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## A Concept Paper on Securities Regulation for Bulgaria

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# **American Bar Association Central and Eastern European Law Initiative (CEELI)\***

## **A Concept Paper on Securities Regulation for Bulgaria\*\***

### **1. Introduction**

This paper is intended to provide an introduction to the issues necessary to be addressed in connection with the drafting of a securities law for, and implementation of securities regulation in, Bulgaria. The intent is to provide support at the developmental stage for a Bulgarian effort to prepare a securities law, in anticipation of the securities offerings in Bulgaria, largely by newly privatized companies. In addition to using this paper, and further assistance from the American Bar Association's Central and Eastern European Law Initiative, Bulgaria should seek technical advice from the U.S. Securities and Exchange Commission ("SEC"), the International Finance Corporation ("IFC"), the International Organization of Securities Commissions ("IOSCO") and the Commission of the European Communities, in order to obtain as complete a range of external perspectives as possible.

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\*The Central and East European Law Initiative (CEELI) is a public service project of the American Bar Association designed to advance the rule of law and commercial law in the world by supporting the law reforms underway in Central and Eastern Europe and the New Independent States of the former Soviet Union. Through various programs, CEELI makes available U.S. legal expertise and assistance to emerging democracies that are in the process of modifying or restructuring their laws or legal systems.

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CEELI provided this concept paper to Dr. Ilko Eskenazi, Deputy Prime Minister, and Dr. Misho Valchev, Chairman of the Council on Normative Acts, Bulgaria. The materials cited in the notes were attached as appendices to the copies of the paper sent to the Bulgarian Government.

As Bulgaria follows a civil law tradition, and as it aspires to European Community membership, which would require eventual compliance with European Community securities law directives, Bulgaria will wish to focus on these directives as guides.<sup>1</sup> European Community securities law is subject to certain limitations in scope and depth due to the harmonization process by which it is formed, and is evolving. Therefore, while Bulgaria will want to comply with the minimum requirements of current European Community law, Bulgaria should adopt a more comprehensive securities law.

There is also much that can be learned from the experience reflected in U.S. securities regulation. Among Western countries, the U.S. has the most experience in securities market abuse and securities regulation, although many criticisms are justifiably levelled at U.S. securities regulation.

Bulgaria will not form a completely satisfactory body of securities regulation immediately, without its own experience acquired over time; therefore, the initial establishment of a securities law may only operate as a framework and beginning for that experience and adaptation. However, Bulgaria should draft and implement a law that will provide as flexible and complete a response as possible to the legal and policy issues raised by securities markets. While this law should be as simple and easy to administer as possible, a degree of complexity will be unavoidable, as securities markets themselves are complex, and the abuses that must be prevented are also complex. In fact, one of the difficult problems in securities law is understanding, and helping the public to understand, that regulation is necessary. Complex abuses that may not appear to unsophisticated observers to have direct victims will nevertheless require significant, and in some cases criminal, sanctions. In addition, although the internationalization of capital markets provides many opportunities for Bulgaria, it also poses the risk of imported abuse by sophisticated operators, either foreigners or Bulgarians who have learned of potential abuses in foreign capital markets.

This paper does not address some of the necessary bases for a securities law, such as (i) a corporation law establishing at least the basic respective rights and responsibilities of shareholders and managers to govern the corporation,<sup>2</sup> (ii) an accounting system and rules that can provide predictable and accurate accounts

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1. For a summary of the approach of the European Communities to securities regulation, see David Reid and Andrew Ballheimer, *The Legal Framework of the Securities Industry in the European Community under the 1992 Program*, 29 COLUM. J. TRANSNAT'L L. 103 (1991).

2. We understand that the Commercial Law of 1991 (Official Gazette, No. 47/1991, corrected Official Gazette, No. 48/1991, p. 28) provides for a type of joint stock company that resembles the French *société anonyme*, the German *aktiengesellschaft* and the U.S. public company. As the securities law is drafted, care should be taken to establish consistency with the Commercial Law, and amendments to the Commercial Law could be required. For example, we understand that the joint stock company provisions currently impose high capitalization requirements, limit the value of bonds that can be issued, provide for public offerings and permit bearer shares; all of these may need to be revised. Privatization laws that deal with public offerings should be conformed also.

and independent audits in accordance with generally accepted standards,<sup>3</sup> (iii) a judiciary that can effectively and predictably apply the securities law, (iv) an administrative law establishing the authority and constraints of a governmental body acting as securities regulator, and (v) a law of property and commercial transactions that would facilitate trading in securities without concern regarding competing claims to ownership or other rights. This paper also does not address the allied field of commodities regulation.<sup>4</sup> Finally, this paper does not address bank regulation or taxation, although the respective regulatory advantages or disadvantages conferred on the banking system or the securities market by regulation or taxation will significantly influence the development of the securities market.<sup>5</sup>

This paper begins by examining the purposes of securities regulation. It turns next to the institutional structure of securities regulation, including governmental regulators, self-regulatory organizations and private liability rules. It then considers the central concept of securities regulation: disclosure. Disclosure is most obviously important in connection with public offerings of securities, but also supports secondary trading markets. The paper then turns to a discussion of secondary trading markets, including antifraud and antimanipulation regulation, which protects trading markets from fraudulent or manipulative practices. We include insider trading and excessive use of credit in connection with our discussion of manipulative practices. The last basic area of securities regulation covered is broker-dealer regulation: the regulation of securities market professionals. After these basic areas of securities regulation are introduced, we turn to two important specialized areas of securities regulation: (i) merger and acquisition regulation, and (ii) mutual fund or investment trust regulation. Finally, we discuss the impact and opportunity of internationalization, and conclude with a discussion of the drafting process.

## 2. Purposes of Securities Law

Securities laws are economic laws that, like tax laws, corporation laws and environmental laws, are necessitated by Bulgaria's transition to a market economy. Securities laws, when written and administered properly, serve to enhance

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3. It would probably be appropriate to participate in and, when Bulgaria has the appropriate professional infrastructure and experience, adhere to the International Auditing Guidelines and International Accounting Standards being developed by the International Accounting Standards Committee, as well as relevant European Community directives.

4. Securities-related futures contracts should be prohibited until Bulgaria can implement an appropriate regulatory framework; when they are permitted, they should be subject to regulation by the Governmental Authority. Commodities-related futures can be permitted immediately subject to regulation by another governmental authority.

5. For example, if interest on bank deposits is not subject to taxation, while interest or dividends from securities is subject to taxation, development of the securities market will be suppressed, all other things being equal.

the operation of the capital market to mobilize and allocate capital, and implement public policies such as investor protection and market stability. Securities laws are required to make the market operate as efficiently as possible, with the lowest transaction costs and the least market failure possible. Securities laws generally are not used to implement public policies outside of these market-oriented purposes. Burdensome securities laws—those that impose costs without producing at least an equivalent economic benefit—must be avoided. All requirements should be evaluated to assess whether they will yield sufficient benefits to be justified.

a. *Mobilization of Domestic Capital and Attraction of Foreign Capital*

Capital mobilization is especially important for an emerging economy. Securities markets can help to mobilize domestic capital by providing greater incentives for savings and investment than alternatives, such as bank deposits. Securities markets can provide a means for foreign investors to provide capital to Bulgaria. Failure to protect investors effectively may diminish the effectiveness of securities markets to mobilize and attract capital. In addition, an organized and regulated securities market can be a useful tool of valuation and disposition in connection with privatization.

b. *Allocation of Capital*

Securities markets, along with banks and private investment, replace central planning as allocators of social capital to productive uses. Therefore, securities markets are an integral part of, and act as the mechanism of capital allocation for, the market economy. Securities markets allocate capital through the market price mechanism. Failure to ensure the integrity of the securities market may diminish the accuracy of allocation of capital, reducing the efficiency of the economy.

### 3. Securities Regulation Institutions<sup>6</sup>

It will be necessary to establish a single centralized governmental authority (the “Governmental Authority”) to take responsibility for regulation of the Bulgarian securities market. This should be an agency of the government, although, like a central bank, it would benefit from a degree of independence from political interference. Many securities regulation schemes rely in addition on self-regulatory organizations (“SROs”): organizations of securities professionals that are delegated authority to regulate their participants. Governmental Authorities and SROs have varying advantages of expertise, information, independence and resources, and regulatory functions should be allocated among them in accordance

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6. See the discussion of governmental authorities and self-regulatory associations contained in William J. Williams, Jr., *Recommended Design for a Securities Law* (unpublished paper dated July 11, 1991). Mr. Williams’ paper was initially prepared for the Polish Ministry of Finance. This paper borrows substantially from Mr. Williams’ paper.

with their comparative advantages. Final authority and supervisory jurisdiction over SROs should lie with the Governmental Authority, whose actions should themselves be subject to judicial review on grounds of nonconformity with law. SROs might be required to obtain permission from the Governmental Authority for changes in rules.

Stock exchanges can serve the regulatory purpose of centralizing transactions, providing for greater transparency and ease of surveillance. It is important that the securities law apply to all transactions in securities involving professionals or the general public, regardless of whether they take place on an organized securities exchange or off the exchange, including in an over-the-counter (“OTC”) market.<sup>7</sup>

Within the various categories of securities regulation, different means of implementation may be appropriate. The available types of implementation include the following:

a. *Supervision*

Here, the Governmental Authority or SRO engages in licensing and inspection of particular firms, institutions or activities, and orders correction of objectionable practices. This technique is used extensively in bank regulation, and is often used in regulation of securities market professionals, such as broker-dealers. An SRO may be delegated partial, initial or complete authority to perform supervision in some or all areas, subject to review by the Governmental Authority.

b. *Enforcement*

The Governmental Authority may be charged with investigating and bringing civil and/or criminal enforcement actions against violators of the securities laws. Certain types of enforcement actions may be delegated to an SRO.

c. *Rulemaking and Interpretation*

Responsibility for implementing the securities law through rulemaking and interpretations to deal with specific or unforeseen issues may be delegated to the Governmental Authority or to an SRO.<sup>8</sup> Western countries with civil law systems, such as France or Germany, seem to have accommodated this type of delegation of power, although in some models more detailed statutes are used. Rules should be required to be published in draft form and circulated for comment to interested persons in the securities professional community and elsewhere prior to being finalized.

d. *Rights of Investors to Sue for Fraud  
and Secondary or Joint Liability*

These serve three functions. First, they represent a means for private persons to seek redress for harms done to them in violation of the securities laws. Second,

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7. See the discussion of exemptions under item 4(e) below.

8. Here, constitutional and administrative law constraints are relevant.

and most important from a public policy perspective, they provide incentives for private persons to identify and attack violations of securities laws. While posing some risks of excessive litigation, providing these incentives may help to extend limited regulatory resources. Third, joint or secondary liability for market professionals such as underwriters can harness the private sector even further to assist in preventing violations of the securities laws.<sup>9</sup> Given the potential problems of an overburdened or inexperienced judiciary, it may be appropriate to consider allowing the Governmental Authority power to order reparations, rather than to require investors to resort to the court system. Another possible alternative would involve use of a system of arbitration of securities law claims.

#### 4. Disclosure Regulation

Disclosure regulation is the central principle of securities law. Disclosure is the basis for accurate allocation of capital. Given that securities markets are complex mechanisms for the collective evaluation by investors of various uses of capital, it is essential that investors receive accurate and complete information about each potential use—about each potential investment. Inaccurate or incomplete information results in inaccurate allocation of capital. In addition, inaccurate or incomplete information deters investors in the future, damaging the ability of the market to mobilize or attract capital. Disclosure regulation requires that investors be provided with accurate and complete information (i) at the time of public offerings by the issuer (“primary offerings”) and (ii) on a periodic basis thereafter to support a trading (“secondary”) market.

The competing principle of securities regulation is known in the U.S. as “merit regulation,” in which government agencies seek to assess the quality of potential issuers of securities, and to deny access to the capital markets to those deemed without sufficient merit. The merit regulation principle probably should be avoided, as it presents opportunities for excessive regulation and central planning of financing, and is inconsistent with the market approach to capital allocation. While merit regulation presents significant risks to Bulgaria and we recommend against it, in a market where strong enforcement capabilities have not yet developed, and where few professional investment analysts exist, some form of very strictly limited merit regulation may be the subject of further discussion.

##### a. *Disclosure Requirements*

Prescribed disclosure should be required of issuers that effect a public offering of securities or that otherwise have a specified large number of security holders. Disclosure regulation begins with the establishment by the Governmental Authority of a list of topics that must be disclosed by issuers of securi-

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9. The role of underwriters' liability and the due diligence defense in harnessing the private sector to prevent fraud in connection with public offerings will be discussed further below.

ties, both in connection with public offerings and, with some modifications, periodically thereafter. In order to provide flexibility, the specific disclosure requirements should be established by regulation, not in the statute itself. The topics would generally include textual descriptions of various aspects of the business of the issuer, the securities offered and the plan of distribution, as well as financial statement disclosure requirements. Here, Bulgaria should at a minimum comply with the European Community's relevant directives: the Listing Particulars Directive,<sup>10</sup> the Mutual Recognition Directive<sup>11</sup> and the Public Offer Directive,<sup>12</sup> but will probably wish to rationalize and expand on the approach of these directives. In addition, most systems require that issuers of securities disclose any information that is material, regardless of whether it is called for by the list of topics prescribed. "Material" is generally defined to mean information that would be deemed important by a reasonable investor in connection with his investment decision. Despite general agreement on the basic topics to be included on the list of required disclosures, and on the requirement for other "material" information, there are wide differences in disclosure scope and style among different securities markets.

b. *Supervision of Disclosure:*  
*The Registration Process*

In most markets, issuers of securities are required to file their proposed prospectus, and perhaps other documents, with securities regulatory authorities, or perhaps with a stock exchange, for scrutiny, criticism and clearance prior to offering. We strongly recommend that the Governmental Authority be solely responsible for scrutiny, criticism and clearance. As discussed above, the standard of review should be disclosure and not merit. While this superficial process does not ensure against fraud, it provides an opportunity to check the apparent compliance of the prospectus with formal legal requirements, and to query any apparent deficiencies in the issuer's disclosure.

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10. Council Directive of 17 March 1980 Coordinating the Requirements for the Drawing Up, Scrutiny and Distribution of the Listing Particulars to be Published for the Admission of Securities to Official Stock Exchange Listing, 23 O.J. EUR. COMM. (No. L 100) (Council Directive 80/390/EEC).

11. Council Directive of 22 June 1987 Amending Directive 80/390/EEC Coordinating the Requirements for the Drawing-up, Scrutiny and Distribution of the Listing Particulars to be Published for the Admission of Securities to Official Stock Exchange Listing (Directive No. 87/345), 30 O.J. EUR. COMM. (No. L 185) 81 (1987) (Council Directive 87/345/EEC). The Mutual Recognition Directive has been supplemented by Directive 90/211/EEC, Council Directive of 23 April 1990 Amending Directive 80/390/EEC in Respect of the Mutual Recognition of Public Offer Prospectuses as Stock Exchange Listing Particulars, 33 O.J. EUR. COMM. (No. L 112) 24 (1990). Bulgaria should also consider the SEC's Regulations S-K and S-X and the London Stock Exchange Yellow Book.

12. Council Directive of 17 April 1989 Coordinating the Requirements for the Drawing-up, Scrutiny and Distribution of the Prospectus to be Published When Transferable Securities are Offered to the Public, 32 O.J. EUR. COMM. (No. L 124) 8 (1989) (Council Directive 89/298/EEC).

c. *Enforcement of Disclosure: Rights of Investors to Sue and The Due Diligence Process*

One of the most significant aspects of the development of U.S. securities regulation over the past 50 years has been the development of rights of persons harmed by violations of certain securities laws to sue the persons responsible, such as the antifraud provisions of the securities laws. As mentioned above, these rights to sue have the benefit of harnessing the private sector—the injured person—to help to enforce the securities laws.

Another critical aspect of the development of U.S. securities regulation has been the development of the concept of joint and several liability of underwriters for disclosure deficiencies. While issuers of securities under the U.S. system have no defenses to liability for material misstatements or omissions, underwriters, directors and certain officers have the benefit of a “due diligence” defense. The due diligence defense is available to underwriters that made a reasonable investigation of the facts and had reasonable grounds to believe, and did believe, that the prospectus was accurate and contained no omissions of material fact. U.S. and U.K. underwriters generally engage in a highly detailed and formal process to establish a record of compliance with the conditions for this defense. The due diligence process would ordinarily include careful review of the issuer’s corporate records, material contracts and financial statements, and interviews with corporate officials, suppliers and customers. The underwriter thus serves to oversee and discipline disclosure by issuers.

This pattern of liability is especially worth considering, as it serves to harness professional private actors to enhance the regulatory scheme: to partially privatize regulation of finance. For a developing country with limited regulatory resources, this type of system may help to overcome these limitations, especially if foreign firms are allowed to compete in the local securities business, bringing with them their skills in compliance with complex regulation. Obviously, this type of system cannot work without an adequate judicial system.

d. *Periodic Disclosure and Proxy Solicitation*

In addition to disclosure in connection with public offerings and initial listings, it is necessary to require issuers to provide periodic disclosure so as to provide the information necessary to support secondary trading in the security. See the European Community’s Periodic Disclosure Directive.<sup>13</sup> This periodic disclosure would include annual reports with detail similar to that contained in the prospectus, and interim reports with less detail, including interim reports in connection with certain material events. If periodic disclosure becomes good enough, it can support “shelf offerings” by seasoned issuers using incorporation by reference to

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13. Council Directive of 15 February 1982 on Information to be Published on a Regular Basis by Companies the Shares of which have been Admitted to Official Stock Exchange Listing (Directive No. 82/121), 25 O.J. EUR. COMM. (No. L 48) 26 (1982) (Council Directive 82/121/EEC).

make unnecessary the preparation of a detailed prospectus at the time of each subsequent offering.

The Bulgarian Commercial Law provides that joint stock companies must hold annual elections for directors. For a publicly held corporation, it is normally impossible for each shareholder to attend meetings for such elections. The normal practice is to allow shareholders to appoint proxies to vote for them. Under U.S. law, for annual meetings to elect directors, the proxy materials must be accompanied or preceded by an annual report. Management or shareholder groups will solicit proxies from shareholders. All proxy solicitations should be required to contain full and fair disclosure of all relevant facts. The Governmental Authority should be authorized to require that proxy solicitation materials be filed with and cleared by the Governmental Authority. It may also be appropriate to require management to assist nonmanagement or dissident shareholders in soliciting proxies, by providing lists of shareholders or by including dissident proposals in materials distributed to shareholders. This process is especially important with respect to allowing shareholders a voice with respect to significant transactions, such as mergers, acquisitions, dispositions or liquidations.

#### *e. Exemptions*

It is appropriate to exempt certain types of offerings, or certain types of securities, from various provisions of the securities laws. For example, offerings by the government or central bank of securities carrying the full faith and credit of the central government or central bank would appropriately be exempted from the securities laws, although secondary trading in these securities should be subject to these provisions. A more difficult question is whether and to what extent to exempt securities issued by municipal authorities. In addition, certain small offerings or offerings to institutional investors might be exempted from the registration requirements but not the antifraud provisions. Commercial paper might also be exempted from the registration requirements. Traditional or conventional bank loans and deposits should be exempted from the registration and antifraud provisions, assuming they are covered by a separate regulatory system deemed adequate. Insurance policies that are not related to securities value and that are subject to separate regulation, and pension schemes subject to separate regulation, should be exempted. The Governmental Authority should be authorized to provide other exemptions as appropriate, for example, in connection with privatization sales to employees at discounted prices.

### **5. Market Regulation: Antifraud, Antimanipulation, Insider Trading and Credit Regulation**

These types of regulation are oriented toward protecting the integrity of the securities market as such. They are oriented more toward the goal of capital mobilization, including the protection of investors, than the goal of accurate

capital allocation. In an efficient securities market, investors can trust prices to reflect the collective evaluation of all other investors; fraudulent activity, manipulation of prices, insider trading and abuse of credit in the trading market may diminish the ability of investors to trust prices, and thereby require them to engage in a more extensive investigation of their own.

a. *Antifraud and Antimanipulation Regulation*

Fraud and manipulation include a wide variety of acts that are intended to mislead the marketplace as to the true market price or trading activity in a particular security. Methods of fraud or manipulation include such devices as spreading false information, making purchases prior to or during an offering of shares in order artificially to inflate the price, selling to drive down market prices, then repurchasing at artificially reduced prices, or artificially inflating volume of trading or stabilizing prices in a security through contrived transactions where the seller and purchaser are the same or are acting together. Manipulative acts may include a program of selling including short selling<sup>14</sup> of a particular issuer's securities in order to create a false market impression of declining prospects and in order to reduce the price of the securities, prior to purchasing in large quantities in order to take advantage of the reduced prices (known as "bear raids"). While most of these practices are detrimental and should be prohibited, most markets permit controlled stabilization of the market price of a security in connection with a distribution of the securities, in order to prevent the additional supply of the securities created by the distribution from having a sudden adverse effect on the market price.

b. *Insider Trading Regulation*

Interestingly, a few economists have argued that insider trading should not be prohibited, because it has the beneficial effect of ensuring the rapid incorporation in market prices of new information. This perspective is mistaken, as it considers only capital allocation, and not capital mobilization, as a goal. Insider trading is extremely detrimental to capital mobilization as it transforms the securities market into a game that only the insiders and their friends can win. This drives the noninsiders out of the market. The European Community's directive on insider trading<sup>15</sup> represents a reasonably good approach to defining and prohibiting insider trading. Bulgaria should at least follow this directive in prohibiting insider trading. In addition to prohibiting the use of inside information, this directive requires

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14. Short sales are sales of borrowed shares in anticipation of a reduction of market price; once the market price has declined, the short seller may purchase shares at a lower price to return the shares that he borrowed. Short sales are separately regulated under U.S. law. In addition, under U.S. law, certain defined categories of "insiders" of issuers are prohibited from engaging in short sales.

15. Council Directive of 13 November 1989 Coordinating Regulations on Insider Dealing (Directive No. 89/592), 32 O.J. EUR. COMM. (No. L 334) 30 (1989) (Council Directive 89/592/EEC).

companies promptly to disclose material information that might form the basis for insider trading.

In addition, Bulgaria may wish to require management of publicly traded companies, as well as the companies themselves and their corporate affiliates, to report their ownership of the company's equity securities and any changes therein. This would assist in limiting insider trading, and also disclose useful information to the market.

### *c. Credit Regulation*

Regulation of the use of credit in the securities market has multiple rationales. First, it is useful to protect investors against their own speculative urges; limitations on their use of credit limit their risk. Second, it is useful to protect broker-dealers that extend credit—to ensure that they obtain adequate collateral for their extensions of credit. Third, it is useful to protect the securities market from the additional volatility and perhaps additional speculative activity that may result from the abuse of credit, where investors do not feel that they are risking their own money. Recent examples of developing country markets that have experienced problems arising from the abuse of credit are India, Brazil and Kuwait.

Credit regulation operates by requiring the investor to pay in cash at least a portion of the purchase price of securities that he purchases, allowing the investor to borrow the remainder of the purchase price. In addition, credit regulation may require the broker-dealer to call for more cash from the investor when the value of the collateral declines significantly. Finally, different types of securities, such as government securities, might be subject to more favorable treatment than other types of securities, requiring a smaller proportion of cash.

## **6. Market Regulation: Structure**

Securities regulation not only is necessary to prevent abuse, but is also useful to provide rules as to the structure of the market and the mechanics of trading. Regulation is appropriate here where uniformity yields economies in terms of reduced transaction costs, or where a particular structure makes it easier to enforce other regulation. The European Community has recently reached agreement in principle on an Investment Services Directive<sup>16</sup> that will deal with certain issues regarding the structure and role of stock exchanges.

### *a. Trading Rules*

Trading rules should generally be established by the markets. The Governmental Authority should require dissemination of quotations and reporting of transactions. It may make sense for Bulgaria to establish a single stock exchange, in

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16. Amended Proposal of February 8, 1990, for a Council Directive on Investment Services in the Securities Field, 32 O.J. EUR. COMM. (No. C 42/06) 7 (1990).

order to concentrate securities transactions, enhancing liquidity as well as the ability to engage in regulatory surveillance. Whether and the extent to which transactions would be permitted to take place off the exchange should be given careful consideration.

b. *Clearance and Settlement*

The Governmental Authority should be authorized to create and operate, either directly or through markets under the supervision of the Governmental Authority, a system for the custody and transfer of registered ownership of publicly traded securities, for the clearance and settlement of transactions in such securities. Bulgaria should seek to move directly to certificateless or book-entry transfers of securities, rather than rely on cumbersome delivery of physical certificates. Bulgaria should consider the recommendations of the Group of Thirty in this connection.<sup>17</sup>

c. *Bearer Securities*

Bearer securities present many risks, including risks of theft, counterfeiting and use for evasion of taxes or regulation. Therefore, they should be prohibited.

## 7. Broker-Dealer Regulation

Broker-dealer regulation is regulation of financial intermediaries as institutions, and it has two main thrusts. First, it protects clients of broker-dealers from abuses by broker-dealers of the client's trust. Second, it addresses the financial responsibility of broker-dealers, ensuring their ability to comply with their obligations. In light of their greater familiarity with market practices, SROs can play a large role in broker-dealer regulation, especially with respect to preventing abuses of clients' trust. The European Community's proposed Investment Services Directive will establish minimum requirements for broker-dealer regulation, and will also establish certain requirements for securities exchange operation. Bulgaria should refer to this Investment Services Directive in preparing its broker-dealer regulation.

a. *Registration, Record-Keeping, Reporting and Segregation of Consumer Property*

It is appropriate to require persons or firms engaging in a brokerage (trading for customers' account) or dealing (trading for their own account) business to register with the Governmental Authority, and to demonstrate compliance with standards of competence and financial responsibility. Persons engaging in investment advisory work should be subject to a similar licensing regime. It is also

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17. GROUP OF THIRTY, CLEARANCE AND SETTLEMENT SYSTEMS IN THE WORLD SECURITIES MARKETS (1989).

appropriate to require that broker-dealers keep appropriate records and adequately segregate customer funds and securities from those owned by the broker-dealer. In addition to being good business practice, the record-keeping requirements establish a basis for inspection and identification of noncompliance with regulation. Finally, broker-dealers should be required to make reports regularly showing their compliance with financial responsibility and other requirements, and to submit to inspection and investigation of complaints by the Governmental Authority.

b. *Financial Responsibility; Bankruptcy of Broker-Dealers*

Broker-dealers experience special financial risk in the form of position risk, when they take a position in securities as dealer that may fluctuate in value, and in the form of customer and transaction risk, when a customer or transaction counterparty fails to comply with its obligations. It is appropriate to establish capital requirements to require broker-dealers to maintain sufficient liquid assets to meet their obligations to other broker-dealers, customers and creditors. The European Community has reached agreement in principle on a Capital Adequacy Directive to establish minimum levels of capital for securities firms,<sup>18</sup> and Bulgaria will wish to refer to this directive in preparing its own capital adequacy rules. Capital adequacy requirements, and self-liquidation when securities firms cease to comply, can help to avoid broker bankruptcies. It may be appropriate to establish a fund, such as the U.S. Securities Investor Protection Corporation,<sup>19</sup> to compensate investors who lose money (subject to limits) in connection with bankruptcies of broker-dealers. The social purpose served would be to enable investors to feel relatively confident that they would not experience losses because of the bankruptcy of their broker-dealer. The social risk raised by this type of insurance is that regulation may not be adequate to prevent extensive losses.

c. *Protection of Customers: Prohibition of Abuse of Trust*

There are many ways in which a broker-dealer can abuse the trust placed in the broker-dealer by his customer, using the broker-dealer's superior market knowledge. These types of practices can often be defined in rules of good business conduct, and can be monitored and regulated by an SRO.

d. *Application to Commercial Banks*

One difficult question that is being grappled with in U.S. and European Community law is to what extent to apply broker-dealer regulation to commercial banks

18. Proposal of April 30, 1990, for a Council Directive on Capital Adequacy of Investment Firms and Credit Institutions, 33 O.J. EUR. COMM. (No. C 152 6) (1990).

19. The U.S. Securities Investor Protection Corporation is funded by assessments on broker-dealers.

with respect to their securities market activities. Commercial banks are subject to different capital requirements, with more of a focus on long-term creditworthiness than short-term liquidity. The approach that appears to be most attractive is to apply the securities law to the commercial banks to the extent of their securities business. This general principle is difficult to apply in practice, and it may make more sense to require commercial banking organizations to engage in securities activities through a legally separate subsidiary.

e. *Merger and Acquisition Regulation*<sup>20</sup>

The market for mergers and acquisitions is an additional source of discipline on management of public companies. It provides discipline by allowing purchasers to acquire companies that have depressed share prices due to mismanagement, and improve management to realize a profit by virtue of greater market valuation. However, the market for mergers and acquisitions may give rise to abusive tactics by both management and purchasers, and requires regulation.

f. *Manipulation and Fraud*

Manipulation and fraud in connection with mergers, acquisitions and tender offers should be prohibited.

g. *Reporting of Acquisitions*

Persons who acquire more than a specified percentage of the shares of a public company should be required to report such acquisition to the Governmental Authority. Bulgaria will wish to comply with the European Community's Major Holdings Directive.<sup>21</sup>

h. *Tender Offers*

The Governmental Authority should be authorized to prescribe procedural and informational requirements in connection with tender offers.<sup>22</sup> In order to prevent the use of abusive tactics that have been experienced elsewhere in connection with tender offers, it is appropriate to require that any tender offer be made on an equal basis to all holders of securities. It may be appropriate to require acquirors of more than a specified percentage, such as 30 percent, of the voting shares of a public company to make a cash tender offer to acquire all the remaining shares at a fair price.

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20. Merger and acquisition regulation may also be appropriate from an antitrust or tax perspective. We consider here only the securities law perspective.

21. Council Directive of 12 December 1988 on the Information to be Published when a Major Holding in a Listed Company is Acquired or Disposed of (Directive No. 88/627), 31 O.J. EUR. COMM. (No. L 348) 62 (1988) (Council Directive 88/627/EEC). The pattern of legislation around the world seems to be tending toward a 5% standard.

22. Legislation should specify a definition of "tender offer" including publicly disseminated or otherwise broadly based programs of acquisition of the securities of a public company.

### i. *Investment Company or Investment Trust Regulation*

Investment companies or investment trusts are funds established to invest in the securities of other companies. They present advantages of professional investment management and diversification to investors. This type of investment vehicle may become important in Bulgaria. However, these funds present special regulatory problems. These special regulatory problems are occasioned by the opportunities for abuse and self-dealing presented by these "investment companies," most of the assets of which are cash and securities. It is therefore felt necessary to have special protections beyond those provided by disclosure in the case of normal public companies. These special protections involve special registration and certain structural safeguards and prohibitions designed to limit the possibility of abuses involving conflicts of interest and self-dealing. Here, securities law protections are more than just procedural or disclosure-related, but restrict the structure of funds and the activities in which they are permitted to engage. The European Community has several directives regarding "undertakings for collective investment in transferable securities" or "UCITS."<sup>23</sup>

### j. *Internationalization*

As noted above, internationalization of securities markets presents risks and opportunities for Bulgaria. The world is moving toward integrated capital markets, and it is useful for all countries, particularly developing or emerging countries, to dismantle barriers to foreign capital, as well as barriers to the exit of capital. As Bulgaria establishes new laws such as the securities law, it should do all it can to promote its integration into the international capital market. It may do so by adopting laws that are not unnecessarily inconsistent with evolving international standards, and by incorporating sufficient flexibility in its law to join in international efforts toward harmonization and mutual recognition of regulation.

### k. *The Drafting Process*

The drafting process should begin with agreement on a set of policy decisions on scope and content of the securities law, taking the Bulgarian context into account. These policy decisions should be formulated by Bulgarian officials in light of the above and other advice. The next step of drafting would involve an

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23. Council Directive of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (Directive No. 85/611), O.J. EUR. COMM. (No. L 375) 3 (1985) (Council Directive 85/611/EEC); Council Recommendation of 20 December 1985 concerning the second subparagraph of Article 25(1) of Directive 85/611/EEC (Directive No. 85/612), O.J. EUR. COMM. (No. L 375) 19 (1985) (Council Directive 85/612/EEC); Council Directive of 22 March 1988 amending, as regards the investment policies of certain UCITS, Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investments in transferable securities (UCITS) (Directive No. 88/220), O.J. EUR. COMM. (No. L 100) 31 (1988) (Council Directive 88/220/EEC).

abbreviated comparative law process in which the laws of selected other countries would be examined to determine how those laws address Bulgaria's policies. We include herewith a few laws and draft laws that may be considered.<sup>24</sup> The drafters of Bulgaria's securities laws should have access to a basic library of materials on U.S. and European securities regulation. In addition to considering what mechanisms can best implement Bulgaria's securities market policies, this process would consider what mechanisms best fit with other aspects of Bulgaria's legal system, economic system and society. It will be extremely important to coordinate the securities law drafting process with the process of drafting other laws, especially economic laws and laws relating to civil liability and criminal sanctions. The process will require great sensitivity to the Bulgarian legal, economic, political and social context. Bulgaria will wish to follow a careful drafting process. The drafting process should also be used to introduce and legitimate the regulation with domestic persons who will be subject to or will operate the regulation, as well as those who will benefit from the regulation.

The final draft should be submitted for comments not only to a broad group of Bulgarians, but also to organizations such as the European Commission and IOSCO.

### 1. *The Implementation Process*

It should be recognized that the implementation of a securities law is a dynamic process. In this regard, it is appropriate to delegate to the Governmental Authority sufficient flexibility to vary and increase certain requirements over time, as the Bulgarian market develops.

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24. The following were included in the paper presented to the Bulgarian Government: William J. Williams, Jr., *A Securities Law for an Emerging Capital Market—A Proposal* (26 June 1990); Quebec Securities Act; *Proposals for a Securities Market Law for Canada*; *The Polish Law of Public Trading in Securities and Trust Funds*, 1992.

## GLOSSARY

- Bearer securities**—Securities that are transferable by delivering possession, as contrasted with securities for which a change must be made to the securities register in order to effect a transfer.
- Broker**—A professional who engages in the business of buying and selling securities for a customer's account; can be used to refer to an individual or a firm.
- Bond**—A debt security, evidencing the obligation to repay money. "Notes" are shorter-term debt securities.
- Book entry securities**—Securities that do not exist in paper form, but that are possessed and transferred by virtue of entries in computer records.
- Clearance and settlement**—The process of actually exchanging securities and cash pursuant to a sale of securities.
- Dealer**—A professional who engages in the business of buying and selling securities for his own account.
- Due diligence**—A process of checking the completeness and accuracy of statements in a prospectus or other offering document; in the U.S., meeting the standard of due diligence may constitute a defense for underwriters against liability for misstatements or omissions in prospectuses.
- Immobilized securities**—Securities that are held by a depository after issuance, and transferred thereafter by virtue of entries in computer records of the depository.
- Investment trust**—A type of collective investment vehicle.
- Joint liability**—Shared liability among several persons, where one of the persons may be held responsible for the entire liability.
- Mutual fund**—A type of collective investment vehicle.
- Public offering**—Legal definitions may differ in different countries, but public offerings may be defined based on the number of offerees or purchasers, the type of advertising used or other factors.
- Public company**—Legal definitions may differ in different countries, but generally a company that has effected a public offering or a company that has more than a specified number of public shareholders.
- Secondary liability**—Shared liability where the secondarily liable person is only liable if the primarily liable person is unable to pay.
- Security**—Legal definitions may differ in different countries, but usually includes a stock, bond or other type of evidence of investment, including an investment contract. This definition is especially important if it determines the applicability of the securities laws.
- Stock**—Common stock or preferred stock. Common stock (or common shares) represents an equity interest in the company, while preferred stock is usually entitled to a fixed dividend and a preference over common stock upon liquidation.

**Tender offer**—Legal definitions may differ in different countries, but generally a broadly disseminated offer to purchase one or more types of securities of a particular issuer.

**Underwriter**—A person who assists issuers with offerings of securities, as sales agent without financial responsibility, as purchaser of the shares for resale or by committing to purchase any unsold shares. Legal definitions differ, but are important in determining secondary or joint liability.