

**Capital market development through deep integration:
A roadmap for Georgia's approximation towards the EU legislation
- Summary of findings -**

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Outline

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- II. Obligations under the DCFTA: Interpretation and verification process
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I. Costs and benefits from convergence under the DCFTA

Priorities in the regulation of early-stage capital markets:

- Transparency at the point of issuance and through ongoing disclosure
- To limit 'self-dealing', including through insider trading and related party transactions

Borrowing credibility from a foreign jurisdiction (the EU) can be sensible for firms and the country as a whole, but many standards are home-grown:

- effective supervision, prosecutors and courts;
- a sound disclosure regime, in particular on ultimate ownership;
- the accounting profession;
- civil liability rules that sanction insider dealing;
- listing standards largely depend on corporate governance rules;
- rules that ban manipulation of trading prices;
- sound security analysis and a financial press.

I. Costs and benefits from convergence under the DCFTA

Potential costs of early or overly ambitious adoption of EU standards:

- listing costs and transparency requirements discourage issuance;
- compliance costs for other market participants, such as investment analysts discourage market entry;
- capital adequacy requirements for investment firms raise brokerage costs;
- Costs from the need to move towards formal trading venues as opposed to more informal 'over-the-counter' transactions;
- Costs of drawing up complex legislation outside the EU structures where EU regulations do not apply and EU supervisory agencies have no powers;
- Costs of subsequent supervision and enforcement;
- Curtailed market entry and investment from other countries.

II. The DCFTA: Obligations and verification process

- Market access benefits are liberal in Georgia but restrictive in the EU financial services sector
- **Art. 87** envisages “progressive liberalisation” on the basis of determination of gradual approximation
- **In the financial services area a full alignment with up to date EU legislation would be required for further liberalisation**

Reservations with regard to national treatment or MFN for cross-border supply of services

EU*		Georgia	
<i>Mode 1</i>	<i>Mode 2</i>	<i>Mode 1</i>	<i>Mode 2</i>
33	13	2	0

Reservations with regard to national treatment or MFN for establishment in service sectors

	EU party reservations		Georgia reservations
	<i>EU-wide reservations</i>	<i>Member state-specific reservations</i>	<i>Georgia</i>
Horizontal reservations	2	31	4
Sectoral reservations	30	98	28
Total	161		32

Source: Emerson and Kovziridze (2016).

Timeline for approximation under Art. 122 and Annex XV-A

5 years starting Sep 2014	6 years	7 years	New/replaced legislation with unclear timeline
Market infrastructure: <ul style="list-style-type: none"> Financial collateral arrangements Finality of settlement 	<ul style="list-style-type: none"> Investor compensation schemes Undertakings for the collective investment in transferable securities (UCITS) Directive 	<ul style="list-style-type: none"> Organisational requirements for investment firms Record-keeping Prospectus Directive and Regulation Transparency requirements Credit Rating Agencies 	<ul style="list-style-type: none"> Markets in Financial Instruments Directive (MiFID) II Market Abuse Regulation

Source: ADB diagnostic study of the capital markets of Georgia

II. The DCFTA: Obligations and verification process

- **‘Approximation’** still to be defined legally
- A common standard needs to be applied to commitments made under Ukraine and Moldova DCFTAs
- It is not:
 - Transposition (full reflection of an EU directive in domestic law)
 - Regulatory equivalence (high standard under which the EU Commission determines equivalent results and enforcement)
- Absence of direct powers of EU supervisory agencies, and of ‘level 2’ legislation needs to be reflected
- Working definition: replicate key principles and objectives of EU legislation

II. The DCFTA: Obligations and verification process

‘Dynamic approximation’

- Art. 418: Association Council to “periodically revise and update Annexes [...], including in order to reflect the evolution of EU law and applicable standards set out in international instruments...”
 - “good faith” application by Georgia would reflect marginal updates that are within the scope of the 2014 commitments (eg UCITS)
 - Major revisions likely deemed to be outside the agreement (eg MAR, and MFiDII)
- **Georgia potentially needs to converge to the ‘moving target’ of the entire EU capital markets legislation.**
- **But there is no presumption on the pace and deadline for this process.**

II. The DCFTA: Obligations and verification process

Verification process (Art. 419-421)

- “continuous appraisal of progress in implementing and enforcing measures covered by this Agreement”.
- “Monitoring shall include assessments by the EU of the approximation of Georgian law to EU law as defined in this Agreement, including aspects of implementation and enforcement.”
- “general or specific measures” and application in “good faith”
- Dispute settlement, though no clear sanctions defined
- **Georgia will be held accountable for approximation, including for implementation, though there is considerable flexibility to demonstrate application in “good faith”. No clear sanctions are defined.**

III. A roadmap for approximation

Potential principles for approximation:

- Prioritize strengthened transparency constraints on ‘insider-dealing’.
- Prioritise legislation in light of actual market development (eg define investment funds) but delay implementation of what is as yet irrelevant.
- Replicate key legal principles, though adapt numerical thresholds and ‘level 2’ rules to local environment
- Where conflicts arise, opt for IOSCO as a ‘stepping stone’ towards later adoption of EU law
- Build adequate powers and resources for enforcement

III. A roadmap for approximation

DCFTA obligations that are sensible

- **Prospectus Regulation.** Simplifies earlier Prospectus Directive (a DCFTA obligation within 7 years of entry into force). EU Growth Prospectus to cater for smaller issuers. Set threshold to capture most potential issuers.
- **Transparency Directive** (within 7 years). Frequency and scope of regular disclosures for listed firms. Work with auditing profession to upgrade non-financial information.
- **UCITS Directive** (within 6 years). A successful format for retail funds also replicated in other emerging markets, though frequent revisions.
- **Post-trade infrastructure** (settlement finality and collateral arrangements, within 5 years).

III. A roadmap for approximation

DCFTA obligations that are sensible in principle but require wide-ranging adaptation

Market Abuse Regulation (supersedes the 2003 Directive, which was included as a DCFTA obligation).

- Addresses advanced market segments (eg commodity trading and derivatives) and conduct issues that were exposed by the financial crisis (eg benchmark manipulation)
- Insider trading difficult to define in an illiquid market
- Risk that comprehensive definition and criminal sanctions discourage market entry
- Corporate governance code and enforcement a key priority

III. A roadmap for approximation

DCFTA obligations that are excessive or irrelevant

- **MFiD which became MFiDII/MFiR** (adoption of IOSCO principles should be priority).
- **Credit Ratings Regulation** (not relevant).
- **Investor compensation scheme Directive** (potentially costly and it would be difficult to contain abuse)

The scope of potential further updates

Securities Markets					Investment Firms	
[Prospectus Directive]* ⁴⁸	Transparency Directive* ⁴⁹	Listing Directive ⁵⁰	Short Selling Regulation (SSR) ⁵¹	Takeover Bids Directive (TBD)* ⁵²	Financial Conglomerates Directive (FiCoD)* ⁵³	Banking Directive (CRD IV)* ⁵⁴
Prospectus Regulation ⁵⁵						Proposal CRD V* ⁵⁶
Market Abuse Regulation (MAR) ⁵⁷	Investor-Compensation-Schemes Directive (ICSD) ⁵⁸	Financial Collateral Arrangements Directive* ⁵⁹	Credit Rating Agencies Regulation (CRA) ⁶³	Markets in Financial Instruments Regulation (MiFIR) ⁶⁰	Banking Regulation (CRR)* ⁶¹	Proposal CRR Amendment* ⁶²
						Annual Accounts and consolidated Accounts of Banks Directive* ⁶⁴
						Banking Recovery and Resolution Directive (BRRD)* ⁶⁹
Market Abuse Directive II (MAD II) ⁶⁵			Benchmark Regulation ⁶⁶	[Markets in Financial Instruments Directive (MiFID) ⁶⁷]	Markets in Financial Instruments Directive II (MiFID II) ⁶⁸	
Key Information Document Regulation (KID/PRIIPs)* ⁷⁰	Securities Financing Transactions Regulation* ⁷¹				Single Resolution Mechanism Regulation (SRMR)* ⁷²	TLAC Proposal* ⁷³
Proposal CCP Recovery and Resolution Regulation* ⁷⁴	Shareholder Rights Directive* ⁷⁵				Proposal Loss-Absorbing and Recapitalisation Capacity Regulation ⁷⁶	Proposal Insolvency Hierarchy of Unsecured Debt* ⁷⁷
Proposal STS Securitisation Regulation* ⁷⁸	Amending Proposal (long-term shareholder engagement)* ⁷⁹					

Investment Vehicles			Market Infrastructure (Clearing & Settlement)	
Undertakings for collective Investment in transferable Securities Directive (UCITS IV) ⁹³	European Venture Capital Funds Regulation (EuVECA) ⁹⁴	Alternative Investment Fund Managers Directive (AIFMD) ⁹⁵	European Post-Trade Forum (EPTF) ⁹⁶	
	European Social Entrepreneurship Funds Regulation (EuSEF) ⁹⁶		European Market Infrastructure Regulation (EMIR) ⁹⁷	Settlement Finality Directive (SFD) ^{*98}
Key Information Documents Regulation (KID/PRIIPs) ^{*109}	Proposal amending EuVECA and EuSEF ¹⁰⁴	European long-term investment fund Regulation (ELTIFs) ¹⁰⁵	Proposal amending EMIR ¹⁰⁰	Financial Collateral Arrangements Directive ^{*101}
			Proposal 3rd Country CCPs in EMIR ¹⁰²	
Application date of PRIIPs ¹⁰⁷	Amending Proposal (long-term shareholder engagement) ^{*108}	European Strategic Investment Fund Regulation (ESFI) ¹⁰⁹	Proposal CCP Recovery and Resolution Regulation ^{*106}	Central Securities Depositories Regulation (CSDR) ¹¹⁰
			Proposal ESFI 2.0 Regulation ¹¹¹	
Money Market Funds Regulation (MMF) ¹¹²	Securities Financing Transaction Regulation ^{*113}			

IV. Key recommendations

- Dynamic of legislative convergence lends credibility to Georgian markets. This process should be supported and be better publicised by both sides.
- Full alignment (equivalence) and further EU market opening should not be seen as policy objectives for the coming years.
- Delivery on the 2014 commitments could be through the prospectus and transparency legislation, investment funds, and 'post-trade' rules.
- Otherwise, and where EU legislation is in conflict or overly complex, IOSCO Principles could be a stepping stone towards EU standards.
- Whatever is legislated needs to be backed by adequate supervisory capacity and enforcement powers.
- A note should be submitted to the Association Committee to clarify implementation status and propose a future strategy for convergence.
- NBG and government should seek a high level dialogue with the EU Commission to agree interpretation of 2014 DCFTA and agree priorities going forward.

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