

PROGRAM TO SUPPORT CAPITAL MARKETS MODERNIZATION

(TC-98-03-26-5-BH)

EXECUTIVE SUMMARY

BENEFICIARIES: The Securities Board of The Bahamas and the Bahamas International Securities Exchange (BISX)

EXECUTING AGENCY: Ministry of Finance and Planning of The Bahamas

SPECIFIC OBJECTIVES: This project will assist the Government of The Bahamas to: (a) upgrade the existing Securities Board to provide the expertise and authority to adequately regulate primary and secondary trading of securities; (b) support the development of the Bahamas International Securities Exchange (BISX) through training and structural guidelines; and (c) promote, and educate the public about, the upgraded Securities Board and the newly formed BISX.

**PROJECT COST
AND FINANCING:**

Execution period:	20 months
Disbursement period:	24 months
Modality:	Grant- Facility I
Local counterpart:	\$300,000
MIF:	\$500,000
Total:	\$800,000

**SPECIAL CONTRACTUAL
CONDITIONS:**

The Bank will require that the Securities Industry Bill be approved by Parliament before the first disbursement is made.

I. COUNTRY AND PROJECT ELIGIBILITY

- 1.1 The Bahamas was declared eligible for all modalities of MIF financing by the Donor Committee on March 22, 1995. The proposed project conforms with the basic strategy presented in the Country Paper for The Bahamas, which proposes Bank support for Government's ongoing objectives of facilitating a stronger private sector led economic development strategy.
- 1.2 The creation of a stock exchange with provisions for regulation and oversight represents a further step by GOBH to build on its already diversified and well developed range of financial products available to local and international investors.
- 1.3 The stock market is expected to assist in development of the local capital market by providing alternative sources of investment finance. Further, the established international image of The Bahamas as a sound offshore financial center, as well as locational proximity to the US and similar time zone to New York, is expected to attract listings of foreign securities. Objectives under the ongoing MIF initiative aimed at modernizing stock exchanges in four Caribbean territories including The Bahamas, are also expected to be complemented and advanced by the two main objectives of this project, namely, operationalization of the regulatory mechanisms and technical support for the establishment of an active exchange. The scope of equity's market operations is expected to be enhanced also by the prospective privatization of various government owned entities. It also conforms with the strategy of raising the standards of the capital markets throughout the Caribbean region. In addition, the proposal complies with the criteria for technical cooperation financing, which authorizes the use of concessional funds for supporting regulatory institutions.

II. BACKGROUND

- 2.1 In September 1995, the MIF funded a Regional Technical Cooperation for the Harmonization of Capital Markets in The Caribbean. The project aimed at establishing regional standards for trading, clearing and settlement systems, and strengthening the self-regulatory systems of the exchanges. The project covered five countries: The Bahamas, Barbados, the Dominican Republic, Jamaica and Trinidad & Tobago. All of these countries with the exception of The Bahamas had existing stock exchanges, with varying degrees of self-regulation and manual methods of clearing and settlement. The project was able to install, with varying degrees of success, a centralized securities depository in the other Caribbean countries using the EFA clearing and settlement software, as well as to upgrade the self-regulatory systems for these countries.
- 2.2 The project in The Bahamas, on the other hand, was more complex because there was no existing stock exchange, regulatory agency or Securities Law. Therefore the first tasks were: (a) to support the creation of the Securities Board, which is a government entity

designed to oversee the securities market; and (b) to help draft the Securities Industry Bill for ultimate passage by the government. The Bill was drafted in mid 1997, but since has undergone many reviews and should be passed in the near future. The Securities Board has been set up and currently has 12 staff members, which concentrate on overseeing the large international mutual funds industry and various compliance issues, but do not regulate the small over-the-counter (OTC) market. The Government of The Bahamas has expressed its strong continuing support for the Securities Board through the authorization of a budget to support both the current level of staffing at the Securities Board, as well as for a modest expansion of staffing.

- 2.3 A secondary goal of the project was to help establish a stock exchange in The Bahamas. Thus far a working plan and budget have been formulated for the Bahamas International Securities Exchange (BISX), but it has not been formed to date because the private sector is awaiting the passage of the Securities Industries Bill. The BISX, as envisioned now, would have two tiers: the domestic tier and the international tier. The domestic tier would have domestic stocks and mutual funds, and possibly public debt instruments. The international tier, on the other hand, could attract any number of instruments: international mutual funds, international Initial Public Offerings (IPOs) seeking offshore funding, Global Depository Receipts (GDR), or preferred shares of multinational companies under an International Business Company (IBC) structure. Clearly any of these products would have to have internationally competitive advantages vis-a-vis other exchanges.
- 2.4 The third goal of the project, to set up a centralized securities depository (C.D.) in The Bahamas, has not been fulfilled because there is still no entity to install the clearing and settlement software from EFA Software, which was used in the other Caribbean countries of the MIF regional project. The Central Bank already has made a \$57,250 commitment to EFA, with the remaining funds of \$35,750 to be paid once the software is installed. Once the software is installed, a number of other issues remain: defining the settlement times (e.g., T+5 at first, moving later to T+3), immobilization of securities at a centralized location, and delivery versus payment (D.P.) of securities. All of these suggestions would, if implemented, reduce the considerable settlement risk in the current system of broker to broker trading on the over-the-counter market.
- 2.5 The Bahamas has become a stabilized and prestigious financial center in the Caribbean. This is partly so because it provides high quality services and supervision and legal and regulatory framework which do not encourage money laundering and other forms of financial crime. The establishment of a stock market will complement the traditional financial activities of The Bahamas. The project shall see that it also complies with international standards of efficiency and transparency in the trading of securities.

III. PROJECT OBJECTIVES AND COMPONENTS

A. Project objectives

- 3.1 The overall goal of the project is to support the development of the emerging capital markets of The Bahamas by upgrading the safety and soundness of the regulatory structure and the primary and secondary trading of securities to be in line with currently accepted international standards, as well as harmonized with other Caribbean markets. These upgraded facilities are critical for private sector development in The Bahamas. The project will: (a) upgrade the existing Securities Board to provide the expertise and authority to adequately regulate primary and secondary trading of securities; (b) support the development of the Bahamas International Securities Exchange (BISX) through training and structural guidelines; and (c) promote and educate the public about the upgraded Securities Board and the newly formed BISX.

B. Basic components of the program

Component I: Support for the securities board

- 3.2 **Objectives.** While the Securities Board is now a functioning entity overseeing mainly mutual funds and compliance issues, it lacks the institutional expertise to regulate secondary trading and issuance procedures. The objective of this component is to provide the Securities Board with the training and the guidelines for effectively managing all of the areas critical for an efficient and well functioning regulatory agency: regulating the issuance process, secondary trading, information dissemination for investors and setting standards of compliance with regulations, especially in regards to the prevention of money laundering. These efforts should be made in consultation with the other regulatory agencies in the region: the Jamaica Securities Commission and the Trinidad & Tobago Securities and Exchange Commission (TTSEC). Additional out of country training could be provided through funding from the MIF technical cooperation for a regional training program and securities market supervision (MIF/AT-140). However, the Securities Board would have to apply to the Advisory Committee under the auspices of either the Council of Securities Regulators of the Americas (COSRA) or the Caribbean Stock Markets Task Force, stressing the regional benefits of the training.
- 3.3 **Execution.** A full time consultant will be hired for a period of 18 months to work with a counterpart designated by the Securities Board. The consultant should help the Securities Board to: (a) write and implement the trading rules and guidelines; (b) upgrade the compliance procedures; (c) define the terms of registration for issuers; (d) define the terms for registration of broker/dealers, including minimal capital requirements; (e) define the disclosure process and the required components of the Information

Memorandum; (f) define regulation guidelines for mutual funds and investment companies; (g) enforce the accounting standards for issuers as defined by the Bahamas Institute of Chartered Accountants; (h) implement regulation of secondary market trading; (i) establish sanctions for rule-breakers; (j) establish a data base of all issuers and mutual funds; (k) define dispute resolution mechanisms; (l) establish disaster management guidelines; and (m) enforce transparency standards in terms of the disclosure and reporting of suspicious money laundering activities.

Component II: Support for the development of the exchange

- 3.4 **Objectives.** While there is considerable vocal support for the development of the BISX in the private sector, currently there are only working plans and an initial budget. The objective is to get the BISX up and running as a functional exchange with domestic and international tiers. This will entail attracting private sector investors and management, and then ultimately issuers for both tiers. The thirteen companies currently trading on the over-the-counter market can transfer to the domestic tier of the BISX, but many more companies could issue Initial Public Offerings (IPOs) and list on the exchange. Although the BISX will be owned by private sector shareholders, the Government of The Bahamas is a strong supporter of the BISX because it allows for a transparent and public platform for the trading of privatized entities; it could be the site for primary auctions and secondary trading of public debt; and it will be tangible evidence of a modern capital market structure.
- 3.5 **Execution.** A full time consultant should be hired for a period of 18 months to work with a counterpart designated by the BISX. The consultant should work closely with the designated counterpart to help the BISX to: (a) develop a comprehensive plan for the structure and development of the BISX, including a chronogram of activities; (b) write an Information Memorandum to attract private sector investors; (c) define membership requirements for member firms, broker/dealers and traders; (d) develop listing requirements for the exchange; (e) develop appropriate trading rules for the BISX; (f) develop compliance procedures for the listed companies and member firms; (g) develop disciplinary rules to govern the member firms, listed companies, broker/dealers and traders; (h) develop a code of conduct for all persons bound by any rules of BISX; and (i) help install the trading system. 1/

Component III: Promotion and education

- 3.6 **Objectives.** To facilitate the acceptance of the new BISX and the upgraded Securities Board, it will be necessary to promote the

1/ Funds for the trading system will come from the capitalization raised through private sector subscriptions.

activities of these institutions to the general public as well as financial intermediaries and potential domestic issuers. A secondary objective is to promote the competitive benefits of investing in and issuing securities on the international tier of the BISX.

- 3.7 **Execution.** Specific seminars will be given to the broker/dealers, custodian banks and other market participants to explain the working dynamics of the new exchange. To attract foreign issuers and investors to the international tier of the exchange, a promotion trip and foreign publicity will be necessary. Overall, the promotion activities should convey messages such that would discourage asset laundering and procedures from illegal activities. This international promotion effort will require working closely with the Securities Board and the Bahamas Financial Services Promotion Board. This component will not require an international consultant, but there will be expenses associated with holding public meetings and international publicity and promotion. The General Manager of the BISX will be responsible for the execution of this component.

IV. EXECUTING AGENCY AND MECHANISM

A. Executing agency and mechanism

- 4.1 The Ministry of Finance & Planning of The Bahamas will be the executing agency for the project, with at least one part time coordinator acting as a counterpart for the program manager. Each one of the components will have a specific counterpart to complete the execution of the component goals: the Securities Board will be the counterpart for Component I; the head of the Securities Task Force appointed by the Minister of Finance and Planning will be the initial counterpart for Component II, with one of the managers of the BISX taking over as counterpart once the exchange is established; and the General Manager of the BISX will be the counterpart for Component III.
- 4.2 Several of the counterpart activities are currently underway, particularly at the Securities Board. The project will recognize counterpart expenses incurred over the last six months prior to approval.

B. Project readiness

- 4.3 In terms of the counterparts, only the Securities Board is currently in existence. Both the Project Task Force (to be appointed by the Minister of Finance and Planning) and the General Manager of the BISX have not been identified yet. In addition, the government must finalize the approval of the Securities Industry Bill before the project can commence. The Bill was approved by Cabinet on June 16 and is scheduled for consideration and approval of the Parliament in September.

C. Direct beneficiaries

- 4.4 The project has several direct beneficiaries: the Securities Board of The Bahamas and the BISX. Indirect beneficiaries include both domestic (including private investors and institutionalized investors such as pension funds and insurance companies) and international investors.

V. COST AND FINANCING OF THE PROGRAM

- 5.1 The cost of the project is US\$800,000 including financing by the MIF of US\$500,000 and counterpart contributions of US\$300,000 (at least 50% of which shall be in cash contributions) which represents approximately 38% of the total project amount. All of the costs for the project are for the execution phase; all operational expenses after the project is completed will be carried by the private sector and through transactional taxes.

MODERNIZATION OF CAPITAL MARKETS IN THE BAHAMAS COSTS AND SOURCES OF FINANCING FOR THE PROGRAM (IN US\$)				
Activities	MIF Financing	Local Counterpart	Total	Percent of Total
1. Administration	10,000	0	10,000	1.3%
1.3 Review and Evaluation	10,000	0	10,000	1.3%
2. Direct Costs	450,000	300,000	750,000	93.7%
2.1 Securities Board	150,000	210,000	360,000	45.0%
2.1.1 Ministry of Finance & Planning	150,000	210,000	360,000	45.0%
2.2 Support for BISX	300,000	60,000	360,000	45.0%
2.2.1 Ministry of Finance & Planning	300,000	60,000	360,000	45.0%
2.3 Promotion and Education	0	30,000	30,000	3.7%
2.3.1 BISX	0	30,000	30,000	3.7%
Contingencies (5% of subtotal)	40,000	0	40,000	5.0%
Total	500,000	300,000	800,000	100.0%
Percent of Total	62.5%	37.5%	100.0%	

VI. PROJECT JUSTIFICATION AND RISKS

A. Justification

- 6.1 The proper functioning of the Securities Industry Act and the up-grading of the Securities Board will increase market transparency and raise investor confidence, and attract increased international flow of funds and investment through the International tier of the

BISX. Through the creation of transparent, efficient trading and clearing on the BISX, the public and private sector will be able to obtain cheaper sources of funds and domestic investors will have a broader range of instruments in which to invest. Finally, publicity for the project to both domestic and international investors should create over time more demand for Bahamian financial instruments.

B. Risks

- 6.2 **BISX Market Structure:** It remains unclear which market structure will be adopted by the BISX: either a competing market maker system or a call auction. A market maker system would provide instant liquidity, but there is no guarantee that there will be enough market makers committing capital to make such a system viable. Also, under a market maker system, there would be no trading floor, but just an electronic bid and offer for all those with access to trading screens. To increase the transparency of price formation, the BISX will have to make the trading screen visible to the public.
- 6.3 **Clearing and Settlement:** The clearing and settlement software from EFA Software, which was a part of the earlier MIF project to support the harmonization of clearing and settlement standards in the Caribbean, has not yet been installed because the BISX is not yet in existence. Once the software is installed, a number of other issues remain: defining the settlement times (e.g., T+5 at first, moving later to T+3), immobilization of securities at a centralized location, and delivery versus payment (DVP) of securities. All of these suggestions would, if implemented, reduce the considerable settlement risk in the current system. These issues still need to be addressed under the current MIF program.
- 6.4 **Public Debt Structure:** A number of market participants stressed the logic and importance of gradually moving the issuance and trading of at least a portion of the public debt to the exchange. This would have multiple beneficial effects: provide Bahamian investors with broader access to public debt instruments; create a yield curve for the market; possibly allow the government to borrow at cheaper rates due to competitive bidding in an auction; and provide a steady stream of trading for the BISX. To ensure that the National Insurance Board (NIB) received the public debt issues it requires, 80% of all public issues could be allocated to NIB. The remaining 20% of public issues gradually could be introduced to an auction system for primary market operations and trading on the secondary markets through the exchange.
- 6.5 **Exchange Control:** While the BISX is planning to have both domestic and international tiers, it is unclear whether or not Bahamians will be allowed to invest on the international tier. A gradual window could be introduced for Bahamians to invest in the international exchange, thereby giving Bahamians limited access to the foreign securities without seriously impacting the level of foreign

reserves. It would help to ensure some immediate volume on the international tier of the BISX.

- 6.6 **Money Laundering.** Stock exchanges are becoming attractive scenarios for money laundering throughout the region partly due to the implementation of stricter controls in the banking system. It is therefore necessary that both the Securities Board as a public entity and the BISX through self-regulation ensure the transparency of the securities market by means of establishing tight standards for the registration and membership of brokers, precise trading rules, rigorous codes of conduct and other means of deterring financial crime in the capital market.

VII. PROJECT PERFORMANCE CRITERIA

A. Project performance criteria/benchmarks

- 7.1 Each component of the project has benchmark performance criteria to judge the degree of success:

Performance Criteria of Each Component	
Component	Performance Criteria
Securities Board	All guidelines and compliance regulations are completed and publicized to all market participants within 6 months of consultancy start
Support for BISX	The BISX should be capitalized and in operation within nine months of the project's commencement
Promotion and Education	At least five domestic and ten international issuers attracted to the BISX

B. Evaluation of results

- 7.2 A mid-term review will be undertaken by the Bank to assess the project implementation performance. A project completion report will be prepared by a third party within six months after program completion to evaluate the attainment of program objectives. The attainment of the performance criteria listed above will determine the degree of success of the project.

VIII. SPECIAL CONTRACTUAL CONDITIONS

- 8.1 The Bank will require that the Securities Industry Bill be approved by Parliament before the first disbursement is made.

MIF - TECHNICAL COOPERATION FACILITY		
<p>GENERAL OBJECTIVES: To strengthen investor confidence in the capital markets in The Bahamas and attract international capital through establishing upgraded supervision of securities and an efficient, transparent trading system.</p> <p>SPECIFIC OBJECTIVES: Assist the Ministry of Finance to upgrade the Securities Board; develop the Bahamas International Securities Exchange; and promote and educate the public and investing community about the changes.</p>		
SUB-PROGRAMS	ACTIVITIES	DESIRED OUTCOMES
Component I: Securities Board	<ul style="list-style-type: none"> - Implement trading rules and guidelines - Define terms of registration and issuance - Define standards of accounting - Create data base of issuers and mutual funds 	<ul style="list-style-type: none"> - All guidelines and compliance regulations are completed and publicized to all market participants - Establish data base of issuers and mutual funds
Component II: Support for BIX	<ul style="list-style-type: none"> - Write Information Memorandum to attract investors - Staff BIX and train them - Develop rules and regulations for the BIX - Install the trading system 	<ul style="list-style-type: none"> - Capitalization of the BIX - Create self-regulatory environment
Component III: Promotion and Education	<ul style="list-style-type: none"> - Conduct seminars for domestic investors, potential issuers and market participants - Launch a "road show" for international investors and issuers 	<ul style="list-style-type: none"> - Educate local investors - Attract domestic issuers - Attract international issuers and investors

PROGRAM TO SUPPORT CAPITAL MARKETS MODERNIZATION
SIMPLIFIED LOGICAL FRAMEWORK

PROPOSED RESOLUTION

BAHAMAS. NON REIMBURSABLE TECHNICAL COOPERATION FOR THE PROGRAM TO SUPPORT CAPITAL MARKETS MODERNIZATION

The Donors Committee of the Multilateral Investment Fund

RESOLVES:

1. That the President of the Inter-American Development Bank or such representative as he shall designate is authorized, in the name and on behalf of the Multilateral Investment Fund, to enter into such agreements as may be necessary with the Government of the Bahamas, and to take such additional measures as may be pertinent for the execution of the project proposal contained in Document MIF/AT- with respect to a technical cooperation program to support the modernization of the capital markets of The Bahamas.
2. That up to the sum of US\$500,000 or its equivalent in other convertible currencies shall be authorized for the purpose of this resolution, chargeable to resources of the Technical Cooperation Facility of the Multilateral Investment Fund.
3. That the above-mentioned sum is to be provided on a non-reimbursable basis.