the actions of other countries in the region and how they will choose to integrate their markets.

6. **The crisis offered a low activity period to adopt and implement the legal framework for MiFID, but as cross border capital market activities grow the authorities must maintain foresight and vigilance to ensure effective oversight.** The domestic legal framework for MiFID was quickly adopted. MiFID implementation challenges were mitigated by the depressed market as trading remained not only largely domestic, but also on a single trading venue, the BSE. Ensuring price transparency and best execution, key aspects of MiFID, has been relatively straightforward, but that will change as the investment industry integrates with the rest of EU and trading becomes more dispersed.

7. **The new regulatory requirements established by MiFID have added administrative and business operation burdens for the investment firms.** Concerns have been raised over increased reporting to the regulator and a significant increase in paper work between the industry and their clients.

8. **Based on the review, the report recommends the following:**

(i) *The Ministry of Finance (MoF) to take the lead in a strategic sale of the BSE (along with the central depository) to a major international stock exchange.* Strategic sale will enable the local market players to get more visibility though membership/listing in a big international market operator, while the BSE will be in a better position to face competition from larger trading venues in Europe. Furthermore, the presence of an international operator will help reform the CDAD structure and operation to allow it to link up with other central depositories in Europe.

(ii) *The FSC to maintain foresight of potential advancements in market development locally as well as across borders and adapt the regulatory and supervisory framework as needed.* As EU capital markets framework undergoes important changes and the local capital market in Bulgaria potentially develops and integrates with the rest of Europe it is important that the FSC embraces changes and prepares the industry for them. As a result, capital market participants as well as a broader financial market will benefit from more transparent, better integrated and robust capital market.

(iii) *The FSC to optimize the compliance and client handling functions in order to improve the business environment for the industry.* This would include reducing the number of reports and issuance frequency of compliance instructions, and other compliance oriented reforms. The broker/client transactional costs could be reduced by electronic contracts and signatures. By taking the lead in implementation of this recommendation the FSC will help create more cost-effective and vibrant industry.

(iv) *The FSC to lessen the barriers for investment firms to conduct business abroad.* Bulgarian firms are not experienced in conducting business abroad and they lack international connections. The FSC could assist this process through providing information to the industry, reducing administrative barriers for setting up overseas branches, or reconsidering the use of tied agents for trading abroad. This way the industry will be better able to realize full benefits of the capital market integration.

II INTRODUCTION

9. **Bulgaria began the adoption of the Markets in Financial Instruments Directive (MiFID) along with other European Union (EU) Member States in November 2007.** MiFID created a new competitive framework among investment firms and securities exchanges within EU, as well as between securities exchanges and alternative trading systems within EU.

10. **MiFID raised implementation challenges for securities market regulators and participants not only in existing EU countries, but also candidate countries and the World Bank has provided advice on the process.** The challenges of implementing MiFID go beyond the transposition of the directive into domestic legislation. MiFID introduced a new business model for the European securities market with far-reaching implications for investment brokerage firms, regulated markets and securities market regulators. In this context the World Bank has been involved in the assessment of MiFID implementation in EU new member states and EU candidate countries.

11. **This note aims to assess the implementation of MiFID in Bulgaria, provide an initial view on the impact it had on the Bulgarian securities markets, and draw lessons about the experience.** The economic benefits sought from MiFID materialize as capital markets integrate, i.e. as Bulgarian investors gain cheaper, easier, and greater access to foreign assets, and as Bulgarian firms gain cheaper, easier, and greater access to funding from foreign investors. The note seeks to reveal implementation gaps and/or risks to the objectives of MiFID. The analysis is not an enforcement tool as it is based on feedback from a limited yet varied sample of participants[3]. Instead it aims to provide insights into how public policy and regulatory/supervisory approaches can better track and provide incentives for the industry to adapt more quickly to MiFID requirements and to achieve the benefits of integration.

12. **This note is part of the World Bank's regional knowledge and advisory services focused on the assessment of MiFID implementation in EU New Member States and EU candidate countries.** A similar report was already produced for Croatia and more limited assessment had been completed for Lithuania and Romania. The World Bank's efforts in this area have been welcomed by the European Commission (EC) and the results of this work can be shared with the EC upon a client request. Since the report analyses major aspects of the MiFID implementation it is closely aligned with the EU standards. However, the methodology for the assessment of MiFID implementation was developed by the World Bank's team in the form of an industry self-assessment survey which was administered to local market participants (investment firms and regulated market) as well as market regulators. Regional approach is

3 A self-assessment survey on MiFID implementation, designed by the World Bank team, was administered among capital market participants in Bulgaria. Survey results were collected from 5 investment firms, BSE and FSC. The team would like to thank investment firms, BSE and FSC for participating in the interviews and in the survey.

further emphasized by the detailed analysis of the degree of capital market integration occurred in individual countries upon MiFID implementation.

13. **The note is organized as follows:** Section III analyzes the Bulgarian capital market development in terms of size, liquidity, and international integration. Section IV presents the results of interviews and questionnaire responses on specific aspects of MiFID implementation. Section V offers recommendations regarding the implementation of MiFID and to derive the full benefits from international market integration and a competitive capital market.

III Capital Market in Bulgaria - Recent Trends and Integration in the European Market

14. **The Bulgarian capital market remains small after the global crisis reversed most of the gains achieved in the pre-crisis years.** Rapid increase in equity market capitalization from 10 percent of GDP in 2004 to 51 percent of GDP in 2007 has been substantially reversed to 15.3 percent of GDP in 2010. The equities segment has been the major driver of market development, whereas the bond market has remained stagnant. The government bond market reached 6.5 percent of GDP in 2010. Pre-crisis capital market development was stimulated by growth in the institutional investor base with assets of collective investment schemes reaching 382.5 BGN million in 2009[4], compared to 18 BGN million in 2003.

Table 1: Bulgaria Capital Markets, Intermediaries and Collective Investment Schemes

BGN millions unless otherwise noted	2003	2004	2005	2006	2007	2008	2009	2010
Securities firms								
Number of firms	108	93	88	85	83	88	86	80
of which owned by banks	31	31	29	29	25	25	25	25
Total assets	323	820	1,323	3,029	7,723	6,810	5,460	
Collective investment schemes								
Number of schemes	5	9	25	45	71	94	102	
Total assets	18	34	95	316	911	328	383	
Special purpose vehicles (SPV)								
Number of SPVs specialized in real estate	2	4	12	34	52	61	61	
Assets of SPVs specialized in real estate			129	542	1,283	1,478	1,482	
Number of SPVs specialized in receivables	1	1	1	6	9	8	7	
Assets of SPVs specialized in receivables			5	97	89	82	98	
Bulgarian Stock Exchange								
Number of listed companies	338	402	343	353	394	395	395	330
Total annual turnover	653	141	3,183	3,384	9,959	2,578	1,314	775
Equity market capitalization/GDP in percent	7.9	10.5	20.1	29.3	51.3	17.1	17.9	15.3
Bond market capitalization/GDP in percent	12.0	11.9	10.0	9.2	8.1	5.3	6.4	6.5

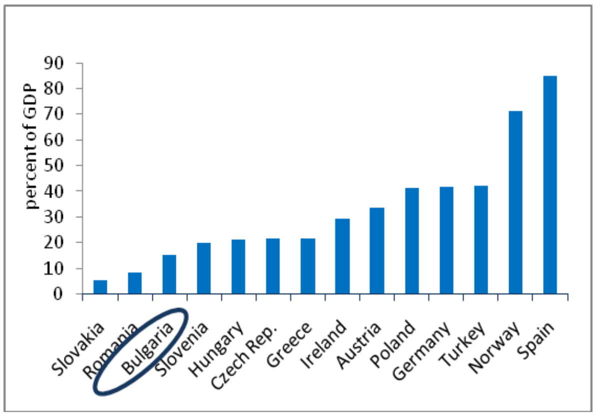
Source: FSC, BSE, FESE, BIS.

15. **The small market is served by a large number of investment intermediaries.** There are 80 licensed investment intermediaries including 25 that are part of big banking groups (Table 1). Non-bank affiliated intermediaries are mostly smaller investment firms, with about 60 percent of them having on average 3 employees. The industry has already consolidated since the early 2000s when industry misconduct after mass voucher privatizations led to strengthened oversight. The capital market grew rapidly until 2007, and amid relatively low pre-MiFID capital requirements most firms stayed active. However, the assets of the industry deteriorated with the

[4] The BGN/US$ exchange rate as of end-2010 was 1.4639, and Bulgarian GDP was US$ 47.7 USD billion in 2010.

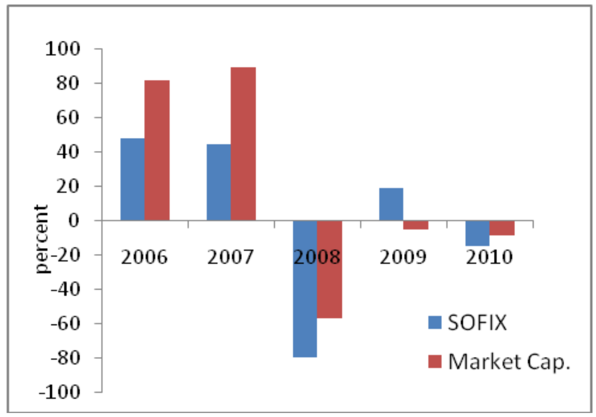
financial crisis, reaching 5,460 BGN million in 2009, compared to 7,723 BGN million in 2007. Most of the firms have been operating exclusively in the domestic market and have not established networks abroad. Each investment firm is a member of the central depository (CDAD), holds the required minimum number of shares in BSE-Sofia and contributes to the Guarantee Fund established to compensate for losses related to activities of investment firms[5].

Figure 1: Equity Market Capitalizations in Europe, 2010



Sources: FESE for market capitalization, IMF for GDP.

Figure 2: Bulgaria[6] Equity Market Capitalization and SOFIX Index, Annual Growth



Sources: FESE for market capitalization, IMF for GDP.

16. **Equity market capitalization is low in Bulgaria compared to both developed Europe and regional income peers (Figure 1), and whereas pre-crisis growth in capitalization reflected both new issuances and increasing prices, the post-crisis period had a stagnation in issuance and drops in prices.** The majority of medium-sized and large companies are financed through bank credit or, in case of those foreign owned, directly from abroad. Pre-crisis peaks in valuation were partially driven by foreign funds inflows, as well as a shift in asset allocations of pension funds from debt to equity[7]. Pre-crisis growth in market capitalization reflected new issuance as much as price growth (Figure 2). However, the financial crisis and increased reporting requirements led a number of firms to delist, and the total number of listed firms was reduced to 330 in 2010. The total capital raised through the Bulgarian Stock Exchange (BSE) dropped by 65 percent in 2010 compared to 2007. There were no Initial Public Offerings (IPOs) in 2010 and the new bond issues were by almost 50 percent lower than the year before.

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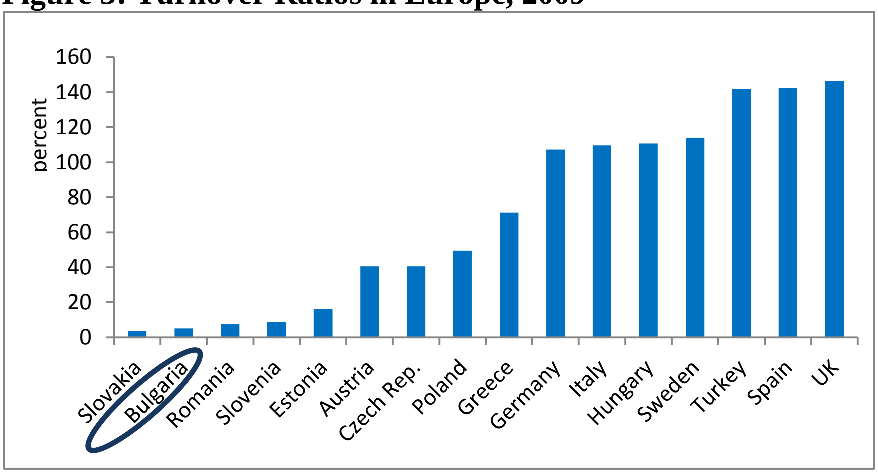
[5] Capital Markets Technical Note, FSAP Bulgaria, September 2008.
[6] The chart provides only an indicative decomposition of the growth in market capitalization as the SOFIX provides only an indicate price of all the securities listed on the exchange.
[7] 2009 changes in investment rules allowed pension funds to increase their investment in equities to up to 30 percent of their total assets.

17. **Market liquidity on the BSE is low with an average annual turnover ratio of 5 percent in 2009 (Figure 3).** The lack of liquidity can be explained in part by the relatively low free float (officially 25 percent on average), which discourages trading by inflating ask-bid spreads, and in part by the low trading activity of institutional investors, which mostly employ "buy and hold" strategies.[8] Because of the low liquidity, there is also a large number of block trades in the market. These must be reported to the BSE within 3 minutes of concluding the transaction. The BSE operates in several different segments (Table 2) both of which are governed by the 'Regulated Market' definition of MiFID, but does not operate any MTF. Equities are listed on official and unofficial markets, which are both divided into two segments, A and B. Listing requirements vary for the different segments and are the most restrictive on the official segment A[9]. Many companies are listed on the unofficial market, and its less restrictive segment B has grown relative to the official market. Although several companies have delisted lately, many companies that are not traded stay listed on the unofficial segment B. Following the perceived misconducts related to mass voucher privatization, the FSC introduced a rule that required majority shareholders to buy shares from minority shareholders through a tender offer and at a price calculated in accordance with procedures specified in the law. This method has been successful in protecting minority shareholders, but it has also curbed the delisting process and thereby artificially inflated the market capitalization on the unofficial segments.

Figure 3: Turnover Ratios in Europe, 2009



Source: WDI.

[8] Capital Markets Technical Note, FSAP Bulgaria, September 2008.

[9] To list on official segment A, a company must have a prior trading history and have been listed on official segment B for at least 1 year, or on unofficial segments A or B for at least 2 years. Other criteria include 25 percent free float, which is lower for other segments.

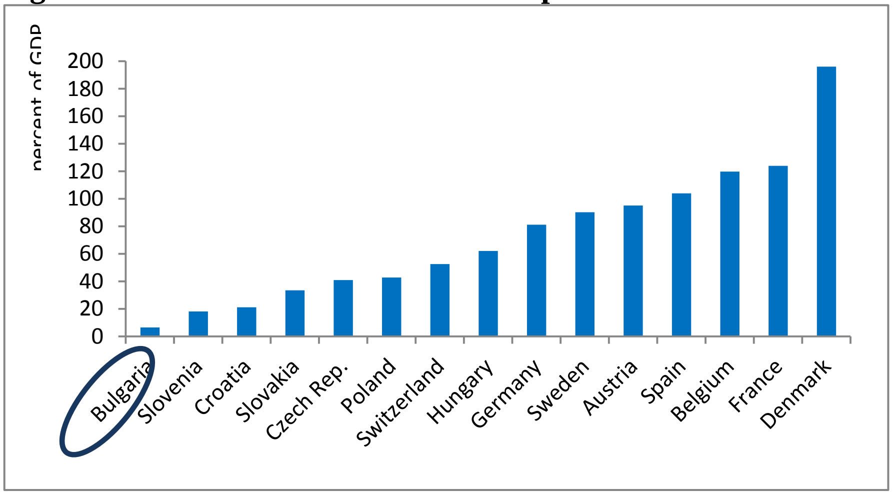
Table 2: BSE Market Segments

	Market Capitalization 2008	Market Capitalization 2010	Turnover 2010	No. of Listed Companies 2010
Official market	*Percent of Total*			
Segment A	1.5	1.8	3.7	
Segment B	30.3	35.4	25.8	
Official market, total	**31.8**	**37.2**	**29.5**	**23**
Unofficial market				
Segment A	64.1	42.9	35.2	
Segment B	4.0	19.9	35.3	
Unofficial market, total	**68.2**	**62.8**	**70.5**	**307**
Total	**100**	**100**	**100**	**330**

Source: BSE.

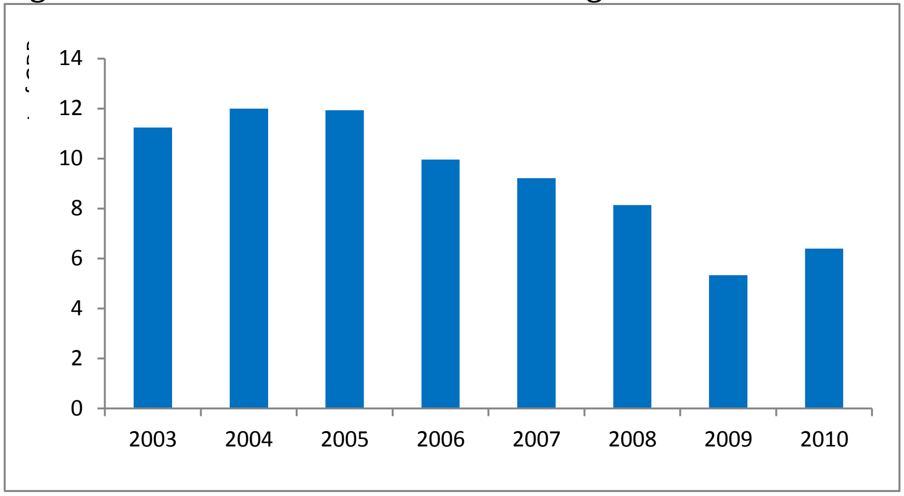
18. **The corporate bond market in Bulgaria is small (Figure 4 and 5).** The corporate bond market had some big issuance in years leading up to the crisis, but then stagnated, and secondary trading is very limited. The main investors in the bond market are local banks and institutional investors. Sound fiscal policy and international borrowing has resulted in a shrinking and small local government bond market. There is no liquid yield curve, which prevents development of other debt market segments. Necessary infrastructure for the market development is in place, including regular issuance calendars, auctions, and primary dealers and legal framework for investors' participation. The IMF has been advising Bulgaria on how to further develop the government segment of the market.

Figure 4: Size of Bond Markets in Europe



Source: BIS.

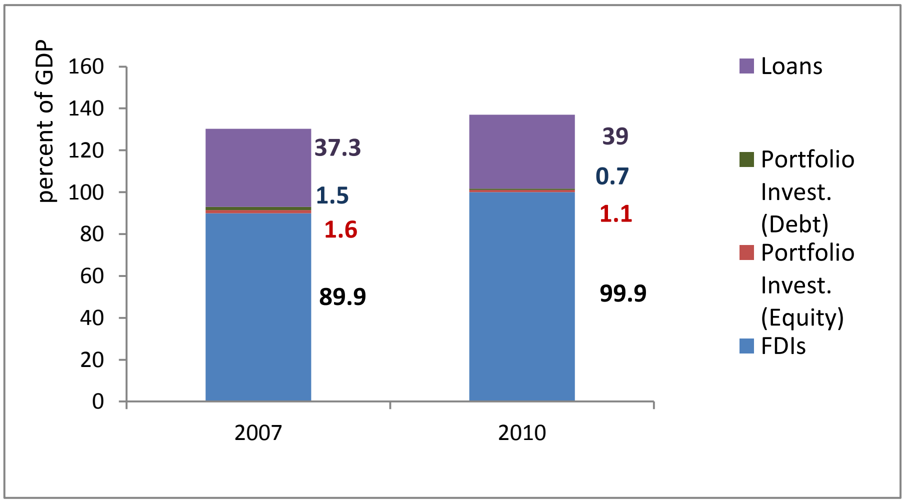
Figure 5: Evolution of Bond Market in Bulgaria



Source: BIS.

19. **International financial market integration was rapid in the pre-crisis period, and that has not been lost, but the listed equity market is only a small part of that integration.** Major benefits of integration have been achieved through foreign direct investments amounting to 100 percent of GDP on a cumulative basis, intermediation by foreign banks, and through direct loans from abroad to the enterprise sector (Figure 6).

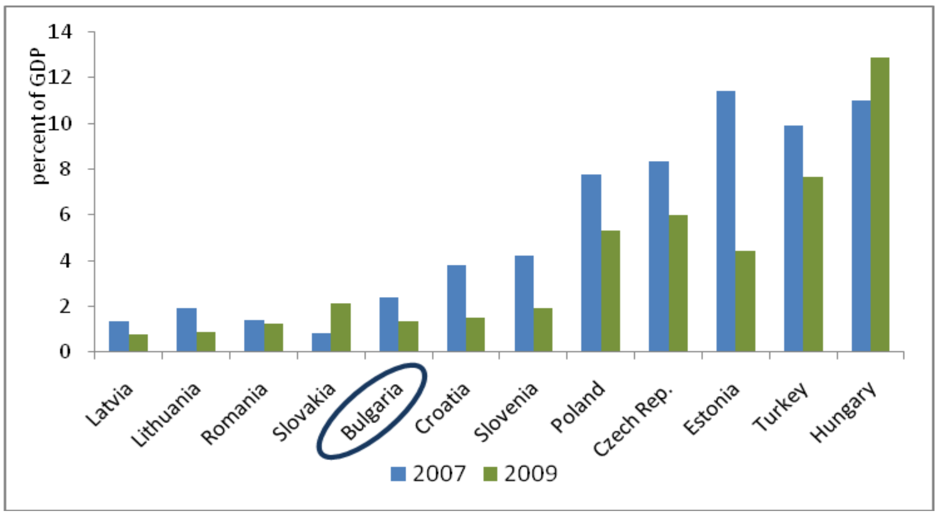
Figure 6: Stock of Foreign Investments into Bulgaria



Source: IMF, BOP Database.

20. **The Bulgarian stock market experienced financial integration with rest of the World pre-crisis, but to a lesser extent than most of emerging Europe (Figure 7).** New Member States with larger and deeper capital markets enjoyed greater foreign investments in the local stock markets and continue to do so. Despite significant inflows into emerging markets equity after the crisis, foreign inflows in Bulgaria have been declining, amid low liquidity and a weak domestic economy. At the same time Bulgarian pension funds are becoming more inclined to invest abroad, as new regulatory framework sets a basis for cross-border trading. This makes it more difficult for Bulgarian firms to access funding in the equity market.

Figure 7: Foreign Portfolio Investments in Equity



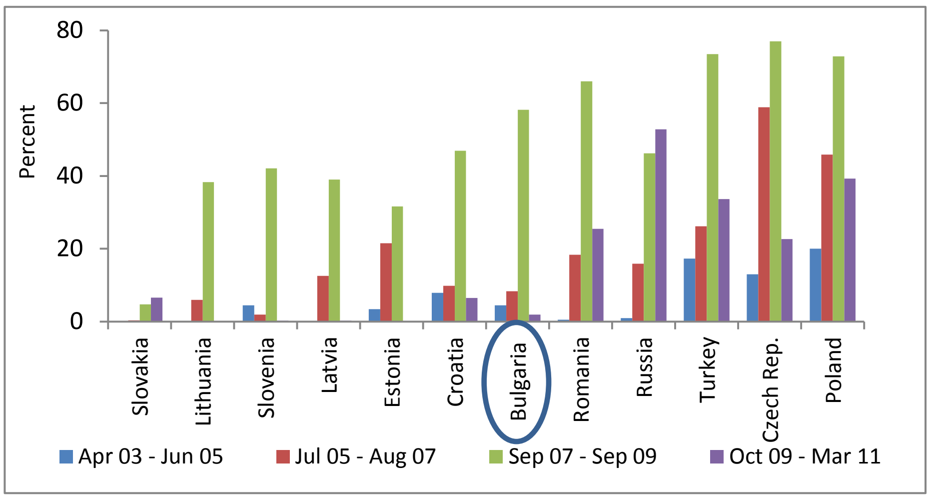
Source: IMF, BOP Database, international investment position.

21. **Price movements in the Bulgarian equity market were quite independent from Europe before the crisis, but became more integrated during the crisis.** The integration of markets as measured by price movements are analyzed using a simple capital asset pricing model (CAPM)[10], where monthly returns of individual indices in emerging Europe are measured against a broad European market index, FTSE Euro Top 100. The analysis produces two key measures, β that measures how prices in emerging markets respond to movements in the European market (Figure 8), and R^2 that measures how much of the variation in emerging market returns are explained by European market movements (Figure 9). Prior to the crisis, the European

[10]Rct = α + β*Rmt + εct, where Rc is a monthly return on a country index (SOFIX in case of Bulgaria) and Rm is a monthly return on FTSE Euro Top 100, selected benchmark for the European equity market. Beta measures how prices in each country respond to movements in the European market as measured by the FTSE Euro Top 100.

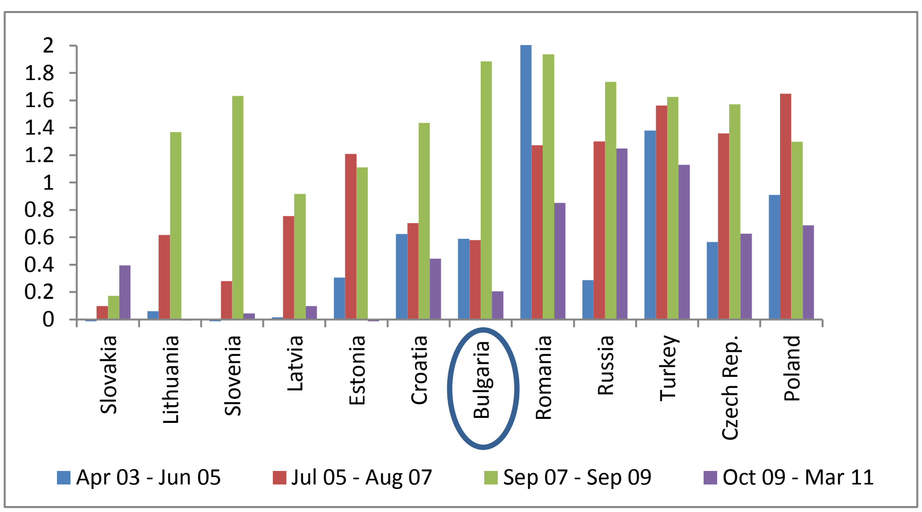
benchmark explained less than 10 percent of Bulgarian price variation. During the crisis, this increased to more than 50 percent, and a high β of 1.9 shows a high responsiveness to the global shock. Other European emerging markets show similar positive correlation with the European market, but greater integration in the non-crisis period, and less responsiveness in the crisis period. It is premature to conclude what is behind the characteristics of Bulgarian integration with the European market, but it appears that Bulgarian capital market suffered large markets corrections during financial crisis, similar to the rest of Europe, while exhibiting less integration in normal times.

Figure 8: β – Price Responsiveness to the FTSE 100



Source: Bloomberg and staff estimates.

Figure 7: R2 – Price Variation Explained by FTSE 100 Movements



Source: Bloomberg and staff estimates.

22. **Capital market integration has not yet affected the structure or market share of local trading venues and market participants, but access to foreign markets has become cheaper as foreign banks are actively serving Bulgarian investors and firms.** The BSE remains the only trading venue in Bulgaria, as is the case in most other EU Member States, but with the difference that although Bulgarian companies gained an access to a variety of trading venues in Europe, most of the trading in BSE-listed shares is still occurring in Bulgaria. Due to the small size of Bulgarian companies, there has not been much interest from the pan-European venues, as most of the MiFID competition in Europe has been concentrated on the blue chips. The passport provision allowing investment firms to trade across the borders and the provision for exchanges and investment firms to establish alternative trading venues in other member states has not had a significant effect, similar to other small European markets. Furthermore one foreign investment firm has established a branch in Bulgaria, but foreign interest in the Bulgarian market has been modest. Bulgarian investment firms have established three branches in the UK, Romania, and Spain, respectively. More important has been provision of investment services by foreign owned banks, and investment firms from abroad have increasingly approached Bulgarian institutional investors, who reported a sharp decrease in costs of trading in foreign markets. Foreign owned banks are also appear to support Bulgarian enterprises with investment banking services helping them to get access to foreign funding, although data on these services are unavailable.

Table 3: Foreign Equity Trading as Share of Total Trading

Percent	2005	2006	2007	2008	2009	2010
London Stock Exchange	78.2	76.8	71.1	43.3	50.1	n.a.
Deutsche Börse	9.5	10.2	8.6	12.1	22.3	16.9
Oslo Børs	17.1	15.8	15.3	20.6	18.7	28.8
NYSE Euronext	4.7	0.5	0.5	0.4	0.4	33.3
NASDAQ OMX Nordic	4.4	5.4	4.8	6.1	6.4	7.3
SIX Swiss Exchange	6.8	7.8	5.7	0.5	0.4	0.4
BME (Spanish Exchange)	1.2	0.9	0.4	0.2	0.6	0.6
Borsa Italiana	6.2	5.8	4	3.6	4.7	n.a.
Athens Exchange	1.2	3.6	9.4	9.8	11.1	7.2
CEESEG - Budapest	0.1	0	0	0.1	0.2	0.2
CEESEG - Vienna	2.1	3.1	7	2	1.5	1.1
Irish Stock Exchange	5	2.4	0.1	1.2	2.9	2.1
Warsaw Stock Exchange	1.7	1.8	3.9	3.8	3.2	1.9
Bulgarian Stock Exchange	0	0	0	0	0	0

Note: NASDAQ OMX Nordic includes Copenhagen, Helsinki, Stockholm, Iceland. NYSE Euronext includes Paris, Amsterdam, Brussels and Lisbon. Source: FESE

23. **The integration of the underlying infrastructure such as the securities settlements systems and central counterparties is a critical aspect of facilitating market integration.** The Bulgarian Central Depository (CDAD) has not established yet operational connections with

other depositories in Europe, although it has to be recognized that this is rather common among the smaller CSDs in Europe. The CDAD legal basis mostly lies in the Commercial Law and the Law on Public Offerings of Securities, with some of its obligations also arising from the Privatization Law. As a result of this legacy, the CDAD still operates the ownership account system, rather than omnibus accounts system[11] adopted by most of the larger Central Securities Depositaries (CSDs) in Europe. To some extent, this made it difficult for the CDAD to establish cross-border connections. Despite the CDAD efforts to do so the only connection was established with the Romanian CSD, which however is still not in use. However, it is recognized that lack of harmonization in the post-trade industry is today a big issue for Europe and has possibly slowed down practical implementation of MiFID provisions that allow access to investment firms and regulated markets to central counterparties, clearing and settlement system across EU Single Market. Most of the smaller CSDs in Europe do not have cross-border links and the introduction of the TARGET2 system will address these obstacles to integration by moving settlement to one platform.[12]Additionally, the CDAD is engaged in the discussion of European Regulators on market infrastructure and has regularly provided comments on the activities of the Expert Group on Market Infrastructures (EGMI), which is mandated to provide advice to EC on issues related to post-trade services and market infrastructure.

Box 1. EGMI and TARGET2 Securities

EGMI was established by EC in September 2010. The EGMI's mandate is to contribute to the development of an efficient, safe and sound European post-trade market. This is done by giving advice to the Commission services on various issues in relation to post-trade services and market infrastructures in the EU. The group is composed of 25 high-level experts with practical experience in post-trade services and market infrastructures. The members of the group are drawn from market infrastructures, investment firms, custodian banks, asset management firms as well as from the academic community. The group's activities started in September 2010 and were expected to continue for two years after that.

TARGET2-Securities Projects is an effort to build the IT platform for the settlement of almost all bonds and equities that are traded in Europe. The project was initiated in 2006 and its implementation is scheduled to start in mid-2014. The objective of the T2S project is to integrate and harmonize the currently highly fragmented securities settlement infrastructure in Europe. It aims to reduce the costs of cross-border securities settlement within the euro area and participating non-euro countries, as well as to increase competition and choice amongst providers of post-trading services. TARGET2 Securities will be built, owned and operated by the European Central Bank (ECB).

Source: EC and ECB

[11] An account in which the securities of multiple parties are recorded together. A participant in a clearing or settlement system often maintains an omnibus account in the system for all its clients, but the identities of individual clients are not revealed.
[12] The current legal basis does not prevent the CDAD to establish an omnibus system of accounts and use it for connections with other depositories.

24. **As part of preparation for the harmonization of post-trading infrastructure in the EU Single Market, Bulgaria could assess the cost-effectiveness of its existing post-trading infrastructure.** There are currently two different CSDs in Bulgaria. Government securities are settled in the Bulgaria's National Bank Government Securities Settlement System (BNBGSSS), owned and operated by the BNB. Corporate securities and securities issued by local governments are settled in the CDAD. The legal and regulatory frameworks and technical features for both CSDs are very different. BNBGSSS for example does have an omnibus account system and has already taken steps towards future membership in TARGET2 Securities. Recommending the ideal post-trading infrastructure is beyond the scope of this note, but Bulgarian authorities could consider different ways to maximize the effectiveness of the existing arrangements, including evaluating the benefits of merging the two CDSs or at least harmonizing their regulatory and supervisory frameworks.

25. **A strategic sale of the Bulgarian Stock Exchange (along with the Central Depository) to a major international stock exchange is in the process and would further international integration.** Local intermediaries, too small to make direct use of their MiFID rights to compete abroad, would gain immediate access to more and bigger trading venues, but would also face greater competition. Listed firms, despite predominantly small size, would gain more visibility and therefore practical access to a greater investor base, and local investors would gain easier access to a larger market through the local intermediaries. The BSE is already facing competition from EU regulated markets and MTFs that could make best performing Bulgarian companies tradable on their markets, potentially leading to split of turnover and liquidity between the BSE and its competitor. As part of the bigger international player, the BSE will be better placed to face competition from other trading venues in Europe. Integration or connectivity of clearing, settlement, and depository services discussed above would have to be considered as part of the strategy, as the CDAD is sensibly envisaged to be part of the sale.

26. **Cross listing across borders offers an alternative of modest importance. Foreign listi**ngs are concentrated on large exchanges, and only Bulgarian firms are listed in Bulgaria. For example, because NYSE Euronext emerged as a merger of five and NASDAQ OMX Nordic of four previously local exchanges, the extent of cross-border trading on the previously independent exchanges is not reflected in the numbers below. Apart from Greece, which has attracted foreign listings, exchanges such as Borsa Italiana, BME (Spanish exchange) have not seen similar trends. The BSE upgraded its trading system in June 2008, through the introduction of Deutsche Börse's Xetra trading platform, hoping to benefit from greater foreign activity in Bulgaria, but that does not appear to yet have happened.

27. **Formulating a strategy for integration of the stock exchange, clearing, settlement and depository services deserves careful consideration beyond the scope of this note and beyond the scope of Bulgaria.** There has been a trend of concentration in the stock exchanges

across Europe with even large players such as Deutsche Börse choosing to merge with another large exchange, NYSE. In that light, central and eastern European exchanges clearly are too small to remain isolated, but it is unclear how they will best fit into the future market landscape. Careful considerations should be given to the benefits of partnerships and mergers as well as how those partnerships may shape the outlook for future collaboration or mergers with other players. The strategy must take into account the likely choices for other small capital markets in the region, and a regional analysis and approach is therefore appropriate to provide guidance.

IV MiFID Implementation in Bulgaria

28. **Bulgaria started implementing MiFID in late 2007 through the enactment of Markets in Financial Instruments Act (MiFIA).** MiFIA, together with three ordinances (Ordinance No.15 on Records and Information Disclosure, Ordinance No.35 on the capital adequacy and the liquidity of investment intermediaries and Ordinance No.38 on the requirements to the activities of the investment intermediaries), Law on Measures against Market Abuse with Financial Instruments, Law on Public Offering of Securities, Financial Supervision Commission Act and series of regulations, form the domestic legal basis for securities market and are fully aligned with EU Directives.

29. **A related issue about the legal framework for clearing and settlement is not comprehensive in Bulgaria and existing arrangements do not allow derivatives trading.** The current architecture of the capital market does not include the central counterparty to allow derivatives trading. A draft Law on Clearing and Settlement was prepared by a working group including representatives from the FSS, BSE and the industry, but it was later decided that some provisions were already present in the Law on Payment Services and Payment Systems. This issue could be resolved in the perspective of adopting upcoming EU legislation on clearing and settlement or through privatization of the CDAD as part of the BSE.

30. **During the EU accession process Bulgaria had already aligned its capital markets oversight to EU standards[13], and the shift to MiFID was therefore not a materially bigger challenge than for other EU countries except for the introduction of the EU Passport.** The EU Passport allowed investment firms in any country in the EU to operate throughout the EU. Well ahead of the MiFID implementation the oversight of the investment industry had already been tightened, and the industry had consolidated in response. Allegedly, voucher privatization to the general public that began in the second half of 1990s in Bulgaria was accompanied by series of misconducts against a population with little knowledge of financial instruments, and this had motivated tighter regulation and supervision.

31. **Major changes introduced through MiFID in Bulgaria were the EU passport provision, enlarged role of home supervisor and regulatory market, stricter fit and proper requirements for managers and shareholders of investment firms and regulated markets, more complex best execution rule applied in a broader market environment and stricter capital adequacy rules and new organizational functions for investment firms.** The EU Passport provision allows investment firms authorized by a supervisor in one member state to do business in all other member states, based on a harmonized set of rules. The role of the home

[13] Most notably the Investment Service Directive.

supervisor is expanded under MiFID, as firms operating outside their home market are no longer only supervised by a host country supervisor, but primarily by their home country supervisor. The market surveillance role of the regulated market is also expanded as it is now required to constantly monitor the activities of market participants to assure that there are no misalignments with the regulated market rules and regulations. Under the MiFID's fit and proper requirements managers and shareholders with qualifying holding in investment firms and regulated markets are continuously evaluated against reputational and professional tests. Bulgarian investment firms, interested in trading in other EU markets, have to evaluate best execution options against a variety of available trading venues and taking into account a broader range of criteria (price, speed of execution, total costs, etc.). Investment firms are also required to operate with stricter capital adequacy requirements and have independent audit, compliance and risk management functions.

32. **The FSC, which oversees capital markets, has effectively upgraded the necessary regulation.** Earlier efforts to restructure the industry through the enhanced oversight following the misconducts related to voucher privatization, served the FSC well. As a result it was able to build strong supervisory capacity and capability to reach out to industry in a pro-active way. Moreover, supervisory upgrading during the EU accession process helped strengthen supervision, and the FSC has demonstrated its capacity through its selection to provide technical assistance to supervisory authorities in Bosnia and Herzegovina and Montenegro, under the umbrella of the EU Twinning program.

33. **However, MiFID expands the role of the home supervisor for firms operating in the rest of EU and introduces new supervision aspects in local market.** As firms begin trading in other countries across multiple trading venues the FSC is required to assure that existing regulatory provisions are adequately executed in more a complex market environment. For example, the adequate application of the best execution rule has to be assured in the presence of a variety of trading venues, compared to only one regulated exchange in Bulgaria. Additionally, since MiFID broadens regulatory requirements for market players, the FSC role is also expanded in the domestic market. The FSC enforcement staff is required to assure that the regulated market adequately applies its market surveillance function and investment firms meet capital requirements, or their risk management and compliance function are robust. Maintaining the FSC supervisory capacity requires adequate resources and training, as the industry develops and integrates across borders and becomes more complex.

34. **MiFID has not had a significant impact on the industry structure, mostly due to the small size of the market, but it has presented a substantial regulatory burden in the industry's internal functions and interaction with their clients**. The industry has experienced material deterioration in revenue and profits since the introduction, but most investment firms have remained in business. There are currently 80 investment firms operating in Bulgaria, down

from 88 in 2008. The global crisis has been the predominant deteriorating factor for the industry, and the impact of MiFID cannot be separated from that of the crisis. New issuances in the Bulgarian market almost disappeared reflecting the spillovers from the global financial crisis. At the same time, many companies delisted from the Bulgarian Stock Exchange. In this environment, investment firms, predominantly small and of limited capacity, experienced the new regulatory requirements as burdensome. The industry's play field became more restrictive to new entries with increased capital and organizational requirements.

35. **The key concerns voiced by the industry are the following:**

a. **The Bulgarian compliance function has been more burdensome with MiFID, as additional reporting and approval requirements increased the amount of paper work.** Bulgarian association of investment intermediaries (BALII) has been arguing to (i) revoke the requirement for compliance officers to approve ex-ante advertising materials; and (ii) optimize the function through cutting the number and the frequency of reports and compliance instructions to brokers.

b. **Investment firms have been facing a greater regulatory burden in handling clients, and the FSC is planning to improve some aspects of it.** Investment firms are currently required to sign a paper contract with clients for each individual transaction. The regulator is planning to introduce electronic contracts and signatures and hence reduce paper work in the investment firms' dealings with clients. Another aspect is a difficulty to adequately apply the suitability test. When providing investment advice or portfolio management services to clients, an investment firm is required to obtain from clients the information regarding their knowledge and experience, financial situation and investment objectives. This information is also important when classifying a client as professional. Reportedly, receiving the necessary information from clients has proven difficult in the Bulgarian market, especially as regarding client's financial assets (bank statements) and investments. Since it seems that there are no legal requirements for clients to provide this information, the matter could be resolved through clients' education. Investment intermediaries cannot receive this information from the CDAD or banks due to legal prohibitions on disclosure and that is adequate.

c. **Investment firms face difficulties in cross-border trading not only because of the limitations in the existing infrastructure, but also because of their relative inexperience outside of the domestic market.** The incompatibility of the CDAD technical system with omnibus accounts operated by most of the European central depositories increases cost of trading outside the local market. Additionally, Bulgarian investment firms are relatively small, focused on the domestic market and with no relevant networks in other countries. One of the investment firms active in cross-border trading reported that it took more than a year to open its first branch abroad. However, it was able to open a second branch in less than a month time. Trading abroad by using tied agents is not currently allowed under Bulgarian legislation. The regulator has taken a conservative approach here, amid the legacy of tied-agents misconducts after the mass voucher privatization. However, the FSC is aware of difficulties that investment firms face in doing business abroad and is considering possibilities for making it easier. Investment intermediaries which are part of big international banking groups have an advantage in cross-border trading, since they can leverage firm's network and custodian abilities.

36. **Inadequate application of the best execution rule is a risk in cross-border trading.** BSE is the only trading venue in Bulgaria, apart from the possibility to execute certain trades over the counter and due to the small size of Bulgarian companies, there has not been much interest from the pan-European trading venues. The best execution is therefore not a challenge in the domestic market. However, Bulgarian investment firms trading in the rest of EU have to evaluate best execution options against a variety of available trading venues while taking into account a broad range of criteria (price, speed of execution, total costs, etc.). There is a risk that inexperienced firms do not take into consideration all the criteria and trading venues and execute trades at terms less favorable for clients.

37. **Irregularities in the investment firms' business conduct are most frequent in the areas of reporting qualifying holdings, safeguarding of clients funds and monitoring of large exposures according to the FSC (Table 4).** However, violations were less frequent in the second year of MiFID implementation, as investment firms became more experienced with changes in the legislation. Also, the FSC reported that the large exposures were mostly present in the low risk instruments. It is important that the FSC continues to develop its capacity and employs the adequate skill mix of professionals able to supervise these various areas of investment intermediation.

38. **In the absence of fragmentation in trading in Bulgaria outside the BSE, the abolition of the market concentration rule has not materially affected the regulated market, but the BSE market surveillance role has been broadened.** The concentration rule previously required all the trades to be routed to the national exchange and in the member states with multiple trading venues it made a substantial impact on the business of regulated market. In case of Bulgaria, some trading has now moved to the OTC market. More generally in the EU, there is a vibrant debate on the line between trading venues and OTC, and whether some of the trading happening in the OTC space should rather be subjected to the RM/MTF rules. This debate will affect Bulgaria with respect to the OTC trading currently taking place. Under the MiFIA BSE is responsible for continuous market surveillance in order to assure that its members comply with the laws governing the securities markets and the rules and regulations of the

regulated market. Non-compliance and disorderly trading are reported to the FSC. Although the BSE reports to have procedures in place to monitor compliance of market participants with its rule and regulation, its small number of stuff poses a risk to effective enforcement of its rules and regulation and monitoring of compliance. FSAP technical note on Capital Markets in Bulgaria (2008) has previously reported that FSC has not regularly conducted off-site visit to the BSE to make sure that the BSE market surveillance roles is conducted adequately. One additional risk is the absence of internal arrangements to cope with system disruptions. BSE said it was planning to create a business recovery center as a mid-term objective. If BSE becomes a part of one of the big European regulated markets, its surveillance and system functions should be improved.

Table 4: Most Frequent Violations by Investment Firms

	Drawn up Administrative Violations		**Issued Penalty Warrants**	
	2008	2009	2008	2009
1. Qualifying holdings: Failure to submit information about persons who posses qualifying holding in the firm and their number of votes in general meetings.	**18**	5	0	1
2. Safeguarding of client funds: Violation of the requirement that investment firm separate its funds from those of its customers	**12**	0	4	0
3. Safeguarding of client assets: Investment firms failed to check at the CDAD if the financial instruments to which the sale order relate are available on the customer's sub-accounts, if they are blocked and if pledge is established on them, or a distrait imposed.	**10**	1	0	2
4. Safeguarding of client assets: Investment firms did not take necessary actions to ensure that the deposited cash of customers is kept on individual account of customers account and separately from that of the inv. firm.	**10**	0	2	0
5. Minimum capital requirement not aligned with legal requirements.	9	0	0	1
6. Occurred circumstances: Investment firms failed to notify the FSC within the set time limit of occurred circumstances.	3	4	1	4
7. Failure of brokers to notify FSC of termination of their contracts	1	3	1	1
8. Large exposures: Investment firm's daily exposure to individual person or to a group of individual persons exceeds 25% of its equity.	0	**16**	0	**15**
9. Large Exposures: Violation of the requirements for the investment firm to monitor daily exposures to an individual person or a group of related persons, as well as to account for the amount of its large exposures with the purpose of limiting the risk from their excessive concentration.	0	7	0	4

Source: FSC Annual Report.

V RECOMMENDATIONS

39. **Based on the review, several suggestions emerge.** The review discovered that MiFID implementation in Bulgarian legal framework has been largely successful. However, it recognized that the pace of integration of Bulgarian capital markets had been modest despite the country's entry into the EU and alignment with EU capital markets legislation. This in large extend can be attributed to spillovers from financial crisis as well as small size and law liquidity in the local capital market. As Europe emerges from the crisis, greater benefits as well as greater challenges are likely to emerge.

40. **Recommendation 1: Complete a strategic sale of BSE (along with the Central Depository) to a major international stock exchange based on careful consideration beyond the scope of 2011.** The BSE has been in preliminary talks with large stock market operators, and their interest has been encouraging. The government stakes in the BSE and the CDAD will be bundled together and offered to a strategic investor. The process is expected to be finalized by the end of the year. Strategic sale will help local market players get more visibility though membership/listing in a big international stock exchange, while the BSE will be in better position to face competition from larger trading venues in Europe. Furthermore, the presence of an international operator will help reform the CDAD structure and operation to allow it to link up with other central depositories in Europe, as well as provide clearing and settlement for derivatives trades. However, it is also important that Bulgaria remains involved in the EGMI's and TARGET2 Securities discussions and adopts its legal framework as necessary. Choosing the right partner and integration strategy requires careful analysis of global development for stock exchanges and clearing, settlement and depository functions as well as of the future strategic choices made by other players. Similar challenges are faced by other central and eastern European capital markets, and a regional approach would be appropriate to provide further guidance on this topic.

41. As the BSE's majority shareholder, the MoF should take a lead in finalizing strategic sale of BSE, but importantly the MoF should work closely with relevant stakeholders, including the FSC and market participants. CDAD, along with the FSC and the MoF shall be responsible for potential updates of the clearing and settlement infrastructure and legal framework in line with any changes on the EU level.

42. **Recommendation 2: Maintain foresight of potential advancements in market development locally as well as across borders and adapt the regulatory and supervisory framework as needed.** This might include the following aspects**:**

a. Preparing the industry and financial infrastructure players in adapting/simulating participation under a major European operation in the light of a potential merger of the BSE with a large European exchange.

b. Implementing provisions and supervisory monitoring procedures to ensure the application of best execution in trading when expanded across a wider range of trading venues.
c. Monitoring changes to the MiFID venue classification expected as part of the MiFID Review which might require a more vigilant enforcement of the rules for equity trading.
d. Strengthening the surveillance function to be able to adequately verify industry's capital and risk management requirements.
e. Increasing monitoring and enforcement of requirements for investment firms in several areas, including safeguarding of client funds, reporting qualified holdings and large exposures.
f. Working with the BSE to increase its mandate of market surveillance and preparing requisite supervision plans and resources in the FSC to support this.
g. Undertaking training and securing resources for the FSC.

Responsibility for all the aspects of this recommendation should stay with the FSC. Capital market participants as well as a broader financial market will benefit from more transparent, better integrated and robust capital market.

43. **Recommendation 3: Optimize the compliance and client handling functions to improve the business environment for the industry.** This would include reducing the number of reports and issuance frequency of compliance instructions, and other compliance oriented reforms. The broker/client transactional costs could be reduced by electronic contracts and signatures. Additionally, the FSC shall explore legal reforms that could facilitate investment firms in determining suitability tests. By taking the lead in implementation of this recommendation the FSC will help create more cost-effective and vibrant industry.

44. **Recommendation 4: Lessen the barriers for investment firms to conduct business abroad.** Bulgarian firms are not experienced in conducting business abroad and they lack international connections. The FSC could assist this process through providing information to the industry, reducing administrative barriers for setting up overseas branches, or reconsidering the use of tied agents for trading abroad. This way the industry will be able to realize full benefits of the capital market integration.

VI ANNEX I: THE MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE (MIFID) - MAIN CONCEPTS

1. MiFID was adopted by the European Parliament and came into force across EU Member States in 2007. It creates a new competitive framework among investment firms and securities exchanges across member countries, as well as between securities exchanges and alternative trading platforms within the EU single market.

2. MiFID raises major implementation challenges for securities market participants and regulators in both new member states and candidate countries of the EU. MiFID also involves several requirements on risk management controls and transparency for the conduct of securities trading. Over the medium term, European neighborhood countries that plan to join the single market in financial services may also be affected.

3. MiFID is based on three pillars to ensure effective implementation:

a. Pillar 1: Strengthens the single passport for investment/brokerage firms. This allows firms to provide investment services in the 27 EU Member States and the 3 European Economic Area (EEA) States on the basis of a single authorization using home member State control. As a *quid pro quo*, MiFID imposes high standards of investor protection that are valid across EU Member States and EEA States. Specifically, the Directive introduces strict rules on the authorization, internal governance and risk management of investment firms, and harmonizes conduct of business rules for securities trading by investment firms, including client categorization, best execution of trades, and transaction reporting to the regulator.

b. Pillar 2: Abolishes the trade concentration rule. The rule had been established under the Investment Services Directive and where member States could require securities trades to be executed on the main domestic exchange. The abolition of the trade concentration rule introduces free competition between regulated markets, multilateral trading facilities (MTFs) and systematic internalizers for the trading of transferable securities both within and across EU Member States. As a *quid pro quo*, MiFID imposes strict authorization and operational conditions for regulated markets, MTF and SIs (including rules on access to the platform, execution system, and surveillance), as well as pre- and post-trade transparency requirements for all equity securities markets taking place on RMs, MTFs or SI (identical for RMs and MTFs, lower for SIs, reflecting the fact that SIs take on capital risk). Pre- and post-trade transparency requirements of the Directive do not apply to the bond and derivative markets, however.

c. Pillar 3: Establishes the powers of securities market regulators and the modalities of cross-border collaboration. MiFID specifies the minimum supervisory and investigatory powers that Member States must ensure for securities market regulators in the exercise of their functions. The Directive regulates administrative sanctions, the right of appeal by market participants, consumer organizations and professional organizations, the extra-judicial mechanism for investor complaints, the professional secrecy of regulators, and relations between regulators and auditors. It also regulates the cooperation between regulators of different EU Member States and third country regulators.

MiFID: Main Concepts explained:

The EC's MiFID Directive 2004/39/EC:	The Markets in Financial Instruments Directive provides a unified framework for securities: It encompasses investment firms, Multilateral Trading Facilities (MTF), Regulated Markets (i.e. exchanges) and financial instruments (transferable securities[14], money-market instruments, units in collective investment undertakings and derivatives, excluding bonds and securitized debt). The Directive, referred to as "Level 1" due to its mode of adoption jointly by the EU Parliament and the Council, sets principles. It needs to be transposed. It is complemented by "Level 2" texts which consist of implementing measures.
Investment firm:	Any legal person whose regular occupation or business is the provision of investment services to third parties and/or the performance of one or more investment activities on a professional basis. Member states may include under this definition undertakings which are not legal persons, provided that (i) their legal status ensures a level of protection for third parties interest equivalent to that afforded by legal persons; and (ii) that they are subject to equivalent prudential supervisions appropriate to their legal form.
Systematic internalizers (SI):	An investment firm which, on an organized, frequent and systematic basis deals on its own account by executing client orders outside a Regulated Market or MTF. Concretely, investment firms declare themselves SIs for selected equities (self-certification regime), and route most orders to other trading venues including their own platform. SIs are associated with the trading in shares, and regulated under

[14] Securities negotiable on the capital markets, with the exception of instruments of payment such as shares in partnerships and depositary receipts, bonds and securitized debt, other securities giving rise to a cash settlement determined by reference to other transferable securities, currencies, interest rates, commodities.

	article 27 of the MiFID Directive.
Multilateral Trading Facility (MTF):	A multilateral system operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance to non-discretionary rules. They are basically alternative trading platforms to exchanges, often created by banks to process their trades such as 'Turquoise' as regards equities. The MTF concept is similar to the Alternative Trading Systems (ATS) widely developed in the US (see Section 2.2).
Regulated Market (RM):	A multilateral system (i) operated and/or managed by a market operator, (ii) which brings together multiple third-party buying and selling interests in financial instruments –in the system and in accordance with its discretionary rules – in a way that results in a contract in respect to the financial instruments admitted to trading under its rules and/or systems and (iii) which is authorized and functions regularly. RMs correspond to the major securities exchanges in the EU, but not all exchanges are RMs, some of them are regulated as MTFs. The main difference between a RM and a MTF remains the non-application of the Prospectus Directive (2003/71/EC), the Transparency Directive (2004/109/EC) and subsequently the IFRS to MTFs.
	<u>Fit and proper requirements</u>
Propriety and fitness test of persons who direct the business:	The regulator must ensure that the persons who effectively direct the business of an investment firm are of sufficiently good repute and experience so as to ensure the sound and prudent management of the firm. The regulator must ensure that the management of the investment firm is undertaken by at least two persons. The investment firm must regularly disclose to the regulator of any changes to its management.
Suitability test of shareholders and members with qualifying holdings:	The investment firm must disclose to the regulator the identity of the shareholders or members, whether direct or indirect, natural or legal persons, that have qualifying holdings in the firm, and the amount of these holdings. Qualifying holding means any direct or indirect holding in an investment firm which represents 10% or more of the capital or the voting rights, or which makes it possible to exercise a

	significant influence over the management of the investment firm in which that holding subsists. The regulator must ensure that the above persons are suitable, taking into account the sound and prudent management of the investment firm.
Relationship with third parties:	The regulator must ensure that the existence of close links between the investment firm and other natural or legal persons does not prevent the effective exercise of its supervisory functions. Close links means (i) participation, i.e., ownership, direct or by way of control, of 20% or more of the voting rights or capital of an undertaking; (ii) control, i.e., relationship between a parent undertaking and a subsidiary as defined in Directive 83/349/EEC, or a similar relationship between any natural or legal person and an undertaking, any subsidiary undertaking of a subsidiary undertaking also being considered a subsidiary of the parent undertaking, which is at the head of those undertakings. A situation where to or more natural or legal persons are permanently linked to one and the same person by a control relationship is also regarded as constituting a close link between such persons.
Acquisitions/Disposals of a qualifying holding:	Any natural or legal person that proposes to acquire or sell, directly or indirectly, a qualifying holding in an investment firm must notify the regulator in advance of the size of the resulting holding. The same applies in case the acquirer proposes to increase its existing holding above a certain threshold (20%, 33%, 50%). The regulator may oppose such a plan if it is not satisfied as to the suitability of the acquirer. In case the acquirer is a financial institution registered in another Member State, or a person controlling such financial institution, the regulator of the other Member State must be consulted prior to approving the acquisition.
Capital Requirements:	The regulator must ensure that the investment firm has sufficient capital in regard to the nature of the investment service or activity provided, in accordance with Capital Market Act (transposition of MIFID in Croatia). Capital requirements rules stipulate the minimum amounts of own financial resources that credit institutions and investment firms must have in order to cover the risks to which they are exposed. The aim is to protect clients and the stability of the financial system. The capital requirement rules are currently under review in the EU, to better account in particular for large exposures, securitization exposures and risks to the trading book.

Organizational Requirements:	Investment firms must satisfy a number of organizational requirements, i.e., to establish and maintain adequate procedures as regard decision making, internal control mechanism, internal systems and procedures, expertise of personnel, accounting policies, business records, personal transactions, conflict of interest, risk management, safeguard rules regarding client funds and account, etc.
Conflict of Interest:	Investment firms must take all reasonable steps to identify conflicts of interest between themselves (including their managers, employees and tied agents, or any person directly or indirectly linked to them by control) and their clients or between one client and another. They should also establish and maintain adequate conflict of interest policy.

Conduct of Business Obligation

C**lient suitability test**:	When offering investment advice or portfolio management, the investment firm must obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, his/her financial situation and his/her investment objectives so as to enable the firm to recommend the investment services and financial instruments that are suitable for him/her.
Product appropriateness test:	When offering other services, the investment firm must ask the client or the potential client to provide information regarding his/her knowledge and experience in the investment field relevant to the specific product or service offered or demanded, so as to enable the investment firm to assess whether the investment service or product is appropriate for the client. In case the product or service fails the appropriateness test, the investment firm must warn the client or potential client accordingly. If case the client decides not to provide the above information or provides insufficient information about his/her knowledge and experience, the investment firm must warn him/her that his/her decision may prevent the firm from assessing the appropriateness of the investment service.
Best execution rule:	Investment firms must take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into

	account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. However, if there is a specific instruction from the client, the firm must execute the order following this instruction. Investment firms must establish and implement an order execution policy to comply with the best execution rule. Appropriate information about the firm's best execution policy should be provided to their clients and their prior consent of the order execution policy should be obtained. In case the order execution policy provides for the possibility that client orders may be executed outside a regulated market or a MTF, investment firms must inform their clients about this possibility. Investment firms must obtain the prior consent of their clients before proceeding to execute their orders outside a regulated market or a MTF.
Market transparency and integrity:	Investment firms must keep the relevant data relating to all transactions in financial instruments at the disposal of the regulators. These records must contain all the information and details on the identity of the client and the information required under the Anti-Money Laundering Directive.
Admission of financial instruments to trading:	Regulated markets must have clear and transparent rules regarding the admission of financial instruments to trading. These rules must ensure that financial instruments admitted to trading in a regulated market can be traded in a fair, orderly and efficient manner and, in the case of transferable securities, are freely negotiable. A regulated market must maintain effective arrangements to verify that issuers of transferable securities that are admitted to trading on regulated market comply at all the times with their obligations in respect of disclosure obligation. There must be effective arrangements in place to facilitate members and participants of regulated market in obtaining information which has been made public in accordance with the national law. A regulated market must publish public without delays the information on suspension and removal of instruments from trading.
Access and membership to the regulated market.	A regulated market must establish and maintain transparent and non-discriminatory rules, based on objective criteria, governing the access to or membership of the regulated market. A regulated market must make sure that the investment firms comply with these requirements when being admitted to regulated market: (1) persons are fit and proper; (2) they have sufficient level of trading ability; (3) firms have

	in place adequate organizational requirements; (4) firms have sufficient resources for the role they perform. Access rules should allow for direct and remote participation of investment firms and credit institutions from member countries. There should be effective arrangements and procedures in place to monitor compliance of participants with rules of regulated markets and to report non-compliance or disorderly trading to the competent authority.

VII Annex II: List of Institution Met During the Team Visit

1. Financial Supervision Commission	Regulator
2. Fair Play Company	Real Estate Investment Trust
3. Bulgarian Stock Exchange	Regulated Market
4. Bulgarian National Bank, International Financial Institutions Department and General Banking Supervision	Central Bank
5. Central Depository	Trading Infrastructure
6. Bulgarian Association of Supplementary Pension Security Companies	Industry Association
7. Bulgarian Association of Licensed Investment Intermediaries	Industry Association
8. Bulgarian Association of Asset Management Companies	Industry Association
9. Elana Company	Investment Firm
10. Global Markets	Investment Firm
11. TBI Investments	Investment Firm
12. KAROL Company	Investment Firm
13. Investment Intermediary of Raiffeisen Bank	Investment Firm
14. Inter-Capital	Investment Firm
15. Inter-Capital Property Development	Real Estate Firm

VIII ANNEX III: BIBLIOGRAFY

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