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Lithuania: Financial Sector Assessment Program Update—Technical Note—IOSCO Objectives and Principles of Securities Regulation Assessment

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FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

REPUBLIC OF LITHUANIA

IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION ASSESSMENT

TECHNICAL NOTE

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INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS
DEPARTMENT

THE WORLD BANK
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VICE PRESIDENCY
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Contents Page

I. INTRODUCTION

1. **This Technical Note provides an analysis of the evolution of the observance of the IOSCO objectives and principles of securities by the Lithuania Securities Commission (LSC).**[1] The analysis focuses on the Core Principles for which there have been changes in observance since the IOSCO Detailed Assessment carried out in the framework of the Lithuania FSAP in 2001.[2]

2. **The analysis is presented principle by principle or for a group of principles depending on the nature of the findings by comparison with the Detailed Assessment (DA) of 2001.** The analysis does not cover Core Principles that were deemed to be fully implemented under the DA, except if evidence was found that any such principle is, in fact, not fully implemented to date.

II. PRINCIPLE-BY-PRINCIPLE ASSESSMENT AND RECOMMENDATIONS

CP2 **CP3**	*The regulator should be operationally independent and accountable in the exercise of its functions and powers* *The regulator should have adequate powers, proper resources, and the capacity to perform its functions and exercise its powers*
Assessment	The DA warned that attracting and retaining qualified staff is difficult for the LSC because of the requirement to adhere to civil service pay scales, and that the reliance on the state budget may decrease the operational independence of the LSC. It recommended that the LSC be given the authority to pay market-based salaries to its staff. The warning of the DA has not been heeded by the authorities. As a result, the LSC has only limited capacity to perform its functions and exercise its powers to date. Between 2005 and 2007, 75 percent of LSC professional staff moved mainly to the supervised sector. They are being replaced by recent university graduates who join LSC as their first job. The new staff are generally bright and fast learners, but most of them leave the Commission within 12 to 24 months. All LSC Departments are affected, but the situation is particularly acute in the Law and Enforcement Department, where there is only one senior legal

[1] This report was prepared by Michel Noel, World Bank.

[2] This analysis does not constitute a full or formal reassessment of the initial IOSCO Assessment, but is instead a targeted review.

	counsel left. His departure would leave LSC without adequate representation in court. There are no specialists with prior work experience in financial institutions, or with CFA, CPA, or any other certificate of proficiency as financial analyst, accountant or auditor. The fundamental reason for this situation is the large and growing gap between civil service pay scales to which the LSC is subjected and salaries for comparable positions in the private sector, in particular in the securities industry. To date, the pay gap is 2 to 1. It is projected to reach 2.7 times in 2008, and to widen further in the coming years. The situation is made worse by the tight labor market conditions resulting from the high migration of young graduates to other European countries. Under these circumstances, the LSC can no longer recruit specialists with the relevant market experience, and its ability to effectively supervise regulated entities is severely impaired LSC only carries out perfunctory surveillance of securities markets, and does not exercise adequate oversight of the governance structure and business practices of financial brokerages, investment funds, and the rapidly growing pension fund industry. LSC does not exercise adequate oversight of the rapidly expanding second pillar pension funds, in particular funds with aggressive investment strategies that concentrate on highly risky investments in regions such as the Balkans and in Ukraine, where asset valuations are highly dubious and the risk of asset loss through fraudulent market practices is very high. Failure of the LSC to effectively perform its market supervisory duties risks putting Lithuania in breach of implementation of several EU Directives, in particular the Market Abuse Directive (2003/6/EC), the Prospectus Directive (2003/71/EC), the Takeover Directive (2004/25/EC), the Transparency Directive (2004/109/EC), and the MIFID Directive (2004/39/EC). This situation is particularly concerning following the entry into force of the MIFID Directive in early November 2007, under which capital market intermediaries licensed in one EU Member State are allowed to operate in any other EU Member State upon simple notification to the host country by the home country supervisory agency. This opens the door for regulatory arbitrage, and for possible damage to the integrity of the single EU market by entities taking advantage of the defective supervisory framework in Lithuania as an entry point to deploy their activities across EU Member States.
Recommendations	The authorities need to redress this situation as a matter of utmost urgency. Specifically, the authorities need to change the legal status of the LSC and of its staff, and provide LSC with an adequate and

	sustainable source of funding, including fees from market participants, to enable it to pay market-based salaries to its staff. The LSC needs to develop and implement a comprehensive staff recruitment, development and incentive plan, aiming to endow LSC with a stable corps of experienced and dedicated supervisors with the relevant market experience in the areas of licensing, surveillance, inspection, investigation and enforcement. The change of status of LSC and of its staff and its securing of an adequate and sustainable funding base to pay market-based salaries to its staff should be implemented by the authorities without delay, as an integral part of the planned overhaul of the financial sector supervisory architecture. This is critical in order to maintain the effective supervision of domestic securities markets and non bank financial institutions and to avoid any potential damage to the integrity of the EU single financial market.
CP5	*The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality*
	The DA recommended that formal restrictions on Commissioners and staff being associated in a contractual, advisory or management position with licensed market intermediaries should be included in the Law on Securities, in addition to the general restriction in the law on civil servants. This recommendation has been implemented at the regulatory level. The Law on Markets in Financial Instruments (LMFI) adopted on January 18, 2007 prohibits Commissioners and administration employees of the LSC as well as their spouses from transferring acquired financial instruments which are traded on regulated markets of the Republic of Lithuania earlier than six months after their acquisition. The Law on the Adjustment of Public and Private Interests in the Public Service sets rigid limitations on concluding employment contracts and representation for former public servants. According to the Law, after leaving office in public service, a person shall have no right, within a period of one year, to take up employment as company head, deputy head, company board or management board member and run other offices directly related to decision-making in company management, property management, financial accounting and control, provided that during the period of one year immediately prior to the termination of his service in public office, his duties were directly related to the supervision or control of the

	business of such undertakings, or the person participated in decisions concerning these companies for obtaining state orders or financial assistance in the course of public contests or otherwise. Moreover the Law stipulates that after official separation from office in public service, a person may not, for a period of one year, represent natural or legal persons in the institution in which he held office or other central or local institutions on the issues which had been assigned to his official functions.
Recommendations	Provided that LSC is given the authority and the funding to establish market-based salaries for its staff, it should consider implementing a one-year cooling-off period preventing LSC staff from joining companies that they supervised at LSC.
CP7	*SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities*
	The DA recommended that, in order to avoid appearance of conflict of interest, employees of the Lithuania Stock Exchange (LSE) and of the Central Share Depository of Lithuania (CSDL) should be excluded from membership of the boards of securities firms as well as issuers whose securities trade on the organized market, and that staff from LSE and CSDL should not be allowed to perform tasks for those entities. The DA also indicated that the Association of Intermediaries of Public Trading in Securities (AITPS) has very limited resources and staff, and may not be able to ensure adequate compliance with its rules. These recommendations have been implemented at the regulatory level. The LMFI requires regulated markets to establish and maintain transparent and non-discriminatory rules, based on objective criteria and drafted and approved by the operator of the regulated market. These rules must be endorsed by the LSC prior to approval by the operator. The LMFI requires that regulated markets establish and maintain effective arrangements and procedures for the regular monitoring of the compliance by their members or participants with their rules. The LMFI requires regulated markets to monitor the transactions undertaken by their members or participants under their systems in order to identify breaches of those rules, disorderly trading conditions or conduct that may involve market abuse. The LMFI requires operators of regulated markets to report significant breaches of their rules or disorderly trading conditions or conduct that may involve market abuse to the LSC. It further requires the market operator of the regulated market to provide relevant information without delay to LSC related to

	possible infringements of the rules of the regulated market, and to provide full assistance to the LSC in investigating and prosecuting market abuse. Since the entry into force of the Market in Financial Instrument Directive (MiFID) on November 1, 2007, OTC trades are no longer reported to the exchange. Because the Trade Reporting System (TRS) is not operational to date, OTC trades are not reported by brokerages to LSC. In the meantime, LSC relies on daily data downloads from the Vilnius Stock Exchange (VSE) and from the Central Securities Depository of Lithuania (CSDL) to track on-exchange and OTC trades, respectively. LSC has joined the Scandinavian TRS project which includes not only a transaction reporting system, but also the creation of an analytical software to detect suspicious transactions. LSC has shared the cost of its creation with Scandinavian authorities. The TRS system is scheduled to be operational before the end of 2007. VSE has the right to impose pecuniary sanctions on its members (intermediaries) for the failure to prevent market abuse. VSE is currently introducing a suspicious transactions detection system (SMART) and intends to make the system operational at the beginning of 2008. The role of LSC will be to exercise market surveillance duties through quantitative and qualitative analysis of post-trade data to be received from the regulated exchange, the alternative market (*First North*) and brokers through TRS, and to supervise how VSE performs its surveillance duties, both for the main market and for the alternative market. The performance of CSDL as SRO is satisfactory. The AITPS is required by regulation to enforce the Code of Ethics for market intermediaries. However, in practice, AITPS fails to perform its responsibility as SRO. The LSC formally notified AITPS of this failure two years ago, without response.
Recommendations	Enhancing market surveillance is critical to ensure the integrity of the Lithuanian securities market following the entry into force of MIFID. LSC needs to take a number of priority actions to improve market surveillance. Specifically, LSC should (i) complete the ongoing implementation of TRS in collaboration with market intermediaries; (ii) extend TRS coverage to the SME First North market; (iii) carry out enhanced market surveillance through TRS and through SMART reports to be provided daily by VSE; and (iv)

	investigate breaches of the Code of Ethics by market intermediaries and sanction AITPS in cases when it fails to enforce the Code, in addition to sanctions applied to offenders.
CP10	*The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program*
	The DA indicated that industry participants remarked on the need to improve the qualification of inspections staff. As a result of the high staff turnover in the LSC in recent years, the LSC currently has few experienced staff to carry out market surveillance, inspections and investigations. The capacity of the LSC to be represented through experienced legal counsel in court cases is down to one senior counsel, severely threatening its enforcement capacity. The LSC is currently developing internal rules to implement risk-based supervision of market intermediaries as required under MIFID. To date, the LSC has no capacity to implement risk-based supervision of regulated entities.
Recommendations	Reducing staff turnover and building a corps of experienced and dedicated securities market supervisors is critical to enable the LSC to effectively exercise its powers of surveillance, inspection, investigation and enforcement. In particular, the LSC needs to attract and build a corps of supervisors with the capacity to carry out risk-based supervision of regulated entities. To achieve this objective, the authorities must proceed without delay with the reform of LSC status and funding as presented above (See CP2-CP3 Recommendations).
CP11 **CP12** **CP13**	*The regulator should have authority to share both public and non-public information with domestic and foreign counterparts* *Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with domestic and foreign counterparts* *The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiry in the discharge of their functions and exercise of their powers*
	The DA indicated that the LSC could not share confidential information (related to surveillance, investigations, commercially sensitive information, client identification or personal data) with

	other domestic or foreign regulators except for the criminal authorities in case of criminal prosecutions. The DA also indicated that a formal mechanism should be established to enable the LSC to provide timely and pertinent assistance to foreign regulators without recourse to cumbersome and narrower procedures reliant on court intervention. The problem has been solved at the regulatory level. The LMFI empowers the LSC to cooperate with supervisory authorities of other Member States. Such cooperation shall include information exchange, participation if conducting investigations, performance of other supervisory functions at the initiative of any of the supervisory authorities The LMFI empowers the LSC to cooperate with supervisory authorities of third countries, provided the information being communicated to third countries is subject to the requirements concerning the security of confidential information as defined under the provisions of the law pertaining to confidential information disclosure by the Commissioners and employees of the Administration of the LSC. The LSC is empowered to obtain existing telephone and existing data traffic record, and to communicate the materials and other information obtained during inspections to law enforcement authorities. In practice, the LSC has MOUs with regulatory authorities in other EU Member States, several bilateral MOUs with third countries, and a multilateral IOSCO MOU. However, neither Russia nor Ukraine is covered by bilateral MOUs or by the multilateral IOSCO MOU. In practice also, the LSC has requested access to telephone records on several occasions but this access has been denied. Access to emails would likely be denied as well because of the contradiction existing at the European level between the Telecommunications Directive and the Market Abuse Directive.
Recommendations	The LSC should sign bilateral MOUs with supervisory authorities in Russia and in Ukraine. The authorities should adopt laws and regulations empowering the LSC to have access to telephone and email records, upon resolution of the conflict between the Telecommunications Directive and the Market Abuse Directive at the EU level.

CP14 **CP 16**	*There should be full, accurate and timely disclosure of financial results and other information that is material to investors decisions* *Accounting and auditing information standards should be of high and internationally acceptable quality*
	The DA indicated that any insider buying or selling of shares of a listed company should be disclosed immediately and available publicly. Delays in such disclosure serve to shake the investing public's confidence and trust in the market. The DA also raised concerns that financial information filed with the LSC is not receiving the scrutiny which would permit the LSC to adequately assess its accuracy and completeness and detect possible infractions, because of the lack of professional resources within the LSC particularly with respect to accountants. Listed companies are required to provide the LSC with a list of persons who have access to inside information in the company. Any transaction by an insider must be reported to the LSE and to the LSC within 3 working days. However, there are serious deficiencies in the regulatory and enforcement framework for insider dealing (See CP28 below). Market participants report no problems in the review and approval process of applications for public offers, and praise the efficiency of the staff of the Issuer Department. Trades in securities of trading unlisted companies are not supervised by the LSC. Listed companies are required to prepare their financial statements in accordance with IFRS since 2005. Financial brokerages and asset management companies will have the option to prepare their financial statements in accordance with IFRS starting January 1, 2008. Starting January 1, 2008, the LSC will be responsible for supervising the implementation of IFRS by regulated entities and by issuers. To date, the LSC has no staff with an accounting degree, and therefore no capacity to deliver its responsibility to check the accuracy of financial statements filed by regulated entities. In addition, the LSC has no staff capacity to analyze the adequacy of risk disclosure in public offering documents or to check how funds

	are applied. The LSC does not vigorously pursue lapses in fulfilling disclosure requirements of public companies that do not trade frequently.
Recommendations	The authorities should extend the mandatory adoption of financial statements according to IFRS to asset management companies and financial brokerages. The ability of the LSC to build a corps of experienced and dedicated accountants is critical for it to deliver its responsibility to check the accuracy of financial statements filed by regulated market intermediaries, listed companies and companies trading through MTFs and through systemic internalizers. The LSC also need to build a corps of experienced and dedicated corporate risk analysts in order to verify the adequacy of risk disclosure in public offering documents.
CP20	*Regulation should ensure that there is proper and disclosed basis for asset valuation pricing and the redemption of units in a collective investment scheme*
	The LSC regulations provide for three alternative methods to value infrequently traded securities, i.e. (i) an independent certified asset assessment if the time lag from the last evaluation is less than one year and no important event which could meaningfully influence the price of the security has occurred; (ii) according to the P/E ratio of similar company times the profit per security of the evaluated company; or (iii) at fair value. The regulations do not provide a method or methods to calculate fair value.
Recommendation	The LSC should prepare and adopt a regulation with alternative methods to calculate fair value for different types of assets..
CP 22	*There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.*
	The DA identified deficiencies in capital adequacy rules for market intermediaries. The problem has been solved at the regulatory level. As of to date, all capital adequacy rules for market intermediaries are compliant with Basle II and relevant EU Directives. The LSC is responsible for supervising capital adequacy rules for all asset management companies and financial brokerages. Asset

	management companies that manage UCITs and do not provide investment services (individual portfolio management) are not subject to the Capital Requirement Directive. For asset management companies that are subsidiaries of banks, the supervisory responsibility can be transferred to the BoL starting January 1, 2008. The LSC has only very limited capacity to supervise the compliance of regulated entities with the capital adequacy regulations. In the short term, the problem is limited due to the small number of financial brokerage companies that trade on own accounts. In addition, the largest independent financial brokerage firm has notified the authorities of its intention to become an investment bank, and will therefore be supervised by the BoL. However, the limited capacity of the LSC will become an issue as investment funds develop following the adoption of the new law on investment funds, to become effective in March 2008.
Recommendations	The LSC needs to attract and build a corps of experienced and dedicated financial analysts to analyze the financial statements of regulated entities and to verify their compliance with capital adequacy regulations.
CP23	*Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.*
	Lithuania has fully implemented the detailed *know your client* provisions stemming from MiFID under the Law on Market in Financial Instruments and in the Rules for providing investment services and reception and execution of orders on behalf of clients adopted by LSC through Resolution No 1K-22 of 5/31/07. In addition, detailed *know your client* regulations concerning anti-money laundering/combating the financing of terrorism are set out in Resolution No 1K-12 "Concerning the approval of the regulation for financial brokerage firms, investment companies with variable capital, management companies and depositories on prevention of money laundering" adopted on 5/12/05 by LSC and in Resolution No 1K-20 "Concerning supervision of the international sanctions realization in regulations field of the LSC "adopted on 7/7/05 by LSC. The DA indicated that the enforcement of rules and regulations by

	the LSC would be more effective if its right to impose sanctions on individuals was included in securities market legislation, rather than in a general code, and maximum fines for individuals were considerably raised. The problem has been solved partially at the regulatory level. On the one hand, the LMFI empowers the LSC to impose sanctions on legal persons, and the Law on Securities (LS) empowers the LSC to impose sanctions on both legal and natural persons, and both contain substantial fines for specific violations. On the other hand, the fines imposed on individual persons under the General Administrative Code are low. The Ministry of Justice is currently preparing a new Administrative Code with increased fines.
Recommendations	The authorities should adopt a revised Administrative Code with increased fines.
CP24	*There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk*
	The DA recommended that adoption of a new legislation establishing an investment protection guarantee scheme to compensate investors due to failure of an intermediary, in compliance with EU Directive. The new legislation was adopted in 2002. The system was triggered in 2005 and the compensation mechanism performed smoothly within the required time frame.
Recommendation	n.a.
CP28	*Legislation should be designed to detect and deter manipulation and other unfair trading practices*
	Listed companies are required by law to disclose their insider list (See CP14 above) According to the Law on Markets in Financial Instruments (Article 62.5), issuers and persons acting in the name of, or in the account of, the issuers shall in the manner prescribed by the LSC furnish to the LSC the data (including personal codes) on persons entitled to have access to inside information by virtue of the employment contract or on other basis, and on persons related to the issuer. The definition of related parties also includes financial brokerages and auditors. These provisions are elaborated in the Rules on disclosure of Information about Issuers, approved on 12.17.04 by resolution 26 of LSC. Corporations filing for listing do not need to disclose shareholders

	and voting rights beyond the first level of control. In case a first-level shareholder is a legal person, the LSC has the right to request information on its shareholders. However, in several instances, such requests have been turned down citing banking secrecy. The LSC carries out investigations on ultimate controllers of issuers on a case by case basis. Financial brokerage companies have "black lists" identifying companies whose shares may not be traded by specific staff. However, these "black lists" are not communicated to the LSC. The interpretation of the Criminal Code by courts prevents the Prosecutor's Office from successfully prosecuting cases of insider dealing. Specifically, the courts consider that information shared by an insider with a related party becomes public information, and therefore no longer is insider information, undermining the possibility of successful prosecution of cases referred to the Financial Crimes Investigation Service (FCIS) of the Prosecutor's Office.
Recommendations	The LSC should issue a regulation requiring companies to disclose their ultimate controllers throughout the chain of control as part of their listing application, and to disclose any change in ultimate controllership following their listing. The LSC should issue a regulation requiring financial brokerage companies to share their "black lists" with the LSC. The authorities should revise the Criminal Code to exclude information shared by an insider with a related party from the concept of public information.