THE ACT ON SECURITIES AND INVESTMENT SERVICES

Ing. František Palko, Ministry of Finance of the SR

The Act on Securities and Investment Services (hereinafter the "Securities Act"), which came into effect on 1 January this year, forms, together with the new Banking Act, the new Act on Insurance Business, the new Act on the Stock Exchange and the new Act on Supervision of Financial Market, an inseparable part of an integrated and recodified legislation governing the operation of players in the Slovak financial market. The strategic goal of this process is to renew the credibility of the financial market in Slovakia through the incorporating the necessary legislative bases for its effective and transparent development.

The reasons for the adoption of the new Securities Act may be summarised in the following seven points:

1. creating a standard, internationally accepted legislative environment for the capital market matching the requirements for full membership in the OECD and EU;
2. setting clear rules for the provision of investment services and capital adequacy rules for securities dealers;
3. arranging conditions for issuing securities, in particular securities issued on the basis of a public offering;
4. improving the standard of information disclosure on the part of issuers of securities issued on the basis of a public offering;
5. enabling the application of tools and procedures for securities trading that are customary in developed capital markets;
6. creating room for making the institutional side of the capital market more efficient, especially the securities registration system and clearing and settlement of securities deals;
7. improving the standard of the protection of clients of securities dealers and capital market investors.

General Features of the Securities Act

The Securities Act creates room for institutional reform of entities involved in the Slovak capital market so as to create conditions for the standardisation of this market with that of the European Union. The changes concern not only securities dealers, but also the central depository, whose functions today are in large part performed by Stredisko cenných papierov SR, a.s. (the Securities Centre of the SR), and also the Financial Market Authority, which performs supervision over the capital market.

In the case of both securities dealers and the central depository, the principle of consolidated supervision has been introduced, as in the case of banks, which means that the Financial Market Authority will be able to acquire information relevant for its activities not only from securities dealers and the central depository, but also from persons with whom these are interconnected in terms of assets, or those having control over them.

Significant changes have occurred already at the stage of granting an authorisation for securities dealing. An applicant will have to prove the suitability of shareholders interested in founding a securities dealer entity, the origin of funds to be used for the registered capital of the securities dealer. Securities dealers will have to meet professional, technical and organisational eligibility criteria for their activities and the Financial Market Authority will at the same time approve persons nominated as members of a statutory body and management. The Act will make it possible for the Financial Market Authority, through the presentation of information required on a regular and irregular basis, to perform supervision of these entities based on "ex ante" principle, thereby strengthening the preventive function of supervision in line with international trends among supervisory authorities.

There is also to be a change in the case of the central depository, which will be allowed to provide a whole spectrum of services common to institutions of a similar nature in developed capital markets, i.e. including the provision of non-core investment services and services associated with the clearing and settlement of the capital market trades on a DVP basis (delivery versus payment). These services should be provided on the basis of a membership principle, where the Act creates enough room most notably for market participants using the services of the central depository to participate to the greatest possible extent in the activities of an institution of a central depository nature. Under the new system, an small investor will not come into direct contact with the central depository, only with its members.

The Act encompasses an integrated regulatory framework for the activities of the central depository, ranging from setting conditions for granting authorisation (with criteria comparable to those for granting authorisations to banks) through a precise definition of authorised activities and the monitoring of its activities (no fewer than on a consolidated basis) by the Financial Market Authority, to conditions under which the central depository may cease to perform its activities.

The Act provides the Financial Market Authority with sufficient regulatory mechanisms to influence the activities of the central depository. For example, it requires the prior

consent of the Financial Market Authority for any change in the shareholder structure of the central depository, for a reduction of its registered capital, for the election of members of the board of directors and the supervisory board and for the appointment of a registered agent.

Other changes relate to widening the powers of the Financial Market Authority. In line with practice in developed market economies, the Financial Market Authority must possess a sufficient range of tools to take remedial action for the purposes of pursuing its mission. The Securities Act envisages the imposition of sanctions on entities licensed under it, as well as to entities forming a part of the consolidated group of a securities dealer and the central depository.

Where the Financial Market Authority reveals any shortcomings in the activities of licensed entities, consisting of a failure to comply with the conditions stipulated in the respective authorisations or a failure to comply with or circumvention of provisions of generally binding legislation relating to the conduct of their activities, it may, depending on the seriousness, degree of fault and the nature of shortcoming revealed, choose from among a range of tools, including the introduction of forced administration and withdrawal of the authorisation for the activities of the securities dealer.

Depending on the seriousness and nature of the violation, the Financial Market Authority may impose a penalty upon a member of a statutory authority or a member of the supervisory board of a securities dealer or the central depository, the head of a branch of a foreign securities dealer, a registered agent or an executive of a securities dealer or the central depository for the breach of obligations arising to them from the Act or from other generally binding legislation relating to the performance of investment services, from the articles of association of a securities dealer or the central depository, or for the breach of conditions or obligations imposed through a decision issued by the Financial Market Authority. Under the Act, a securities dealer or the central depository is obliged to withdraw from his position, without undue delay, a person who through the valid imposition of a penalty has ceased to be trustworthy.

The Securities Act also addresses the issue of legal provisions governing entities that collect funds from the public and conduct business using these funds. It stipulates that this activity may be performed only on the basis of a public offering, whereby the money manager is obliged to present to the Financial Market Authority the prospectus of an investment before carrying out its project. Without this approval, the money manager will not be allowed to collect funds from the public for further business activities. At the same time, the money manager will have to meet its disclosure obligations both in respect of the Financial Market Authority and its investors and the public.

Investment Instruments

The Securities Act arranges the activities of a securities dealer from the point of view of conducting individual investment services in relation to particular investment instruments. Investment instruments comprise certain types of securities and financial derivatives, whose essential feature is that they are the subject of investment, into which entities invest their disposable funds, and are traded in the capital market and in some instances also in the money market.

Instruments classed as investment instruments include shares, bonds, units, fungible securities with which the right to acquire shares or bonds is associated (such as interim certificates), fungible securities establishing the right to settlement in cash except for bank-books, bills of exchange, checks and traveller checks (such as treasury bills), securities issued outside the territory of the Slovak Republic, to which similar rights as to securities pertain, and from among derivatives they include financial futures relating to securities and cash in local and foreign currencies.

Unlike forward rate agreements (FRA), financial futures are standardised contracts traded in organised markets and they particularly encompass securities futures including securities indices, as well as currencies and interest rate futures. As is clear from their name, commodity futures cannot be classed as financial futures. Investment instruments are also represented by other instruments normally employed in the financial markets, such as interest and currency swaps and share swaps and put or call options for investment instruments, currency options and interest rate options.

Investment Services

Under the Securities Act investment services are broken down into core and non-core. The basic feature of an investment service is that it is provided to a third party (a client) on a professional basis. Investment services may be provided only on the basis of an authorisation granted by the Financial Market Authority, where entities providing these services must have sufficient capital in line with the set rules. The Act concurrently requires that individuals who manage the business of a provider of investment services are of sufficiently good repute and are sufficiently experienced.

Included among the main investment services that can be performed only on the basis of an authorisation are the receipt and transmission of an order relating to investment instruments, the execution of orders to sell or buy investment instruments for the client's account or on the account of a securities dealer, the management of a portfolio formed of one or several investment instruments as commissioned by the client under a contract on the management of a securities portfolio and underwriting of investment instruments or their placement.

The receipt and transmission of an order relating to investment instruments means the receipt of the order assuming that the entity that has received it will either execute it itself (if it has such an opportunity, e.g. is a member of the Stock Exchange) or will transmit it to a third party for execution. This service will be used especially in the case where a client commissions a person performing investment ser-

vices to buy or sell an investment instrument on his behalf and since this person cannot execute this sale or purchase (for example because he is not a member of the stock exchange where the security is traded), this person will transmit the sell or buy order to a third party who will execute it.

The execution of orders to sell or buy investment instruments for a client's account means the execution of these orders on one's own behalf or on behalf of the client and for the client's account. This means that a securities dealer will buy or sell some investment instrument in his own name or in the client's name and for the client's account.

The execution of orders to sell or buy investment instruments for one's own account means that a securities dealer will execute the client's order in such a manner that it will sell investment instrument to the client from its own assets or buy the investment instrument from the client. If an entity providing investment services buys an investment instrument for its own account on the basis of a client's order, in addition to the client – investment service provider relationship, also a buyer – seller relationship is formed between the client and the securities dealer.

The management of a portfolio comprising one or more investment instruments in accordance with the client's commission under a contract pursuant to § 43 of the Securities Act constitutes management of the client's assets.

Underwriting of securities or their placement means the acquisition of any investment instrument from the issuer in the primary market when investment instruments are being issued with the aim of their sale to other persons including a commitment to buy the unsold tranche, or the performance of services associated with the placement of an investment instrument in the secondary market.

The Act also defines non-core investment services that securities dealers are allowed to perform, providing that these services have been listed in their authorisation. Under this Act, no other entities than securities dealers are permitted to carry on custody and management of securities. From the provisions of this Act, the Banking Act or the Foreign Exchange Act it follows that only banks and securities dealers will be permitted to make loans and lend to clients, as well as to accept funds from clients when providing investment services. Other non-core investment services (advice on business strategy) are governed by the Act only where such services are provided by securities dealers, which means that the Act does not impose limitations upon their provision by other persons (such as auditors or attorneys). It is left to the client's discretion to decide whether he will request consultation from a qualified licensed entity subject to supervision or another person.

Securities Dealer

A securities dealer is a joint-stock company that provides at least one core investment service. An authorisation from the Financial Market Authority is required for such activities. Authorisation of entities providing investment services and supervision over them is a must as regards the safe functioning of the financial sector and for creating optimum conditions for investors. Making it possible to take up the business of investment services exclusively on the basis of an authorisation granted by a competent authority is one of the basic conditions required by the Directive on investment services in the securities field.

In contrast to statutory provisions in place so far, securities dealers are forbidden under the Act, with a view towards protecting the clients and their funds, to carry on activities other than investment services. In the interest of transparency of ownership relations it is stipulated that a securities dealer founded as a joint-stock company may only issue registered shares in book-entry form. Depending on the type of services provided, a minimum amount of registered capital is set for securities dealers as one of the capital adequacy requirements.

The conditions, which a securities dealer must meet in order to be granted an authorisation for its creation and activities, are directed at transparency of funds, suitability of future shareholders of the securities dealer, professional fitness and trustworthiness of persons nominated as members of statutory body and the management and transparency of relationships within an interconnected group, to which also a shareholder with a qualifying holding in the securities dealer belongs.

Apart from other requisites, an applicant must prove the suitability of persons to become shareholders with a qualifying holding in the dealer. This requirement is due to the fact that a supervisory authority is obliged to assess the dealer's ownership structure. What is required when the suitability of a potential shareholder is assessed, is veracious proof of the transparent and credible origin of the money invested in the registered capital and also its reliability in terms of requirements on the safe functioning of a securities dealer and the financial sector as a whole. The abovementioned facts are verified so that an authorisation for the establishment and activities of a securities dealer is not issued to shareholders whose background is unclear or unsuitable (such as to persons coming from tax havens or persons connected to such centres) or to persons whose main line of business is not a guarantee for the safe performance of financial services and might be threat to the stability of the financial sector. This would for example hold true for persons who are not of a good business repute, do not exhibit probity as citizens (in the case of a natural person) or are not able to prove transparency in their financial and property relationships to other entities. Another precondition for the authorisation to be granted is that a securities dealer shall conduct a substantial part of its activities within the territory of the Slovak Republic.

The conditions on the basis of which a securities dealer has been granted an authorisation, must be observed by this dealer throughout the entire time of its being in existence, until this authorisation ceases or is withdrawn from it.

Under the Act, the institute of prior consent, to be granted

by the Financial Market Authority, has been introduced. Prior consent from the Financial Market Authority is required for:

a) the acquisition or exceeding of a holding in the registered capital of a securities dealer or in the voting rights of a securities dealer, with the level at which the holdings start to be reviewed proposed to be 10%, whereby any significant influence of shareholders on the business done by a securities dealer shall be identified;

b) reduction of registered capital, where its reduction on account of clearing with another party is not involved;

c) the election of persons nominated as members of the statutory body of a securities dealer, the head of a branch of a foreign securities dealer aimed at assessing their professional fitness and trustworthiness;

d) a change in the registered office of a securities dealer, which is important in terms of the effective performance of state supervision;

e) a merger, amalgamation or division of a securities dealer, including a merger between another legal entity and the securities dealer in order to provide for transparency of ownership relationships of the securities dealer and the influence of the supervisory authority on such a design of the securities dealer's business strategy that would be in line with conditions under which the securities dealer has been granted the authorisation;

f) the sale of a securities dealer or of its part on the same grounds as mentioned earlier, including the respectable pursuance of the interests of clients of the given dealer;

g) the activities of a member of the central depository.

With regard to the special nature of a securities dealer, requirements as to its management and organisation are laid down in the Act, which differ from those set on other business entities that are subject to the Commercial Code only, such as a requirement concerning the internal control system, the information system or a requirement to include in the organisational structure a unit or an employee to be in charge of prevention or identification of laundering of proceeds from criminal activities.

In its internal rules of operation a securities dealer is obliged to set out the types of transactions over financial instruments that can be executed by members of the board of directors, the supervisory board and by other employees.

The Act also imposes an obligation on a securities dealer to arrange its relationships with members of the statutory body through a mandate contract on the position to be held. The Act goes beyond the provisions of the Commercial Code in requiring that these management contracts make it possible to enforce liability against members of the statutory body and the head of a branch of a foreign securities dealer for actual damage caused to the company in conducting their office, if obligations arising from laws and other generally binding legislation, the articles of association of a securities dealer and other internal management acts are violated.

Basic rules that a securities dealer should abide by in its relations with clients are laid down directly in the Act. These rules are directed at guaranteeing due care and honesty in providing investment services and at ensuring that the client is fully informed about a transaction undertaken. These rules aim to minimise the risk that a client is injured by a securities dealer, either intentionally or due to insufficient care taken.

Under the Act, a securities dealer is charged with an obligation to maintain the adequacy of its own funds. A securities dealer is obliged to maintain capital adequacy at a level of at least 8% on an individual as well as consolidated basis as part of the consolidated group it controls.

A securities dealer is also charged with an obligation to maintain records on orders received from clients and deals concluded on the basis of these orders. These records are to serve the securities dealer itself on the one hand and are an important source of information for performing supervision on the other. Besides the data prescribed by law, such records may also contain other details according to the securities dealer's discretion and may also be maintained in electronic form.

Apart from basic obligations with regard to accounting records to be maintained stipulated in the Accounting Act and other generally binding legislation, a securities dealer is obliged to also observe the rules set out in the Securities Act. Assets and liabilities denominated in foreign currencies must be converted to Slovak koruna on a daily basis and statutory financial statements must be compiled not only as at the last day of a calendar year, but also as at the last day of each calendar quarter.

At the same time, an obligation is imposed on auditors, who are to audit the financial statements of a securities dealer or of persons who form a closely interconnected group with the dealer, to notify the Financial Market Authority of any fact that has come to their attention during the course of their activities, which bears evidence of a breach of statutory obligations by a securities dealer, or which may lead to the rejection of annual financial statements or an expression of qualification.

Under the Act, a securities dealer is charged with reporting obligations vis-à-vis the Financial Market Authority and the Ministry of Finance of the Slovak Republic. A securities dealer is under an obligation to submit to the Financial Market Authority and the Ministry of Finance of the Slovak Republic a half-yearly and annual financial reports, notify the Financial Market Authority of any changes in its financial position which could threaten its solvency and report any deal involving investment instruments accepted for trading on the Stock Exchange, a foreign stock exchange or a foreign regulated public market, even where such a deal has been executed outside an organised market.

The obligation to notify the Financial Market Authority also applies to persons wanting to reduce their holding in the registered capital of a securities dealer below 50, 33, 20 or 10%.

(to be continued in the 12/2002 issue)