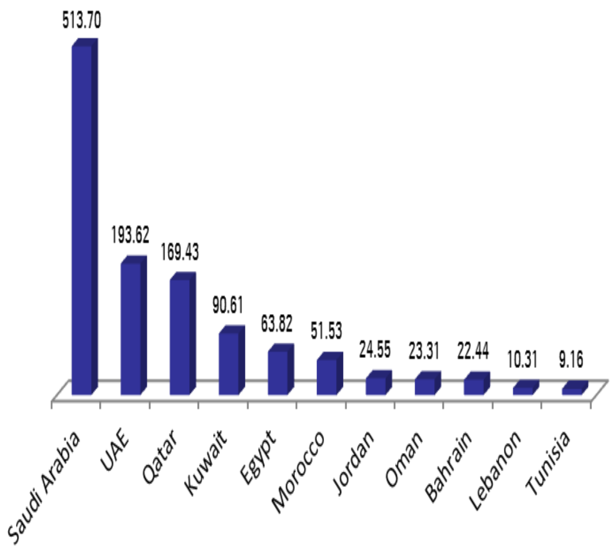
CMA: First Step to Developing Lebanese Capital Markets

BLOMINVEST BANK

Market Capitalization for Regional Stock Exchanges
(In $B)



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Contact Information

Research Assistant: Lana Saadeh

lana.saadeh@blominvestbank.com

Head of Research: Marwan Mikhael

marwan.mikhael@blominvestbank.com

Research Department

Tel: +961 1 991 784

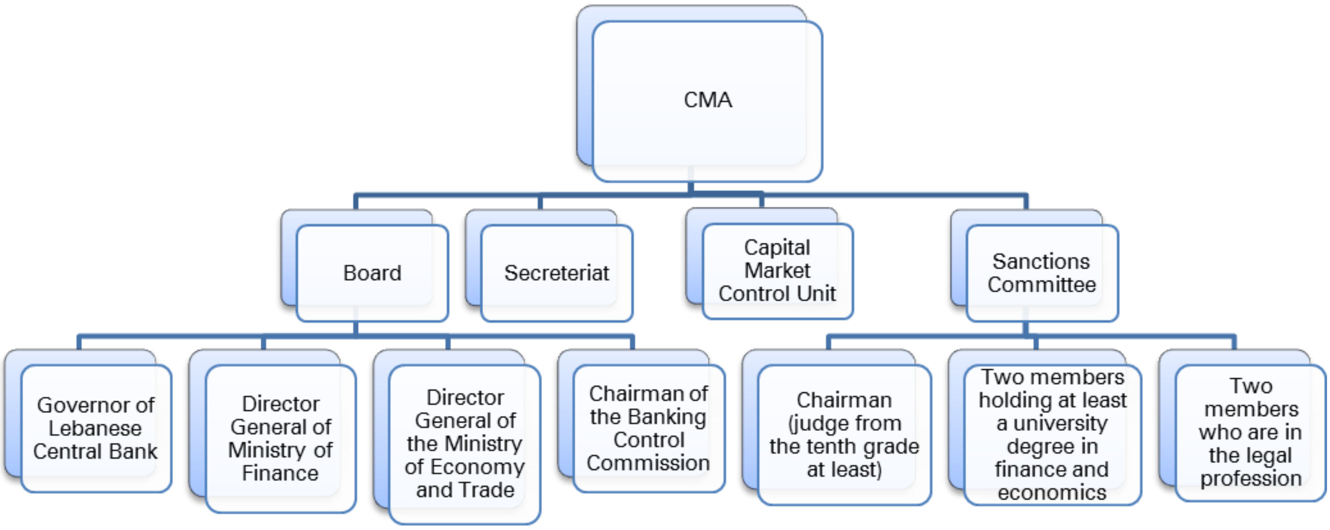
Being the second oldest market in the MENA after the Egyptian Bourse, the Beirut Stock Exchange (BSE) was founded in 1920, by a decree of the French Commissioner. In its early years, Lebanon witnessed substantial economic activity, which translated into banking and services companies listing their stocks on the BSE. Moreover, trade was expanded to encompass shares of private companies set up under the French mandate to operate and manage some public services and sectors. This prompted the Lebanese bourse to flourish, with 50 stocks listed in the 1960s. Unfortunately, in 1975 the Lebanese Civil War erupted, hindering trade on the BSE, which was decisively halted in 1983. The Lebanese Bourse reopened in 1996. However, its trading activity was not substantial as it was before, due to the political and security uprisings that Lebanon faced, making the BSE the region's second smallest stock exchange (in terms of market capitalization) exceeding only that of Tunisia.

After its re-launching, the BSE did not gain the momentum it had before, due to many reasons. First, almost 95% of enterprises in Lebanon are small and medium-sized family businesses. These family business' owners are not entirely open to the idea of exposing their companies' ownership to outsiders. Moreover, there is a lack of laws and regulations requiring compliance, transparency and disclosure. Finally, with the presence of a strong banking sector, business owners do not feel the need to go public because they receive adequate financing from banks. These shortcomings led to lack of incentives for companies to list their shares and similar reservations for investors to buy them.

Capital Markets Law 161: Establishment of Lebanese CMA

In the 1990s several draft laws surfaced to regulate the capital markets, however it was not until 2011 that the Capital Markets Law was passed in a move that would create the framework to establish proper regulations. On the 17th of August 2011, Capital Markets Law 161 called for the establishment of the Lebanese Capital Markets Authority (CMA) that has two main aims delineating its mission: promoting and developing the Lebanese Capital Markets; and protecting investors from fraudulent activities through issuing regulations that are in line with international best financial markets practices. The CMA is an independent autonomous regulatory authority, with a wide mandate which ranges from supervision of market players, to licensing and registration of individual and institutions. This body, consisting of a Board, Secretariat, Capital Markets Control Unit and the Sanctions Committee, would serve its twin objectives. Moreover, the CMA has the power to sanction non-compliant individuals and institutions through an independent Sanction Committee and a Capital Markets Court. The autonomy of this body, as established by the law, permits the CMA to issue its own regulations and supervise the financial markets in a way to reduce Systemic Risk.

Composition of the CMA



Source: BdL

Capital Markets Law 161 provides a good framework and clear definition for the responsibilities of the CMA and protects it from any interference, political or otherwise. According to this law, the CMA should, among other things, organize and develop capital markets in Lebanon, promote their use by investors and issuers in Lebanon and abroad, reduce systemic risks in capital markets, protect investors from illegal, irregular or unfair practices, organize the availability of information to those distributing financial instruments to the public, organize and supervise the professional activities of the people who perform operations on financial instruments.

Moreover, Law 161 governs all operations related to the issuance, purchase, sale, or marketing of financial instruments that are directly offered for public subscription, or that are purchased or sold on behalf of the public, in addition to the commodity and metal markets.

Almost a year after the adoption of the Law, the CMA's board of directors was selected in July 2012. It took the board another nine months to completely take over activities from the Lebanese Central Bank as capital markets regulator.

The CMA is in the process of updating and releasing new regulations. Up until now, the CMA released 17 regulations that govern financial markets including disclosure policy, crowd-funding, insider trading, derivatives, securitization and collective investment schemes as well as regulations concerning financial institutions, introducing brokerage firms, and the suitability of people selling financial products.

Selected Regulations Released by the CMA

The first regulation aimed at protecting the rights of all stakeholders was passed on the 29th of April 2013. It states that all companies, whose shares are traded on the regulated stock markets or over the counter, shall put in place a disclosure policy in order to abide by the best corporate governance. A copy of the disclosure policy should be provided to the CMA three months before adopting it.

In the same day, another rule was issued concerning information disclosure. It states that all listed and investment companies should provide their shareholders with clear and accurate information about the company's capital and its end of year financial results. This transparency would help stockholders 1) have approximate forecasts of their returns on investment and 2) make educated decisions concerning whether to buy, sell or hold their shares.

Regarding, crowd-funding, the use of small amounts of capital from a large number of individuals to finance SMEs or startups, the CMA has set some laws on the institutions providing this service, such as drafting a feasibility study involving the projected profits and losses, covering a period of 3 years. In addition, the institution should publish a term sheet revealing to the investor the capital to be raised, the necessary conditions for investment, and a summary of the expected risks that the investor might face.

To protect the investor and to validate the information presented to him, the CMA requires all corporations to form a Compliance department that investigates whether the company is conforming to all the rules, and an internal audit department that examines independently and objectively the work of all other departments in the company.

The CMA forbids any listed company from issuing any new financial instrument, unless it has been preapproved from the CMA.

In case of any violation, the sanctions committee has the authority to impose administrative sanctions and monetary penalties listed by Law 161.

These regulations are a first step to developing capital markets, but following suit is the question of supply and demand. Therefore, the subsequent steps should include getting more companies to list and attracting the attention of more investors.

How to Build On from Current Progress

One way is by privatizing the Beirut Stock Exchange. In fact, one of the articles in the Capital Markets Law calls for the BSE to be turned into a joint-stock company. This would provide incentive for the shareholders to increase activity because it would be run as a for-profit business. Once a joint-stock company is made, it would have a board of directors and a CEO that would run it properly. Turning the BSE into a privately held company would make it more efficient in attracting local and regional companies to list on the BSE.

Other options to increase supply on the stock exchange include listing government-owned companies, as well as creating incentives for family-owned companies to list. This should be done through tax incentives, such as providing a tax waiver that would make it more attractive for companies to list.

Furthermore, the CMA needs to work with the government on different legislations that would create the right incentives for both businesses and investors: that is encouraging citizens to invest in capital markets and businesses to go public and enlist on the BSE. In this domain, the CMA should engage with all concerned government entities on creating a business friendly environment that would encourage regional and international businesses to come to Lebanon.

Moreover, there is a need to change an entrenched culture which is focused on short-term financing secured by banks. This would in no way adversely affect the work of commercial banks. In fact, well-developed capital markets would complement and support the activities of banks and vice versa.

Besides, investors should be educated about the advantages of investing in long term securities market. Developing an investor education program would promote financial literacy among citizens.

Laws and regulations should change to encourage the creation of pension funds, which are the major investors in the stock exchange.

With the lack of active capital markets, banks has been providing the major source of outside financing to private companies, resulting largely in lending monoculture. The long term objective of the CMA is to once again set Lebanon as a major player in the regional financial industry. The biggest stumbling block that the CMA is trying to break is how to broaden and deepen the capital markets and instill faith in the securities industry in Lebanon. In the same context, the Lebanese capital markets are considered small scale and less active, shadowing the dominant banking sector. Market dynamics shifted the capital market functions toward the more regulated banking sector with its already existing infrastructure, legislations and regulations. Yet, their conservative lending policies dictate a disproportionate amount of collateral on loans, leaving much of the market financially underserved.

Separating the stock exchange management and the regulating authority on one hand, and privatizing the stock exchange on the other hand, have a great importance on Lebanon's Bourse. Splitting regulation from management reinforces market transparency and widely opens the market to institutional investors especially when the control is performed by an independent administrative authority with undisputed credibility. As for handing the market management to the private sector, it certainly develops the market activity by increasing the number of issuers and diversifying the financial instruments. Moreover, corporatization brings in new technologies such as stock trading on electronic communication network, provides a level playing field, thereby encouraging competition and facilitates mergers with other exchanges reinforcing the market capitalization.

For your Queries:

BLOMINVEST BANK s.a.l.
Research Department
Bab Idriss, Weygand Str.
POBOX 11-1540 Riad El Soloh
Beirut 1107 2080 Lebanon

Lana Saadeh
Tel: +961 1 991 784
lana.saadeh@blominvestbank.com

Marwan Mikhael, Head of Research
marwan.mikhael@blominvestbank.com
+961 1 991 782

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