

**Vladislav Pavlát**

**Educational & Didactic Communication 2014**

**Vol. 3 The Birth of the Prague Stock Exchange**

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# **Educational & Didactic Communication 2014**

## **Vol.3 The Birth of the Prague Stock Exchange**

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## Foreword

I started to write the book on setting up the Prague Stock Exchange several times and never completely finished it.

For the first time, I decided to write a book on the beginnings of the Prague Stock Exchange, in which I was personally involved, as soon as at the end of 90ties. Originally, the aim of my book was to collect and register the documents which I had in my private archive, to describe the difficult way how the Stock Exchange emerged and unfavourable conditions under which it started to trade. I did not want to comment on the documents or to analyse them. My collection of documents had to be published to be at disposal for a thorough analysis by historians later on, maybe after elapse of some two-three decades.

During the years 1999-2001 I selected 30-40 most important documents and prepared a brief description of these documents. But this was the end of my first attempt: in 2000 I fell ill and two medical operations followed.

After my recovery, I started again. This time I decided to extend the above mentioned “descriptions” and to write a study of some 60-80 pages. During the year 2002 the bulk of the text was written and I hoped to be able to publish it before the 10<sup>th</sup> Anniversary of the Prague Stock Exchange (6.4.2003). But again my study was abandoned as I was invited to start teaching at the Institute of finance and Administration in Prague. During the next 5 years I was fully absorbed by my new academic duties.

With the approaching 15<sup>th</sup> Prague Stock Exchange Anniversary I tried to finalize my unfinished study as I remembered how inadequately the PSE beginnings were presented at the occasion of its first 10- years’ anniversary. This time I was no more reluctant to disclose as much of a *pléiade* of real problems connected with the creation of the PSE. On the eve of the 15<sup>th</sup> Anniversary of the PSE, I published the article “Setting up The Prague Stock Exchange (1993-2008) in *Acta VSFIS* (No.2, 2007, pp. 066 – 078). This article was an abbreviated and re-made version of my study of 2002 written in Czech language.

In summer 2008 I tried to complete my extended manuscript, however, I was not sure that my proofs and arguments were good enough my critical remarks to be understood

There were reasons why critical opinions about the *genesis* of the Czech capital market, of its failure and real impacts - if presented by anybody - would not be acceptable under political situation of 2008: In 2008, I discovered a lot of further documents, connected with the first stages of PSE trading (the period of 1993 – 1996/7), especially with trading. During this period, I was Chairman of the Trading Committee (which was one of the most important Committees at that time) and member of the Stock Exchange Chamber as well. Unfortunately, this time again, because of illness, I was unable to continue in writing the second volume of the PSE history.

It was not earlier than in summer 2013 that I decided to completely rewrite my Czech book on “setting up the PSE,” this time in English. By the end of December 2013 my English manuscript was ready. My new book “*On the beginnings of PSE*” contained many

fundamental original documents (in English or in Czech languages), either full text or selected parts of some texts.

I hope that the new version of my book will be helpful not only for researchers on the transition period of the former communist countries in the 90ties, but also for English speaking academicians interested in capital markets development, and maybe as a *memento* for public as well.

Vladislav Pavlát  
Prague, August 2015.

## Introduction

This monograph deals with the genesis of the Prague Stock Exchange during the period of 1990 till 1992. At the beginning of the 90ties, the process of setting up the Czechoslovak capital market was started as an important part of the economic transformation.

There are important reasons for an analysis of this first period. One of the main reasons is the fact that a Stock Exchange is still recognized as a symbol of market economics. From the long-term view, the existence of a national Stock Exchange – a top institution of any capital market – was considered to be a very important task for all governments of the former so called socialist countries setting up a stock exchange in transition period was expected to be a base for a successful long-term capital market development.

An objective description of economic and political conditions under which the Prague Stock Exchange was created (“from scratch”) and a true characteristic of the unsolved problems represents a starting point of the Prague Stock Exchange analysis, and – at the same time - the analysis of the Czech capital market during the 90ties as well.

From the very beginning, the fight for setting up the Prague Stock Exchange was, at the same time, a fight for setting up a base for an effectively working *standard* capital market – corresponding to capital markets in all developed countries with a market economy.

This monograph does not directly deal with the capital market development in the Slovakia which was finalized by creation of Bratislava Stock Exchange. However, some of the important moments which influenced the creation of both Stock Exchanges – the Prague Stock Exchange and the Bratislava Stock Exchange – are referred to.

### **Economic and political situation at the beginning of 90ties and priorities of the government economic policy in 1990-1991**

Shortly after the November 17, 1989, the power of the communist *régime* practically collapsed. On December 19, 1989 the new government - called a government of national mutual understanding – published a *Government Declaration*, formulating the main directions of the next political and economic development of Czechoslovakia.

The main political goal consisted in renewing a democratic regime with all its attributes – with political plurality, with all democratic freedoms, especially with the freedom of press. It was promised to abolish all hindrances which would endanger this new course. The Government Declaration promised the rehabilitation of political prisoners, the free return of political emigrants to the country and a quick solution of other urgent tasks.

In spite of the fact that the new political power was not yet strong enough, new Government had a massive support practically of all Czechoslovak population. Any “return” before November 1989 was out of question. The way to the political, economic and social transformation (called the “velvet revolution”) was open.

The atmosphere of the beginning of Czechoslovak 90ties, with its enthusiastic chaos and with its illusion of liberty without limits never will be repeated, and never will be forgotten by majority of Czechoslovak population. This was a very important fact that enabled the new Government to act quickly, without bureaucratic hindrances. The political climate of that time made possible to establish new political parties, sometimes based on casual acquaintances, personal sympathy or antipathy. Personal changes of management in the still state-owned enterprises and changes at all levels of state administration were frequent and sometimes surprising. From the present point of view it simply was more a “take-over” more than a revolution.

The Government had three main and very difficult tasks: First, to maintain a macro-economic relative stability as a condition for preventing economic chaos; second, price liberalization – as a condition for economic transformation of the “socialist planned economy” into a standard market economy, and third, privatization of the state ownership and restitution of the property expropriated after the year 1948. <sup>1</sup>

The idea of privatization was declared (for the first time) in a Memorandum of Czechoslovak Government on April 6, 1990. In July 1990, Federal Assembly on its 2<sup>nd</sup> and 4<sup>th</sup> common meeting which was held for three days (July 3, 4 and 5) the *Programme Declaration*

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<sup>1</sup>Discussion about the strategy, methods and forms of privatisation was very heated. It took almost one year, before it was feasible (in January 1991) to vote the so called law on transformation (Act no.92/1991 Coll.) Discussion about privatization was almost endless – it was continued for a couple of years. The most important objections against the very idea of privatisation were raised by the “fundamentalist followers” of the other idea, i.e. the so called restitution, which were supported from western countries where many of those people spent years as emigrants. At the same time, objections against privatizations were raised by socialist economists from almost all post-socialist countries. As for the Czechoslovakia, two different scenarios of privatisation existed. The first one was prepared by the Czechoslovak Economic Council (headed by *František Vlasák*) in the period of March 3 and April 2 1990. This scenario proposed to divide the process of transition into two stages: the stage one would consist in a total change of structure of the big Czechoslovak state-owned enterprises; only after the implementation of the first stage, stage two, i. e. a standard privatization, should be started. The second scenario was prepared by the Federal Ministry of Finance (headed by *Václav Klaus*) and announced on April 20, 1990. According to this second scenario, the strategy of the Czechoslovak economic reform also consisted of two stages, but in a reverse way: the first step should consist in privatisation, and the second step would be the re-organisation. The difference between the two scenarios was very deep: the first scenario was much time-consuming than the second one. But the second scenario was more attractive, as it proposed to give the new owners of the privatized enterprises more freedom to re-organise these enterprises in the sense of the free market economy. In addition to this, as a new and very attractive privatization method the so called coupon-privatization was proposed. The authorship of this method was claimed by two Czech economists – by *Tomáš Ježek* and by *Dušan Tříška*. The result of the discussion between followers of the two scenarios was a formal compromise. But in fact, the followers of the coupon privatization were the real winners. See: Mlčoch, L., Machonin, P., Sojka, M. *Ekonomické a společenské změny v české společnosti po r. 1989*. Praha: Universita Karlova – Nakladatelství Karolinum, 2000, s. 223.

of Governments of the Czecho-Slovak Federative Republic was approved and a resolution (No.31) was voted.<sup>2</sup>

The main groups of problems were explicitly enumerated: a definition of ownership; privatization; de-monopolization; budget rules; transition to a new system of taxation; price liberalization and its inflationary impact; social impact of the economic reform and the role of the National Property Fund.

If the legality of the new political power had to be observed, new legal norms had to be created and old laws (and other legal norms) changed, in case it was not possible to abolish them. The first stage of the transformation process was a stage of creating the new Czechoslovak legislation. Both Chambers of the Czechoslovak Parliament were very busy all the time.

It is necessary to enumerate the most important new Czechoslovak laws which paved the way for a successful process of transformation. Inter alia, it was the Act no. 91/1991 Coll.<sup>3</sup> the Act no.513/1991 Coll., the Act no.328/1991 Coll., the Act No.563/1991 Coll., the Act No.21/1992 Coll., the Act no. 124/1992 Coll., the Act 286/1992 Coll.<sup>4</sup> These changes of legislation were followed by institutional changes of the Czechoslovak economic system.<sup>5</sup>

### **Specific conditions and starting points for setting up the capital market in Czechoslovakia**

At the beginning of 90ties, capital market in Czechoslovakia practically did not exist. Securities – both negotiable and non-negotiable – existed in a very restricted quantity.

In 1990, *Československá obchodní banka* (Czechoslovak Commercial Bank) issued a public issue of Eurobonds together with a consortium of 34 foreign bank the head of which was Commerzbank A. G. Frankfurt, of a value 350 mil. DEM. *Komerční banka* (Commercial Bank) and *Všeobecná úverová banka* (General Credit Bank) issued bonds in value of 2,4 bil. Czechoslovak Crowns. These issues represented approximately 60% of permitted bond issues in 1990. These negotiable bonds were demanded because of higher interest yield than interest yield of deposits on deposit books.

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<sup>2</sup>See: 31. Resolution of the Federal Assembly, July 11, 1990, digital archive of the Parliament of the Czech Republic. ([www.psp.cz](http://www.psp.cz))

<sup>3</sup>This law was normally quoted as a “law on the big privatisation.”

<sup>4</sup>The laws related to the capital market are characterized more in full in the Chapter 2.

<sup>5</sup>Analyses of the political and economic events during the November 1989 and the following two-three years lays stress on the discrepancy between the development of the legal and institutional framework, which was a cause of many problems related to the transformation strategy. See: Mlčoch, L., Machonin, P., Sojka, M. *Ekonomické a společenské změny v české společnosti r. 1989*. Praha: Universita Karlova – nakladatelství Karolinum, 2000, s. 222.

Majority of Czechoslovak population was not used to keep its saving in the form of securities. The normal way was to use deposit books. There was another reason as well: saving with deposit books were guaranteed by State; securities not – except for state bonds. Interest from deposit books was not taxed, but the yield from securities was. Taxation was one of the negative factors which worked against the capital market. Many financial experts criticized this abnormal situation, however, in vain. The power of the state budget was stronger than common sense or professional experience.

In 1990, a government order no. 74/1990 Coll. about the rules of an experimental use of bonds were issued. The enterprises were allowed – under certain conditions - to issue their bonds which were negotiable. The enterprises also had the right to issue non-negotiable bonds for their employees. It was a way how the enterprises could mobilize the saving of their employees. However, very early – on October 1<sup>st</sup> 1990, a moratorium was introduced. One of the reasons of this unexpected decision was that issues of non-negotiable bond could not motivate the capital market development. Another reason was that from the point of view of state it was unacceptable that state-owned enterprises would have to guarantee the liquidity of bonds by their own (i.e. state-owned) assets. In a situation when a re-organization of institutional structure was expected, it was risky to own employees' bonds.

Despite all these problems, the Government Order opened the way to issue different kinds of bonds. Till August 1990, 160 issuers asked the Ministry of Finance for a permission to issue bonds in an amount of 4.3 billion Czechoslovak Crowns. Very quickly - till September 1990 – bond issues in the amount of 3.9 billion Czechoslovak Crowns were approved.

In connection with the process called “rehabilitation” of former owners of assets confiscated or expropriated by the communist regime, an issues of state bonds in a value of approximately 1.5 billion Czechoslovak Crowns was prepared.

Shares, an important financial instrument which could be exploited in the process of privatization, were generally used by state owned foreign trade enterprises. These shares were negotiable. Another way how to support privatization was a possibility to issue securities which would be sold to Czech people living abroad.

During the first years after 1989 many private joint-stock companies were founded. These companies issued their shares. However, these shares - held by company owners - were not traded.

It is obvious that in 1990, neither a primary nor a secondary securities market existed and the main necessary conditions for its existence were absent. One of the main problems was the absence of a proper new legal base. The Law on bonds, during the year 1990 prepared and finally approved by the Federal Assembly was a *condition sine quanon* for setting up one of the most important financial markets' segments – the bond market.

But this was still not enough: the absence of financial infrastructure suitable for a capital market was another obstacle. A new Czechoslovak banking system was emerging, but

its development did not meet the transformation needs, and lagged behind. Capital of banks was low and did not enable the banks to play their expected role in capital market development. Security traders' firms were missing, no brokers or dealers existed; there were no institutional investors – investment companies and investment funds.

In 1990, two investment companies (one in Prague and the other one in Bratislava) were approved, but they did not start their activity. One of the main obstacles was the absence of a qualified staff in banks and other institutions which would be able to organize securities trading.

It is obvious that the situation in Czechoslovakia as far as conditions to start a normal securities market, was much worse than - for example - in Hungary or Poland. During the 80ties, in Hungary certain segments of securities' markets were growing. It reflected the different approaches of communist regime in Hungary to the question of elements of market economy in comparison to Czechoslovakia.

In our country, a rigid planning system still existed, and officially declared attempts to start some reforms did not include any element of market economy. In Hungary (and partially in Poland as well), elements of market economy were not banned, but – on the contrary – officially supported and implemented. During the second half of 80ties, in Hungary official securities trading was started, before the Budapest Stock Exchange officially was founded.<sup>6</sup>

The above mentioned differences between the former socialist countries were historically based on differences in the scope of nationalization. In Czechoslovakia, after 1998, small enterprise, trade and business practically were abolished; most of small *entrepreneurs* were forced to be employed in nationalized industry and some of them were imprisoned, if they could not emigrate. But: in most of socialist countries small business was not fully suppressed, and some elements of market economy still existed and were not forgotten.

During the year 1990, the Government was fully engaged by preparing necessary conditions for privatization, but the conceptions of this difficult political, economic and social process were not yet ready for use. At the beginning, two problems had to be solved: firstly, the so called “small privatization”, and secondly, the process of rehabilitation, i. e. the restitution of property expropriated to original owners after 1948. It really was a big and difficult task.

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<sup>6</sup> The Budapest Stock Exchange started securities trading as soon as in 1988, however it was not officially founded until June 1990. In the former Yugoslavia, similar situation existed. Beograd central stock exchange was founded in 1989, Ljubljana Stock Exchange on December 26, 1989. The Warsaw Stock Exchange exists since April 1991.

It is evident, that in 1990, Czechoslovak Government had not power enough to take care of capital market. There were only two institutions – the Federal Ministry of Finance and the Czechoslovak State Bank which were able to start some limited preparatory work on this field.

## Chapter 1.

### A search for an acceptable theoretical and practical solution

It is obvious that serious contacts with relevant institutions of foreign countries, especially with the Federation of Exchanges of the European Community, and later on with further international organizations, were absolutely necessary to be able to set up a Stock exchange in Prague.

Without contacts with several foreign Stock Exchanges and with several important personalities abroad, Prague Stock Exchange probably – for different reasons – never could be founded.

#### 1.1 Inspiring basic literature

To be able to discuss the Stock Exchanges' "basics" with financial industry professionals abroad, it was necessary to go through some reliable and respected literature on capital markets. In 1990, this was the main task of the author of this book.

To start with, it was the well-known German textbook "Geld-, Bank und Boersenwesen" originally written by *G.Obst* and *O.Hintner* in 1900. In 1988, *Prof. Norbert Cloten* and *Prof. H. von Stein* (as editors) published a completely revised and modernized version of this classic book as a 38<sup>th</sup> (!) edition.<sup>7</sup> This book contains more than 600 bibliographic items.

As a second, very important source, the "*Canadian Securities Course*" has to be mentioned.<sup>8</sup> It contains a very impressive and instructive survey of the Canadian securities industry.<sup>9</sup>

Another important source was a monograph written by *Francois Bacot, Paul-Francois Dubreucque* and *HervéJuvin* - "*Le Nouvel Age des Marchés Francais*" which describes the difficult modernization process of French Stock Exchanges during the years 1988-89. French Stock Exchanges replaced the old trading system used in France by a new electronic trading system imported from Canada and substantially upgraded it. In France, it was a break-through that time. This book was very important for two reasons: firstly, it was a warning not to hurry up (every change needs its proper time to succeed!). Secondly, under favourable conditions, it is possible to set up a standard Stock Exchange within a period of two-three years. More than 100 items of literature are quoted at the end of this interesting book.

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<sup>7</sup>Obst, G. - Hintner et al. Geld- Bank- und Boersenwesen. 38. Aufl. Stuttgart: PoeschelVerlag, 1988. ISBN 3 -7910 – 0407 – 7.

<sup>8</sup>TheCanadianSecuritiesCourse. Toronto, 1990. ISSN 0317-9451.

<sup>9</sup>The book was a very important source for basic courses given to the Czech brokers and dealers before the Stock Exchangestarted its trading in 1993.

These sources (and, of course, many others) served as an important basis for an evaluation of advantages and disadvantages of different trading systems and other questions connected with stock exchanges and capital markets.

To be able to prepare reasonable recommendations „what the Prague Stock Exchange should look like”, it was absolutely necessary to take the “plusses and minuses” in consideration. It was necessary, on one side, not to simply copy any securities trading system from abroad (without its modification to fit to the existing conditions of legislation, financial and informational infrastructure), and – on the other side – not to create a hybrid composed of contradictory parts arbitrarily taken out from several systems.

## 1.2 The Basic Approaches

During the autumn months of 1990, a preliminary conception of the future character and role of Czechoslovak capital market and stock exchanges, step by step, was put together. As a main source for this work the results of several short-term stays abroad, visits to foreign Stock Exchanges, and different documents obtained from abroad were used.

In autumn 1990, Czechoslovak politicians’ views on capital market and stock exchanges differed - *inter alia* - in an important point: should securities trading be concentrated at only one (Czechoslovak) Stock Exchange, or not.

In principle, three solutions theoretically were possible: 1. only one Czechoslovak Stock Exchange located in Prague as a Capital of Czechoslovakia would be established; 2. a second Stock Exchange for Slovakian Republic located in Slovakian capital Bratislava would be founded; 3. several regional stock exchanges located in regional big towns would arise.<sup>10</sup> On the political top level, these three possible ways were not discussed and no decision was taken.

To summarize: this situation was a serious obstacle which delayed the finalisation of the Stock Exchange Act.<sup>11</sup>

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<sup>10</sup>The title of the prepared Stock Exchange Act originally was “The Act on Stock Exchanges” (plural). From the actual point of view the discussion about the number of stock exchanges in Czechoslovakia seems to be rather naïve. However, there were some rational reasons to discuss this problem: at the beginning of 90ties, the necessary financial markets’ infrastructure practically was missing – telephone network was obsolete, the payment system was unsuitable, securities depositary did not exist etc. In addition to this, a strong feeling against any state monopoly (a fear of a possible monopoly of a state-owned stock exchange included) was wide-spread.

<sup>11</sup>See Chapter 2.

### 1.2.1 The first Report

At the beginning of September 1990, the first broad version of an intern Report (first draft proposals on stock exchanges in Czechoslovakia) was prepared by *V.Pavlát*, as a part of information for *Josef Tošovský*, Chairman of the Czechoslovak State Bank.<sup>12</sup>

This Report characterized the relations between the model of market economy and capital market and the role of a stock exchange in these relations. Functions of a stock exchange were defined, and its place in the emerging financial sector was characterized. The stock exchange had to play a very significant role in the process of privatisation.<sup>13</sup>

The concept tried to fix policy priorities, both in the process of creating a stock market and the process of setting up the bond market. According to the concept, both markets would have to be created simultaneously. In case of a serious delay on the field of legislation (a delay of more than one year), it was proposed to set up an interim arrangement – the so called simulated securities interim market. Selected securities market features should be verified at one spot, where selected securities' periodical trading would be simulated.<sup>14</sup> The *rationale* of this proposal consisted in getting some experience in the trading technique without any risk which would arise in case of real trading on the emerging real market.

In the Report, the legal form of a stock exchange was proposed, i.e. the form of a joint stock company. The Stock Exchange Act should define some space for self-government of the stock exchange management. The old, European traditional stock exchanges were strictly subordinated to the State which traditionally had a strong position. Some exchanges were directly owned by State, majority of exchanges were controlled by a state high functionary. However, at the beginning of 90ties, a tendency to transform the legal status of exchanges, to transform the stock exchanges into joint-stock companies with all consequences stemming from this transformation, was under way. At the beginning of 90ties, the most important German Stock Exchange – the Frankfurt Stock Exchange – already decided to transform its status.

One of the popular questions, most discussed by the interested parties in Czechoslovakia, was the choice of a proper securities' trading system. Two issues were at hand: either a “traditional” exchange with a floor, or an “electronic” exchange. The Report addressed to Chairman Tošovský proposed to set up an exchange with a floor, th “... reasonably supported by computers, to set up a Stock Exchange corresponding to the normal character of exchanges in the European Community countries, enabling a further

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<sup>12</sup>Information for Chairman Tošovský, 4.9.1990.(“Navrhované řešení základní problematiky burzy cenných papírů”).

<sup>13</sup>The standard method of privatization “step by step” of the state owned enterprises through the stock exchange, normally used in some European Community countries was rejected.

<sup>14</sup>The so called “interim secondary securities market” was started by the Czechoslovak State Bank; the only players were the few existing banks.

development of the stock exchange.”<sup>15</sup> The discussion of interested parties on the above question was very heated, and their views were contradictory: the potential advantages of one of the above mentioned solutions praised by followers of the first solution were totally rejected by followers of the second solution.

The solution proposed by the Report was based on the argument of cost. The cost of traditional trading on the floor was substantially lower; the cost of computer equipment was substantially higher. The second point was that – at the beginning of 90ties - no fully “electronic” stock exchange existed in Europe. In the US and Canada, different electronic systems existed, however, it was doubtful whether they could be applied in Europe without a substantial (and costly) modification. This was why several important big European Stock Exchanges decided to set up “parallel” trading systems to be able to check the reliability of these systems first, and – if this would be successful – to broadly apply the electronic trading.

The proposed solution for Czechoslovakia represented a sort of compromise, as it supposed to start with a “traditional” trading on the floor, supported by computers, and to approach - step by step - to the “fully” electronic system later on. It is obvious, that the expected cost of use of the “fully” electronic trading in Czechoslovakia would highly surpass the possibility of amortisation.<sup>16</sup>

The Report recommended the future stock exchange members to be restricted to universal banks, saving banks and insurance companies. The necessity to link the Czechoslovak Exchange to foreign Exchanges (information systems included) was not considered.<sup>17</sup>

The Report discussed the question of the possible number of exchanges in Czechoslovakia, their location and their functions. “Because of the federative structure of Czechoslovakia, foundation of two independent Stock Exchanges in Prague and Bratislava has to be expected. Both Stock Exchanges would have their own Main Markets of quoted securities as their basic markets. They would have to be technically linked one to the other one.”<sup>18</sup>

In case the Government would approve to set up several regional stock exchanges – in addition to the two central stock exchanges - as well, the Report recommended the regional stock exchanges to be authorized to trade unquoted securities only. By the two central stock

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<sup>15</sup>Report, p. 5.

<sup>16</sup>At the beginning of 90ties, in Czechoslovakia the use of computers was very limited. In minds of public, the word “Stock Exchange” had a negative meaning due to frequent information about speculations, frauds etc. A transparent Stock Exchange with a floor, run with a back-office supported with computers was one of the ways how to motivate the public to support the creation of a standard capital market.

<sup>17</sup>Recommendations related to legislation will be referred to in Chapter 2.

<sup>18</sup>Cited Report, p. 3.

exchanges, quoted securities would be exclusively traded. All Czechoslovak Stock Exchanges should be technically interconnected. An Association of Czechoslovak Stock Exchanges should be established and the membership of this institution would be obligatory for all Czechoslovak stock exchanges. This model was based on the German and British experience: at the beginning of 90ties; this model already existed in Great Britain and in Western Germany.

“The advantage of a higher number of technically interconnected stock exchanges (in Czechoslovakia) would consist in a substantial influence of regional stock exchanges on the regional privatisation process, i. e. creation of the financial market would not be supported only by the two focuses (the capitals of both republics). ...A disadvantage of a greater number of stock exchanges would consist (in a addition to the effect of cost) in a de-concentration of turnover, a lower market efficiency.”<sup>19</sup>

The Report evaluated the potential role of off-exchange securities' trading as negative. “At an early stage of the development of a stock exchange it is desirable to concentrate the bulk of securities' trading on the stock exchange, i.e. off-exchange trading - for the beginning at least - should be restricted.”<sup>20</sup> The negative influence of the off-exchange trading consists in lowering market transparency and multiplying the risk. It was explicitly ask the quoted securities' trading to be allowed only on the so called official market of a stock exchange.<sup>21</sup> The off-exchange transaction should be immediately reported to the stock exchange (he so called information duty). “This would make possible the registration not only of the prices of exchange traded securities, but also of the prices of the off-exchange traded securities. It is desirable from the point of view of transparency.”<sup>22</sup>

The settlement system should organized according to the principle of “delivery versus payment” (i.e. the delivery of securities against the payment) in regime called “T + 3”, i.e. during the period of three days at the latest, after concluding of a transaction. This rule fully corresponded to the G30 recommendations.

The text of information addressed to the Chairman Tošovský was compressed into 14 items comprising the individual recommendations. As for stock exchange transactions, it was recommended to exclude all term transactions for a certain (not specified) period. Spot trading should be permitted without any restriction. During the first period of securities trading, it was recommended to reduce the volume of off-exchange trading. Banks had to be excluded from off-exchange securities trading.

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<sup>19</sup>Cited Report, p. 4.

<sup>20</sup>Cited source, part II, par. 8.

<sup>21</sup>The influence of the German and Austrian Stock exchange Acts was very strong; at the beginning, the new Czech terminology was derived from the German and Austrian terminology.

<sup>22</sup>Cited source, *ibidem*.

According for the final information for the Chairman, in comparison to the “concept,” the legal form of the Stock exchange was partially changed. It was recommended to give the Stock Exchange a special status, enabling to take its specific role into consideration. This change was influenced by the talks with the Ministry of Finance.

There was a certain change of the former recommendations relating to the Stock exchange membership and the question of regional exchanges. The Stock exchange membership would be possible not only for universal banks and saving banks, but – in a general formulation – for other legal persons (and event. physical persons as well), with their seat in Czechoslovakia, “...authorized to securities’ trading, and which are fulfilling further conditions defined by the Stock Exchange Statute.”<sup>23</sup>

As for the number of stock exchanges, the original idea also was re-formulated: “The existence of only one stock exchange on the Czechoslovak territory would enable a maximum market transparency, price objectivity and reasonable liquidity. The optimal solution would be to found one Stock exchange with two sites – one in Prague, the other on in Bratislava, interconnected and working in one regime.” However, this solution was not feasible. And further: “Another possible solution would be a two-level system of stock exchanges: the lower level would be represented by regional stock exchanges (4-6 exchanges); these stock exchanges would take care of privatisation of all enterprises located in every region (i.e. primary offer and sale of shares of privatized enterprises). At the same time, securities issues by enterprises located in the regions where they could not be quoted, because they could not meet the higher requirements of the central market, should be traded at the “low level, i. e. the regional level. The higher level of the system of Czechoslovak stock exchanges would be the central stock exchanges with two floors – one in Prague and the other one in Bratislava.”<sup>24</sup>

The idea of the two-level system of exchanges was abandoned for a couple of reasons, *inter alia* because of high cost and lack of money, communication problems (lack of telephone lines) and lack of skilled personnel. It is necessary to remark that the Ministry of Finance discussed a different method of privatisation without a stock exchange, based on an off-exchange system.<sup>25</sup>

### 1.2.2 Second Report

During September 1990, a broader document (of some 50 pages) was prepared by the Czechoslovak State Bank. This document on capital market and a stock exchange was addressed to the Government. The document was based on most of the previous expert recommendations, but some of the former recommendations were not included. To the last, Czechoslovak State Bank did not present the whole text, but only a part of it, to evade the expected polemics with the Federal Ministry of Finance.

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<sup>23</sup>Information for Chairman Tošovský, p. 3.

<sup>24</sup>*Ibidem*, p. 4. There was an intention to prepare a detailed description and explanation of the two-level system for Czechoslovak Government.

<sup>25</sup>The document is not available.

In the document addressed to the Czechoslovak Government it was stressed that “ it is necessary .. to make possible securities trading on a secondary market”.<sup>26</sup> The necessity to give way to the so called “broker firms,” i.e. security dealers’ firms, was explained and stressed. It was recommended to set up only one Czechoslovak Stock Exchange as a joint-stock company. The idea of a fully electronic stock exchange was rejected. It was proposed to apply the existing German system of securities settlement (T + 3), as a safe system. The interim experimental secondary securities trading system was to be established as soon as possible. It was proposed to organize a system of broker and dealers’ education. Several proposals related to the offered foreign aid projects were included as well.

The problem of the off-exchange trading was a very controversial and explosive question. Czechoslovak State Bank did not propose any solution. The idea of a two-level system of stock exchanges also was not accepted. The document did not propose which official authorities should be involved in the process of setting up the stock exchange; it was recommended “...to nominate a group composed of experts from the Czechoslovak State Bank, Federal Ministry of Finance, Czech and Slovak Ministry of finance, banks, savings banks and other interested organizations. The task of this group would consist regulation in the evaluation of the capital market development and in giving general advice for its . One expert should be nominated by the Czechoslovak State Bank to organize the preparative work and to present the results to the monitoring group for evaluation.”<sup>27</sup> Evidently, the Czechoslovak State Bank tried to keep the preparative works in its hand, and – maybe – to play the role of a co-ordinator, but was not prepared to take a direct responsibility for the implementation. At the same time, the State Bank thought that “...the Government should not guarantee the quality of preparative works of experts aiming at the development of the capital market and setting up a stock exchange.”<sup>28</sup> Later on, this standpoint of the Czechoslovak State Bank was decisive for a delimitation of certain competencies to the national governments, i.e. to the Government of the Czech Republic and to the Government of the Slovak Republic. The national governments were authorized – inter alia - to sign agreements on technical aid offered by foreign states to Czechoslovakia. This delimitation was one of the signs of the approaching split of Czechoslovakia into two independent states – the Czech Republic and the Slovak Republic.

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<sup>26</sup>Working document for a Government Session (“Tézepodkladů pro jednání vlády o kapitálovém trhu a burze v ČSFR”).

<sup>27</sup>Cited source, p. 18.

<sup>28</sup>Ibidem, p.18.

### 1.2.3 Third Report

In October 1990, a third Report was written by *V.Pavlat* and *M.Kučera*, translated into English language and sent to selected foreign institutes with a request to comment on it. The document was based on the most important results of the a series of discussions in Czechoslovakia preceding the above described document of the Czechoslovak State Banka addressed to the Czechoslovak Federal Government.<sup>29</sup>

The aim of the new document sent abroad was to verify the proposals and recommendations of Czechoslovak State bank addressed to the Chairman of the State Bank and to the department for Legislation of the Federal Ministry of Finance. An expertise from recognized foreign institution would be helpful to solve some of the unsolved problems and /or controversial views. It was expected that some of the foreign stock exchanges and other institutes which were interested in Czechoslovak reforms would consider their possibility to offer some help, as many of them disposed of financial means to be offered to post-socialist countries. In addition to a potential financial aid, there was a hope that a qualified – direct or indirect - political support from abroad for correct decisions concerning the Czechoslovak capital market development in the near future might be given.

Later on, majority comments from abroad showed our expectation to be correct. Our Third Report was accepted with a great interest, as it contained new information on the preparative work for setting up the stock exchange with many new details. Sooner or later, comments from all relevant institutions from abroad were at our disposal, and new offers – mainly on the field of education of the stock exchange personnel – were received..<sup>30</sup>

The Czechoslovak State bank Report contained 5 parts. The first part dealt with the relation of a stock exchange to the market economy model, defined functions and the role of the stock exchange at the Czechoslovak financial market, and described the way how the new stock exchange has to be set up. Second part described the main questions discussed by Czechoslovak economists – the number of exchanges and their location, legal form of a stock exchange, type of a stock exchange, kind of transactions, quotation methods, stock exchange membership, off-exchange trading, securities settlement, contacts to foreign exchanges, securities' taxation and the actual state of preparative works. In the third part of the

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<sup>29</sup> “Stock Exchange in Czechoslovakia, Oct. 1990. 27 pp.

<sup>30</sup>“Comments on Report on Stock Exchange in Czechoslovakia”, IFC, 7 pages; Hans-Joachim Schwarze: “Leitsatzefuer die Errichtung einer Wertpapierboerse”, Frankfurter Wertpapierboerse, 26.10.1990, 9 pages; “Prague Stock Exchange report”, Coopers and Lybrand, 31.12.1990, 17 pages (6 pages Addenda); “A comment on the Stock Exchange in Prague”, The International Stock Exchange in London, 9.11.1990, 6 pages; “Remarques concernant le rapport initial Stock Exchange in Czechoslovakia”, Société des Bourses Francaises”, 29.11.1990, 9 pages.

document, technical, personal and financial questions were discussed. The fifth part characterized the so called interim secondary market.<sup>31</sup>

### 1.3 The foreign institutions' answers and recommendations

First of all, let us present the full list of foreign institutions which were asked to comment on our report: International Finance Corporation (Washington), Merrill Lynch, Mc Carthy, Frankfurter Wertpapierboerse, Coopers and Lybrand, Nomura Research Tokyo, The International Exchange (London), Bourse de Paris, Hugh Cleland (Toronto).

Comments from the side of foreign institution were positive, and the report as a whole was positively evaluated. All foreign institutions were trying to give us useful advice and some of them a specific aid as well. Naturally, the scope of comments was different: some institutions commented on selected problems, other institutions commented on the document as a whole. Critical remarks were presented in a tactful form. Some institutions applied an indirect form of criticism, by pointing out some topics missing or neglected in our report. It was generally recommended to distinguish and to categorize the short-term and long-term goals, and to formulate priorities in a more pregnant way, or to change them. There was a lot of warnings as well.

Let us quote some of the comments and recommendations of foreign institutions to selected questions. Majority of these questions were discussed by Czech experts, journalists and public; the results of these discussions were very controversial.

One of controversial questions was the desirable number of exchanges in Czechoslovakia, and their location.

The standpoint of Paris exchange was strictly centralistic: do set up one exchange only.<sup>32</sup> The IFC recommended the same simple solution – one exchange. Regional exchanges are not to be set up, securities' trading is the role of securities' dealers.<sup>33</sup> Frankfurt Stock Exchange recommended only one Stock Exchange to be set up, but with two floors – one located in Prague, and a second one in Bratislava.<sup>34</sup> Nomura Research approved the intention to set up only one Exchange, because a low level of initial trading was expected. The International Stock Exchange London recommended to set up a central stock exchange; regional exchanges were not refused, but it serious problems connected with their existence were pointed out.<sup>35</sup>

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<sup>31</sup>All foreign institutions did not answer all asked questions. Some questions were answered in a contradictory way. Answers were professional and impartial, without any attempt to push through a distinct stock exchange model.

<sup>32</sup> "Remarques concernant le rapport initial Stock Exchange in Czechoslovakia", Société des Bourses Françaises", par.2.1, p.1.

<sup>33</sup>Paris Bourse, par. 2.c, p. 3.

<sup>34</sup> Frankfurt Stock exchange p. 4.

<sup>35</sup>International Stock Exchange London, p. 3

Coopers and Lybrand Company's recommendation was different: according to this recommendation, two independent stock exchanges were to be set up; the idea of a two-level system with 4-6 regional exchanges was to be reconsidered.<sup>36</sup>

The IFC recommended the exchange to be set up as a private non-profit organisation, for example in a form of a joint-stock company with a special legal status.<sup>37</sup> The same solution was recommended by the Paris Stock Exchange.<sup>38</sup>

The solution concerning the choice between a standard exchange with a floor, electronic exchange and a standard exchange with electronic support was unanimous. The last form of exchange was the most suitable and feasible.<sup>39</sup> The standpoint of the IFC was a little bit more cautious: the final solution should depend on the trade volumes.<sup>40</sup>

The auction principle of trading (the order-driven system) was recommended by the Paris Stock Exchange, Nomura Research and the company Coopers and Lybrand as well.<sup>41</sup>

As for stock exchange membership, the views differed. The IFC recommended all persons with a valid permission to securities trading to be admitted as members. But according to the IFT, the insurance houses should not be accepted as members, because they should use services of securities dealers which are specialized for this activity.<sup>42</sup> The Paris Stock Exchange described the French system and agreed with the opinion of IFC. In 1990, some 60 securities dealers were members of the Société des Bourse Francaises. The membership was obligatory.<sup>43</sup>

The Frankfurt Stock Exchange supported the Czech recommendation, according to which the Stock exchange membership should be banks and saving banks, but recommended to accept securities dealers as well (similarly as in Germany). The insurance houses should not be accepted.<sup>44</sup>

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<sup>36</sup> Coopers and Lybrand Company, p. 6.

<sup>37</sup> IFC, par. 2.d/, p. 3.

<sup>38</sup> Paris Bourse par. 2. 2, p. 2

<sup>39</sup> The standpoint of the Paris Bourse, par. 2. 3, p. 3, the standpoint of Frankfurt Exchange, par. II., p. 8, and the comment of Coopers and Lybrand, p.6.

<sup>40</sup> IFC, par. 2.e/.

<sup>41</sup> The standpoint of the Paris Bourse, par. 2.5, p. 5; the standpoint of Nomura Research, p. 5, and the comment of Coopers and Lybrand, p. 6.

<sup>42</sup> IFC, par. 3.a/, p. 4.

<sup>43</sup> Paris Bourse, par. 2.7, p. 7.

<sup>44</sup> The Frankfurt Stock Exchange, par. III., p. 3.

The settlement system was accepted by all respondents from abroad. According to the opinion of the Paris Stock exchange, at the beginning of securities trading, the system 5 + 1 was recommended to be applied; it should be replaced by the 3 + 1 regime later on.<sup>45</sup>

The opinion on off-exchange securities trading was different. The Czech proposal to limit the off-exchange trading (at the beginning, at least) was strongly supported by the IFC.<sup>46</sup> On the contrary, by Paris Stock Exchange and the company Coopers and Lybrand a reporting duty (information duty) was recommended. Frankfurt Stock Exchange supported the proposal to introduce an information duty.<sup>47</sup>

The IFC supported the principle of tax neutrality, without commenting on an advantageous taxation of dividends and interests. IFC pointed out that a double taxation of dividends should not exist.<sup>48</sup>

According to Paris Stock Exchange, options and futures trading has to be prohibited, from the beginning of securities trading at least.<sup>49</sup>

Foreign institution commented not only on solutions recommended in the Czechoslovak document, but they commented on other problems – not discussed by the Czechoslovak document – as well. This made possible a number of important additional regulations to be included into the Stock Exchange Act. The reason why such regulations were missing was, firstly, a lack of time, and, secondly a lack of material experience on the side of legislators.

Almost all comments stressed the necessity to continue discussions, and to find solutions of the existing questions which were important not only for a standard Stock Exchange, but for the Czechoslovak securities market as a whole. The following questions were considered to be the most important ones:

- investors' protection
- quotation, prospects and information on companies
- quoted and non-quoted securities trading
- disputes between the trading parties
- confidential information
- insider trading

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<sup>45</sup>System 3+1 needs a more sophisticated SW. See: The Paris Bourse par.2.9, p.9.

<sup>46</sup>IFC, par.2.a/, p.3. IFS proposed this sort of trades to be prohibited. Compare Paris Bourse, par. 2.8, p.8.

<sup>47</sup> Paris Bourse, p.12.

<sup>48</sup>IFC, par. 4.c/, p.6.

<sup>49</sup>Paris Bourse par.2.4, p.4.

- capital adequacy of securities traders
- detailed regulation of trading licensing
- the necessity to set up a Securities Commission
- compatibility of different laws relating to securities trading
- fusions and absorptions
- foreign companies securities trading in Czechoslovakia
- the organisational structure of the stock exchange,
- the scope of internal regulations of the stock exchange
- a primary securities market and its regulation.

In Prague, some of the above questions were already discussed by the interested parties, however, in most cases, no consent existed, and no decisions were taken. Many of the above questions were not included into the document sent abroad to be commented. The fact that new problems by foreign institutions were raised was of a great help for those in Prague who proposed these questions to be solved as soon as possible, and proper regulations included into the Stock Exchange Act.

It is necessary to say that some of the recommendations of the US or Canadian institutions from the USA or Canada simply could not be applied in Czechoslovakia because of the incompatibility of the Anglo-Saxon and European continental legislation. For example, according to the IFC recommendation, investment banking should be separated from commercial banking. According to this principle, banks would have to set up their daughter-companies to be authorized to securities trading. However, In Czechoslovakia the model of universal banking was applied – and universal banks are authorized to securities trading.

The comments of most of foreign institutions included many serious – direct or indirect – warnings.

The IFC, for example, pointed out that on the emerging markets investors' protection must be guaranteed. Emerging markets are very vulnerable. Small investors have to be protected against fraud and manipulation, as they are unable to recognize this danger themselves. IFC pointed out – as a categorical condition – the necessity of setting up a regulatory authority. As a part of its comments, the IFC included information on the role of a Securities Commission, its organisation and the way how its independency has to be granted.<sup>50</sup> IFT warned that the creating an interim securities market should not be presented as a creation of a standard securities market- without a stock exchange. IFC also warned that banks easily could prevent an entry of other intermediaries on the capital market, if they would not be prohibited to do so.<sup>51</sup> It is a long-term task to educate the public to invest their savings into securities. IFC stressed that employees' securities issues should be stopped. IFC strictly recommended international accounting standards and audits without any delay to be

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<sup>50</sup>These warnings were – unfortunately – completely ignored which – a few years later - had very negative effects.

<sup>51</sup>A few years later, exactly this happened.

accepted. Without doing this, foreign investors would not trust the Czechoslovak emerging securities market.

Frankfurt Stock Exchange warned that securities markets fragmentation would be very harmful, if this would happen. Frankfurt Exchange explicitly rejected the idea of securities dematerialization and warned that securities transfer could cause some problems. Frankfurt Stock Exchange did not recommend two separated stock exchanges located in Prague and Bratislava to be set up.

By the International Stock Exchange in London, the necessity of investors' protection was pointed out with a warning that the only existence of legislation was insufficient; investors' protection had to be guaranteed by practical measures.

Paris Stock Exchange explicitly recommended options and futures trading to be banned. According to the opinion of Paris Stock Exchange it an Act on the Securities Commission to be prepared and a central securities depository to be set up.

Nomura Research accentuated the danger stemming from regional exchanges which would be inefficient because of the small market volumes. The Czechoslovak document was criticized because of the alleged confounding the primary and secondary markets. According to Nomura, an emerging stock exchange would be unable to fulfil the function of a primary market.

According to the opinion of the Company Coopers and Lybrand, the Stock exchange Act should not regulate details – it was desirable to let the Stock Exchange have a broader space for its own, independent regulations. The Czechoslovak document was criticized by the Company Coopers and Lybrand for confounding the problem of securities quotation with the trading system of the Stock exchange. It is necessary to distinguish these two questions. The Company rejected the idea that the securities “retail trading” could be based on the auction principle (order-driven system), while the “wholesale” securities trading could be based on the system with market-makers (price-driven system). The unsatisfactory attention to the primary mark and the absence of market rules were criticized as well.

To resume: the survey of the main critical remarks of foreign institution on the address of the commented Czechoslovak document is a proof showing the high efforts to positively influence the emerging Czechoslovak capital market by proposing a standard capital market legislation, and by proposing correct practical measures verified by the long experience of the advanced capital markets and by serious warnings to avoid evident errors and to evade imminent dangers.

## Chapter 2. Legislation

As in all post-socialist countries, the feasibility of economic transformation in Czechoslovakia depended on a suitable legislation and its practical implementation

The Czechoslovak Government plan of legislative works to be performed in 1991 did not foresee a global concept of financial legislation. The set of laws - The Act on Bonds, Commercial Code, Draft Stock Exchange Act, Act on the State bank and Banking Act – did not represent a sufficient legislative base the capital market smooth working.<sup>52</sup>

At the beginning, only two possibilities existed: either to implant some of the foreign legislations as such, without any modification, or to try to create the own, Czech capital market legislation, using some elements of the existing Czechoslovak legislation. Both possibilities were very difficult and risky.

The only possible result was to try to find a feasible combination of these two approaches, i. e. a compromise. This is why the “*per partes*” approach was applied. This solution was not very good, because the “step by step” method prevented to create a logically interconnected, uncontroversial system. The result was that “something” always was missing or “something” was false. Most part of the so called “omissions” was caused by some hidden or openly declared “group interests” of different pressure groups.

### 2.1 Legislative work concerning Czechoslovak capital market and the Stock Exchange

First of all, the federative structure of Federative Czechoslovak Republic has to be reminded to be able to understand the impact of this structure on legislative works.

In Czechoslovakia, the legislative process on the level of Czechoslovak Federation was organized in such a way that every ministry – as a unit of the central administration – was authorized to prepare drafts of laws and other regulations relevant to its special field of activity (for example, the Ministry of Finance was responsible for financial legislation). Before a draft was prepared, a ministry had to consult other ministries, if these ministries’ activities were touched by the content of the draft. After having discussed the eventually controversial matters, the draft was circulated, and all ministries had to comment on it. All commentaries were to be sent to the Government Legislative Council, and if approved, the draft was passed to the Government. In case the draft was approved by the Government, it was to be passed to the Parliament.

The Czechoslovak Parliament consisted of two Chambers – the Chamber of People and the Chamber of Nations. Drafts had to be discussed in relevant parliamentary committees, and if recommended, they were passed to the Plenary Session of both Chambers. A similar way was applied on the level of the Czech National Government and on the level of the Slovak Government. The laws and other regulations had to be approved by relevant national

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<sup>52</sup> “Materiál pro poradu vedení SBČS”, 10.6.1991, p. 11

authorities, i. e. by the Czech National Council (the Czech parliament) or by the Slovak National Council (the Slovak parliament).

In the Czechoslovak Republic, the bulk of financial legislation was in the hands of the Federal Ministry of Finance. A specific part of financial legislation concerning the Czechoslovak currency and banking was committed to the Czechoslovak State Bank.

Such a division of labour always depends on a convention, because the financial sector is an inseparable unit. In case the official competencies are divided, and more than one authority takes care of different parts of financial legislation, all the authorities have to respect the real economic and financial relations within the financial sector. Therefore, a close co-operation of these authorities is expected. However, different approaches, methods and instruments (which are suitable for different parts of the financial sector) may be applied, and different views exist. If competencies are not clearly defined, frictions are frequent. This was exactly what – to a certain extent - happened in Czechoslovakia during the first three years after November 1989.

As for the Czechoslovak financial legislation and financial market development, the Federal Government decided to go step by step, i.e. to prepare one financial act after the other, in applying certain priorities. Most probably, this way was a pragmatic, but not optimal, solution. It was unconceivable to abolish all financial legislation by one stroke, and to replace it by a new one. Unfortunately, a clear conception of the new legislation did not yet exist. This was the reason why many old laws and other regulations had to retain validity for a certain time; only a small part of them could be partially modified or, eventually, abolished.<sup>53</sup>

On the field of financial legislation, the situation was rather specific: for a period of forty years, an appropriate financial legislation, corresponding to the needs of a free market, did not exist at all. The situation can be described as a legislative *vacuum*. *Per partes* method was a surrogate. For the Czechoslovak Government the privatisation was the highest priority – not the creation of a capital market and a stock exchange. From the retrospective, this approach was not correct: under existence of a standard stock exchange, privatisation process could be more standard.

During 1990, several drafts of financial laws were prepared: the Act on Bonds, and the Stock Exchange Act, and in 1991, the Securities Act followed. Legal regulation of collective investment – by the Act on investment companies and investment funds – was approved very late. The price for this delay was high: many investment companies and investment funds were established in a chaotic way, without any legal authorisation. This paved the way for the famous “tunnelling.” The so called Harvard Funds - with their famous guru *Viktor Kožený* -

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<sup>53</sup>The Act on Bills and Cheques (*Zákon směnečný a šekový*) No.191/1950 Coll., in force from January 1, 1951, was the only exception: it was never necessary to novelize it. On the contrary, a majority of new laws, enacted after 1989, had to be novelized many times. In 2002, substantial changes of many laws had to be accepted, because of the expected EU membership of the Czech Republic.

are a fragrant example of frauds and manipulations on the emerging capital market of the Czech Republic.

A global approach to the capital market legislation was recommended by all foreign experts. However, up to May 1991, the Securities Act - which had to fill in important gaps existing in the other laws - was still missing. It was the intervention of Czechoslovak State Bank which persuaded the Ministry of Finance to decide the Securities Act to be prepared.

The Securities Act had to contain the following main parts: definitions of different kinds of securities; conditions of securities tradability; conditions for securities dematerialization; financial intermediaries' licencing; registration of securities property, system of securities property transfer, and securities settlement; regulation preventing frauds and insider trading; liability of securities issuers, information duty; establishing of a regulatory authority (i.e. of a securities commission). It was expected that this law would enable to solve majority of discussed, but not yet solved questions. The Securities Act had to be passed to the Czechoslovak Government till the end of 1991 at the latest. However, this failed.

One of the further necessary conditions for a standard capital market was *investment funds regulation*. In June 1991, a first draft of principles applicable to investment companies and investment funds' regulation was in preparation. However, preparative work lagged behind the needs of the emerging Czechoslovak capital market. Several investment funds already existed. They were established by the Investment Bank with a permission of the Czechoslovak State Bank (*sic!*) according to an agreement of the Federal Ministry of Finance, Ministry of Finance of the Czech Republic and Ministry of Finance of the Slovak Republic. The above permission was derived from the Act on banks and savings banks.

## **2.2 The special law on the Stock Exchange**

The first official *draft of the Stock Exchange Act* (summer 1990) was prepared by *Ing. Dušan Libnar* and *JUDr. Jiří Špička* (both: Czechoslovak Federal Ministry of Finance).

This draft was completely based on the German and Austrian Laws on Stock Exchanges. The authors tried to apply the archaic terminology used in the old, pre-war Czechoslovak Act on stock exchanges. It was a formal attempt to link the pre-war tradition of securities trading in the capitalist Czechoslovakia with the requirements of the period of transition to a market economy. In fact, this formal approach (from the

material point of view, no part of the old regulations could be applied) was probably caused by the legislative practice: in the Czechoslovak legislation, the use of foreign words was not allowed. However, in 1990, the Czech language did not use the old expressions used in the pre-war stock exchange trading. The modern Czech terminology was emerging, but different Czech translations of the Anglo-Saxon, German and French terminology were frequently mixed together, and a real mess existed. In fact, the authors of the Draft were criticized for using the old terminology, but these criticisms were undeserved: a new, correct and recognized terminology simply did not exist.

The main deficiencies of the Stock Exchange Act consisted in the general concept of this law, and the scope of it. *Inter alia*, there was a question, whether this law should be related only to securities' exchanges, or commodity exchanges as well. The first idea was to prepare a general law relating to all types of exchanges, but this idea was abandoned because of practical reasons. It was easier to prepare a law on securities exchanges, and to prepare another special law on commodity exchanges later on. However, the Czech title of the law which was used was "The law on Stock Exchanges" (i.e. plural), because the existence of more securities exchanges was still considered.

The first draft was very brief – it consisted of 13 paragraphs. The first part of the draft (the first 11 paragraphs) was called "Stock exchanges" defined conditions of establishing a Stock Exchange, a stock exchange Statute, the material responsibility and liabilities of founders, the form of an application for a state permission, the state surveillance and the intern stock exchange regulations were defined. The second part (two paragraphs only) related to exchange trading and the so called "sensal" (in German: Sensal; in Czech: burzovní dohodce). In comparison with the later wording, first draft was very poor – something as a skeleton, or a torso. It was not only caused by a lack of time, but there were deeper reasons. On one side, it was caused by a lack of practical experience how securities exchanges really work; on the other side it was caused by the fact that no conception of an exchange or exchanges was approved by the Government.

The first draft did not define any legal form of a stock exchange or of a type of a stock exchange. Stock exchange transactions, types of trades, stock exchange authorities, the way of securities' quotation, the securities settlement etc. - all this was missing.

Later, the above questions were included to the following drafts, however, this was done in co-operation between the Department of legislation in the Federal Ministry of Finance and the emerging expert team in the Czechoslovak State Bank. Most of the amendments proposed by the team were based on documents acquired from abroad, and translated to Czech. The process of improvement can be shown on selected examples.

The original draft prepared by the Ministry of Finance limited the number of "founders" by 5 persons. Later, this number was changed – minimum 10 founders would be needed. The reason for this change was simple: the idea of establishing a greater number of stock exchanges was abandoned, and the law if exchange practically did not expect more than one Czechoslovak stock exchange to be set up.

According to the above amendments, general conditions for founding a stock exchange were stricter, but this "rigorous" definition of an entry to securities trading caused some problems, when applications of different interested persons were examined: the definition of these conditions was not unequivocal.<sup>54</sup> Legislators probably tried to evade of being accuses of preferring only one federal stock exchange (by granting a quasi-monopoly status to it) and, at the same time, they tried to keep a possibility of a competition. Whatever

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<sup>54</sup>Two attempts to set up a new exchange failed. One of these exchanges was proposed as an option exchange.

was the motive to let “an open door” for more exchanges, it was a misunderstanding. The way to establish a standard Czechoslovak capital market should be supported by setting up only one central Czechoslovak stock exchange. By the way, one of the main objections against the membership of the Prague stock exchange in FIBV (World Exchanges Federation) and in the FESE (The European Federation of Exchanges) was the de-concentration of trading on the Czech emerging capital market. This could be easily prevented, but a clear political decision was missing.<sup>55</sup>

According to the original draft, it was expected that the role of intermediaries on the stock exchange markets would be reserved to the “sensals” (official and private), as it was the case on the pre-war Prague Stock Exchange. The “official sensals” would have to become members of the exchange. The Stock Exchange would have the right to approve of these intermediaries’ professional quality. The Stock Exchange official authorities would be the Stock exchange Chamber (in Germany and Austria – Boersenkammer) and a Supervisory Council.

*The Second draft of the Stock Exchange Act* (September, 1990) which was discussed by the experts from the Federal Ministry of Finance and from the Czechoslovak State bank during *September 1990*, was prepared more in detail. In comparison with the former draft, this version was of a much better quality. In October 1990, a *Parliamentary Report*<sup>56</sup> was prepared.

As a result of the aforementioned co-operation between the Ministry of Finance and the team of central bank experts, the main principles of the concept prepared by the expert team were projected into the last version. Majority of questions were covered by this version, however, some partial regulations were still missing. It is necessary to say that most of uncovered items were criticised by foreign institutions’ comments. But in general, the quality of the draft last version (both for material and formal side) corresponded – more or less - to standard foreign stock exchange legislation.

The third *Draft Stock Exchange Act* (1990) was divided into the following parts: the first part consisted of general rules (§ 1-5), in the second part stock exchange authorities were defined (§ 6-15), the third part contained regulations related to permissions of trading (§ 22-24), part four characterized the ways of trading (§ 22-24), part six regulated different kinds of transactions (§ 25-30), by the part seven tasks and liabilities of intermediaries (“sensals”) were regulated (§ 33-35), part eight regulated the disputes and sanctions (§36-37), part nine defined the state surveillance (§38) and the last part - ten - consisted of special and final regulations (§ 40-42).

From a retrospective point of view, many paragraphs were not properly formulated, but the Draft – as a whole – represented an important step forwards.

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<sup>55</sup>Poland never accepted the possibility the Polish capital market to be split.

<sup>56</sup>In Czech: “důvodová zpráva”.

The Parliamentary Report set forth that the Draft Act was limited to the securities exchanges regulation. The original intention of preparing a broader regulation of exchanges, commodity exchanges included, was definitely rejected.

The Report summarized the principles of the Draft Act in the following way: “if the main task of a stock exchange has to be fulfilled – i.e. to secure an organized securities market, it is necessary for the stock exchange to be able to act as an independent market institution separated from the state and endowed by the necessary self-government, under surveillance of a state authority; the task to act as a public beneficial institutions<sup>57</sup> securing from its incomes financial means for its activity and for its further development; the task be to an open institution, enabling the membership to further members and excluding a dominancy of one of its members, the task to organize securities trading in an efficient and flexible way to guarantee a sufficient trade volume, market transparency, a sufficient liquidity, and to protect financial investors’ interests; the task to respect the international recommendations relating to trading, especially the recommendation of the European Community Commission, and gradually to join the international securities market.”<sup>58</sup>

The Report also set forth that the Draft Act “secures a possibility of establishing more exchanges, but this is to be considered very cautiously. The foreign experts from Germany, Austria and France unanimously recommended only one stock exchange to be set up in Czechoslovakia.”<sup>59</sup>

The Draft Act recommended the legal form of a joint-stock company to be used, with some special arrangement in comparison with the Joint-stock Company Act.<sup>60</sup> The priority of the legal form of a joint-stock company enables the stock exchange to collect the capital needed for its foundation in a more easy way.

According to the § 16, only banks and intermediaries (sensals) would be permitted to stock exchange trading; not all stock exchange member would be automatically permitted to trade. As for off-exchange trading (§ 16), the persons entitled to trading are obliged “to conclude off-exchange trades only to an extent permitted by the Stock Exchange Chamber, and to inform the Stock exchange.”<sup>61</sup> The Report explained this regulation setting forth, that in the early development stages of a stock exchange, it was desirable to concentrate the

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<sup>57</sup>In Czech: “obecně prospěšná instituce.”

<sup>58</sup>Report about the Draft Stock Exchange Act, Federal Ministry of Finance, No. I/29 258/90, p. 2.

<sup>59</sup>Report about the Draft Stock Exchange Act, Federal Ministry of Finance, No. I/29 258/90, p. 3.

<sup>60</sup>The joint-stock companies’ regulation later was included into the Code of Trade (Obchodnízákoník).

<sup>61</sup> Draft Act, p. 13.

maximum of trades at the stock exchange, i.e. off-exchange trading should be limited, transparent trading secured and risk from frauds reduces.<sup>62</sup>

The Draft Act included the original wording of the intermediaries' (i.e. the official and private "sensals") role which consisted in concluding contracts on securities transactions. The "official" intermediaries had to take care of the "official" market: they had to fix securities' prices on this market. They were not allowed to trade on their own account and own name.

The "private" intermediaries were permitted to trade on their own account and own name (§34). Private intermediaries would have to work on the regulated and free markets. Later, the way of trading and the market types were substantially changed.

Option and future trades had to be permitted by the Stock Exchange Chamber (§ 22). The Draft Act expected the possibility of a computerized trading.

The Draft Act still was influenced by the old German and Austrian stock exchange laws. By legislators, they were used as models. The archaic Czech terminology was still applied.

If the Czechoslovak Draft Act is compared with the Hungarian or Polish Stock Exchange Acts, there is a substantial difference. In the Hungarian law<sup>63</sup> many heterogeneous elements of laws valid in different countries were mixed together. The heterogeneity was evident not only as far the material content is considered. Many paragraphs' wording was too detailed (as they were re-written from Anglo-Saxon legislation), other paragraphs' wording was more general. These differences clearly reflected the well-known difference between the Continental and Anglo-Saxon legislation.

The superiority of the Polish approach – as far as the financial markets' legislation is considered - consists in its integrity and lucidity. There is no doubt that the success of the Warsaw Stock Exchange was based on the standard, internationally recognized capital market legislation. The Polish legislators evidently preferred the long-term goals to the short-term ones.

One of the most important deficiencies of the Czechoslovak Draft Stock Exchange Act was the obsolete conception of trading - the so called "ways of trading", and the quotation of prices. The Draft Act defined the out-cry system on the floor, but the future computer support was not expected. Later, this evident mistake was partially corrected. The settlement regulation was completely neglected, in spite of the fact that standard international principles could be mentioned as a recommendation for the Stock Exchange Chamber.

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<sup>62</sup>Report about the Draft Stock Exchange Act, Federal Ministry of Finance, No. I/29 258/90, p. 10.

<sup>63</sup> Act on Securities and the Stock Exchange, Budapest: Ministry of Finance, 1990. ISBN 963 - 390 - 0 - 52 - 2.

One of the advantages of the Draft Act undoubtedly were the efforts to set up only one Czechoslovak Stock Exchange and to reduce the off-exchange trading. Members of the expert team from the central bank persuaded the legislators to accept this solution as the best one.

However, the idea of limiting or monitoring the off-exchange trading was never accepted by banks: they preferred their short-term interest to the long-term interest of the emerging Prague Stock Exchange. It is a paradox that banks – being Stock Exchange members - flagrantly violated the regulations and were sanctioned for it.

At the beginning of 1991, the Draft Stock Exchange Act was discussed by Czechoslovak Government Economic Council, by Czechoslovak Federal Government, Government of the Czech Republic, Government of the Slovak Republic and by one of the Committees of the Federal Government Legislative Council. The Draft was passed back to the Federal Ministry of Finance to be amended and finalized. The competencies of the Federal Government and national governments in relation to stock exchanges had to be more precisely defined.

Government of the Slovak Republic did not accept the proposed way of setting up the exchanges. According to the Slovak standpoint, the stock exchanges regulation and surveillance had to be in hands of national governments. By the Czech Government a similar argument was pointed out, however it proposed to discuss the problem more in detail. According to the Czech Government, stock exchanges trading and securities transactions were closely connected with Czechoslovak currency which was regulated by the Federal Government. The Czechoslovak Economic Council recommended the stock exchange surveillance to be administered at the level of Czechoslovak Federation. The Legislative Council and some of the federal ministries (for example, the Ministry of Agriculture) recommended commodity exchanges to be included into the Stock Exchange Act. However, a special regulation of the two types of exchanges had to be prepared. Federal Ministry of Finance and the Czechoslovak State Bank recommended the Stock Exchange Act to be changed: the Act had to define only general conditions of Stock Exchange foundation and the functions of a stock exchange. The intern rules and regulations had to be delegated to the Stock Exchange itself. According to the Czechoslovak Bank, the Act should not define the legal form of the Stock Exchange.<sup>64</sup>

The revised Act accepted some of the above recommendations, and the new Draft was passed to the Federal Government. The regulation and surveillance of a stock exchange was reserved to the Federal Government. The stock exchanges' legal form was a joint-stock company, with a specific arrangement of its top managerial structure. The self-government of a stock exchange was widened.

Majority of rational views were approved. As for some controversial questions (for example, the discussion about Central Government competence), the discussion proved to be

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<sup>64</sup>The Czechoslovak State Bank explicitly showed that its views were based on the opinion of experts from European Community countries and from Canada. See: "Materiál pro poradu vedení SBČS", 10.6. 1991, p. 3-4.

unnecessary: after one year, Czechoslovakia was divided into two independent states. The decision not to extend the Stock Exchange Act to contain commodity exchanges regulation as well had a positive impact: a further delay was prevented.

The improved version of the Stock Exchange Act was passed by Minister of finance to the Czech and Slovak Ministries. The reasons to keep the competence of stock exchange regulation and surveillance on the level of Czechoslovak Government was explained. The two national ministers were asked whether they would propose to change the Czechoslovak Constitution: a change would be necessary, if competence on the Stock Exchange would be passed to the national level. The Slovak minister of finance answered that they preferred the national level.

Further negotiations were protracted for a couple of months. The Slovak political representatives did not want to disclose their intentions, and they secretly prepared to set up an independent Slovak Stock Exchange located in Bratislava. Nevertheless, the Draft Stock Exchange Act amended by the Federal Ministry of Finance, was no more changed.

## **2.3 The Securities Act**

At the beginning of 1992, the Draft Securities Act was prepared by the Czechoslovak Ministry of Finance. prepared the Draft Stock Exchange Act. The draft principles were changed several times.

### **2.3.1 Commission for capital market development**

In the first months of 1992, a Commission for capital market development was nominated by the Federal Ministry of Finance, as an advisory authority for this Ministry. The Committee's task consisted in evaluating the process of legislative works on the field of the emerging Czechoslovak securities market, and in supplying expertise on some unsolved questions or on solutions proposed by the Ministry of Finance which were criticized by the press or by financial experts.

The Commission for capital market development was headed by *JUDr. Ing. Dušan Tříška, CSc.* The Commission was composed of the following members: Chairman *Kučera* (Association) and Vice-Chairman *Pavlát* (Association), *Ing. František Vejmla* (Komerční banka) and *Ing. Marian Šedo* (Všeobecná úverová banka, Bratislava), *Ing. Dr. Zdenko Alexy* (Director General of the Bratislava Stock Exchange), and *JUDr. Josef Mesároš* (Secretary General of the Bratislava Stock Exchange). The presence of Slovaks was very useful, as their views could not easily be ignored by the Czechoslovak Ministry of Finance, notwithstanding that negotiations about the dissolution of Czechoslovakia had begun.

The Commission discussed the Draft Principles for the Securities Act for a couple of months. Regular sessions started at the end of April, 1992 and lasted till the autumn, 1992.

The atmosphere of discussions was not very inspiring. Some sessions were marked by frequent attempts of ministerial officials to criticize the views and proposals of "extern" members. Sometimes the minutes were incomplete, they did not correspond to the course of

discussion, or they were distributed very late, so that it was difficult to control the content. Ministerial officials defended all “official” proposals, and sometimes their arguments were unfriendly. This was the way frequently used by the Chairman *Tříška*, *RNDr. Jaroslav Lízner* and *JUDr. Jan Pauly*.

During the last sessions, it was quite evident that important and rational recommendation of the Stock Exchange Chamber would not be accepted. The Stock Exchange Chamber - supported by the Czechoslovak State Bank which was interested in some amendments of the Draft Principles - asked the Czechoslovak Government Office (Úřad předsednictva vlády) to intervene. As a result of this request, on October 1992, a meeting at the Government Secretariat was held. At the meeting, representatives of all interested parties (the Czechoslovak Government Office), Federal Ministry of Finance, Czechoslovak State Bank and Prague Stock Exchange) were present. The aim of this meeting was to agree several modifications of the Draft Securities Act, however, Ministry of finance rejected to do so. In the minutes<sup>65</sup> it was *verbatim* explained, that “... the Stock Exchange representatives insist on their declaration that the Draft Act is creating worse initial conditions for the Stock Exchange trading on the emerging capital market”<sup>66</sup>, and that the Stock Exchange Chamber requests the principle of the absolute centralization of securities registration to be modified: the framework of the unified securities evidence ought to consist of two layers, namely, (a) the Central Securities register, and (b) Dealers’ Register and Stock Exchange Register.

On the programme of the same meeting, another question was to be discussed as well: the competence of the Czechoslovak State Bank and the Federal Ministry of Finance related to the securities issuance nominated in foreign exchanges. But Deputy-Minister of Finance *Ing. V. Rudlovčák* did not come to the meeting, and the above item was scratched.<sup>67</sup>

The Draft Securities Act was discussed in a parallel way: in the Czechoslovak Federal Parliament, and the Czech National Council. The Drafts were not identical – in some respects they substantially differed.

The Draft Securities Act was presented to the Czech National Council by its Deputy *Ing. Tomáš Ježek* (at the 7<sup>th</sup> session). The document was called “Act on the securities’ system and on securities trading.”<sup>68</sup>

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<sup>65</sup> Minutes of meeting held on October 27, 1992 at the Government office about the “Law on the system of Securities and trading with them”.

<sup>66</sup>The settlements process was discussed. More in 2.4.2.

<sup>67</sup>Reasons for his absence or an apology were not communicated. However, it was well-known that this high official was no fan of the Prague Stock Exchange.

<sup>68</sup>The document of the Czech National Council Nr. 155; digital Archive of the Czechoslovak Parliament, [www.psp.cz](http://www.psp.cz).

Before passing the document to the 7th Plenary Session the Draft was discussed by two Czech National Council Committees – the Economic Committee and the Committee for Budget. Unfortunately, the meeting of these Committees was postponed till 21.00 (*sic!*). Many deputies did not come at all, and most of deputies who came were not interested in securities' problems at all. They wanted to go home.

The course of discussion showed that many deputies were financially ignorant. From the point of view of the Prague Stock Exchange, only one positive result was achieved: an important modification of one of the disputed paragraphs. The wording of this paragraph – enumerating duties of the Central Securities Register – was very vague, giving to the Register a possibility to evade one of its duties. According to the original wording, the Central Securities Register was obliged to act “without an unnecessary delay,” – which is a very vague definition. The new wording of the § 22 approved by the Committee for Budget, defined the timing of Central Securities Register action by words “same day” which means that securities traded during one day had to be registered on the same day, not later. This was one of the “*casus belli*” between the Stock Exchange and the Ministry of Finance.<sup>69</sup> On the November Session (17. 11. 1992), the Resolution No. 87v., the “Act on the securities' system and on securities trading” was approved. On the whole, 11 minor modifications were approved. On November 20 1992, 7th Session of the Czech National Council approved the Securities Act by its Resolution No. 75.

The Czechoslovak Parliament approved the Securities Act on December 2, 1992, as an Act Nr. 600/1992 Coll. with no modification, by votes of all deputies.<sup>70</sup>

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<sup>69</sup>Minutes of the 11. Meeting of the Budget Committee of the Czech national Council, held on November 17, 1992 (a joint session with the Economic Committee).

<sup>70</sup>The Minutes of the joint session of the Chamber of People, and the Chamber of Nations, December 1992. The draft Securities Act was discussed - as an item 7 of the programme, print 162, and the proposal prepared by several Committees, print 178. On October 27, 1992, the Draft was presented by *Jan Klak*, Czechoslovak Minister of Finance; a report was presented by deputy *Miroslav Richter* and deputy *Miroslav Ransdorf*. During the discussion, four additional proposals were presented; two of them were discussed as one item. Reporter *Richter* recommended the two proposals to be voted both at the same time: “I am informing you that about this modified proposal a long discussion was held, both in the Economic Committee, which accepted it, and in the Guaranty Committee, which rejected it. The sense of this proposal is to include ... the words “until three working days at the latest”. It refers to the process of securities registration by the Securities Centre. The Law says that the Centre will register immediately. There is a permanent strive to fix the time (for registration – V.P.). The Committees do not accept this modification. They think that the word “immediately” correctly defines the moment of registration. It is simply the ...moment, when the Centre is able to do it. If we fix a time, it means that the Centre - during the next two and a half days – will do nothing, and the registration will be done at the end of the third day. As a Parliamentary Reporter, I do not recommend the modifying proposal to be accepted.” It is obvious that *Mr. Richter* did not understand what it was all about. It was important to say, that the Centre *must* register a transacted security within 3 days *at the latest*, i. e. the registration has to be its obligation, and if this obligation would not be fulfilled, some sanctions against the Centre

The draft Securities Act was discussed (item 7 of the programme, print 162) and the proposal prepared by several Committees, print 178. On October 27 1992, the Draft was presented by *Jan Klak*, Czechoslovak Minister of Finance; a report was presented by deputies *Miroslav Richter* Chamber of the People and *Miroslav Ransdorf* Chamber of Nations

## **2.4 Discussion about important questions connected with the legal framework of the Czechoslovak capital market: what should not be forgotten**

At the beginning of 90ties, the scope of questions connected with the emerging Czechoslovak capital market was very broad, because the securities market did not exist for more than 40 years. In 1992, from the point of view of the Association (Preparative Committee), the most relevant topics were the following ones: 1. The optimal type of a stock exchange system; 2. The role of the Central Securities Centre, and 3. The role of an off-exchange system – RM-S.<sup>71</sup>

### **2.4 1. The optimal type of a stock exchange system**

It was quite clear that the Prague Stock Exchange would not have the form of an outdated Exchange with a floor, but – at the same time – it was sure that for a couple of years the trading could not be fully automated.

This is one of the reasons why a compromise had to be accepted. The open-outcry-system was incorrectly described to be an archaic, outdated type of the existing trading systems: therefore, it was rejected, without knowing anything about numerous undisputable advantages of such a system. The open-outcry-system currently was applied by smaller exchanges, where only low numbers of orders are expected. This is a real fact which has to be respected, when any new trading system is introduced. The open-outcry system is cheap, quick and reliable.

Nevertheless, there were other important reasons why the open-outcry-system was not applicable at the Prague Stock Exchange: a high trading volume was expected, because the coupon privatisation was expected to bring several thousand issues to be traded (some of them quoted, other ones unquoted) at the Exchange. It was expected that three parallel markets would exist; it was quite possible that even the capacity of the three markets possibly would not be enough for such a big securities' number. Applying a rational organisation, even a very big issue numbers can be mastered – as the experience of the Zurich Exchange and of some other foreign Exchanges shows.

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could be applied. Otherwise the Centre would be free to do anything, because in case the Centre would not be able – for any reason – to register a security “immediately” (i.e. without delay), the registration could be postponed for a couple of months. *Sancta simplicitas*, or “an interest of State”? The first two proposals were not accepted. On the contrary: the other two unimportant modifying proposals, recommended by *Mr. Richter*, were approved.

<sup>71</sup>The joint company RM-S, a .s. was founded on January 28, 1993 and was registered by the Commercial register.

The reasons why the open-outcry-system application would be advantageous for Prague - given by some foreign experts in 1990 - were the following: 1. a general lack of experience with securities trading in Czechoslovakia, 2. the open-outcry-system was very advantageous for the new brokers which would have to be educated, as they were expected to learn it very quickly. The open-outcry-system was presented as a pre-stage and a necessary condition for the more complex trading system in the future. According to the view of foreign experts and advisors, the open-outcry-system would have to be applied for a five years horizon at least. It is interesting that the same experts very quickly changed their estimate, because they recognized that Czech people learned the new technologies very quickly; therefore, the idea of a computer support was no more rejected as a non-feasible method. But: there was a very important obstacle – the very high cost of modern equipment.

It was expected that one of the factors influencing the success of an open-outcry-system could be the question of evidence and settlement, if the number of trade really would be high. The experience of some Western European Stock Exchanges showed that it was difficult to produce all the necessary documents in time; for example, the process of settlement in Italy lagged behind the trading.

The delivery of payment system (DVP) was misused by some of the securities buyers: they postponed their payments to the last moment to be sure that the securities which were bought (but not paid up), would be prepared for delivery against money. The same was expected by sellers.

Historically, this problematic situation was one of factors leading to settlement computerisation. All this was well-known in Prague, and the possibility to establish a computerized settlement system was examined. But a dilemma existed: it was necessary to decide, whether the system of fixing, or the system of continual trading should be applied. The system of fixing is based on a static price-formation; the continual trading is a dynamic price-formation process.

Different modules for continuous trading were offered to the Stock Exchange. One of these firms was, for example, company Digital. But: the SW price was very high – 65-70 million CzCr. The expected PSE members could not afford to pay it. The price corresponded to the complex character of the SW module for continuous trading: the SW had to be complex, because one of its roles was to prevent possible market and price manipulation in case the buy and sell orders would not be sufficient to form a fair price. And there was another problem as well: nobody was able to predict what the future trade volume at the Prague Stock Exchange really would be. The estimates widely differed.

The SW for the fixing system is relatively simple (in comparison to the SW for continual trading), and definitely much cheaper. Fixing does not depend on a great number of buyers and sellers. For an emerging Stock exchange, the fixing system is more simple, easy to use, more transparent, and safer than the continuous trading system.

All these reasons were important for the final decision: the advantages of fixing prevailed, and it was decided to apply it.

## 2.4.2 The role of the Central Securities Centre

Before the expected PSE members (the “Association”) got to know what the role and mechanism of the Securities Centre (SCP) would look like, no decision on the settlement system was taken. The trading system was a priority. However, the Association recognized very soon that both decisions are interconnected. The settlement system must be compatible with the trading system - otherwise both systems could not work. This was the reason, why the Association – after having signed the Contract with the Société des Bourses Françaises (SBF) – asked the SBF to extend the contract, and to deliver the SW for a Stock Exchange Securities Depository.

The Stock Exchange Securities Depository had to be connected with the Securities Centre, but an unexpected problem arose. The Association repeatedly discussed this question with *RNDr. Jaroslav Lizner*, the director of the Centre for Coupon Privatisation (the pre-destined predecessor of the emerging Securities Centre) without any positive result.

Suddenly, a lot of obstacles arose. The group which prepared the Securities Centre and – at the same time – the off-exchange system called RM-S, had the intention to connect the RM-S directly with the Securities Centre. At the same time, all securities dealers were offered to be directly connected as well. But: the Stock Exchange should not be directly connected with the Securities Centre – the connection was planned to be intermediated by securities dealers-Stock Exchange members.

At a first glance, this was an outright attempt to discriminate the Stock Exchange: the proposed model would give to the RM-S a more favourable way of settlement, i. e. a comfortable, direct, less time consuming and cheaper way.

It was an unfair attempt to detract the security dealers from the Stock Exchange. The mechanism would be the following: Stock Exchange members would have to settle their on-exchange trades with the Stock Exchange Depository; the Stock Exchange Depository would have to transfer the securities traded from the account of the seller (the Stock Exchange member) to the account of the buyer (the Stock Exchange member as well), and to pass the transaction documents to Stock Exchange member-seller which had the duty to pass the transaction documents to the Securities Centre. The Securities Centre would have to register the transfer from the seller and buyer accounts – and only after the registration the transfer would be finally finished and valid. Obviously, this long chain of operations would be longer than if a direct contact of the Stock Exchange Depository with the Securities Depository would exist. The Stock Exchange would be discriminated, and the RM-S off-exchange trades would gain a considerable advantage.

All the experience of the advanced capital markets would be upside down by this break-neck way: the longer the way, the more dangerous it is. At the advanced capital markets, the Stock Exchange trades always were considered to be safer than off-exchange trading, because the Stock Exchange is recognized to be the top institution of any capital market. The model described was a degradation of the role and significance of the Stock Exchange. The Association protested against the model and proposed the Prague Stock

Exchange Depository to be directly connected with the Securities Centre. The protest was supported by the Czechoslovak State Bank. Nevertheless, nothing happened. As a pretext not to change the “model”, technical problems, such as the quality of telephone lines etc., were raised. Final result: the transfer of securities was valid as soon as the transfer was reported by the Stock Exchange Depository to the Securities Centre.

### 2.4.3 The role of an off-exchange system – RM-S.<sup>72</sup>

The third problem was the RM-S. The founder of this company was the company PVT (Podnik výpočetní techniky, a. s.). According to the Securities Act,

RM-S role was defined as a “market organizer”. In the Stock Exchange Act, this word cannot be found.

The stock exchange market was defined by the Stock exchange Act. Securities had to be traded according to this Act.<sup>73</sup> The Stock exchange Act did not define the off-exchange trading.

The Securities Act was constructed - and presented – as a Law which has to complete the whole structure of laws about the capital market. At the 7th session of the Czech National Council (i.e. Parliament of the Czech Republic), it was said by Deputy *Tomáš Ježek*, and by Deputy *Richard Mandelík* (as a reporter).

Parts of their speeches are extremely important (which are cited according to the minutes) to be able to characterize the reasons why RM-S was founded.

*Tomáš Ježek* said about the Securities Act: “...This Act was expected with some impatience, as the privatization of more than 950 joint-stock companies in the Czech republic depends on it. This Law will enable ... to finalize the coupon privatization which is – up to now – going on very well and according to the original assumptions. This Law completed the existing system of Laws regulating the capital market. We already have the Commercial Code, the Act on Bonds, the Stock Exchange Act and the Act on Investment companies and investment funds... This Law regulates the securities trading, but a significant, substantial part of it is oriented on the off-exchange market... because the Stock Exchange Act already exists. *The off-exchange market is the market, by which the shares originated by the coupon privatization will be served (sic!),* irrelevant whether the holders are individual coupon-holders (so called “dikové”) or the investment privatization funds. Exactly from the point of view of the special Czech policy in the privatization area, the Law is extraordinary important,

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<sup>72</sup>The joint company RM-S, a .s. was founded on January 28, 1993 and was registered by the Commercial register.

<sup>73</sup>See: §1 (1): “a Stock Exchange trade is the purchase and sale of securities at the stock exchange, and for the purpose of this law also intermediation of purchase and sale by the authorized persons. The time and location of a stock exchange trade is regulated by the Stock Exchange Statute.”

and – similarly as the coupon privatization – represents something what by nobody was tried up to now. On the off-exchange market, which ...is founded by this Law and which will be opened, the bulk of shares trading ...will be effectuated, and only step by step can be expected, that a certain part of this burden will be taken over by the Prague Stock Exchange which also will be founded, but ...*on the Stock Exchange...exclusive shares, rather exclusive, ...best shares will be traded, and the big mass of trades will be done... on this off-exchange market* (sic!) that will be created by the Law, which – as I hope – will be accepted to-day.”<sup>74</sup>

In a similar way, the significance of the Securities Act was evaluated by *Richard Mandelík* as well: “.. Draft of this Law is a part of the system of economic laws, and it is a substantial part, because without this norm, the existence of an advanced financial market is not possible, and it is not possible to speak about the market economy. The existing laws do not allow setting up such an economy, but after approving the draft of this law, an advanced legislative framework for an efficient working of financial market, comparable with the European standard, will be created.”<sup>75</sup>

From the speech of *Ježek*, at least three important conclusions can be drawn: firstly, that the Czech share market should be set up (on the basis of this law – V.P.) as a non-standard off-exchange shares market with shares originated by the coupon privatisation; secondly, that bulk of “privatisation” shares will be traded on this market; and thirdly, that the Exchange will play a subordinated (“third fiddle”) role on the shares market.

Let us come back to the word “system organizer”. *Tomáš Ježek* in his speech clearly explained the meaning of this word, and by whom this role should be played: “Off-exchange market organizer, in fact, is a name for the institution which will be a descendant of the Coupon Privatization Centre, it will be the institution which will take care of securities trading originated by the coupon privatization.”<sup>76</sup>

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<sup>74</sup>See the Minutes of the 7<sup>th</sup> session of the Czech National Council, November 20, 1992.  
www.psp.cz

<sup>75</sup>*Ibidem*. Ex post, the legislative framework was neither “advanced”, nor “comparable” with the European standard, as far as investors’ protection, insider trading, market surveillance, etc. is considered: these items were not sufficiently regulated. The deficiencies of the capital market legislative was criticized by Association members, however these comments were totally ignored by responsible government authorities. A slight correction of some regulatory arrangements was achieved by novelization of the Law No. 591/1992 Sb., the Law Nr. 89/1993 Sb. about the securities, which was in force since March 15, 1993. Into this novel a part of Law Nr.600/1992 Sb. about the System of Securities and trading with them (approved by the Federal Parliament on December 2, 1992) was incorporated. Without these modification, securities’ trading - both at the Prague Stock Exchange, a .s., and the RM-S, a. s., would not be possible.

<sup>76</sup>See the cited Minutes.

In the Act No.214/1992 Coll., on the Stock Exchange, this institution was defined as a legal person authorized "...to organize at a fixed place and time securities offer and demand intermediated by authorized persons". It seems to be quite logical to call the person which has to organize the off-exchange market "a market organizer."

But, in fact, the new name veiled the real substance of the predestined organizer which was to become the most important Czechoslovak capital market institution (as it was planned by the ideologues of the RM-S). It should be a quasi "off-exchange Exchange", and which was expected - because of its technically advanced equipment- to be able to replace the Prague Stock Exchange.

Now it is necessary to explain some wide-spread views about the character of a stock exchange – a definition (if you like) of what a stock exchange really is, and which role a stock exchange should play.

When the electronic support of stock exchange trading was considered to be "a supplement" which served as a technical tool to make the "normal" floor trading more comfortable, there was no regulatory problem. The Stock Exchange was well defined by the existing laws and regulations. In different countries the definition was - more or less - different, but it was clear which institution is a "stock exchange" and which not.

During the 80ties, but more at the beginning of 90ties, the use of computers for securities trading - especially in the USA, Canada and England - spread very quickly and new types of institutions, electronic systems for financial instruments trading were developed. In the first half of 90ties, prominent new systems of this sort were, for example, DELTA, GLOBEX, IBIS, INSTINET, NORDEX, OM, POSIT and others. These systems widely differed one from the other. In principal, they were not universal ("all-embracing") systems similar to stock exchanges - quite contrary, they were developed as partial, specialized systems. There were systems specialized in different sorts of financial instruments (shares, option contracts); there were systems using different algorithms for order routing (centralized auctions, market-makers systems, direct investors trading etc.). Some of these systems had either a character of public systems (connected with stock exchanges) or a character of private systems, owned and run by banks, brokers and dealers, investors companies etc.

In countries where they were set up, serious regulatory problems arose: the current regulation was not apt to fully regulate the new subjects because of their new construction. Maybe this was one of the real reasons for their existence: they were more flexible, quicker, cheaper – and not properly and fully regulated (at the beginning, at least). They were very attractive for wealthy investors, but for regulators they were real "monsters", as Ruben Lee called them.<sup>77</sup>

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<sup>77</sup>In a paper called "What is an Exchange", a MONSTER is a market Oriented New System for terrifying Exchange Regulators.

At the beginning of 90ties, a discussion on the meaning of the word “stock exchange” was started, however, with no definite result. The motivation was practical: to change the regulation to be able to regulate not only the activities of the “classic” stock exchanges, but to regulate the new electronic securities trading systems as well – because the systems proved to be a dangerous competitor.

The Czech RM-System was constructed as a specific “Proprietary Trading System” (PTS) similar to (or derived from?) the foreign electronic systems. Formally, it was not a “stock exchange”, but it was expected to become the biggest and most important Czechoslovak stock exchange. The specific character of RM-S consisted in its original purpose: it was expected to serve the off-exchange market with shares generated by the coupon privatization. The main expected actors on the RM-S off-exchange market were the emerging investment companies and funds.<sup>78</sup>

The main objections against this idea of a “specific leadership” of RM-S (and its so-called technical superiority over the emerging “archaic” Prague Stock Exchange) stemmed from the different conception of the capital market in a country where a capital market for half of a century did not exist. According to the Association, the optimal Czechoslovak capital market organizational structure should be formed by a system of financial intermediaries, i. e. subjects trading securities on the securities markets, where on the top of a pyramid would stay the stock exchange. During the first stages of the emerging capital market development, the Stock Exchange would have to play a leading, monopolist role. The off-exchange transactions should be limited. In this model, there was no place for an organization of a private quasi-exchange system alias “market organizer.”<sup>79</sup>

The above model was based on the idea that the capital market development has to be regulated and surveyed by a state, and that a regulatory authority (such as Securities Commission) must be set up to protect the investors’ interest.

Instead of installing the above described system, a model which - under pretext of desirability of a competition – was introduced on the emerging Czechoslovak capital market. A harmful dichotomy was pushed through by force. The stock exchange market and off-exchange were established without necessary market regulation and surveillance.

One of the arguments used to support the second model, was a fiction that the emerging stock exchange will not be able to manage the expected big number of transactions with securities generated by coupon privatization. This argument was a malicious fiction, as it was – ex post – proved by the real development of trading: the securities trade volume on the Prague Stock Exchange was substantially higher than the trade volume of the RM-S system.

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<sup>78</sup>These systems are known as “Private Proprietary Systems” (PPS). They were competitors of Stock Exchanges; they significantly contributed to the accelerated computerization of many stock exchanges.

<sup>79</sup>See: Pavlát, Vladislav, Kubíček, Antonín. *Regulace a dozor nad kapitálovými trhy*. Praha: Vysoká škola finanční a správní, o.p.s., 2004, s.137-138.

In 1995, the Prague Stock exchange trade volume represented 195,4 billion CzCr., i. e. 38,2% (of the aggregate trade volume of 512,3 billion CzCr.), and the RM-S trade volume was only 25,2 billion CzCr., i. e. 4,9% of the aggregate trade volume.

Some unscrupulous journalists tried to glorify the non-standard character of the RM-S as a specific Czech “discovery”, as an “original tool” for capital market development, driven by the coupon privatization.

The Prague Stock Exchange tried to high-light the real character of RM-S as a hybrid system, playing - at the same time - the role of a stock exchange (“market organizer”) on one side, and the role of a securities dealer on the other side.<sup>80</sup>

#### **2.4.4 Capital market supervision**

During 1992, one of the specific features of the situation was the fact that formally almost nobody rose objections against a reasonable way of capital market regulation and supervision and/or against investors’ protection – except for a group of “hard” liberals. These “true” liberals reject any regulation as such and preach that the market “regulates itself”.

There was another topical elementary question as well: what is the market regulation? The views on capital market regulation and supervision widely differed, and – in some cases – they were very “original”. The well-known difference between the thoughts, words and deeds was manifested – as far as the Czech discussion on capital market regulation is considered – in a “classical” way: “everybody” agreed that the capital market regulation was necessary, nevertheless, “everybody” – for different (selfish) reasons – rejected the enforcement. The regulation should exist, but it (obviously) should be “toothless”.

The main cause of this rather strange behaviour (according to my view – V.P.) was the fact that – up to the 90ties – no experience related to the capital market regulation and supervision existed, because for a period of almost 50 years, capital market in Czechoslovakia did not exist. The start from scratch was inevitable. Necessary conditions for the existence of an efficient capital market regulation and supervision system are, firstly, the capital market legislation, and secondly, a regulatory and supervisory institution, able to monitor the markets, to prepare necessary regulation, and to enforce the law through sanctions.

At the beginning of 90ties, in Czechoslovakia neither the one, nor the other condition was fulfilled. The “*per partes*” approach applied in the legislative process was characterized by a situation when some “*licet*” and “*non licet*” in every law existed, but there was no homogenous system of financial market regulation and supervision. The official government documents – as it already was mentioned – did not characterize the process capital market

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<sup>80</sup>The Prague Stock Exchange offered the membership to the RM-S. The RM-S did not react. Later on, the Czech Securities Commission examined the position of RM-S on the Czech capital market and discussed certain modifications of its character and role: the RM-S should be transformed into a standard securities dealer.

reconstruction and capital market regulation and supervision - with exception of the Government declaration of July 13, 1992 – was not mentioned at all.

The process of capital market legislation lagged behind the real economic development. The delay was mainly caused by the protracted discussions about character of the economic reform. Practically, the legislative works were started, after decision on the way of privatization, i.e. on coupon privatization, was taken. This decision predestined the way of one very important financial market segments – the shares' market. The creation of this market was subordinated to the coupon privatization.

The distorted “privatization logics” was reflected in the following: at first, privatisation legislation has to be created (the aim was to generate shares of the privatized state enterprises by a quasi-issue process), then secondary market legislation has to be created, according to these laws a secondary (off-exchange) securities market would arise, and - to the last – as soon the secondary market would be working, some state authority would be able to supervise this market. Therefore: let us wait, there is time enough. It seems to be almost incredible, but it corresponds to the historical events: up to 1998, the financial market supervision was highly (deliberately?) underestimated. Who was the culprit?

Traditionally, the financial market consists of a money market and of a capital market; basically, the capital market is divided into three segments: bond market, shares' market and financial derivatives' market. In Czechoslovakia, the bond market reconstruction was a standard one (according to the Law on bonds) , the market of shares was designed as a “by-product” of privatization, i. e. in a non-standard way.

The Ministry of Finance “stopped to sleep” only when the law about the mass privatization was approved (April 1992). Then a special organization unit – the department of capital market supervision – was established.

The framework of activities of this department was defined by the following laws: the Act No. 214/1992 Coll. about the Stock Exchanges, the Act No.248/1992 Coll. about investment companies and investment funds and Act No.591/1992 Coll. about the securities (Securities Act). According to these laws, the Ministry of Finance was due to prepare necessary by-laws. In addition to this, the supervisory activity of Ministry of finance was based on the law approved by the Czech national Council (ČNR – Česká národní rada) No. 552/1991 Coll. about the State Control.

From the above brief description, it is quite evident that the new department of capital market supervision was glutted by drawing the by-laws and by organizing its supervisory agendas. The department was ready to start all its function not earlier than after – approximately – one year, when the Czech capital market began to work.

A hope that a Securities Commission would start its activities, when trading at the Czech capital market would be started, proved to be a pure illusion. The Polish and Hungarian experience was ignored, and the experience of financially advanced countries as well. The

development of the Czech capital market in the next three years proved that this negligence was detrimental.

Although a Securities Commission was not established parallel to the start of the Prague Stock Exchange and RM-S trading (April 6, 1993), it is not possible to deny that the Ministry of Finance of the Czech Republic was trying to analyse the deficiencies and distortions detected at the Czech capital market during the first months of its start. At the end of 1992, the Department of Supervision prepared a report on “Topical problems of the financial market” (Ministry of Finance of the Czech Republic, no. 32/67 532/1993, with the Annex No.1, evaluating the Departments’ activities in the period since September 1992 till November 11, 1993) prepared for a ministers’ meeting. An urgent need to novelize many basic regulations (laws and by-laws) related to the Czech capital markets, was signaled.

## **2.5 Final Effects of the “*per partes*” Approach**

The reasons why to apply the “step by step” approach stemmed not only from objective obstacles by which other solutions were made difficult. Another (maybe a stronger one) was a strive for an “originality”: all sorts of things were “invented”, irrelevant whether it was invented or rejected as unsuitable somewhere else a long time ago. A negative role was played by underestimation of foreign legislation, ignorance, indolence and a language barrier on the side of haughty ministerial officials. By the objective and subjective deficiencies the process of the Czechoslovak capital market legislation was predestined.

If we try to evaluate the whole process of capital market legislation, a very important factor cannot be omitted, namely that in some cases (for example the case of a chaotic origin of privatization funds) the real economic process was far ahead of the legislation. Some of the efforts to make up for the time-lag were not only useless, but also harmful.

During the legislative process of the above laws, some of the deficiencies of different laws were recognized; nevertheless, in many cases they were approved without improving some of the identified deficiencies. Inter alia – the existence of two market organizers (with a possibility to set up an unlimited number of market organizers), an unsatisfactory regulation of the off-exchange trading, the discriminatory relation of the Stock Exchange Depositary to the Securities Centre, the low protection of minority shareholders, the absence of protection against the market manipulations etc. were enacted. All protests against these “mis-acts” were ignored, the foreign experts warnings as well.

Very soon, most of the above deficiencies were manifested in practice of trading. The big part of political and moral responsibility for the negative events at the Czech capital market is to be imputed to the legislators and further participants of the legislative process, and to the deputies of the Federal Parliament, deputies of the Czech National Council, and later on the deputies of the Parliament of the Czech Republic. A low performance of the regulatory and supervisory authorities is one of the negative elements of the Czech capital market development during the 90ties.

At the beginning of the 1993, the legal environment of the Czech capital market was represented by the

- Act no. 530/1990 Sb. about bonds (in force since February 1, 1991),
- Act no. 214/1992 Sb. about the Stock Exchanges (in force since May 15, 1992,
- Act no. 241/1992 Sb. about the investment funds (in force since May 29, 1992),
- Act no. 591/1992 Sb. about securities (in force since January 1, 1993),
- Act no. 513/1991 Sb. The Commercial Code, and notifications of the Ministry of Finance of the Czech Republic.

According to the Ministry of Finance view, in November 1993, they already were outdated and had to be novelized.

## Chapter 3. Foreign expertise and help

From the very beginning, contacts with foreign institutions and experts had a key importance for the efforts to set up a Czechoslovak stock exchange. The aim of these contacts was – on one side, to get information on the practical activities of capital market institutions – stock exchanges, securities depositaries, regulators, and – on the other side - , to try to find some foreign aid to support the project of a Czechoslovak stock exchange.<sup>81</sup>

### 3.1 Canadian Aid

In the autumn 1990, the project “Task Force on Central and Eastern Europe” was approved by Canadian Government. Two Canadian experts – Mr. Hugh Cleland and Mr. Eduard Waitzer were nominated to implement the project which was divided into three stages. The primary aim of the project was to help to set up a new Czechoslovak stock exchange.

One of the very valuable results of Canadian aid on the first project stage were detailed comments on the capital markets laws, especially comments on the Draft Stock exchange Act. These comments were prepared by *E.Waitzer* in a form of a Memorandum.<sup>82</sup>

According to the *Memorandum*, the regulatory framework for a securities market “should be designed to promote, other than constrain, the benefits of having a strong securities market as an integral part of Czechoslovak capital market.” There are two necessary conditions to establish a standard capital market: a wide availability of timely and accurate market and corporate information, and an ownership, trading and settlement system which is fair which fosters investor confidence.

E. Waitzer recommended the legislative framework to be as simple as possible; “...the legal framework should focus on essential principles and try to be accommodating as possible” “...a simple framework will facilitate the accommodation of the requirements of European Community Directives and the ability to harmonize with the efforts of organizations such as the Federation Internationales des Bourses de Valeurs, the International Accounting Standard Committee of the Group of Thirty.... It also ensures that the Czech securities market will not be encumbered by unnecessary barriers to its subsequent emergence as a significant international market.”

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<sup>81</sup>Important positive results were achieved on the basis of the agreement with the International Stock Exchange in London and another similar agreement with Stock Exchange Berlin. These agreements were very successful on the field of education, as tenths of managers from Czechoslovak banks took part in courses on capital markets and stock exchanges in Austria, Germany and Great Britain

<sup>82</sup>Waitzer, E. Memorandum from Edward J.Waitzer to Vladislav Pavlat, RE Draft of the Law Regarding a Stock Exchange of Securities, April 8,1991, p.4.

*E. Waitzer*, addressing the Draft Stock Exchange Act, wrote: “The law should facilitate a workable and forward-looking securities market, rather than force such a market into a pattern which derives from the complex traditions and special interests which dominated Germany ... during a pre-technologic era. This is the unique opportunity you enjoy (amidst so many obstacles) in starting from scratch.”

According to the Memorandum, “... there are numerous other instances where the draft statute may be unduly complex or attempt to address detail which may be better be left to delegating rule-making. “Many of the details in the statute derive from (as with the Joint Companies Act) the German mode, which has evolved in a historical setting and institutional framework that has no parallel in modern Czechoslovakia. If the Germans (or any other mature market) had the opportunity to start from scratch, they would do many things differently. Czechoslovakia should be able to learn from the experience of others without mimicking the frameworks which have evolved elsewhere to meet the needs of specific interest groups in that jurisdiction.”

*E. Waitzer* criticized many other parts of the draft as well. He pointed out that the Exchange “would be allowed to determine its own governance mechanism and, subject to oversight by the governmental authority would have independent rule-making authority.” At the same time, he warned that proportional voting may be subject to abuse. “It is not difficult to conceive of circumstances where a small number of market participants could assume effective control over the exchange.” The draft did not provide for a coherent system of initial and periodic reporting. Licensing of intermediaries was missing: “... there is no requirement that some regulator (the Exchange or the government regulator) put in place a comprehensive scheme for the licensing and on-going regulation of securities dealers ... investment advisors ... and their representatives...” No regulation of Abusive Practices was provided for in the draft. “Most regulatory frameworks contain specific provisions with respect to fraud, insider trading and trading practices deemed to be manipulative.”

The Memorandum recommended market participants to be protected by separating banks (or other financial institutions which engage in securities trading) from direct securities trading: “...it is desirable to require such financial institutions to conduct such activities through a separate legal entity.” As a result, “it would insulate securities clients, the Exchange and its members from any financial risks which may exist in the financial institutions.”

The second stage of the Canadian advisors’ stay in Prague was finalized by presenting the second Memorandum, called “*Plan for Czechoslovak Securities market.*” This Memorandum touched a broad range of problems. It contained many important recommendations.

The following principle questions were examined: the way of securities registration, the trading system and securities settlement. The Exchange organisational structure was discussed. The relation between the securities’ market and the process of privatisation was analysed. The problem of internal Chinese wall in banks was discussed. The importance of the Interim securities’ market was stressed.

*Hugh Cleland* laid stress on the fact, that "...A unique opportunity is available in Czechoslovakia to build a rational securities market system. It does not have to be a product of the historical distortions, traditions and special interest groups which are such important factors in the structure and organization of present European and North American markets."

*H. Cleland* refused material securities, he recommended dematerialized securities and auction trading system (order-driven system), at the beginning manually performed and automated later on. The Exchange regulations should enable the Stock Exchange to be run in a flexible way and cheaply. The Exchange should be overseen by State, but must not be managed by it.

According to the Memorandum, off-exchange trading should be limited. Listed securities should be traded exclusively on the Exchange. No competing markets within Czechoslovakia should exist. "In order to maximize liquidity and pricing (allocation effectiveness) there would be only one market for trading any particular issue or contract. For example, if there is a stock exchange in Bratislava, it would offer markets only in companies located in Slovakia; enterprises located in Moravia and Bohemia would be traded only in Prague. This rule should be drafted so as permit a mature company with an international following to be listed internationally, once the Czechoslovak market has matured and is able to compete with international exchanges." The Canadian expert recommended the Exchange to be localized in the Centre of Prague: "The people that deal in the financial markets serve on Committees of the Exchange and meet with the Exchange administration on numerous matters. This is important for participants in the financial community (lawyers, investment managers, brokers, underwriters, accountants, etc.) that are naturally drawn together. Obviously, the Exchange is a valuable focal and coordinating point for this community and therefore be located in a central location which is convenient for its members and other participants, i. e., in the financial district."

All trading instruments should be organized under one administrative structure: the system should be simple, should be coordinated and understandable for all market participants. "Unnecessarily differentiated systems for trading financial instruments... lead to high development costs, confusion in the minds of advisors and investors, error and wasteful administrative efforts."

*H. Cleland* recommended banks to be separated from the Stock Exchange - a bank would not be Stock Exchange member itself, but through its "subsidiary": "...banks are not directly members of the Exchange. They must form a separately capitalized subsidiary to be the members of the Exchange. Financially, such subsidiary must stand on its own feet..."

However, this recommendation was formulated under false premises, that Czechoslovak banks' regulation would be based on the "Chinese Wall" principle: this was absolutely impossible. This recommendation which was formulated in *Cleland's* memorandum in detail undermined – to a certain extent – his position in the eyes of some powerful representatives of the Czechoslovak banking community.

In comparison to the “Chinese Wall” problem, Cleland’s other ideas were fully acceptable, especially the idea the “interim market” be created as soon as possible: “I believe that a systematic approach to the Interim market should be developed as soon as possible so that trading and settlements services can be made available.” There was a very sound rational approach which was hidden behind this recommendation: “It is not practical to think that an Exchange system can be bought and simply flown into Czechoslovakia and turned on.” And further, it is necessary “...to gain experience in organized trade and settlement, to train industry personnel and to work with investors.”

The Memorandum was closed by a “*Summary Exchange Development Plan*” where the most important recommendations were put together (“7 points”).

More than 20 years elapsed from the day when Memorandum was written, however, majority of principles and recommendations based on these principles are still valid. One of the most progressive ideas was a long-term, systematic approach to setting up the Czechoslovak capital market. The implementation of standard Stock Exchange functions was one of the very important “building stones” for it.

Unfortunately, many persons involved in the preparative works were not prepared to understand the well elaborated “Summary Exchange Development Plan”; those who refused it, were mainly the representatives of big Czechoslovak banks. Unfortunately, this negativist position was accepted by some leading people from the Federal Ministry of Finance: instead of supporting the rational, sound and safe outline of the future Czechoslovak capital market, they blocked it. On one side, this attitude was caused by financial ignorance and by a lack of time – it seemed, as if everything had to be done “in one stroke”, and immediately, which of course was false. On the other side, there were serious signs that group interests were the main reason why many rational decisions were blocked.

### **3.2 The Danish Expertise - Vaerdipapircentralen Kopenhagen**

The Canadian advisors recommended a visit to Denmark to be prepared with the aim to contact the Copenhagen Securities Centre to be prepared. The aim of a short stay was to get more information on the Danish capital market based on dematerialised securities, especially to get more information on securities registration, dematerialized securities trading and settlement. The capital market of Denmark was considered to be one of the most developed European capital markets. In Denmark, securities were dematerialized as early as in the first half of 80ties, and Danish Securities Centre existed since 1983. According to the view of the Canadian advisors, the implementation of the Danish system would be one of the first steps for creation of the Czechoslovak capital market infrastructure in a form of a coherent system containing trading, settlement, property registration and transfer of payments.

The results of the short stay of Canadian advisors and two representatives of the Preparative Committee in Copenhagen were very positive. Finally, Jens Bache, Director of the Danish Securities Centre was asked by *J.Tošovský*, the Chairman of the Czechoslovak State Bank to write a study on the possibility of the implementation of the Danish system in Czechoslovakia.

During May and June 1991, the study was prepared. It was financed by the Danish IMO Fund under the title “Project for Central and Eastern Europe”. The scope of this study was much larger than it would correspond to the needs of the future Czechoslovak Exchange.

In Chapter One of this report, aims and contents are formulated. Chapter Two repeated the general characteristics of the securities’ markets role in the market economy. In Chapter 3, actual situation on the field of the Czechoslovak capital market, the interim securities market and privatisation was described. In Chapter 4 an “Action Plan” which summarized the main tasks for creation of the capital market was proposed. The last Chapter 5 contained a proposal for establishing the Danish Central Depository system in Czechoslovakia.

In the Report, the future dimensions of the Czechoslovak securities market were estimated. The capitalization was estimated at 15-20 bil. USD, and the annual value up to 6-8 bil. USD.

In the “Action Plan”, tasks relating to different aspects of the emerging capital market were systematically analysed. As for legislation, it was recommended to integrate the capital market regulation into one whole; the laws should represent a general framework which will be complemented by other regulation with a lower force. The regulations should contain clear and transparent principles of market participants’ behaviour. The infrastructure of the capital market should be flexible, and the information system efficient. The emerging Czechoslovak clearing system should be used for securities settlement as well. The creation of the Czechoslovak Securities Central Depository should be based on the register PVT, a.s., which was established to serve the privatisation process. Danish experts’ opinion on the possibility of starting a fully automated Czechoslovak stock exchange was negative: this idea was not recommended.

The cost of setting up a Central Securities Depository according to the Danish pattern was estimated at 65 mil. Danish Crowns. The most important part of this cost would be represented by the cost of the Danish system modification. Hardware would cost 8.5 mil. Danish Crowns, and software approx..8.3 mil.DCr.

The Report contained a lot of very interesting Addenda, for example a detailed description of the Danish Vaerdipapircentralen, the way how Czech and Slovak banks would be connected with the Central Depository, the feasibility of inter-connection between the Prague and Bratislava Stock Exchanges, a description of the Securities Exchange in Copenhagen etc.

In Czechoslovakia, the Report was positively evaluated. In spite of the fact, that the proposed system was not implemented, the Danish practical experience was very useful.

### **3.3 The Aid from Programme Phare – company Pardevo**

During the process of setting up the Czechoslovak Stock Exchange, there was an opportunity of obtaining a grant from the programme Phare, which was one of the programmes financed by the European Community. In 1991, company Pardevo S. A. from Brussels was allotted some financial means by Phare to evaluate the process of shaping the

emerging Czechoslovak capital market. In summer 1991 (5.- 9. 8. 1991), *Luc de Brabandere*, one of the representatives of the company Pardevo S. S., visited Prague. He held a series of consultations with the Preparative Committee members, visited some banks (Živnostenská banka, Agrobanka) and the company Telekom. The results of his consultations were summarized in his Report.<sup>83</sup>

The evaluation of the state of preparative works prepared by *Luc de Brabandere* was very positive. He wrote, that “he met a very good team which prepared a series of things to be done. They certainly are able to manage the whole process of setting up the Exchange.”<sup>84</sup> At the same time, he pointed out that in Czechoslovakia not only an Exchange should be set up, but the whole Czechoslovak capital market architecture has to be created.

During his short stay, *Luc de Brabandere* was able to get detailed information only on some selected problems. One of these problems was the problem of securities settlement, telecommunication and education. *Luc de Brabandere* recommended one technical expert for telecommunication problems to become Preparative Committee member. *Luc.de Brabandere* explained that it was not necessary the telecommunication equipment to be installed in the building where trading would be organized. It could be installed on a proper place outside the Centre of Prague. As for education, he recommended the programme of education prepared by one of the subcommittees, to be extended to be able to “educate the educators” as well, and he recommended some computer supported educational programmes to be used.

The second stage of Pardevo consultancy activities in Prague which originally was approved by Phare, was not implemented. By some Preparative Committee members the short expertise of Pardevo was considered to be only one of the “episodes” of low priority, however, as a paradox, many of recommendations were implemented. The probable reason is that they did not touch the controversial problems the solution of which was blocked by different interested persons.

### **3.4 The British Know-How Fund – Company Coopers and Lybrand**

Since the beginning of the 90ties, the British Know-How Fund distributed financial means for the purpose to help the former communist countries in Central and Eastern Europe to implement the process of transformation. In the autumn 1991, the Coopers and Lybrand/Deloitte won a tender offer, organized by the British Know-How Fund, and the company was officially nominated as an advisory firm for Czechoslovakian emerging capital market (not only for the Stock exchange).

On the whole, 180 days were at disposal for the winner: the time was divided into several periods. Several periodical stays of a fortnight or three weeks in Czechoslovakia were foreseen; after every stay, the representatives of the firm went back to London to prepare a

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<sup>83</sup> “Capital Market in Czechoslovakia”, Pardevo S.A., 1991.

<sup>84</sup>ibidem, p. 8.

report on the results. The British team was directed by *Christopher Morgan*, and the members were *Dennis Sherwood, Patrick Fell, Patrick van Hoof, Peter Milroy and Martin Goodall*.

The basic task of the British firm activity was the help to the Stock Exchange on the field of intern regulation and securities settlement. The setting up of the Securities Depository and of the Stock Exchange Securities Registry was the main task for the first stay. The British team had to comment on the Stock Exchange Act and some other capital market laws which were in preparation by the Ministry of Finance.

From the present point of view it has to be said, that the British advisors tried to fill in the missing parts of intern regulations. The regulations concerning the agenda of Company Prospects, the shares of which should be quoted on the Exchange, were commented and corrected by British professionals, and projected into the final wording of these regulations.

Many obsolete regulations disappeared from the Stock Exchange Act. Especially the German and Austrian out-dated distinctions between the so called “official” and “private” intermediaries were crossed.

Unfortunately, it was impossible to push through many recommendations of the British advisors and to add some important paragraphs into the final internal regulations’ wording. For example, investors’ protection was still missing; minority shareholders were unprotected; information duty, fair trading, market transparency, fair price etc. were not defined. Stock Exchange members were not bound to follow the internationally recognized Ethical Code. The British team perfectly fulfilled its role, as it repeatedly pointed out the missing regulations and/or incorrect wording etc.

The reasons why many recommendations of the British advisors were not taken into account were manifold. First of all, the ultra-liberal political atmosphere of that period of time connected with an underestimation of international principles, standards and practices prevailed. Secondly, the over-estimation of the short-term horizon approaches was stressed. Thirdly, there was lack of knowledge and professionalism on the side of politicians and economists: they did not know what a capital market is. Many legislators, bankers etc. did not understand what it was all about – how the capital market works, what shares are and so on. Some of the leading representatives of banks were unable to react in a flexible way, to learn more to be up-to-date, and in many cases, they even refused to try.

One of the well-known slogans and populist illusions was, that “one should not listen to foreign advisors too much” – because Czechoslovakia had its sad experience with some of the Russian experts. The common provincial approach was always trying to put forth patriotic ideas and slogans. But there was another wide-spread, completely misleading approach: everything what came from the West was *sanctum*, and who was against it, was a “traitor” etc., or a stupid man who objected to accept *manna* which was for free.

The activities of Coopers and Lybrand were oriented, on one side, on the specific question connected with creation of conditions which were necessary for the emerging

Czechoslovak capital market, on the other side, on the intern stock exchange regulation. It was *Patrick Fell* who prepared majority of the new documents' drafts.

It was him who commented and reviewed some of the new stock exchange regulations prepared by the stock exchange staff. He reviewed the quotation rules, matching of orders, the structure of trading hours and regulation of prospects.

British advisors prepared a document on stock exchanges financing which was addressed to the Prague Stock Exchange and to Bratislava Stock Exchange as well. The first part analysed the relations between the Stock Exchange, the shareholders and members. The British advisors recommended other institutions than banks not to be accepted as shareholders. In the second part of the document services offered by the Stock Exchange were defined. Types of costs charged for services and the prices of services were defined. The Stock Exchange services were divided into 5 groups, namely services connected with trading, information services, services bound to quotation, members' fees and services connected with the intern supervision (the item "sanctions" was defined here). Analytical methods related to the costs (i.e. the sensitivity analysis) were recommended by advisors as well. By the document advantages for big users of services, i. e. investors, Stock Exchange members, securities issuers and state were defined. Feasible ways of Stock Exchanges financing (used by advanced market economies) were described – shares issuance, middle-term obligations' issues (guaranteed by state or Stock exchange shareholders), bank loans and returns from services were described. Later on, some of these recommendations were applied, for example, to regulate the fees.

A very important document was the report dealing with the capital market supervision and the Stock exchange. The function of supervision was described in detail (corresponding to the type of Securities Commission), and main tasks of this institution were characterized. The main activities normally performed by Securities Commissions or by other types of supervisory Authorities in countries with advance market economy were described as well. The activities on the field of investors' protection were described in detail.

Unfortunately, practically no recommendation related to the capital market supervision was used neither in the prepared laws (namely, The Stock Exchange Act and the Securities Act), nor in the Stock Exchange intern regulations. Evidently – as seen *ex post* - the function of supervision was not only underestimated, but - from the very beginning - absolutely ignored (maybe on purpose).

The question of creating the Securities Commission was – unofficially – considered to be a "taboo". For a couple of years, all proposals to set up the Securities Commission were – under different pretexts – rejected. Authors of these proposals often were attacked by adversaries of capital markets supervision.

Another example of a (*de facto*) rejected very important recommendation was the case of a set of regulations regulating the ethical behaviour of capital markets participants and of a set of rules about "fair trading". These problems were partially accepted, but they were included into the capital market legislation in a general form which would cause the

enforcement of this regulation to be very difficult, even in case if a Securities Commission would exist.

During the first years of the process of the Czech capital market creation, when its foundations were laid, the business ethics was almost completely neglected. Later on, this negligence was one of the causes of many failures. This situation was frequently strongly criticized from abroad; some attempts to reduce the big number of scandals occurred, however, without any significant effect.

The Cooper and Lybrand company prepared a list of important unsolved questions to the Prague Stock Exchange. The following items were on the list: 1. Bookkeeping and disclosure; 2. Fusions and acquisitions; 3. Primary issues regulation; 4. Management of the secondary market; 5. Securities taxation; 6. Issuers' education; 7. Legislative activities.

Recommendations on the above enumerated problems were – step by step – prepared for both exchanges – the Prague Stock Exchange and Bratislava Stock Exchange. During the second half of the year 1992, the space for a discussion about the results of the new recommendations and expert views was very narrow. During the following years, some of this expertise was discussed by the Prague Stock Exchange management; the possibility of applying them as amendments to the existing internal regulations was studied. Unfortunately, general critical remarks related to the Czech capital market situation and the recommendations how this situation could be improved, were neglected.

The significance of the aid and support which were given by the British Know-How Fund to the future Prague Stock Exchange during the years 1991-1992 was very high. The British aid significantly contributed to the gradual implementation of the international experience on the capital markets and stock exchanges: it was a factor by which the way of thinking of the Czech capital markets experts and market participants was very positively influenced

### **3.5 The French Aid**

In March 1992, the *Contract* on putting the Prague Stock Exchange into operation was signed by the Chairman of the Paris Exchange *Jean-Francois Théodore* (SBF) and Vice-Chairman of the Preparative Committee Assoc. Prof. *Vladislav Pavlát*. The official ceremony took place in the building Na Můstku in Prague. *Karel Purkyně*, vice-minister of the Czech Ministry of Finance held a speech; he wished to the emerging Stock Exchange all the best.

According to the Contract, a working document (*Feasibility Study*) was prepared, with the following main items: intern Stock Exchange regulations, choice of market types, quotation procedure, the first quotation of shares of privatized companies, the role of privatization funds (in the process of trading), order routing, the securities forms and their compatibility with the Group of 30 recommendations, the organisation and settlement system. In this paragraph, the education of the Stock Exchange personnel was defined as well.

According to the par. 1.2 of the protocol, the French aid would be concentrated on technical conditions and regulations leading to creation of the Stock Exchange market,

working according to the principle of fixing. During the second stage of technical aid, adaptation of the SW (originally using the computer AS400) was finalized. Par.3 and 4 defined the responsibility for project management. The project implementation was controlled by a *joint Czech-French Pilot Committee*. The Czech employees had to take care of the following activities: verification of partial task fulfilment, users' education, translation of French texts into Czech language, testing of individual modules (together with French technicians) etc. The French team co-ordinated the project, controlled the delivered SW etc. According to the par. 5 of the Contract, SBF (as an owner of SW) ceded the use of SW to the Prague SE and the right to upgrade it. A cession to other companies (paid or payless) was prohibited without a permission of the SBF. It was permitted to use the SW only in Prague. According to the par.9, the value of the aid (gift) of the French government was fixed to 2 million French francs, i.e. approx. 10 million CzCr.

On the French side, the Project as a whole was managed by *Paul-Francois Dubreucque*, director of a SBF Department. The head of the Prague Project was *Catherine Coffin* (from the International Department SBF), the team members were *Yves Aubert* (International Department SBF), *Rolland Gaston-Bellegarde* (Quotation Department SBF), *Patrick Lessard* (Computer Department SBF) and *Joseph Florentin* (advisor to Eurogroup). *Stéphane Remus* was designated as a head of the French group in Prague. He was staying with the Stock Exchange Prague till the end of the French mission.

The above mentioned *Feasibility Study* was mainly prepared by *Stéphane Remus*. His analysis showed the necessity of buying the SW not only for securities trading, but for the Stock Exchange depositary as well. This change was caused by an announcement of the Ministry of Finance, that dematerialized shares would be registered by the Securities Centre (Středisko cenných papírů – SCP). In such a case, the Stock Exchange would have to be linked with the Securities Centre.

As a result, a *new Contract* with SBF (on July, 9, 1992) was signed, which provided for the delivery of the Depositary SW. By SBF a consortium with SICOVAM was agreed, the task of which was the installation of the Stock Exchange Securities Depositary. The value of this additional contract was 5 million French francs. This amount was paid from the financial means provided for in the framework of the French government agreement on technical aid to the Czech Republic.

The Feasibility Study had 5 parts. In the first part, surroundings of the Prague Stock Exchange was described, i. e. the expected process of privatization, the investment funds' role, the description of the Czechoslovak banking system and the situation on the bonds market. The probable interaction between the Stock exchange and its surroundings was analysed. The second part of Study was related to the Stock Exchange intern legislation. The aim of this part of the Study was to review the existing rules and regulations and to recommend eventual changes and amendments. The fourth part analysed the problem of treatment of dematerialized shares by the Stock Exchange depositary, the clearing system and the expected connection to the central securities depositary (i.e. the Securities Centre). The last part of the Study dealt with different questions connected with the start of trading,

technical problems (computers' installation etc.), and the way how the securities' initial prices should be fixed.<sup>85</sup>

The Feasibility Study analysed some of the potential risks which were expected to arise during the first stages of trading. An important risk was signalized: the imminent risk for investors caused by potential defaults of privatized enterprises and with the danger of the so called "tunnelling" of the investment funds. Technical potential problems were described as well: the possibility of deficiencies in opening of banking accounts, the problems with the material securities immobilization (whether they should be excluded from the stock exchange trading) etc. There were many questions connected with securities settlement system: the potential non-bank securities dealers' insolvency risk, caused by their low capital. There was a question how the non-bank dealers would be allowed to use the interbank clearing system, of which only banks were members.<sup>86</sup>

A very important part of the Feasibility study analysed the role of the Stock Exchange Depository and the problem of securities' settlement. The proposed solution was based on the Group of Thirty recommendation. The settlements had to be finalized 5 days after the trade at the latest (according to the well-known formula 1 + 5), and the principle "delivery versus payment" was strictly applied.

Originally, it was expected that only approximately 30 most important privatized companies would be listed at the first market, and approximately 300 companies would be listed at the second market. However, it was not clear how many companies would be traded at the "free market" (unlisted market). The SW capacity of the French system was sufficient for all the three markets. But the question was, whether - from the point of view of "reputation" of the Prague Stock Exchange - it would not be better to run only the first and second markets.

There were, again, two questions: firstly, how the company to be listed would have to be selected (and which companies should be allotted to one or other of the two markets), because no rules for selection definitely were approved, and secondly, the question of "time": the privatized companies had to prepare their Prospectuses, before they could be listed; the Listing Committee was expected to thoroughly examine these important documents; but there was no experience both on the side of issuers and the Stock Exchange - how time-consuming these procedures could be.<sup>87</sup>

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<sup>85</sup>: Étude de faisabilité, point advancement No.1, 1. Juin 1992, and "Étude de faisabilité, point advancement No.2, 17 juin 1992.

<sup>86</sup>This problem was solved by a regulation which forced the non-ban securities dealers to settle their trades through banks. The position of non-bank securities dealers was improved.

<sup>87</sup>Joint-stock managers did not understand the principle of listing. The Association organized several meetings with managers selected for the first market of the emerging Prague Stock

The French experts warned that probably both the banks and investments funds, and also speculators, would try evade the stock exchange; the off-exchange trading could be dangerous for the emerging Stock exchange both on the side of issuers and the Stock Exchange - how time-consuming these procedures could be.

It was possible, that three parallel, relatively independent markets would arise: 1. RM-S market; 2. interbank off-exchange market, and 3. local off-exchange private markets, which could be run on a “half-legal” base.<sup>88</sup>

In the autumn 1992, it was clear that the off-exchange RM-System will be set up, the Association – unofficially – asked the RM-S representatives, whether they would accept an agreement on the “division of labour” between the Stock Exchange and RM-S. This “division of labour” would consist in the following: the Stock Exchange would start trading only at the first and second market, but would not start trading at the “free” market. RM-S, in turn, would start trading exclusively with unlisted shares. This proposal was strictly rejected, and the Stock Exchange - by the end 1992 - was prepared to open all the three markets. The Stock Exchange invented a slogan “30 + 3000 + 3000”, which was officially declared to show that the Stock exchange was ready to absorb high trade volumes. The “slogan” was an answer to the RM-S propaganda saying that the Stock Exchange capacity was too low, because the “French system” was “outdated” (and was sold to the Prague Stock Exchange as a “second hand” product).<sup>89</sup>

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Exchange to highlight the procedure of listing and to discuss it. Company managers proved not to know what the listing is. They expected that the listing will be paid by the Stock Exchange (!). This is not a joke – it simply reflects the true state of knowledge about the capital market in Czechoslovakia.

<sup>88</sup> Memorandum RL/FAISAB1 of June 15, 1992. The hypothesis about the creation of local capital markets was derived from the development in Poland. In the Czech Republic, a distorted form of peculiar “local markets” was created by some “entrepreneurs” who visited villages and bought shares (created by the coupon privatisation) from their individual owners at low, ridiculous, prices. This is one of the examples of negative effects of the coupon privatisation: people were ignorant – they preferred cash to shares, because they had no idea about the shares’ value.

<sup>89</sup>These false “arguments” were accepted by many people. Some brokers - in high profits’ expectation – did not trust the “outdated Lyon system”. A significant pressure on the Association was caused by these calumnies and lies. Many dealers and brokers were misinformed: they did not know that system of computer supported trading was a modification of one of the first automated trading systems called CATS (Computer Assisted Trading System) introduced by the Toronto Stock Exchange. Before 1992, this system was applied by many stock exchanges – Toronto, Sao Paulo, Paris, Lyon, Brussels, Madrid, Korean stock exchanges, Tai-wan and Malaysian exchanges. At the beginning of 90ties, the CATS belonged to the top high-tech trading systems. See: Pardy, Robert: Regulatory and Institutional Impacts of Securities Markets Computerization. Washington: Country Economics Department, The World Bank, February 1992, WPS 866, p.5, and Annex IV-1-5.

The Stock Exchange Act was approved in spring 1992, but the Securities Act still was not ready. It was approved by the Federal Assembly on December 2, 1992 as an Act Nr. 600/1992/ Coll.<sup>90</sup>

As a result of the split of Czechoslovakia into two independent states, the Securities Act had to be changed very shortly after its approval. In the Czech Republic, the Securities Act was substituted by the Czech National Council Act no. 591/1992 Coll. (valid since January 1st, 1993). However, this Act was novelized by the Act Nr. 89/1993 (valid since March 15, 1993).

This was the cause why the start of trading both at the Prague Stock Exchange and RM-S had to be postponed by two months – until April 6, 1993.

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<sup>90</sup>It was very difficult to finalize the Securities Act, because the division of Czechoslovakia was connected with settlement of mutual obligations created in the course of coupon privatisation.

## Chapter 4. Main unsolved questions

Before the trading at the Prague Stock Exchange was started, it was evident that during the short stage of 1991-1992 many very important questions related to the future form of the Czechoslovak capital market and its mechanism remained unsolved. Some problems were still open (they were not solved at all), other solutions (in my view – author) were unsatisfactory or false. Some of these pseudo-solutions were evident and known, other were hidden, and potentially more dangerous. Different omissions or false solutions existed, on one side, in a form of “false concepts” of the capital market system, on the other side, in the form of legislation through which a legal environment of the Czechoslovak (and Czech) emerging capital market was created. However, another factor is important as well: some of the good - decisions enacted in the laws and regulations, or in the intern Stock Exchange regulations – in fact – were not sufficiently enforced. Here we have in mind the capital markets supervision. With the absence of markets supervision the question of market participants’ ethical behaviour very closely was connected: very frequently, the necessity of business ethics either was openly denied, or there was a deep silence.

### 4.1 The Philosophy of the Czech capital market

Priorities of the Czechoslovak government, as far as the main targets of its politic and economic activity are concerned, were briefly mentioned in the Introduction. In the Czechoslovak Government Declaration the necessity of capital market reconstruction and of setting up a Stock Exchange was included. But: it was not defined as one of the priorities. The reconstruction of a capital market was a partial question of complex tasks connected with the economic transformation – of the transition from the “directive model” (i. e. from the model of the “socialist planned economy”) to the market economy. The reconstruction of a capital market *implicite* was considered to be a small part of market environment; sometimes this task was reduced to the creation of financial (or capital) market legislation.

From the point of view of different central authorities’ competency, the capital market agenda belonged to the sphere of the Czechoslovak Federal Ministry of Finance. As far as I know, this authority did not present any consistent concept of a capital market reconstruction. The Ministry of Finance, however, took some necessary decisions which started creation of the future legislative infrastructure.

The primary question – from the point of view of Czechoslovak state budget - was the bonds’ issuance. This question was very topical, as it was closely connected with the “restitution”: Czechoslovak Government did not dispose of financial means to be given to the former owners of expropriated property. The Securities Act was the first Act which had to pave the way for creating the capital market institutional infrastructure. These steps were closely connected with the economic transformation, and – as seen *ex post* – they were directly or indirectly subordinated to the economic transformation needs. Before a final decision on the scale, orientation and procedures necessary for privatization (which was one of the three declared economic priorities), no feasible concept of the capital market reconstruction officially could be declared.

Another institution which was *ex professo* interested in the Czechoslovak capital market reconstruction was the Czechoslovak State bank. The attempt to create necessary conditions for capital market reconstruction was – logically – started by the central bank. So it was, as far as the reconstruction of a stock exchange is concerned.<sup>91</sup>

The concept of the Stock exchange which was prepared by the Czechoslovak State Bank in the autumn 1990 (see Chapter 1), corresponded to the standard requirements of financially advanced countries on securities exchanges and their functions. These requirements reflected the leading role of Stock Exchanges on the capital market.

Under situation when final decision on the ways of a mass privatization implementation was not yet taken, on one side, it was natural and logical to elect a stock exchange model corresponding to the internationally recognized principles, which would – in the future – guarantee the compatibility of the Stock Exchange with the international financial environment and with the international capital market. On the other side, it was logical that the Czechoslovak State Bank was not in a position to try to prepare a compact concept of the Czechoslovak capital market.

Nevertheless, the Stock Exchange concept *implicite* represented such compact conception, but *explicite* never declared it. The behaviour of the State Bank was professional and rational. The Report on the capital market prepared for the Chairman of the Central Bank, in fact, did not explicitly include the broad questions of the whole capital market reconstruction.<sup>92</sup>

The fact that the Czechoslovak State Bank took the lead of preparative works for the Stock Exchange was very positively – and very optimistically – evaluated by the press and by the Czech public as well. The “man in the street” was proud of the fact that Czechoslovakia would have its own, new Stock exchange.

The Federal Ministry of Finance – after all – in co-operation with the Czechoslovak State Bank and with a new interim professional body - the Association alias Preparative Committee started to prepare a draft proposal on stock exchanges.<sup>93</sup> These preparative works were preceded by the draft law on the mass privatisation – the Act No. 92/1991 Coll. – valid from April 1, 1991.

The Association did not dispose of any information on the proposed non-standard capital market reconstruction connected with the privatization process. The original

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<sup>91</sup>Central banks in all post-communist countries played an important role in the process of capital market formation connected with the existence of stock exchanges.

<sup>92</sup>Document Tézepodkladů pro jednání vlády o kapitálovém trhu a burze v ČSFR”, p. 4.

<sup>93</sup>Introduction, about the Czechoslovak Government Programme.

information was very scarce and incomplete. The first information was contained in the document of Ministry of Finance in November 1991.<sup>94</sup>

During the time when the preparative works on the stock exchange already were running, the Association had no information on any bounding document about a financial or capital market concept declared by the Czechoslovak Financial Council with which the concept prepared by the Preparative Committee would be irreconcilable.

Federal Ministry of Finance, on the base of the law No. 92/1991 Coll., started the preparative works for the coupon privatization. By the above law Federal Ministry of Finance was empowered to set up new institutions serving the privatisation. One of these institutions was the *Centre for coupon privatization*<sup>95</sup>. A broad securities dematerialization was expected (i.e. dematerialization of shares owned by the privatized enterprises). In spite of the fact that the Securities Act was not yet valid, it was expected that a new central institution - a Central Securities Registry – would be established. This registry would be in charge of evidence of all dematerialized securities. The new institution had the name *Securities Centre* (Středisko cenných papírů – SCP).<sup>96</sup>

The Ministry of Finance (according to the Law no.92/1991 Coll.) started to prepare the project “*Czechoslovak securities secondary market*”, i. e. the secondary market of securities generated by the process of coupon privatization, which “are traded, registered and settled outside the Stock Exchanges in Prague and Bratislava.”<sup>97</sup>

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<sup>94</sup>See: Chapter 9.4.

<sup>95</sup>Director of the Centre was RNDr. Jaroslav Lízner.

<sup>96</sup>The Securities Centre was founded according to the law of the Czech National Council nr. 576, about the rules regulating the use of budgetary financial means of the Czech Republic and villages in the Czech Republic. The activity of the Securities Centre could not be started before the law Nr. 591/1992 Sb. about securities was in force. The Securities Centre was a legal person, registered by the Commercial Register (Obchodní rejstřík). The Centre was not authorised to securities trading.

<sup>97</sup>Development of secondary markets in the Czech and Slovak Federal republic. Ernst and Young, July 1992. pre - implementation overview report. (42 pages, 22 diagrams and an Appendix of 7 pages) The report was prepared for the British Know-Fund as a result of the first stage of aid to the managerial team of RM-S. It is not quite clear why the RMS project was called “Czechoslovak Secondary market”. Why the Project dealing with the market with shares generated by the coupon privatisation was called like this? Is it a proof that this off-exchange market was to be created as a preferred or a single off-exchange market? Should the Prague Stock Exchange and the Bratislava Stock Exchange exist as a specific “decorative element” ? Although the Report did not directly say so, from the diagrams published in the Report can be clearly seen that the role of the two Exchanges’ (i.e. the new Czech Stock Exchange and the new Slovak Exchange) was considered to be marginal.

The project of the “Czechoslovak secondary market” had to be prepared by a company RM-S, closely connected with Podnik výpočetní techniky, a.s. (PVT). Later on, Ministry of Finance asked the British Know-How Fund to support the project. This way, a non-standard situation arose: on one side, the Project (i.e. the non-standard off-exchange market of securities generated by the coupon privatization), prepared by the RM-S, was advised by one British company (Ernst and Young), and on the other side, the Association/Preparative Committee was advised by another British Consultancy firm (Coopers and Lybrand). It was a paradox that – indirectly – the two British firms “competed” in designing the Czechoslovak capital market (*sic!*).

As far as the market infrastructure is concerned, company Ernst and Young recommended (*inter alia*) a legislation “for a single compulsory immaterialized depository” to be created. The Czechoslovak “securities industry” should prepare a legislation which would prevent the issuance of material securities and only one central depository to be set up.<sup>98</sup> The Ernst and Young Report recommended the development of market intermediaries to be supported. The Report requested to be ensured that the Czechoslovak securities industry “...develops in a coordinated manner with common standard and common objectives.”<sup>99</sup> This recommendation shows that the company Ernst and Young was well aware how “dangerous” the Czechoslovak “terrain” was. Maybe therefore it showed a sense for reality writing that “a possibility of interaction” between the exchanges in Prague and Bratislava was to be taken in consideration.<sup>100</sup> An interesting comparison of the two different mechanisms – the RM-S mechanism and the Prague Stock Exchange mechanism – was prepared.<sup>101</sup>

Table 1. Comparison of Stock Exchanges and RM-S mechanisms.

Area	Prague SE Bratislava SE	RM-S
Listing and trading	Trading only 30–300 stocks feasible. Additional listing requirements.	Will have the capacity to trade all 3000+ stocks. All voucher stocks automatically listed.
Trade input and volume	Only 15-25 brokers allowed on each floor. Trading volumes reduced by netting.	Allows anyone to trade (including retail and IPFs) through 500+ outlets. IPFs may also net trades before passing on. System will cope with high volumes.

<sup>98</sup>Report, p.3

<sup>99</sup>*Ibidem*, p.3. The international standards are the standard published by the Group of 30 (G30), FIBV, ISSA and IOSCO. In the Report the standards were not specified.

<sup>100</sup>*Ibidem*, p. 26. The Report refers to a state of “non-cooperation”: “...there currently is little co-operation between RM-S and other potential central markets providers”.

<sup>101</sup>See Annex 2 of the Report.

Trading methods	Floor based – limited methods	Distributed network – will allow any form of trading.
Validation	Carried out after trade matching, but before clearing and settlement. Trade failure possible,	Carried out before trades are matched. Trade failure highly unlikely, ensuring a high degree of stability and certainty.
Clearing and Settlement	Via custodian banks and commercial banks who will keep customer security and banking records	Centralised SCP functions offered with the ability to decentralise, or pass information, to participants, as they develop the ability to manage these tasks.
Settlement periods	Target is T + 5 Trade date + 5 days	Varies depending on methods of trading. Target is T + 5 wherever possible
Live date	1 January 1993	1 January 1993

Source: Development of Secondary markets in the Czech and Slovak Federal republic Ernst and Young, July 1992. Appendix II.

The comparison in the Table 1 reveals that the company Ernst and Young had an incomplete data on the Prague Stock Exchange and did not have exact data at its disposal. Ernst and Young, for example, thought that by the Prague Stock Exchange an open-outcry system would be applied, the trading capacity would be low, and trading defaults would be frequent. The table shows that the position of the Prague Stock exchange would be worse than the position of the RM-S as far 4 items are concerned. Only one items (clearing and settlement) would be better at the Stock Exchange.

Nevertheless, the co-existence of both systems would be possible, “as they would be trading different shares.”<sup>102</sup>

During the years 1991-1992, the discussion about the Czechoslovak capital markets conceptions was very topical. The “duel” was undecided. On one side of the “barricade”, followers of a standard system - by which the leading role of a Stock exchange as a top capital market institution was recognized - were standing; on the other side of the “barricade” followers of the off-exchange system were concentrated.

The followers of a dominant position of a stock exchange did not succeed in their efforts to prohibit or to restrict the off-exchange trading; a compromise consisting in a temporary prohibition or a limited number of off-exchange trades, was not accepted. As a result, a space for non-standard off-exchange trading and for a parallel existence of different prices of the same securities was opened. The possibility of price-arbitraging and other

<sup>102</sup>Ibidem, Annex 2. The assumption that both systems would be trading different shares was not implemented.

anomalies as well prevented the Czech capital market from working as an efficient, fair and stable market.<sup>103</sup>

The followers of a dominant position of a non-standard off-exchange market RM-S succeed in their efforts to put under into the Securities Act *via facti* (not *de iure*) a monopolist off-exchange trading system, but they did not succeed to formally enthrone RM-S as a Stock Exchange which could replace the standard Stock Exchange. The RM-S *de facto* represented a great potential danger not only for the Prague Stock Exchange, but also for the Czech capital market as such. The RM-S appeared to be non-standard, non-transparent, and unpredictable.<sup>104</sup>

Fortunately, these apprehensions were not fulfilled by the future development of this system, because the high ambitions of RM-S failed, but the possibility of a non-transparent off-exchange trading was one of the causes why many foreign investors considered the Czech capital market to be very risky.

One of the main causes why the Czech capital market was considered to be non-standard, and therefore risky for foreign investors, was the fact that –according to the Securities Act – it was possible to transfer the property of securities directly through the Securities Centre. Transferred securities were not traded (neither at the Prague Stock Exchange, nor at the RM-S), only formally re-registered, i.e. they evaded the normal market mechanism with a normal price formation, and – as a result – their prices very often were arbitrary. It was a form of a quasi-legal tax evasion.

The parallel existence of the two “market organizers” – the Prague Stock exchange and the RM-S, without any “division of labour”, can be characterized as a “dichotomy” of the Czech capital market which created a pseudo-competition. The objection that the RM-S was given (*de facto*) a quasi-monopolist position was formally rejected by the regulation that – under certain condition – it was possible to run off-exchange systems. This situation opened the way to other potential and/or real deformations of the Czech capital market.

It is a paradox that the possibility of a direct “transfer of property” through the Securities Centre was not criticized from the very beginning. The volume of these “pseudo-trades” was very high. This caused a significant distortion of shares’ prices which normally would have to be sold and bought at both organized markets. The fictitious share “prices” arbitrarily declared by the parties involved in these “deals” very absolutely non-transparent and out of control. Nobody cared. Seen *ex post*, this phenomenon of price deformation was one of the most dangerous events at the emerging Czech capital market. Unfortunately, it was impossible to find the real author of this “phenomenal discovery”.

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<sup>103</sup>These three characteristics are essential elements of standard requirements. See: Pardy, op. cit., p. 13.

<sup>104</sup>It differed from the private off-exchange systems abroad.

As a result of the above described queer practice, both Prague Stock Exchange and RM-S lost a big volume of potential trades. But the loss of credibility of the Czech capital market as a whole was higher than the loss of potential transactions at the regulated market: it was a school of trade manipulation, tax evasion and other criminal activities the bulk of which never were investigated and punished. What to think about “transfers” at a pseudo-price” of one Czech Crown (*sic!*)? It was a “legal” tax evasion. As this practice was spreading very fast, it started to be criticized by financial experts and later on even by the press, but nothing happened. The “political will” was missing.

In July 1996, i.e. three and a half years after the start of regulated securities trading, some minor changes of Securities Centre rights and obligations were enacted. However, the problem of “direct transfers” was not solved. The Securities Centre was obliged to publish (once a week) the data on the number of “pieces of securities” which were transferred by the Securities Centre at some price. Nevertheless, these data were absolutely worthless, because only an average price of each issue was published.

A homogenous conception of the Czech capital market development never was prepared. Specific elements of it existed, but they were not interconnected.

As a matter of fact, the construction of these elements was strictly subordinated to the coupon privatization. The Czech capital market was forced to support the coupon privatization – without any standard environment necessary for a further, long-term capital market development. The Czech capital market had to serve the privatization, and this is why it had to be subordinated to this aim.<sup>105</sup>

Many key questions which have a decisive significance for a smooth working of any capital market remained unsolved. One of these crucial questions was, for example, the investors’ protection. The capital market regulation and supervision was another problematic question. *Ex post* it is clear that the existence of an efficient and powerful supervision was – in fact – unwanted. This lack of political will is the reason why any standard regulatory and supervisory capital market authority – for a long time of some 5 – 6 years - did not exist. It was a result of a liberal theory that the “market regulates itself”. In spite of the existence of a Department of capital market supervision at the Ministry of Finance, the limited staff of this department was unable to meet the requirements imposed to it by the vast agenda (stemming from the Securities Act), although many of the honest officials were trying to do their best.

In the period when the Czech capital market was emerging, securities owners were not preferred – they had no tax advantages, i. e. an environment fiscally adverse to investors existed. Foreign advisors’ recommendations to create an environment friendly to investors were ignored.

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<sup>105</sup>See: the “Nástin, “op.cit.

The emerging Czech capital market protection against the imminent outflow of securities trades abroad was never considered by the Czech official authorities to be harmful, although this danger repeatedly was signaled by foreign advisors.<sup>106</sup>

The under-estimation of capital market institutions' self-government (not only of a stock exchange) by official authorities also was an element of total ignorance.<sup>107</sup>

The danger of frauds, price manipulation, misuse of insider information, corruption etc. etc. seemed to be totally absent from the minds of legislators and bureaucrats, as if the danger of financial criminality never would exist.

As seen *ex post*, the lack of political will to solve the crucial problems of the Czech capital market was partly due to the ignorance, but also partly due to a strong pressure of interested groups, skilfully hiding their real interests under a cover of populist slogans connected with the "national task" of privatisation. The pressure was so strong that it was practically impossible to face it, although some of the honest politicians tried to do so – unfortunately, in vain.

The dangers of a non-standard capital market were not sufficiently understood even by the growing group of Czech financial experts and educated public. The legislative work was in hands of a small group of persons. Unfortunately, many of them did not resist against the pressure of groups trying to push through the non-standard approaches and priority of the short-term aims of privatisation (connected with their own selfish interests) to the long-terms real interests of the Czech society and economy.

#### **4.2 Main causes of serious deficiencies**

General conditions under which in post-socialist countries at the beginning of the 90ties the Stock Exchanges were set up and the capital market emerged were very different. Some of these specific differences were already mentioned. The Czechoslovakia (and the Eastern Germany – GDR) were the most advanced of these countries, but – at the same time, they were the countries where the normal market was significantly limited by planning and other regulations. This is why the economic reform was one of the most important tasks of the transition period.

The word "reconstruction" used for a re-establishment (or a revival) of the capital market - in fact - was confusing, opaque and euphemistic. It was impossible to "reconstruct" something what did not exist for 50 years. It is true that a few formally analogous market

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<sup>106</sup>In Hungary, the consequences of the absence of regulation were significant. Several Hungarian companies (for example, one of the big companies - Ibusz) suffered big losses, because of the outflow of an important part of trade transactions from the Budapest Exchange to the Vienna Exchange.

<sup>107</sup> Later on, in the Act on the Czech Securities Commission, the self-regulation was not mentioned at all.

elements existed in the so called planned economy – but the real economic content was different. The Prague Stock Exchange (probably) *de iure* existed after World War II, but it did not work – the Germans stopped trading in 1939; however, after World War II, securities trading was not started. Therefore, at the beginning of 90ties, new institutions were set up “from scratch”. We use the word “reconstruction” referring to the official government wording.

In this paragraph, an attempt to describe and explain the main general causes influencing the creation of the Czechoslovak (and Czech) capital market and of a Stock exchange during the last decade of the 20<sup>th</sup> century is presented. However, probably a longer lapse of time would be needed to be able to present an impartial analysis of what really happened.

From the point of view of theory, the basic roots of the Czech capital market deficiencies stem from the wide-spread ideology of liberalism, in a combination with a lack of practical experience. This was one of the reasons why many political and economic decisions were based on unrealistic assumptions. Through the combination of liberal principles and assumptions with the lack of technical skills, a big part of problems and market deficiencies was predestined.

The range of problems which are enumerated in the following text, is open; other problems easily could be added. The open list of important factors through which in the 90ties the creation and development of the Czech capital market was influenced, can be set up as follows:

- 1.Non-existence of a systematic financial market concept
- 2.Capital market subordination to the privatisation policy
- 3.Unregulated and uncoordinated approach to capital markets’ problems solution
- 4.The existence of the two irreconcilable systems of securities trading.
- 5.Competition between the two trading systems
- 6.Lagging of legislative works
- 7.Underestimation of capital market supervision
- 8.Delayed preparation of a capital market supervisory system
- 9.Underestimation and rejection of many foreign experts’ good advices
- 10.Quick decisions influenced by a lack of time
- 11.Undervaluation of legality
- 12.Too many gaps in capital market legislation
- 13.Self-government underestimation
- 14.Absence of ethics related to privatisation and securities trading
- 15.Strong group interests, lobbying and corruption

It is well-know that in 1989-1990 no clear concept of an economic reform existed. There was a wide range of different approaches presented by theoreticians and a broad range of views were presented by practitioners. Nevertheless, it was generally accepted that the so-called “socialist planned economy” was dead and a market economy has to be installed. This

was the real reason why the Government Programme Declarations – both in 1989 and 1990 – did not define a clear characteristic of an economic policy necessary for the economic transition.<sup>108</sup>

The non-existence of an embracing economic conception was reflected in the absence of concept related to the capital market reconstruction. As seen by the liberal wing of economists, the economic transition would have to be driven solely by pure market forces (with a limited influence of the State); on the contrary, Keynesian economists expected that the transition process has to be regulated by a powerful State.

No wonder that – in a situation of a political struggle for democracy – no clear and distinct tasks and priority aims of economic policy could be formulated. The capital market was considered to be one of many tasks. This was one of the reasons why in 1990 and 1991 no clear idea about the capital market architecture and the role of stock exchanges simply could exist.

In spite of this situation, a group of academics and practitioners existed which expected that a stock exchange had to be a top capital market institution whose role was indispensable. The efforts of this of this group were already described.<sup>109</sup>

On the field of capital market legislation prepared by the Federal Government, the series of laws was started by the Act on Bonds. One of the first laws was the Stock Exchange Act, preparative works of which were started by the Ministry of Finance in co-operation with the Czechoslovak State Bank.

The concept of the new Stock Exchange and the architecture of the Czechoslovak capital market were prepared and financed by the Czechoslovak State Bank until the Association (“Preparative Committee”) was set up. The Czechoslovak State Bank acted independently and rationally, without following any government plans: that time, such plans did not exist.<sup>110</sup> The Czechoslovak State Bank efforts related to the capital market reconstruction were a significant contribution to the emerging economic reform and to the economic transition.<sup>111</sup> It fully corresponded to the Czechoslovak Government Declarations.

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<sup>108</sup>The resolution no.31 of the Federal Assembly about the programme declaration of the Czech and Slovak Federative Republic, as of July 1990, par. 2, recommends to the Government (until September 1, 1990) to prepare a scenario of economic reform and to specify the problematic parts which were not sufficiently elaborated in the Programme Declaration. Legislative conditions enabling the foreign capital entry on the Czechoslovak market should be specified as well. See: Digital Archive of the Parliament, [www.psp.cz](http://www.psp.cz).

<sup>109</sup>See Chapter 1.

<sup>110</sup>It cannot be excluded that some other (unofficial) documents were published.

<sup>111</sup>The Czechoslovak State bank did not hide its support of the idea to set up the Stock Exchange. The series of the intern documents is a proof that the Czechoslovak State Bank

Nevertheless, the situation substantially changed when fundamental decisions about the mass privatisation on the government level were taken and the form of a coupon privatization was elected. A great part of energy of the Government was consumed by the privatisation agenda which was a super-priority. The capital market reconstruction was intended to be partially (but fully in fact) subordinated to the coupon privatization; the emerging institutions had to serve the privatization.<sup>112</sup>

The relation between the coupon privatization and the capital market reconstruction – for the first time – was officially and unequivocally defined by the Czechoslovak Government Programme Declaration of July 13, 1992. In part 4 of this Declaration, paragraph 1 - “Economic Reform and Principles of Economic policy” – first results of the economic reform were evaluated and new tasks declared. The creation of a secondary capital market and the creation of a state supervision was one of the new tasks.

For the policy of capital market reconstruction the following text is of an imminent significance: “On the basis of the experience from the privatization process, the Government will pay attention that the second wave of privatization be based on application of such privatization methods which will guarantee its transparent and quick implementation. The Government considers ... the coupon privatization, auction sale or public tenders to be the suitable methods... The privatization is connected with creating the secondary capital market which will enable the capital transactions to millions shareholders. Its existence is a condition of the final success of coupon privatization and of creating a favourable climate for private enterprise ... In connection with this task the Government will initiate a creation of ... state supervision, the decisive task of which will be the licensing of stock exchanges, insurance companies, investment companies and investment funds and regulation of securities trading. These subjects will be controlled...by the State supervision which will supervise their activities and support the competition at the emerging capital market. These measures are necessary in interest of investors’ and citizens’ protection.”<sup>113</sup>

The Czechoslovak financial market reconstruction – as seen *ex post* – was based on a legislation prepared “step by step”, i. e. on a pragmatic approach and not on an all-embracing concept. The existing institutional infrastructure was modified (if possible) to a new form which corresponded to the new legislation; in a parallel way, new infrastructure elements were set up (for example, new banks, securities dealers, investment companies and investment funds, etc.).

It is not possible to say whether – and to what extent – this process really was managed and co-ordinated. The real situation was rather chaotic and different groups

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took part in the elaboration of the Stock Exchange Act which was passed to the Government. The Draft Stock exchange Act (the first version of the Act) was prepared at the end of 1990.

<sup>112</sup>See: Chapter 1.

<sup>113</sup>See: [www.psp.cz](http://www.psp.cz)

competed. One of the results of this situation was the parallel creation of two top institutions – the Prague Stock Exchange (as a standard Stock Exchange) and a new system RM-S to render its services to the so called off-exchange secondary market.

If an officially accepted homogenous concept of capital market development had existed, this non-rational result would be impossible. It was rather surprising that a “green light” was given to set up two controversial securities trading systems: a stock exchange and a non-stock exchange. One of these two systems was standard, and the other one was non-standard, but specific and unique.

The existence of two trading systems was a systemic mistake. Serious market anomalies were created as a result of this dichotomy which was harmful for the Czech capital market as a whole. The anomalies were gradually removed, and the protracted “normalization” of the Czech capital market lasted almost for one decade.<sup>114</sup>

The two systems’ relations were unfriendly from the very beginning. The banks which were the main founders of the Prague Stock Exchange possibly were afraid of the loss of a part of their potential trades. A certain role possibly was played by what could be called “*horror vacui*” – a fear of a new, unknown, non-standard and un-intelligible system.<sup>115</sup>

The founder-banks were disappointed by the attitude of a part of the state authorities which openly supported the off-exchange “secondary market” because of its expected role in the privatization process. In plus, the original intention declared in the Government Declaration was discriminatory: the Stock Exchange should not have a direct access to the Securities Centre. This “*casus belli*” was not meaningless: on the contrary, securities settlement was a crucial thing for smooth trading.<sup>116</sup>

The “war” really began and was lasting approximately for the next two years, until the Prague Stock Exchange gained superiority at the market of shares.

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<sup>114</sup>A question of *cui bono*, i. e. the question who really gained by the creation of two parallel trading systems (if ever somebody?) is still unanswered. Nevertheless, it is sure that the existence of the RM-S devaluated the position of the Prague Stock Exchange: the Federation of European Exchanges accepted the Prague Exchange only as an associated member, and the World Federation of Exchanges refused the membership of the Prague Exchange. The reason was the same: the non-standard Czech securities market architecture, caused by the existence of a non-standard RM-S.

<sup>115</sup>The apprehension and fears resulted from the description of the new system. See: Chapter 2.

<sup>116</sup>Although the arguments of the Prague Stock Exchange explaining the need for a direct connection to the Securities Centre were correct, the Ministry of Finance rejected this rational request to set up a multi-level registry. The problem was finally solved later on: finally, the Central Securities Depository (a daughter company of the Prague Stock Exchange) was established.

The only positive, however, important effect of this competition was that both competing trading systems were modified and upgraded, technical improvements were introduced and the quality of services rendered to users was higher.<sup>117</sup>

During the first years, one of the general features of the Czechoslovak economic reform was the relatively quick rise of real economy, and delays in the process of capital market legislation. The effect of this lagging was detrimental to the capital market. Nevertheless, more detrimental was the underestimation of capital market supervision during the first two or three years. It is difficult to understand and regrettable that capital market supervision in the Czech Republic was neglected until the delayed creation of Securities Commission in 1998.<sup>118</sup> The need of a supervisory authority was formally recognized, and the Government Programme declaration of July 13, 1992 referred to it, however, in practice, real conditions for an efficient supervision were not created. Up to now, it is not clear who was responsible for this deficiency, and what were the real motives of this incredible “omission.”

During the period of 1990-1992, the preparative works for a system of capital market regulation and supervision were delayed. Better to say, almost nothing was prepared. On one side, the delay was partially caused by the protracted legislation process; on the other side, the wide-spread liberal views were a powerful hindrance which prevented the Ministry of Finance from applying a more rigorous approach to supervision which was badly needed.

One of the proofs of the unpreparedness (the proper word – maybe – would be “sabotage” – V.P.) was that – when trading at the Prague Stock Exchange and the RM-S was started - the ministerial supervisory authority did not dispose of its own information system which would to be able to monitor the capital market development as a whole.<sup>119</sup>

The Prague Stock Exchange was – according to the Stock Exchange Act – supervised by a Supervision Commissioner. This way of supervision was traditional way, but it was absolutely unfeasible in case of a computer- supported trading systems. It is obvious that one person (i.e. the Commissioner) is unable to perform this task.<sup>120</sup>

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<sup>117</sup>Jonathan Miller in his Report (1994) wrote that after one year and a half, both systems past over the original framework.

<sup>118</sup>See: 16.3

<sup>119</sup>The construction of the capital market information system was started at the beginning of the 1993, however, when trading (in April 1993) was started, the information system did not work. See: Pavlát, V., Kubíček, A., op. cit., p. 134-

<sup>120</sup>The Prague Stock Exchange never should forget the work of *Ing. Karel Ulrych*, the first Supervisor of the PSE. During the process of creating the PSE he was one of the most reliable functionaries, devoted to the idea of preparing a transparent system of supervision.

A very negative feature of the first years was an underestimation or rejection of views, advices and recommendations prepared by foreign experts and institutions, or - on the contrary - an overestimation and/or the uncritical acceptance of different views. These specific attitudes of many ministerial officials possibly stemmed from the excited atmosphere of the first years “after”. The reasons of these attitudes probably were twofold. On one side, the nationalist feelings: the Czech “brain” should always be right. On the other side: everything what is imported from the West is excellent and suitable, and “sanctioned” in before. Many officials staggered between these two types of behaviour.

As far the preparative works related to the stock exchange is concerned, the situation was different: it was clear that the institutional, commercial, technical, organizational etc. know-how had to be “imported” by foreign experts. Nevertheless, the staffs of the emerging Prague Stock Exchange were trying - from the very beginning - to confront the foreign know-how with the Czech reality to be able to have an objective view. The foreign experts’ experience, views, advices and recommendations were highly appreciated; at the same time, before they were applied, they were critically analysed and – if necessary – modified and adapted to the Czech environment. Unfortunately, sometimes some of the foreign experts’ views were misinterpreted by some of the Czech ignorant journalists.

The permanent lack of time and haste were the powerful “enemies” of correct and solid solutions of many practical tasks. Unnecessary discussions of unimportant details which took a lot of time were frequent. Sometimes, systemic problems were put aside and ignored – with a pretext to be solved in the next (?) future.

The Czech capital market development was heavily damaged by a distorted relation towards the legality. During the privatization process, many laws and by-laws were hurt and/or circumvented, but – in most cases, nothing happened (!). The possibility to seize a property seems to eradicate not only any ethics, but an instinct of self-preservation as well. Frauds and trespasses of all kinds were on daily order; only few trespassers were punished.

During the period of 1993-1998, Czech capital market regulation was of a poor quality: existing laws and by-laws frequently did not meet the requirements of the growing Czech economy. Many lags in regulations existed, and manifold explanation of the real meaning of different regulations by lawyers was possible and frequent. For capital market supervision, all these unfavourable conditions were very stressing.

Many new inexperienced entrepreneurs who became securities market participants had no idea what a business ethic or professional ethic is; the supreme principle of their activities and behaviour was to attain profit, at any cost and by any possible means. From this point of view, it was a “remake” of an époque of the original capital accumulation, described by Karl Marx.

The significance of self-regulation of the capital market institutions was underestimated, the Stock exchange included. Elements of self-regulation were dispersed in many laws and by-laws, however, the application of the self-regulation principle was

(unofficially) declared to be premature, and the application of this important element of capital market regulation was - *de facto* - postponed to some distant future.<sup>121</sup>

It is not surprising that the excited and chaotic environment paved the way to corruption and lobbying. Suddenly many pressure groups emerged, and their particular interests were superimposed to common interest of the State and its citizens.

All the briefly described factors together gave birth to unexpected problems which intoxicated the financial environment and the emerging financial market for long years, without any real hope for a change.

Let us briefly recapitulate the impact of the above described general deficiencies of the emerging Czech capital market, which were mainly due to the *defacto* chaotic, unregulated and adventurous privatization process, on the Prague Stock Exchange.

For the Prague Stock Exchange, one of the most important events was a selection of a trading system. In fact, the final decision was taken, because the big founder-banks were not prepared (and not willing) to pay the cost of necessary investment.

Another important factor was the dominance of the two biggest Czech banks, in a positive and negative sense in turn. Weaker partners were disciplined by the bigger ones. At the beginning of preparative works, certain elements of a “banking monopolism” existed. The relations of banks to the non-bank securities dealers were not very friendly: a discriminatory approach was frequent, and haughtiness of banks was in the air.

The lack of time and the dramatic events at the end of 1992 prevented to analyse the results and positive experience of the Interim Secondary Market run under the support of the Czechoslovak State Bank.

The activities of the Association sometimes suffered from non-professional behaviour of Association members, such as a formal attendance or frequent absence in the meetings, unnecessary discussions, alibis, attempts not to “irritate” the Ministry of Finance or other authorities, wire-pulling behind the scene etc. The decision making was frequently handicapped by absence of basic knowledge about the stock exchanges. The above “list” of imperfections reflects the efforts to critically evaluate the activities of the Association. Nevertheless, it is necessary to stress that without the enthusiasm, successful co-operation of Association members, the three years of efforts characterized by “rises and falls”, the Prague Stock Exchange never could be founded.

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<sup>121</sup>The self-regulation was understood as an obligation of the Stock Exchange Chamber to prepare a Stock Exchange Statute and the Stock Exchange Rules (See: the Act no.. 214/1992 Coll., § 8.).

## Conclusion

It would be superfluous, on one side, to repeat what was said in the preceding chapters. On the other side, it is advisable to try to summarize the main positive and negative aspects of what during the critical years 1990-1992 really was achieved.

As seen from a pure pragmatic point of view: the Czech Stock Exchange was set up, and it still exists, and the Czech capital market was created as well. This is a real success. But: at what price?

Let us try to resume the main „plusses and minuses“, which contributed to the final results. We will try to evaluate the effects of the main driving forces of the whole process, presented as factors through which the final result of 1990-1992 was determined.

*1. Political factors.* Although the political programme of a transition from the “planned economy” to the “market economy” existed, its implementation was very difficult because of the inner contradictory nature of this programme. There was no clear definition of freedom, democracy, and many other attributes of a democratic society. There was a tendency to understand the democratic principles as an absolute freedom of every citizen, i.e. the absence of regulation, or its substantial restriction.

As far the capital market is concerned, the general goals of the so - called “reconstruction”<sup>122</sup> were declared, but the way how these goals should be attained was uncertain and opaque. Thrown to the water, everybody had to learn swimming.

*2. Juridical factors.* The Czechoslovak capital market legislation, unfortunately, became an object of political discussions and pressures as well. The laws were moving (or better: staggering) between an extreme liberalism and an extreme dirigisme, according to the situation: the winner was who was able to push his wishes through.<sup>123</sup> It was very detrimental that the new capital market laws contained big doses of both above mentioned ingredients. As a rule, the relation of these “doses” – contained in different laws – was not the same: the heterogeneousness and unsystematic character of the majority of capital market laws was the common result of this alchemy. And the final result for the period of – at least – 5 years after the creation of the PSE: the frequent changes of capital markets laws, and the existence of risky surroundings for foreign and domestic investors’ investments.

*3. Economic and financial factors.* After the liberalist wing in the Czechoslovak Government took the economic power, the content of the word “transition” was made clearer. Under the false slogan “market is self-regulating”, an almost unlimited space for the new “entrepreneurs” activities was opened. The model of the coupon privatization was pushed

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<sup>122</sup>Better: creation from scratch.

<sup>123</sup>During the period of 1990-1993, the only law which was accepted both by the Government and the Parliament without bigger problems was the Act on bonds. In this case, it was a law of a technical character which was badly needed by the Czechoslovak state.

through. Every citizen was supposed to be given a part of the privatized national property, practically for free.

The Government decision to start the coupon privatisation – *inter alia* – opened the way to the creation of new institutions, such as Centre for Coupon Privatisation, the RM-S, etc. The “original Czech way” of capital market creation started, the institutional dichotomy of the Czech and Slovak capital markets was legalized.

The short-term political effect of this “democratic” coupon privatisation evidently was positive; however the consequences of this method of capital market creation (as seen *expost* in the optic of the next 5 years) were disastrous.<sup>124</sup>

4. *Human factors.* One of the very positive aspects of the so - called Czechoslovak “velvet revolution” of 1989 - was the fact that majority of population was ready to support the Government Programme of transition to market economy. Nevertheless, majority of population was completely unprepared to understand the process of the transition process. Financial literacy was at “zero level.”

As for financial sector, the situation was similar, however, the process of financial education started very soon. Czech “market terminology” was invented and spread through all possible channels. But the practical knowledge of securities trading was limited to a small group of bank employees and to a small range of financial products (mainly bonds).

This is why the low financial literacy represented a risk factor for financial market creation. During the period of 1990 – 1992, the lack of special knowledge and know-how was a limiting factor of a faster progress, and one of the causes of many suboptimum and risky solutions.

5. *Technical and technological factors.* At the beginning of 90ties, information techniques and technologies applied in the financial sector were primitive. Czechoslovak telecommunication system (except for military uses) was backward, slow and inefficient. The post, telephone, telegraph and fax were the main disposable technical means.

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<sup>124</sup>In spite of the fact that the Prague Stock Exchange dominated the regulated secondary market, the Centre for Coupon Privatisation (SCP) - *via facti* - became a centre of quasi-trading outside the regulated markets (which were represented both by the Prague Stock Exchange and RM-S), and was run as an unregulated off-exchange market. The reasons why this happened were clearly and precisely formulated by *Antonín Kubiček*. It was: 1. Speed (the settlement practically was immediate); 2. Low fees (unified and independent on the securities volume); 3. The possibility of indicating any price; (the SCP was not authorized to examine the price); 4. Absence of transparency (tax-evasion was possible, because of securities transfers between interconnected companies owned by the interconnected owners). In: Pavlát, Vladislav, Kubiček, Antonín. *Regulace a dozor nad kapitálovými trhy* (Financial Markets Regulation and Supervision), 2. ed.. Praha: Vysoká škola finanční a správní, o.p.s., 2010, p.137-138. ISBN 978-80-7408-036-4.

As for the capital market, this situation limited the application of progressive communication technologies in Czechoslovakia which were used in most of developed European states, USA and Canada. This situation limited the creation and development both of the Prague Stock Exchange and the RM-S for a couple of years.

The Czech and Slovak capital market development – during the “roaring nineties” – proved that many of the foreign advisors’ and experts’ serious warnings were true. A long list of these warnings - many of which were described – could be repeated here, as striking signs of ignorance and absence of rationality. For example: the absence of minority shareholders protection, market fragmentation, price non-transparency, lack of information on quoted firms, a very low level of surveillance, refusing of any ethical principles on the side of traders and investors, etc. etc. Short-term interests of groups and/or individuals were preferred to long-term common interests of the whole society.

In spite of all above described deficiencies, Prague Stock Exchange and RM-S securities trading was started on April 6, 1993.

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## Appendices

### Appendix 1. Inquiry on the immaterial form of shares

In 1992, the Association organized an Inquiry about the immaterialized securities. The first Inquiry was organized in February 1992, and the second one in November 1992.<sup>125</sup>

The Associations' decision to organize the Inquiry was motivated by the results of a discussion about a document written by *Dušan Tríska*<sup>126</sup> and was based on unofficial scarce information. According to this information, it was expected that all tradable shares will be immaterializes, without any exception. Many entrepreneurs were dissatisfied by this possible solution.<sup>127</sup>

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<sup>125</sup>The Inquiry was organized by the company Ecoma – Research Institute for Trade (Ecoma – Výzkumný ústav obchodu), located in Bratislava.

<sup>126</sup>See Chapter 9.5.

<sup>127</sup>These problems were solved by the Securities Act which entered into force on March 15, 1993.

The Inquiry was based on a representative pattern of Czechoslovak population. The total number of respondents was 1603, of which were 777 women and 826 men. On the territory of the Czech Republic, 66,6% respondents were selected, and the rest – 33,4% - were selected on the territory of the Slovak Republic. The respondents were selected by the standard criteria (age, gender, education and number of inhabitants at the location). The inquiry was performed by 150 extern employees of the company Ecoma -VÚO at 111 locations in Czechoslovakia.

The aim of the Inquiry was to gather as much as possible information on the views of respondents concerning the immaterialized form of shares, and on the interest of acquiring shares of different forms.

Final results were very interesting: in November 1992, the average degree of respondents financial literacy was approx. 10% higher than in February. Approx. 40,5% of respondents were informed that shares can be registered with a special register. In November, women were better informed than men. In November, more than a half of women had some information on the dematerialized shares, while in February, it was only one quarter. The share of “informed” men grew only by 2% (!). The best information had the groups of respondents aged 30-39 and 40-49 years, the worst was the group aged more than 60years (only 25% of respondents of this group).

The degree of acquired knowledge about the immaterialized share was correlated with the education: the best informed group (from relevant groups) were academics (63,2%), “intellectuals” (59,3%) and entrepreneurs (56,8%). Better informed were the citizens with higher incomes and inhabitants of bigger towns.

The “classic” – material - shares were evaluated as more reliable than the immaterialized shares. Immaterialized shares were positively accepted by younger people (aged up to 39 years). The interest about the stock exchange and the preferable form of shares was related to the degree of education.

The Association decided to take more care of high-lighting the questions connected with securities dematerialization; later on, several educational actions were organized (for example, selected groups of entrepreneurs from different branches were invited to visit the Stock Exchange to be given more information).

## **Appendix 2**

### *Proposed Solution regarding the Basic Aspects of the Stock Exchange in the Czech and Slovak Federative Republic*

#### 1. Stock exchange(s) in the Czech and Slovak Federative Republic may be established based on the following key principles:

The key objective and purpose of founding a stock exchange is to create an organized market for all types of securities the circulation of which is envisaged in the Czech and Slovak Federative Republic, thereby promoting the development of the financial market as a whole. Moreover, a stock exchange is to play an important role in the course of the

privatization process (particularly as an institution possessing a mechanism that allows objectification of the relevant prices).

In order to attain the aforementioned objectives, a stock exchange must:

- Operate as an independent market institution, separately from the government, and feature the necessary self-administration;
- Function as a public-benefit institution (with possibility to secure internally funds required for further development – in addition to funds for ordinary activities);
- Be an open institution, allowing other members to enter and preventing some members to exercise a dominant influence,
- Organize securities trading in a flexible and effective manner, to guarantee sufficient trading volumes, market transparency, sufficient liquidity, and to reasonably protect interests of parties to individual transactions.

2. Application of the above mentioned principles is associated with a selection of a corresponding concept concerning the legal status of the stock exchange, its bodies, powers of such bodies, internal organizational structure of the stock exchange, stock exchange trading rules, transaction types, organization of individual markets, method for determining prices (rates) and their monitoring (information system), settlement, payment system, delivery of document and deposit of securities, assessment of stock exchange fees, as well as the definition of tasks for the state supervision of the stock exchange activities.

It is advisable to leave most of the aforementioned tasks within the competence of the stock exchange. Prior to the stock exchange establishment, it is necessary to define the way some basic issues would be resolved in the Stock Exchange Act.

3. Legal status of the stock exchange

The stock exchange should have a special legal status that would make it possible to consider its specific nature, arising from the tasks to be undertaken by the stock exchange. In the light of this, we cannot recommend immediately applying some of the existing organizational legal forms used for business undertakings (e.g. joint-stock company, corporation), or a form of an association, since these forms generally do not cover the specifics of the stock exchange as an institution.

4. Stock exchange type

Since the expected volume of stock exchange transactions is not likely to be very high during the initial stage of the stock exchange existence, we recommend using a modern type of stock exchange with floor trading partially supported by computers.

5. Types of (stock) exchange transactions

Solely spot transactions should be permitted within the stock exchange of the Czech and Slovak Federative Republic. Term transactions should be excluded for some period of time (to be determined by the stock exchange bodies).

6. Trading method of price determination

Provided the transaction volumes are relatively low, an auction principle and the so-called order-driven system should be applied.

7. Over-the-counter transactions

During the initial stages of the stock exchange development, it is beneficial to restrict the scope of the OTC transactions. Banks should not be allowed to carry out such transactions.

8. Stock exchange bodies

The supreme body of the stock exchange shall be the General Meeting of the stock exchange members that elects an exchange council, supervisory committee, committee for the monitoring of the compliance with business ethics, and expert committees. The exchange council appoints a director (general secretary) of the stock exchange secretariat.

9. Stock exchange members

Legal entities with their registered office in the Czech and Slovak Federative Republic that hold a license to carry out activities in the area of securities trading and that comply with other terms and conditions defined within the stock exchange Articles of Association may become stock exchange members. It is assumed that the stock exchange members will recruit from banks and savings banks, as well as other legal entities and individuals (as appropriate) authorized to act as stockbrokers.

10. Settlement, payment system, delivery and depositing of securities

Smooth functioning of the above mentioned system is a precondition to normal stock exchange operations. The payment system, delivery and depositing of securities may be entrusted directly to the stock exchange (for the initial stage, where the scope of such transactions should be limited). A specialized organization is likely to be developed later that would be in charge of the payment system and delivery of documents. The issue concerning the deposit of securities would have to be resolved in connection with the expected scope of immobilization or later dematerialization of securities, as appropriate. The central register (depository) of securities should be established within the stock exchange (or central stock exchange in case several stock exchanges exist).

11. State supervision

State supervision shall be ensured by state inspectors for the stock exchange, appointed by the government of the Czech and Slovak Federative Republic or by the government of the Czech Republic/Slovak Republic, as appropriate (for regional stock exchanges, if established). Together with the enforcement of legislation and stock exchange regulations, the state stock exchange supervision should mainly accentuate the development of the business spirit of the stock exchange and of the securities market.

12. Number of stock exchanges in the Czech and Slovak Federative Republic

In case a single stock exchange is established within the territory of the Czech and Slovak Federative Republic, it would allow the highest possible market transparency, price objectification, as well as sufficient liquidity. This solution is optimal from the economic perspective; however, it is not realistic. The solution envisages the establishment of a single stock exchange with two branches – in Prague and in Bratislava – that must be interconnected and operate within a single mode. In the light of the necessary privatization, during which the stock exchange would assume an important role consisting in the trading in securities of privatized enterprises, another alternative solution may be taken into account. Such solution would consist in a two-level stock exchange system: 1<sup>st</sup> level (i.e. lower level) should consist of regional stock exchanges (about 4 to 6); such stock exchanges would be in charge of the privatization of the entire business sector (i.e. primary sector – i.e. primary sale of privatized enterprises' shares) as

well as the trading in securities of relevant regional companies that would be unable to comply with the strict listing requirements set down by the central stock exchange; 2<sup>nd</sup> level (i.e. higher level) of the stock exchange system would comprise a central stock exchange with its branches in Prague and in Bratislava. (Detailed description and rationalization will be included in the report for the government).

13. Founding a stock exchange

Stock exchange may be established by legal entities holding a securities trading license. For this purpose, no less than 10 founding members are required; none of the members may own more than 10% of assets; the capital required to set up a stock exchange shall be no less than CZK ..... Million (the limit would be lower for regional stock exchanges than for the “central” stock exchange, if applicable). The stock exchange foundation shall be subject to an approval by the Federal Ministry of Finance (or governments of the Czech Republic/Slovak Republic, as appropriate, for the regional stock exchanges).

14. Preparations for the establishment of stock exchange(s)

It is necessary to constitute a preparation committee for the stock exchange establishment of the Stock Exchange Commission, as appropriate. This body should not be considered a public administration authority and should not be directly connected to the government, as it should operate relatively independently (however, with the participation of Czechoslovak National Bank/Federal Ministry of Finance representatives).

Detailed proposal shall be included in the reported that is being prepared for the government.

Prepared by: *V.Pavlát*

15. Number of stock exchanges in the Czech and Slovak Federative Republic

In case a single stock exchange is established within the territory of the Czech and Slovak Federative Republic, it would allow the highest possible market transparency, price objectification, as well as sufficient liquidity. This solution is optimal from the economic perspective; however, it is not realistic. The solution envisages the establishment of a single stock exchange with two branches – in Prague and in Bratislava – that must be interconnected and operate within a single mode. In the light of the necessary privatization, during which the stock exchange would assume an important role consisting in the trading in securities of privatized enterprises, another alternative solution may be taken into account. Such solution would consist in a two-level stock exchange system: 1<sup>st</sup> level (i.e. lower level) should consist of regional stock exchanges (about 4 to 6); such stock exchanges would be in charge of the privatization of the entire business sector (i.e. primary sector – i.e. primary sale of privatized enterprises' shares) as well as the trading in securities of relevant regional companies that would be unable to comply with the strict listing requirements set down by the central stock exchange; 2<sup>nd</sup> level (i.e. higher level) of the stock exchange system would comprise a central stock exchange with its branches in Prague and in Bratislava. (Detailed description and rationalization will be included in the report for the government).

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Detailed proposal shall be included in the reported that is being prepared for the government.

Prepared by: *V.Pavlát*

## Appendix 3

### *Outline of the Uniform Dematerialized Securities Market Project in the Czech and Slovak Federal Republic*

#### Introduction

Arguments in support of voucher privatization have always stressed that the execution of this privatization method fulfills the following three, mutually interconnected goals:

- (1) Rapid privatization of the significant part of the Czechoslovak economy;
- (2) Evaluation of assets to be transferred to private ownership via voucher privatization;
- (3) Immediate establishment of foundation for the securities market.

The presented material addresses the third of the aforementioned goals. It shows that voucher privatization will result in the technological base that could be used for the capital market development.

The voucher privatization will, *inter alia*, result in the following:

- (a) Immediate formation of massive supply of and demand after securities;
- (b) Technological base that would enable securities trading as well as the regulation of such transactions in compliance with the principles customary in market economies.

#### 1. Exercising of shareholders' rights following the completion of one voucher privatization wave

Organizational arrangements of the voucher privatization are very simple:

On the supply side, there are hundreds of joint-stock companies and their shares. On the demand side, there are individuals that purchase their voucher books and register them in time.

Following the completion of a privatization wave, an offered set of several hundreds of millions shares (at thousand crowns per share) will be matched with several millions of holders of confirmed share orders. It is necessary to issue a written confirmation on the number of shares held (as well as names of specific titles/joint-stock companies) to all these individuals as soon as possible.

Moreover, it is necessary to allow all these individuals to factually exercise their shareholders' rights without any undue delay. Such rights include, but are not limited to: right to take part in the election of bodies of a joint-stock company, right to a share in the given company's profit, and right to sell one's shares at a market price.

#### 2. Share "accounts"

None of the shares that are sold for investment vouchers exist physically (in paper form). In addition to other factors, it would be technically very difficult and expensive to print such high numbers of shares simultaneously. In terms of exercising shareholders' rights, it is sufficient that such shares and ownership rights thereto are registered in a central computer's memory.

Each individual that registers as an owner of investment vouchers opens an account – figuratively speaking – in which the numbers/names (titles) of individual shares owned by are registered. After the completion of a privatization wave, each new shareholder receives a statement from his or her account.<sup>128</sup>

At the same time, individual privatized joint-stock companies receive list of their new shareholders. Based on the list, it is possible to convene General Meetings and reelect corporate bodies. Registration locations, where individual shareholders are registered, may arrange communication between the Board of Directors and such shareholders.

The same locations may also arrange the payment of dividends to individual members.

From the technical perspective, the most difficult thing is to ensure the third of the fundamental rights of each shareholder – i.e. the sale of their shares. The solution proposed herein assumes a dematerialized form of sale and purchase. Each transaction thus takes place as a transfer from one person's share account to another person's share account. Most of these accounts would already be opened during the voucher privatization. However, even those that do not take part in the voucher privatization may open their share accounts, provided they apply for such account with any registration location in a timely manner. The account application will be carried out by registering the so-called trading books. They are formally similar to voucher books. Each book contains two registration cards, 30 offer sheets and 20 order sheets. The price of a trading book would be similar to the voucher book price.<sup>129</sup>

The trading between individual share account holders will be similar to cashless (bank) payments. A transfer from one account to another will take place on the basis of a written order in the nature of a “payment order”.

### 3. Selling price of shares

The basic complication for the commencement of share trading is the fact that their market value is not known at the time. Shares have already undergone voucher privatization and relative valuations of the sold shares may be estimated on the basis of overall results. However, the absolute value of individual prices depends on the overall volume of funds people are prepared to invest in the share trading.

The market value of shares can only be determined by gradually nearing to it during auction rounds. Individual auction round stages would be fully analogical to the privatization round stages, as we know them from the voucher privatization process.

Each auction round is divided into the following four stages:

- (a) Publication of prices;
- (b) Offers and orders;
- (c) Processing offers and orders;
- (d) Announcement of the auction round results.

#### Publication of prices

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<sup>128</sup> For example of such account statement, see Annex no. 1.

<sup>129</sup> For example of an offer sheet, see Annex no. 2. For example of an order sheet, see Annex no. 3.

In case there are relevant reasons for the categorization (relative valuation) of individual joint-stock companies, it is possible to differentiate share prices of individual companies based on the expected demand during the first auction round already.

However, for the sake of simplicity, we will assume that each one-thousand crown share would be offered at CSK 100 during the first auction round.

### Offers and orders

Each account holder shall consider, whether they wish to sell or buy their shares at the given price. There is always a price, at which a shareholder is willing to sell at least one of his or her shares. However, there is also a price, at which the same shareholder is prepared to buy the same share. In addition to this, there is a wide range of prices, at which shareholders do nothing, as they would be satisfied with the number of shares currently owned.

For those, who wish to offer or order shares, the so-called offer and orders sheets will be printed. These sheets will be sold in books that would resemble voucher books in their format.

Offers (or orders) will be carried out by writing the relevant identification number of the offered (ordered) joint-stock company as well as the number of offered (ordered) shares.

Individuals shall, within a specified period of time, submit completed offer (order) sheets to any registration location of the said PVT network.

### Processing offers and orders

This stage will proceed similarly as during the voucher privatization. It is mainly centrally verified, whether the given account really contains at least the offered shares. The aggregate supply and demand is then determined for each joint-stock company.

In case supply exceeds demand, it is not possible to fulfill all offer sheets. In case demand exceeds supply, it is not possible to fulfill all order sheets.

### Announcement of results

Orders/offers will be settled in compliance with the “first come first served” principle. For this purpose, submission date and time shall be entered on each offer/order sheet. For example, the auction round results for company XYZ may be as follows: All orders shall be fulfilled; any offers submitted after 10:30 am on 27 November 1992 will not be fulfilled.

### Share market price

The process applied during the second auction round is similar to the first one. However, share prices adjust to the supply and demand ratio of the first round.

Shares of those companies, where supply exceeded demand, are sold at prices below CSK 100 per share during the second round. On the other hand, where demand exceeds supply, shares prices will go up.

A mathematical model will be constructed, on the basis of which it would be possible to carry out such adjustments automatically. This model will rely on experience acquired in connection with a similar model during the voucher privatization.

As call price draw near to market (equilibrium) prices, the duration of individual stages will decline. Once an equilibrium price is achieved, it will be possible to sell all shares in a very short period of time or even immediately.

#### 4. Trading in other securities and the regulation thereof

In addition to shares purchased for investment vouchers, any other securities may enter the above described system.

For example, the given mechanism may be applied to sell shares of individual joint-stock company for financial consideration. This means that this procedure may be used to privatize a single joint-stock company. Shares of such company are evaluated and then offered and ordered via the PVT network. The sales are, once again, carried out in compliance with the “first come first served” principle.

The same applies to any issuer of new securities (shares and/or bonds).

It is possible to enact such dematerialized sale system as the only legal form of securities trading. Such transactions could also be regulated pursuant to principles customary in developed market economies.

The key instrument of this regulation will be restrictions set down for opening share accounts. For example, new issuers may only open their accounts after they document their qualification/competence to issue shares.

Another regulation measure will consist in restrictions imposed on some account owners/holders. Such restrictions may relate to either volume or quality of sold/purchased securities, and are very likely to be temporary.

#### 5. Monetary accounts

Monetary (financial) accounts must be unambiguously assigned to each share account. When transactions are executed, payments from share acquirers’ accounts are transferred to such account or payments are made from such account for the purchase price of purchased shares. Demand (inquiries) cannot be partially or fully satisfied if the ordering party’s account does not have sufficient funds.

## **Tables**

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