FINANCIAL SECTOR ASSESSMENT PROGRAM
DEVELOPMENT MODULE

MONGOLIA

CAPITAL MARKETS

TECHNICAL NOTE
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THE WORLD BANK
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EAST ASIA REGIONAL VICE PRESIDENCY
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GLOSSARY
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<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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</thead>
<tbody>
<tr>
<td>ALM</td>
<td>Asset-liability management</td>
</tr>
<tr>
<td>APR</td>
<td>Annual percentage rate</td>
</tr>
<tr>
<td>BOM</td>
<td>Bank of Mongolia (central bank)</td>
</tr>
<tr>
<td>CSD</td>
<td>Central Securities Depository</td>
</tr>
<tr>
<td>EAP</td>
<td>East Asia and Pacific region</td>
</tr>
<tr>
<td>ETT</td>
<td>Erdenes Tavan Tolgoi (mine project)</td>
</tr>
<tr>
<td>FRC</td>
<td>Financial Regulatory Commission</td>
</tr>
<tr>
<td>FSAP</td>
<td>Financial Sector Assessment Program</td>
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<tr>
<td>GDP</td>
<td>Gross domestic product</td>
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<tr>
<td>GoM</td>
<td>Government of Mongolia</td>
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<tr>
<td>IFRS</td>
<td>International Financial Reporting Standards</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
</tr>
<tr>
<td>IPO</td>
<td>Initial public offering</td>
</tr>
<tr>
<td>IT</td>
<td>Information technology</td>
</tr>
<tr>
<td>KYC</td>
<td>Know your customer</td>
</tr>
<tr>
<td>LSEG</td>
<td>London Stock Exchange Group</td>
</tr>
<tr>
<td>MICPA</td>
<td>Mongolian Institute of Chartered Public Accountants</td>
</tr>
<tr>
<td>MNT</td>
<td>Mongolian Tughrik</td>
</tr>
<tr>
<td>MOF</td>
<td>Ministry of Finance</td>
</tr>
<tr>
<td>MOJ</td>
<td>Ministry of Justice</td>
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<tr>
<td>MOU</td>
<td>Memorandum of understanding</td>
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<tr>
<td>MMOU</td>
<td>Multilateral memorandum of understanding</td>
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<tr>
<td>MSE</td>
<td>Mongolian Stock Exchange</td>
</tr>
<tr>
<td>OT</td>
<td>Oyu Tolgoi (mine project)</td>
</tr>
<tr>
<td>OTC</td>
<td>Over-the-counter</td>
</tr>
<tr>
<td>ROSC</td>
<td>Report on Observance of Standards and Codes</td>
</tr>
<tr>
<td>SCH</td>
<td>Securities Clearinghouse</td>
</tr>
<tr>
<td>SML</td>
<td>Securities Market Law</td>
</tr>
<tr>
<td>SPC</td>
<td>State Property Committee</td>
</tr>
<tr>
<td>T+3</td>
<td>3 days after trade date</td>
</tr>
<tr>
<td>TA</td>
<td>Technical assistance</td>
</tr>
<tr>
<td>US$</td>
<td>United States Dollar</td>
</tr>
<tr>
<td>WB</td>
<td>The World Bank</td>
</tr>
<tr>
<td>Yoy</td>
<td>Year-on-year</td>
</tr>
</tbody>
</table>
I. Executive Summary

1. This technical note summarizes findings and recommendations on measures for the strengthening of the capital markets in Mongolia. The analysis in the technical note is presented in the following parts:

   I. Executive summary

   II. Current state of the capital markets in Mongolia: Domestic currency bond markets, equities market, intermediaries and investor base

   III. Deepening and Broadening Capital Markets in Mongolia: Challenges and recommendations
      A. Increasing efficiency of the institutional, regulatory and supervisory framework
      B. Improving supervisory effectiveness
      C. Modernizing market infrastructure
      D. Strengthening domestic bond and equity markets
      E. Developing a sound institutional investor base
      F. Building capacity of regulators, MSE and market intermediaries

2. The authorities have taken bold steps in the last two years to modernize the Mongolian Stock Exchange (MSE) and put in place modern legal, regulatory and market infrastructure for the capital market. Improving the institutional, regulatory and supervisory framework is a key priority, and the enactment of a new Securities Market Law should lay a sound foundation for the regulation and supervision of the securities markets. However, its current draft has several gaps that should be addressed. The Financial Regulatory Commission (FRC), as supervisor of the capital market and non-bank financial sector, needs greater human and financial resources in order to carry out its role effectively. Likewise, the MSE and market intermediaries need to invest substantially in skills and capacity.

3. Nonetheless, development of the domestic securities market in Mongolia should take into account the inherent problems for small markets, because a central feature of the securities market is economies of scale. Given Mongolia’s small size (with population of only 2.75 million people in 2010), its correspondingly small and underdeveloped banking and financial sectors, and a still significant percentage of the population with relatively low financial literacy and only limited involvement in formal financial markets, the challenges of developing a liquid and efficient securities market in Mongolia are enormous. Some of the measures for developing local markets, while well-intentioned, might not have the desired impact in terms of overall market development unless the fundamental challenges are effectively addressed.

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1 Please see paragraphs 27 and 28 for more detailed discussion on the new SML.

2 IMF, World Economic Outlook, 2011.
4. **Currently, the local capital market is not representative of the full universe of Mongolian enterprises that are operating in the country at present.** As a result, it may be difficult to attract foreign investors’ interest if the country’s most attractive firms are not listed domestically. While the fact that most large Mongolian companies that have needed capital have gone abroad to raise capital may not in itself be a negative thing, there are nonetheless some significant implications on the prospects for local capital market development in terms of developing the domestic market as a feasible fund-raising market for firms with huge capital requirements.

5. **Improving the functioning of the government bond market is vital.** A robust capital market relies on a reference yield curve and a credit risk-free instrument for hedging risk. Although the government has taken a number of positive steps in this direction, it should continue to promote market development and liquidity further by adopting a more market-based pricing methodology, and it should promote transparency and facilitate investment by developing a central repository of information on the issuance, outstanding amount, and terms of government bonds that investors are able to access.

6. **One of the most important elements for a strong domestic capital market is a diversified institutional investor base, and the regulatory agencies involved should pursue a concerted strategy toward developing the investor base.** Mongolia needs to provide an enabling environment to attract a diverse range of institutional investors’ participation, including investors from abroad. Undeveloped insurance and pension sectors and other contractual savings institutions have limited the domestic pools of liquidity for investment in domestic capital markets. This has serious implications for the sustainable development of the domestic capital markets. In this regard, it may be useful for the authorities to review successful strategies taken in other jurisdictions (such as pension funds in South Korea, Singapore, Thailand and Malaysia in developing the domestic institutional investor base). In addition, improving timely and accurate information disclosures and their effective enforcement is crucial to promote liquidity and facilitates more efficient price discovery.
Table 1

<table>
<thead>
<tr>
<th>Recommendations</th>
<th>Level of Priority&lt;sup&gt;3&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Increasing Efficiency of the Institutional, Regulatory and Supervisory Framework</strong></td>
<td></td>
</tr>
<tr>
<td>- Adopt a comprehensive SML, consistent with international good practices, to underpin the modernization of the MSE and the operations of a modern securities market (FRC, MOJ, MSE, MOF).</td>
<td>Short-term</td>
</tr>
<tr>
<td>- Adopt a market-based due diligence system where valuation is done by a qualified independent party (and not the regulator) and for such valuation to be disclosed in the prospectus (FRC).</td>
<td>Short-term</td>
</tr>
<tr>
<td>- Consider introducing a system of sponsors to support IPO listings on MSE to enhance due diligence (FRC, MSE).</td>
<td>Short-term</td>
</tr>
<tr>
<td>- Introduce a KYC obligation on regulated entities that provide investment advice to clients (FRC, MSE).</td>
<td>Short-term</td>
</tr>
<tr>
<td>- Provide explicit legal authority for FRC to provide assistance to foreign securities regulators in line with IOSCO standards (FRC, MOJ, MOF).</td>
<td>Short-term</td>
</tr>
<tr>
<td><strong>Improving supervisory effectiveness</strong></td>
<td></td>
</tr>
<tr>
<td>- Enhance FRC’s operational independence with sufficient financial resources and flexibility in acquiring and managing skilled human capital. This can be done by allowing FRC to retain the fees it collects and to share a small percentage of clearing fees from sales and purchase transactions that are effected on the stock exchange&lt;sup&gt;4&lt;/sup&gt; (MOF, FRC).</td>
<td>Short-term</td>
</tr>
<tr>
<td>- Ensure the new SML or the Law on Legal Status of the Financial Regulatory Commission provides sufficient legal protection to the FRC and its staff in carrying out their duties in good faith or consistent with</td>
<td>Short-term</td>
</tr>
</tbody>
</table>

<sup>3</sup> ST, short term, indicates action can be undertaken in 0-6 months. MT, medium term, indicates 6 months-1 year. LT, long term, indicates more than 1 year.

<sup>4</sup> This is the common approach in many jurisdictions (for example, Hong Kong, Sri Lanka, Malaysia and Thailand).
<table>
<thead>
<tr>
<th><strong>Modernizing market infrastructure</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>MSE should commission a market readiness assessment conducted by a professional firm in regard to the operations of the new trading, clearing, settlement and depository systems. The market readiness assessment report should be submitted to FRC prior to FRC giving its approval for the launch of the new system (MSE, FRC).</td>
<td>Medium-term</td>
</tr>
<tr>
<td>Brokers should be given appropriate training on KYC so as to be able to manage the risks in the move to a T+3 clearing and settlement system. MSE should document and convene briefing sessions for all relevant stakeholders on the level of stakeholder participation expected (MSE, FRC).</td>
<td>Medium-term</td>
</tr>
<tr>
<td>Authorities should consider introduction of a settlement guarantee mechanism with appropriate risk management framework including appropriate risk-based capital framework (MSE, FRC).</td>
<td>Medium-term</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Strengthening domestic bond and equities markets</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Improve debt issuance strategy to support the development of the risk-free yield curve (MOF).</td>
<td>Short-term</td>
</tr>
<tr>
<td>Review the pricing methodology of government bonds to ensure that they are properly priced and market-based, so as to avoid distortions (MOF).</td>
<td>Medium-term</td>
</tr>
<tr>
<td>Build a central repository of information relating to the issuance, outstanding amount and terms of government and corporate bonds to promote transparency that could facilitate investors’ decisions about investment in corporate bonds and other financial instruments (MOF).</td>
<td>Medium-term</td>
</tr>
<tr>
<td>Review the suitability of using the MSE auction system for primary issuance of government and corporate bonds, and consider the feasibility of introducing a primary dealer system (MOF).</td>
<td>Medium-term</td>
</tr>
</tbody>
</table>

- Targeted training for FRC on consolidated supervision and risk-based supervision (FRC).

- Modernizing market infrastructure

- MSE should commission a market readiness assessment conducted by a professional firm in regard to the operations of the new trading, clearing, settlement and depository systems. The market readiness assessment report should be submitted to FRC prior to FRC giving its approval for the launch of the new system (MSE, FRC).

- Brokers should be given appropriate training on KYC so as to be able to manage the risks in the move to a T+3 clearing and settlement system. MSE should document and convene briefing sessions for all relevant stakeholders on the level of stakeholder participation expected (MSE, FRC).

- Authorities should consider introduction of a settlement guarantee mechanism with appropriate risk management framework including appropriate risk-based capital framework (MSE, FRC).

- Strengthening domestic bond and equities markets

- Improve debt issuance strategy to support the development of the risk-free yield curve (MOF).

- Review the pricing methodology of government bonds to ensure that they are properly priced and market-based, so as to avoid distortions (MOF).

- Build a central repository of information relating to the issuance, outstanding amount and terms of government and corporate bonds to promote transparency that could facilitate investors’ decisions about investment in corporate bonds and other financial instruments (MOF).

- Review the suitability of using the MSE auction system for primary issuance of government and corporate bonds, and consider the feasibility of introducing a primary dealer system (MOF).
- Identify a pool of large and high-quality issuers to expand the issuer base, including channeling privatized, formerly state-owned enterprises that are financially viable for listing on MSE (SPC, FRC, MSE).
- Provide a framework that facilitates foreign listings or dual listings (FRC, MSE).
- Broaden the product range of MSE, including depository receipts (MSE, FRC).
- Enhance investor education and awareness in order to build an equity culture, and enhance investors’ confidence (FRC, MSE, Ministry of Education).

### Developing a sound institutional investor base

- Undertake further analytical work to understand demand dynamics in the equities and bond markets, with a view to widening the investor base (MOF, FRC, MSE).
- Set up a high-level task force to review how contractual savings institutions, particularly pension funds and perhaps sovereign wealth fund-type entities, can be developed as a viable domestic institutional investor base for Mongolia (MOF, BOM).
- Review the current regulatory framework of institutions, such as commercial banks, insurance companies, and other contractual savings institutions, to identify any requirements that might limit their participation in capital markets (BOM, FRC, MOF).
- Enhance the quality of financial information, particularly for entities that raise funds in capital markets, by enhancing enforcement capacity of FRC and developing an audit oversight system (FRC, MICPA, MOF).
- Introduce investment fund and custodian regulations that are benchmarked against international best practices (FRC, MOF).

### Building capacity of FRC, MSE and market intermediaries

- Provide structured and systematic training and capacity-building programs for staff of FRC, MSE in risk-based supervision, market surveillance, and corporate finance (FRC, MSE).
- Enhance FRC’s enforcement capacity, especially in the implementation
of the new reforms to the Companies Law and the new SML (FRC)

- Enhance financial literacy and promote investor education programs on stock market investments (FRC, MSE).

<table>
<thead>
<tr>
<th>Roadmap for Capital Market Development</th>
</tr>
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<tbody>
<tr>
<td>- Develop a 5-year road map for capital market development that documents the relevant strategies and initiatives to meet various development challenges</td>
</tr>
<tr>
<td>- Develop an implementation plan that prioritizes and sequences the necessary development initiatives.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Medium-term</th>
<th>Medium-term</th>
</tr>
</thead>
</table>

**II. CURRENT STATE OF CAPITAL MARKETS IN MONGOLIA**

7. With a financial market that is dominated by the banking sector, the undeveloped capital market is ill-equipped to support the growth momentum that the country aspires to over the next 10 years. The nonbank financial sector constitutes less than 3 percent of the total assets in the financial sector, with capital markets contributing less than 1 percent. Instruments available for long-term investment remain limited, and the growth of both the retail and institutional investor bases has lagged. The bond market remains quite small relative to its emerging market peers. Mongolia’s ranking for financial market development is far lower than its own overall competitiveness ranking based on The Global Competitiveness Report 2010-2011. In particular, the performance on the sub-pillars “Financing through local equity market” and “Regulation of securities exchange” appear to have a negative effect on Mongolia’s overall competitiveness.
Table 2. Competitiveness in Eurasia

<table>
<thead>
<tr>
<th>Country</th>
<th>Overall Rank (out of 139)</th>
<th>Financial Market Development</th>
<th>Financing through local equity market</th>
<th>Regulation of securities exchanges</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia</td>
<td>98</td>
<td>110</td>
<td>131</td>
<td>121</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>57</td>
<td>71</td>
<td>79</td>
<td>103</td>
</tr>
<tr>
<td>Georgia</td>
<td>93</td>
<td>108</td>
<td>125</td>
<td>124</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>72</td>
<td>117</td>
<td>106</td>
<td>119</td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>121</td>
<td>111</td>
<td>121</td>
<td>132</td>
</tr>
<tr>
<td>Moldova</td>
<td>94</td>
<td>103</td>
<td>124</td>
<td>116</td>
</tr>
<tr>
<td>Mongolia</td>
<td>99</td>
<td>129</td>
<td>99</td>
<td>129</td>
</tr>
<tr>
<td>Ukraine</td>
<td>89</td>
<td>119</td>
<td>120</td>
<td>127</td>
</tr>
</tbody>
</table>

Source: The Global Competitiveness Report 2010-2011

8. **Over the past two years, there has been a growing appreciation by the authorities of the need for a well-diversified financial market, which can meet the demands of savers and investors in a cost-effective way.** MOF, BOM, and the FRC are actively cooperating in dealing with reform measures, and the MOF has formed a new unit to focus on financial sector policy and capital market development. The authorities are aware of the issues impeding capital market development and are taking steps to address these issues through further strengthening and enforcement of the regulatory frameworks, good governance practices, internal controls, and measures to increase investor confidence.

9. **A major milestone is the strategy to modernize the MSE,** supported through a strategic partnership with the London Stock Exchange Group, signed in December 2010. The project’s goal is to leverage LSE’s experience and resources with the aim to establish the Mongolian capital market as a world-class market, with the MSE operating according to internationally accepted standards and participating as one of LSEG’s key partners in Asia. Under these arrangements, LSEG has nominated some of MSE's board of directors and mobilized a management team to supplement MSE's own management to provide knowledge and expertise on managing and operating exchanges in accordance with international standards. LSEG is providing market technology, such as software licensing, training, maintenance and configuration services, in order to enhance the MSE's operational capabilities. During the first phase of the project, LSEG will collaborate with MSE on the modernization of the MSE, the

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5 The Mongolia Stock Exchange was established in 1991, following the privatization of 475 state-owned enterprises.

6 MilleniumIT technology and IT system.
Securities Clearing House (SCH), and the Central Securities Depository (CSD), and the second phase would see to the eventual privatization of the MSE. In this regard, LSE as the strategic partner should work closely with the authorities to address some of the fundamental issues and critical steps that can be taken to greatly increase the number of issuers and investors in the domestic market.

10. The Financial Regulatory Commission is playing a significant role in facilitating development of capital markets in Mongolia. The achievements of the FRC since its establishment in 2005 are noteworthy, especially its introduction of the legal, regulatory, and accounting and auditing frameworks for the regulation of the securities market. However, more needs to be done to ensure its stable and sustainable development, particularly in relation to FRC’s effectiveness in enforcing these new laws and regulations. The FRC has issued Resolution No. 228 in October 2008 outlining the capital market development strategy for 2009-2012, and it has initiated a number of measures for the strengthening of the capital market.

11. FRC has championed legal reforms aimed at strengthening the regulatory framework for capital markets. Amendments to the Companies Law that were approved by Parliament in October 2011 introduced sound corporate governance standards, strengthened minority shareholder protection in clarifying and broadening the definitions of related-party transactions, and conferred the FRC with enforcement power against breaches of these provisions. A detailed discussion of these reforms is given in Annex 2.

12. A new Securities Markets Law (SML) is being drafted, which seeks to align the framework for securities regulation in Mongolia with international best standards. The existing Securities Market Law (enacted on 12 December 2002 and amended in November 2005) regulates the issuing, registering and trading of securities, transfer of share ownership rights, investor protection and supervision of brokers. The Law on the Financial Regulatory Commission (issued on 17 December 2005 and amended in July 2006) regulates the establishment, organization and operations of the FRC and provides for the coordination and monitoring of financial services. Legal and regulatory reforms to the existing Securities Market Law (through a new SML) are expected to facilitate the introduction of new and innovative products, such as depository receipts, and to facilitate cross-listings on the MSE. The new SML is in the last stages of finalization and is targeted to be approved by Parliament before the end of 2012. A new Investment Fund Law and Custodial Regulations are also being drafted and targeted for implementation concurrently with the promulgation of the new SML.

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7 The draft SML that is reviewed for discussion in this technical note is based on the November 2011 draft that was provided by the FRC to the FSAP team. For purposes of reference in the aide memoire, this document is referred to as the “new SML.”
13. **FRC together with MSE have been very determined to weed out listed companies that have not complied with MSE rules.** Out of 336 companies currently listed on the MSE, 118 are suspended from trading, and it is expected that they will be delisted over time. These companies have not complied with the listing requirements on disclosures and financial reporting. FRC has also taken aggressive action against companies for non-compliance with reporting requirements, although its enforcement powers are severely handicapped by the current law. The new SML, if approved by Parliament, would considerably enhance the enforcement powers of the FRC. Only 40-50 companies currently listed on the MSE are traded on a regular basis. Larger stocks tend to have less than a 10 percent free float in the market. These shares also tend to be highly concentrated to only a small number of long-term investors, mostly insiders. There are only a handful of large institutional investors active on the MSE, and their main strategy is to negotiate directly with the companies to acquire a significant stake and play an active role in managing the company. Other larger investors fill their orders by way of block trading with a holder of a large stake in stocks, often an insider of the company. These deals are usually sourced and executed by a nominated local broker.

A. **Domestic Currency-Denominated Bond Markets**

14. **There has been some progress in government debt management since 2008, though key issues have yet to be addressed.** The government is advised to take a more pro-active stance towards developing the government securities market by adopting and maintaining a program of regular issuance, regardless of whether it needs the funding, in order to build a robust benchmark yield curve. This is particularly important, as the government plans to issue a significant amount of bonds to fund various public projects. Currently, it issues debt on an “as-needed” basis without any regular schedule. The requirement that government securities be traded through the MSE should be reconsidered, as most trading in bond markets is conducted over-the-counter and among professional investors (such as banks). The MSE conducts multiple-price auctions on behalf of the government, with the cut-off rate being decided by the Debt Market Department (DMD). Typically, fewer than five commercial banks purchase 99 percent of the securities auctioned. Pricing of recent government bond issues did not appear to be market-based. Since the primary market is conducted through MSE, many commercial banks are unwilling to sell their bonds through the MSE, due to the costs involved. Consequently, commercial banks tend to transfer their bonds directly to other banks, and this process lacks transparency.

15. **The regulation governing domestic borrowing is The Procedures on Issuing and Making Payments for Treasury Securities (2005) which regulates the processes and**

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8 Many of these companies were listed as a result of the government’s earlier privatization efforts whereby a large number of companies were ‘listed’ by decree, but without the necessary provisions for ongoing disclosure, sound corporate governance, etc.

9 19 companies were delisted in 2010, and 22 companies were delisted in 2011.
procedures for domestic issuances Treasury securities. The regulation states that borrowing can take place to finance current deficits, seasonal discrepancies in cash flows, as well as investment projects. An annual limit for domestic borrowing is approved by Parliament, and translated into a published borrowing plan. Furthermore, Parliament approves an order that specifies the securities types, nominal value, maturity, etc. The information is disclosed to the public on the website of the Treasury Department, and through mass media. The Procedures on Issuing and Making Payments for Treasury Securities is quite comprehensive, and is available on the website of the Treasury. The existing Securities Market Law requires that a security issued by the government and by the aimag and City Mayors shall be registered at the FRC and at the MSE. However, under the new SML, the requirement to register with the FRC would be removed, making the process for issuance of government securities more efficient.

16. **Domestic debt is planned and executed by the DMD within the Ministry of Finance.** The debt management strategy is prepared by the DMD, and provides background, summarizes the main risks, and outlines the desired direction for debt management (for example, an increase in the share of domestic debt, longer domestic maturities, reduction of the foreign exchange rate risk, etc.). The strategy is formally approved by the MOF with input provided by the BOM, and it is available on request, but not published.\(^\text{10}\)

17. **To date, the bond market comprises outstanding government bonds worth MNT 200.2 billion (US$171 million) and corporate bonds worth MNT 12.9 billion (US$11 million) as at end-2010.** Government bonds account for 98 percent of the total bond market. Money market development has progressed, and a continuation of the reform effort will yield further benefits. The advances made in developing the payments and settlements infrastructure are helping liquidity management practices. A competitive interbank market may evolve as the economy diversifies and the demand for hedging and other treasury products by the household and corporate sectors grows.

18. **The corporate bond market in Mongolia is very small with most Mongolian companies preferring to seek financing either from banks or abroad.** Outstanding corporate bonds traded on MSE account for only 0.04 percent of total bond market capitalization. More than 50 percent of the corporate bonds sold were short-term.

19. In March 2008, a joint decree of the MOF and the Governor of BOM was signed. The decree formalizes the exchange of information between the two institutions, including cash flow forecasts, and establishes a joint working group to ensure that monetary and fiscal policy is well coordinated. The group meets monthly. Furthermore, the decree mentions the need for coordination when issuing BOM bills for monetary policy purposes, and government securities for debt management purposes. Despite the MOU that was signed between the BOM and the MOF specifying that the two institutions will collaborate to develop the domestic yield curve, nonetheless, with the limited funding need and high inflation environment, the issuance of maturities longer than one year has been very uncommon. The settlement of trades in government bonds occurs on the same day. There are no primary dealers for the government bond market. There is no centralized database of all outstanding government bonds available to investors. Records of government securities-holders are updated and controlled every time a security transaction is made. The registry is with the SCH and CSD, and it is audited by an external auditor twice per year.

20. Given the very small size of the corporate bond market today, it is not surprising that despite the passage of the Law on Asset-Backed Securities on January 1, 2011, there is no asset securitization market in Mongolia. As the domestic banking sector is at a very nascent stage of development, the market for conventional corporate debt instruments is virtually insignificant, and the institutional investor base is narrow, it is not surprising that there are few buyers of such asset-backed securities. In this regard, it is important that the authorities prioritize resources to address the most critical challenges in the financial sector in building viable long-term financing sources for the economy.
**B. Equities Market**

21. **Mongolia’s equities market exhibits classical frontier market characteristics.** The growth momentum in the domestic economy was reflected in the impressive performance indicators of the MSE. As indicated in Figures 3 to 5, the price indices, market capitalization, and number of transactions have risen rapidly over the past two years, albeit from a very low level. By end-2011, the market capitalization of MSE increased by MNT 794.6 billion or by 58 percent compared to 2010, reaching MNT 2.2 trillion (US$1.6 billion). The price indices and turnover levels of the MSE surged in 2009 and 2010, with the MSE becoming one of the best-performing emerging stock markets in the world.\(^{11}\)

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\(^{11}\) The TOP-20 index of the MSE rose by 46.9 percent in 2011.
Figure 3. Stock Market Capitalization to GDP, 2001-2010

Source: FinStats 2012

Figure 4. Stock Market Turnover Ratio, 2001-2010

Source: FinStats 2012
Nonetheless, the Mongolian stock market is still very small and illiquid. The ratio of stock market capitalization to GDP was merely 16 percent at its peak in 2010. The entire market capitalization amounts to less than US$2 billion. Listed companies are still few in number (336 listed companies) and small in size, with most of the larger ones focused on metallurgy and mining. The MSE Top-20 listed companies account for 86 percent of the current market capitalization. Turnover on the MSE is also among the lowest when compared to other emerging market peers: average daily turnover is only around US$200,000. This low liquidity makes the market disproportionately sensitive to changes in global capital flows and financial risk appetite. At the same time, the principal problem with the MSE Top-20 Benchmark Index is that the majority of the securities are illiquid.

In July 2010, Eurasia Capital launched MonBiz Mongolia Index, a debut global benchmark that tracks the share price performance of 20 largest companies with assets and operations in Mongolia. The MonBiz Mongolia Index covers publicly-listed companies with the total market capitalization of US$15.4 billion, including six companies from the Mongolia Stock Exchange and 14 companies from the New York, Hong Kong, Toronto, London

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12 In Mongolia, the government provided vouchers to each citizen with a right to purchase state shares in state-owned enterprises. The reorganization and listing of these 475 SOEs were the first steps for capital market development. However, the government’s additional selling of remaining shares through auctions resulted in a sharp decrease in market liquidity (Tsolmon, 2008).

13 For comparison, Sri Lanka’s market capitalization is 40 percent of GDP, and Indonesia’s market capitalization is 50 percent of GDP.

14 FRC is working together with MSE to delist companies that do not meet the listing criteria relating to public float.
The MongBiz Mongolia Index is one of the best performing benchmarks globally. To date, it has outperformed MSCI World (-3.31 percent), MSCI Emerging Markets (-0.40 percent), MSCI Frontier Markets (1.15 percent).

24. **Poor standards of transparency and corporate governance negatively affect growth prospects.** The OECD Principles of Corporate Governance say that “corporate governance is one key element in improving economic efficiency and growth, as well as enhancing investor confidence.” By instilling investor confidence, corporate governance is a *sine qua non* for capital market development, and there are strong links among strong corporate governance, capital markets development, and economic growth. Most Mongolian companies do not disclose their earnings with an adequate degree of transparency and accuracy. Poor corporate governance and weak disclosure make the markets volatile, and there is a low level of foreign investor participation. In addition, remote access by international investors is not permitted on the MSE due to the requirement that all trades be routed through a local broker. The listed companies have little free float (estimated at only 5 percent in 2011).  

25. **One major challenge for the MSE is the lack of supply of large and “blue chip” listings on its stock market.** Only six of the listed companies have market capitalization that is over US$5 million. Most of Mongolia’s leading business groups are not listed on the domestic stock market. However, a positive development is the decision of the State Property Committee to privatize large state assets through MSE, and state mining assets might be distributed in the form of shares to the public through MSE (as in the case of ETT). According to the Mineral Law, 10 percent of strategic mineral deposits would have to be listed. According to MSE estimates, out of 100 top local companies in Mongolia, only 13 are listed on MSE. There are at least 18 mining companies operating in Mongolia (estimated to be worth over US$29 billion) producing 5 times the Mongolian GDP, which are listed abroad. As a result, inflow of foreign funds into the capital market on the back of further privatization of undervalued, MSE-listed coal mines is expected to spur dynamic growth of the local stock market.

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15 At least one-third of the market value of these companies is related to Mongolia. The MonBiz Index, which is US$-denominated and market capitalization-based, is aimed to become a leading benchmark for assessing the performance of Mongolia-focused companies.

16 The biggest reason is that majority shareholders do not wish to dilute their shareholdings.


18 Resource Investment Capital, 24 January 2011.
C. Capital Market Intermediaries

26. Capital market intermediaries are not well developed to effectively intermediate between savers and channel them toward investments in the capital market. As of January 2012, the number of broker-dealer companies licensed by the FRC reached 88, out of which 22 act as underwriters, 16 investment advisers, and 1 credit rating agency. Of the 88 broker-dealers, one company carries out more than 50 percent of total transaction volumes on MSE. Most brokers do not actively conduct brokerage business and have very small capital base.\(^{19}\) To date, there are no intermediaries for fund management, no mutual funds in the domestic market, and no derivatives market.

D. Investor Base

27. The institutional investor base in Mongolia is very small. The insurance and pensions sectors and other contractual savings institutions are not developed, and they have insignificant investments in equities and bond instruments. In Mongolia, almost all government bonds are purchased by a small number of big commercial banks, which usually hold them to maturity. In the equities market, individual investors comprise 99.8 percent of the total number of accounts maintained in the CSD. However, it should be pointed out that more than 60 percent of these accounts are dormant and not actively traded. However, it would appear that more and more individual investors are opening new accounts with brokers in anticipation of trading shares on the MSE. Despite this, local and foreign funds account for the most of the volume of trades on the MSE.

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\(^{19}\) FRC plans to raise the capital requirement for broker-dealers to US$250,000 once the new SML comes into force.
III. DEEPENING AND BROADENING CAPITAL MARKETS IN MONGOLIA: CHALLENGES AND RECOMMENDATIONS

28. Mongolia faces several key challenges to deepen and broaden its capital markets. Deepening capital markets will require addressing these pre-conditions through a comprehensive, prioritized reform program that involves:

- Increasing efficiency of the institutional, regulatory and supervisory framework;
- Improving supervisory effectiveness;
- Modernizing market infrastructure;
- Strengthening domestic bond and equities markets;
- Developing a sound institutional investor base; and
- Building capacity of FRC, MSE and market intermediaries.

A. Increasing Efficiency of the Institutional, Regulatory and Supervisory Framework

29. Modernizing the legal and regulatory framework is a critical prerequisite for deepening the capital market in Mongolia. Hitherto, legal and regulatory reforms have been piecemeal in nature. The new SML is expected to lay a sound foundation for the regulation and supervision of the securities markets.

30. The new SML reflects a number of improvements over the existing law and more fully reflects prevailing international standards. Key improvements of the new SML over existing law include the following:

   a. The new SML does not require companies issuing securities in Mongolia to be registered in Mongolia. The existing law requires a company issuing securities in Mongolia to be registered in Mongolia (and therefore requires the company to observe Mongolian laws). This is a deterrent to secondary listings in Mongolia by foreign companies with Mongolian assets or operations that are already listed abroad, as those companies would be subject to the legal and regulatory regimes of their jurisdictions of incorporation. Compliance with both Mongolian and foreign listing rules and other regulatory requirements is very onerous, due to overlapping and perhaps conflicting requirements. The new SML allows a company whose securities are listed abroad to list and trade its securities on the MSE. This would make it far more attractive for dual or foreign listings, as dual compliance would not arise.

   b. The new SML explicitly recognizes the domestic issuance of depository receipts that have underlying securities traded on a foreign exchange (and introduces a legal versus beneficial ownership distinction). The existing law does not recognize the concept of depository receipts. Together with the liberalization of secondary or cross-listing requirements, the net effect is that secondary listings on MSE would be more attractive and feasible.
c. The new SML introduces a clear distinction between legal and beneficial ownership and permits trustees or custodians to provide services to beneficial owners, thereby paving the way for brokers, trustees and custodians to be able to offer their services to investors. The existing law does not make a distinction between legal and beneficial ownership.

d. Other enhancements reflected in the SML are: (i) it sets out in greater clarity responsibilities of brokers, dealers and underwriters; (ii) it strengthens disclosure and transparency requirements; and (iii) it lays out the framework for settling trades based on T+3 system whereby securities trades are settled via delivery and payment within 3 business days consistent with general international practice (as opposed to the current settlement based on a pre-funded system).

31. Nonetheless, there are areas of improvement to the SML for it to effectively underpin the operations of a modern securities market in Mongolia. In particular, the SML should address the following critical policy issues:

a. The roles of the FRC and the MSE, particularly in relation to listings, need further clarification to ensure efficiency and effectiveness. The delineation of responsibilities between the FRC and MSE may be established through an MOU or guidance that documents the regulatory arrangements between the regulator and the stock exchange.

b. Market feedback from participants in Mongolia also suggests that it is often far simpler and faster for companies to seek either equity or bond financing abroad rather than domestically, largely because the domestic market lacks depth to absorb companies’ financing needs, and partly because regulatory approvals can take a long time. As competitiveness of the MSE must be an important consideration in attracting both domestic and foreign companies to list, the regulator would benefit from a more market-friendly approach that is practiced in established markets.

c. Broad discretion that is conferred on the FRC (in its dual role as competent authority for listings and securities market regulator) may raise investor protection concerns, if such discretion is not exercised under a transparent and consistent framework. In order to mitigate the risks of legal challenge to FRC’s actions, it would be useful for FRC to review its internal systems and processes to ensure that appropriate checks and balances operate on its supervisory judgments and initiatives with regard to the new powers under the new SML.

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20 The November 2011 SML draft was provided by FRC to the FSAP team. The mission team has reviewed the November 2011 version of the SML and provided detailed technical comments to the FRC, some of which are discussed in this technical note.

21 An example of the broad discretion that is given to FRC is the provisions under Article 9 in regard to FRC’s approval of fundraising proposals.
d. With regard to regulatory approach to approving fund-raising proposals, Mongolia’s capital market would benefit from a market-based due diligence system where valuation is done by a qualified independent party (and not the regulator) and where such valuation is disclosed in the prospectus. Article 10.7 of the new SML provides, among other things, that the methodology for pricing securities for public offer shall be an inseparable part of the prospectus for public offerings. This provision would inevitably have the effect of requiring FRC to review the valuation of assets of the issuer, among others. In regard to valuation of assets that may not have historical earnings record (such as mining assets and green field projects), the regulators may not be well-equipped to review the valuation in a credible way, as this may potentially distort market-based price discovery. As the target pool of listings of the MSE are companies which are engaged in the exploration for and extraction of natural resources that typically may not have a historical track record of earnings, valuation of such companies would more appropriately be done by qualified valuation experts.

22 e. The FRC might consider introducing the concept of sponsors for IPOs. Concerns about the quality of due diligence could be addressed by introducing sponsors for fund-raising transactions. Sponsors would be responsible for preparing issuers for listing, submitting the application for listing, and dealing with all matters concerning the application. Additionally, sponsors would have to be satisfied that new issuer are suitable to be listed, that information contained in each prospectus is complete and accurate in all material respects, and that issuers’ directors will be able to honor their obligations under the listing rules and regulations post-listing. In this regard, the concept of sponsors in certain markets has been found to be a very useful tool by regulators to bring about an acceptable standard of due diligence. However, the service they provide comes with considerable costs to the issuer. The trade-off is that for certain types of markets, such as for companies with no earnings track record or high-risk markets, relying on sponsors to “weed” out companies that are not suitable for listing can be a useful mechanism for regulators as regulators and competent authorities may not be in the best position to assess the suitability of listings.

f. Roles and responsibilities of different participants in a fund-raising transaction should be clearly spelled out to ensure that responsibility and liability are properly apportioned and understood by all concerned. Article 9.15 states that “A person involved in preparing the prospectus and relevant documents shall be liable for

For example, under the Hong Kong Listing Rules, it is provided that valuation should be made by persons who are certified under The Standards and Guidelines for Valuation of Mineral Properties endorsed by the Canadian Institute of Mining, Metallurgy and Petroleum, February 2003; the South African Code for the Reporting of Mineral Asset Valuation (2008 edition); or the Code for the Technical Assessment and Valuation of Mineral and Petroleum Assets and Securities for Independent Expert Reports (2005 edition), as prepared by the VALMIN Committee, a joint committee of The Australasian Institute of Geoscientists and the Mineral Industry Consultants Association.
any losses incurred to others by this person’s service”. When read together with Article 10.7, it may have the potential effect of imposing liability on lawyers, accountants and professionals who may be involved in the preparation of the prospectus as part of their professional responsibilities as accountants or lawyers (and not as experts). If this is the intended effect, then this provision may not be in keeping with general standards on civil liability for such type of professionals. Generally, civil liability for the contents of the prospectus extends only to information which is within the knowledge of those responsible for particulars of the prospectus and listing, or information which it would be reasonable for them to obtain by making enquiries. The persons responsible for the prospectus and listing particulars are:

i. The company itself;

ii. The directors at the time when the prospectus is submitted to the stock exchange. However, a director is not responsible if the prospectus is published without his knowledge or consent and, on becoming aware of its publication, the director immediately gives reasonable public notice that it was published without his knowledge or consent;

iii. Each person who has authorized himself to be named, and is named, in the prospectus as a director;

iv. Each person who accepts, and is stated in the prospectus as accepting, responsibility for the prospectus and listing particulars or part thereof; and

v. Any other person who has authorized the contents, or any part of, the prospectus.

With regards to the “non-expertise” portions of the prospectus, the professionals can rely on the due-diligence defense based on the standard that, after making reasonable investigation and due inquiry, they have no reason to believe that there was any misstatement or omission in the prospectus. For the “expertise” portions of the prospectus, the experts would need to give their consent to the information that is disclosed in the prospectus. In addition, for the “non-expertise” portions of the prospectus, professionals such as lawyers perform due diligence based on information and representations made by the board members and management. In this regard, they should be responsible for reasonable standards of due enquiry of the veracity and accuracy of the information, but should not be held liable for the contents of the prospectus.

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23 Article 10.7 states that “Methodology for pricing securities for public offer, the issuer’s financial statements for the last three years verified by an Independent Auditor registered pursuant to 33.3.3 of Article 33 of this law and respective regulations, quarterly and monthly financial statements prior to the application for listing the securities, and the Lawyer’s report shall be inseparable parts of the prospectus”. 
h. No provisions have been made in the SML for “preliminary prospectus” or “red herring” prospectus to facilitate the “book-building” process in an IPO. Often in an IPO a preliminary prospectus, or a “red herring” prospectus (as it is called in the U.S.), would have all the relevant information concerning the securities offering such as the business profile of the issuer, risks, management profile, business direction, earnings track record, etc. What would be unavailable in such a prospectus are the number of shares proposed to be issued, and the final pricing for the issue, among other things. The process of “book-building” facilitates the issuer and its underwriter to gauge the level of institutional interest and support in a corporate proposal. This enables the issuer through its underwriter to fix the best possible price of the securities which are to be offered. The SML should clarify the position of such preliminary or “red herring” prospectus. Of course, there must be controls to be imposed to ensure that it is not used to advertise to members of the public. Typical controls include: the preliminary prospectus is required to have a conspicuous notice that it is not a prospectus; no application form is contained in or attached with such a preliminary prospectus; and categories of investors to be circulated must be institutional investors or professional investors.

i. Article 11.5 of SML needs to be reviewed to ensure that the power of the FRC to revoke or revise its approval of a fund-raising proposal should be circumscribed, so as not to affect the rights of third parties that have acquired rights as a result of the implementation of a fund-raising proposal. Once the rights are vested in investors upon the listing of the shares, the action to be taken by the FRC (in the face of false and misleading information that is provided in the prospectus) would necessarily be different. Hence, while the FRC should be able to revoke or revise a given approval, or even impose further terms and condition in relation to a fund-raising proposal, FRC should only be able to do so if it does not affect the rights of a third party that may have been created arising from the listing of the securities.

j. “Stop order” power should be considered for the FRC, in case the FRC finds that a prospectus contains false and misleading information after its registration. In addition to the ability of investors to claim compensation through the court as provided under Article 11.9, consideration should be given to providing the FRC with the enforcement option to issue a “stop order”, if it is discovered that a prospectus contains any false and misleading information. By means of a “stop order”, the FRC would have the administrative powers to prevent the circulation or publicizing of the prospectus that contains false and misleading information.

k. It is important that the competitive positioning of the MSE in regard to listings be clearly articulated through the Listing Regulations, such as the aspiration to attract mining companies to list on the MSE. In this regard, it would be useful that the Listing Regulations clearly address mining and extractive industry requirements. While it certainly would be necessary to provide for rules on general matters, such as public spread, it would be useful for the Listing Regulations also to make special
provision for early-stage mining and exploration companies in articulating the policy that MSE is prepared to list early-stage or pure-play exploration companies. For example, LSE AIM’s Note for Mining, Oil and Gas Companies\(^{24}\) includes requirements for a Competent Person’s Report (CPR), admission document disclosure, material assets of the applicant, site visits, etc. AIM asks the mining company applicant to provide a Mineral Resources and Reserves Statement that meets internationally-recognized standards that are acceptable under one of the following codes and/or organizations: CIM, IMMM, JORC, Russian, SAMREC and SME. In Canada, TMX has five categories of “Listing Requirements for Exploration and Mining Companies.“\(^{25}\) These are not mentioned in the draft Listing Regulations.

1. **There appears a fair bit of overlap between the provisions in the SML and the Listing Regulations.** It would be important to determine the provisions that must be in the new SML, and the implementation aspects arising from these to be provided for in the Listing Regulations.

m. **Regulatory policy on derivative instruments should be clearly articulated in the new SML.** There appear to be some inconsistencies in the definitions. More importantly, the question arises whether Mongolia needs a derivatives market today, particularly given the small size of the cash markets and the level of sophistication among local market intermediaries. Care needs to be exercised in determining what are to be excluded from the scope of regulation in the new SML for derivative financial instruments. Since the term “derivative instrument” is very broadly defined under Article 4.1.7 to refer to “other financial instruments permitting Options Contract and Futures Contract to be traded in regulated markets”, it would appear that even in regard to call warrant products, retail investors may not be permitted to participate. The definition of “securities” under Article 5 does not appear to extend to stock options or futures products.

n. **The regulatory framework needs to introduce the concept of “Know Your Customer” (KYC) obligations on a regulated entity,** which would require regulated entities to determine the suitability of investments for their clients. This is particularly important, given the planned migration of the securities settlement system from a pre-funded basis to a T+3 cycle. It also represents an important aspect of securities regulation related to investor protection. Such a provision provides reasonable defense to the regulated entity if the entity has conducted due diligence and made reasonable enquiries of the risk profile and investment needs of its customers.

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o. It is important that the FRC be conferred with explicit legal authority to provide assistance to a foreign securities regulator. The law should make it clear that the FRC can act where the request for assistance relates to the functions of the foreign securities regulator, and that it will not be necessary for the subject matter of the request to constitute a breach of Mongolian law. In this regard, safeguards can be incorporated, such as: (i) requiring that the foreign regulator be willing to provide reciprocal assistance in response to a comparable request from the FRC; (ii) limiting assistance to instances that serve the public interest; (iii) requiring that the foreign regulator provides satisfactory confidentiality arrangements; and (iv) limiting assistance to instances where the foreign regulator pays some part of the costs associated with the request.

p. Article 49.4 of the new SML may need to be reviewed; as currently drafted, it authorizes FRC to “prescribe the methodology for financial ratings”. Under IOSCO Standards on oversight of ratings agencies, Principle 18 spells out the need for quality and integrity of ratings services that are in line with IOSCO Standards as set forth by the Code of Conduct Fundamental Standards. Ratings agencies whose opinions are directly used for regulatory purposes may have such an important function in the market that they should be subject to an appropriate oversight regime. Such a regime should include regulatory requirements that set out initial entry standards and ongoing supervision of the respective entities. Hence, article 49.4 of SML should reflect the IOSCO terminology.

q. Provisions relating to enforcement should be clear about the consequences of non-compliance.

r. Mongolia is not a signatory of IOSCO’s Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMoU). This MMoU establishes international standards for co-operation and information exchange for enforcement purposes among its signatory securities regulators. Failure to sign the MMoU may be seen as a weakness of the regional authorities’ international co-operation and enforcement capacity, particularly with the strategy to attract foreign listings on the MSE. Through the new SML, the FRC aims to seek the legal authority necessary to enable it to become a full signatory to the MMoU.

32. Recommendations with regard to institutional, regulatory and supervisory framework include the following:
   
a. Adopt a comprehensive SML, consistent with international good practices, to underpin the modernization of the MSE and the operations of a modern securities market (FRC, MOJ, MSE, MOF—short-term);

   b. Adopt a market-based due diligence system where valuation is done by a qualified independent party (and not the regulator) and for such valuation to be disclosed in the prospectus (FRC—short-term);
c. Consider introducing a system of sponsors to support IPO listings on MSE to enhance due diligence (FRC, MSE—short-term);  
d. Introduce a KYC obligation on regulated entities that provide investment advice to clients (FRC, MSE—short-term); and  
e. Provide explicit legal authority for FRC to provide assistance to foreign securities regulators in line with IOSCO standards (FRC, MOJ, MOF—short term).  

B. Improving Supervisory Effectiveness  
33. The FRC must have sufficient financial resources and operational autonomy commensurate with its expanding responsibilities to effectively meet the complexity and challenges in supervising the capital markets. This is particularly crucial with the rapid developments in the securities market today. The FRC is tasked with supervision of both nonbank financial institutions and capital markets, and it faces the challenge of filling the gaps in the legal framework and strengthening the regulatory, supervisory, governance, internal control, and accounting and auditing frameworks. It has a tremendous workload, but it is severely constrained in terms of resources. With the rapid modernization of the capital markets, this needs to be matched by a reasonable level of human and financial resources in the FRC.  
34. FRC’s operational independence should be enhanced with sufficient financial resources and flexibility in acquiring and managing skilled human capital. Two possible approaches may be: allowing FRC to retain the fees it collects from licensing and registering prospectuses; and sharing with FRC a small percentage of clearing fees from sales and purchase transactions made on the stock exchange. This is the common approach in many jurisdictions (for example, Hong Kong, Sri Lanka, Malaysia and Thailand).  
35. It appears that the SML provides FRC insufficient statutory protection against legal actions brought against it or its member staff in the course of the discharge of their statutory functions. This presents a risk to those charged with enforcing regulations, because they could be subject to lawsuits by entities or individuals, regardless of whether they conducted their actions in good faith. This could create an aversion to carrying out needed enforcement actions. FRC has indicated that in the event a legal action is taken against the FRC or any of its member staff, according to the Law on Civil Service and State Inspection, legal counsel is provided by the state attorney to assist the FRC member staff in defending the legal action. It would appear, then, that the extent of legal protection to the FRC and its staff is insufficient as required under IOSCO’s standards. The SML would need to explicitly provide for legal protection of FRC and its member staff in carrying out their statutory responsibilities, as long as they carry out their responsibilities in good faith. This would be in line with IOSCO principles to ensure that the regulator can act without fear or favor and be effective in the implementation and enforcement of the securities law.  
36. Under the recently amended Banking Law, the FRC is required to work with the BOM to jointly adopt regulations on consolidated supervision. The FRC is also required to
work closely with the Financial Intelligence Unit (FIU) on AML/CFT initiatives and has recently adopted a regulation regarding reporting requirements for NBFIs. More coordination and training for FRC is needed to implement effective consolidated supervision. It will also be necessary for FRC to work closely with the FIU in implementing effective AML/CFT regimes at organizations under its supervision.

37. **Recommendations with regard to improving supervisory effectiveness include the following:**
   
   a. Enhance FRC’s operational independence with sufficient financial resources and flexibility in acquiring and managing skilled human capital. This can be done by allowing FRC to retain the fees it collects and to share a small percentage of clearing fees from sales and purchase transactions that are effected on the stock exchange\(^\text{26}\) (MOF, FRC—short-term);
   
   b. Ensure the new SML or the Law on Legal Status of the Financial Regulatory Commission provides sufficient legal protection to the FRC and its staff in carrying out their duties in good faith or consistent with the law (MOF—short-term).
   
   c. Targeted training for FRC on consolidated supervision and risk-based supervision (FRC – medium term).

C. Modernizing Market Infrastructure

38. **The commitment of the authorities to the modernization of market infrastructure for the securities markets should also be matched with urgent attention to addressing the fundamental issues of a narrow investor base and product range on the MSE.** An automated surveillance, trading and settlement system using the Millenium IT technology and IT system is being installed in the MSE. It would monitor trading activity, settlement obligations and exposures daily. This system will be shared by MSE, SCH, CSD, and the FRC. However launching the new trading, clearing, settlement and depository systems without a market readiness assessment by an independent professional firm gives reason for concern. New systems provide complex operational challenges for the MSE, SCH, and CSD, and the intermediaries involved. It is important that a market-readiness assessment be carried out by a competent and independent professional firm. The firm should report to the FRC on the readiness of the new market infrastructure and effectiveness of its risk management framework before giving its approval for the launch.

39. **Of equal importance is the need to ensure that securities intermediaries are well trained to manage the risks that will arise from the migration from a pre-funded settlement system to a T+3 settlement cycle.** KYC know-how would be new to domestic brokers, since the current system operates on a pre-funded basis. At the same time, an effective clearing and

\(^{26}\) This is the common approach in many jurisdictions (for example, Hong Kong, Sri Lanka, Malaysia and Thailand).
settlement system should necessarily detail the roles and responsibilities of all market participants and relevant stakeholders to minimize uncertainties in relation to the MSE, SCH, and CSD.

40. **An important feature which appears to be absent from the design of the new clearing and settlement system is the settlement guarantee mechanism.**\(^{27}\) The benefit of a settlement guarantee mechanism is that trades on the stock exchange are protected from defaults that may arise from the insolvency of or inability to settle by a broker or a broker’s client. Settlement risk is further mitigated with appropriate capital standards for intermediaries. In most systems, access to clearing and settlement systems is limited to those intermediaries that meet capital requirements. The strength of the enforcement of compliance with capital standards will have a direct impact on settlement risk.

41. **Systemic risks arise with the inability of one institution to meet its obligations when due causing other institutions to be unable to meet their obligations when due.** The Bank for International Settlements (BIS) has defined “systemic risk” to be "... the risk that the collapse or insolvency of one market participant will be transmitted to another participant." Systemic risk can be reduced by a centralized system through two mechanisms. First, these systems can reduce the credit and liquidity risks that might precipitate problems for any one participant. This reduces the risk that these problems might be transmitted to others. Second, a centralized settlement guarantee system creates opportunities to install risk containment mechanisms that can absorb systemic risks before they have an impact on other participants. The purpose of the settlement guarantee mechanism is to provide a guarantee to participants of the MSE that the settlement of their transactions will take place no matter what happens to their counterparty. The settlement guarantee mechanism is not a compensation fund for clients (it does not replace the Fidelity Fund), and it could be funded through contributions of money or liquid securities by each participant through assessments on each transaction.

42. **Recommendations with regard to modernizing market infrastructure include the following:**

   a. MSE should commission a market readiness assessment conducted by a professional firm in regard to the operations of the new trading, clearing, settlement and depository systems. The market readiness assessment report should be submitted to FRC prior to FRC giving its approval for the launch of the new system (MSE, FRC—short-term);

   b. Brokers should be given appropriate training on KYC so as to be able to manage the risks in the move to a T+3 clearing and settlement system. MSE should document and convene briefing sessions for all relevant stakeholders on the level of stakeholder participation expected (MSE, FRC—Medium-term);

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\(^{27}\) The FSAP team was informed by the LSEG representative in MSE that there is a very preliminary proposal for settlement guarantee mechanism that is being discussed with the FRC.
c. Authorities should consider introduction of a settlement guarantee mechanism with appropriate risk management framework including appropriate risk-based capital framework (MSE, FRC—medium-term).

D. Strengthening Domestic Bond and Equity Markets

Bond Markets

43. Although the authorities have recently initiated a number of important reforms in relation to the government bond market, particularly in relation to public debt management,28 significant improvements are still required to develop a robust, local-currency bond market. The relatively low level of development of the government bond market in Mongolia is primarily due to the following factors: the irregular issuance of bonds, the lack of a comprehensive bonds database available to investors, and an emphasis on mobilizing urgent funding without due consideration of the longer-term consequences for debt management and market development. In addition to fiscal objectives, public debt management in Mongolia ought to have market development and liquidity objectives in mind.

44. Weaknesses in the government bond market are impeding the development of corporate bond and derivatives markets due to the lack of a reference yield curve or a credit risk-free hedging instrument. The government plans to issue a significant amount of bonds to fund various public projects, and an efficient government bond market would enable the government to reduce the cost and the risk related to debt management. To-date, government securities are issued through a market-based mechanism, but borrowing by the government is ad hoc. Although participation in primary auctions is open to all financial institutions and individual investors, only a handful of large local commercial banks typically participate in auctions. In the absence of a regular issuance of government bonds, there is no established benchmark yield curve in Mongolia.

45. The lack of regular and open dialogue with key market players also dampens participation in auctions of government bonds. The current practice of identifying the bidder of each bid is another disincentive, as it can disclose sensitive information about banks’ positions to competitors. To improve transparency and the ability of market participants to plan and absorb the government’s funding requirement, the Debt Management Department should consider publishing quarterly updates of the auction calendar, announcing its intentions for the quarter in terms of specific volumes and tenors to be auctioned. Regular consultation with market participants would enhance their confidence.

46. The design of government bonds should be standardized and their issuance concentrated in a limited number of popular, benchmark maturities. A key goal at this stage

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is to achieve sufficient depth in benchmark maturities across the yield curve in order to create a term structure for “risk-free” interest rates as a basis for developing auxiliary markets in derivatives for risk management and hedging purposes. Design should take into account investor preferences in maturity, coupon, and tax status.

47. Developing a liquid market in long-term government bonds, however, requires active participation by intermediaries and an efficient market infrastructure. Market intermediaries, including securities houses, investment banks, brokers, and commercial banks, should operate on a competitive and efficient basis, with adequate capital and risk management practices. There has been some discussion within MOF about the introduction of a system of primary dealers and Asian Development Bank is proposing to provide technical assistance to MOF in examining the suitability of introducing such a system for Mongolia.

48. The MOF is currently exploring the best option in regard to the primary market infrastructure for government securities. Currently, MSE conducts multiple price auctions on behalf of the government, with the cut-off rate being decided by the DMD. Typically, fewer than five commercial banks will purchase 99 percent of the securities auctioned. The MOF is currently reviewing three possible options with regard to the primary auction system: (i) continuing to use MSE’s auction platform, (ii) integrating it with the Bank of Mongolia’s auction platform for central bank bills, or (iii) developing a new auction platform customized to the MOF’s needs. Each alternative has its own strengths and weaknesses. To name a few, MSE’s auction system is open to all investors including non-bank financial institutions and individual investors, while BOM’s system is only accessible to banks. However, BOM’s auction system might be more efficient and secure than other alternatives in terms of its connectivity to the payment system. An entirely new system can be developed to meet the market’s needs most effectively, although it might cause some concerns about cost and duplication of investment. In this regard, the authorities are in the process of working with the Asian Development Bank through technical assistance (TA) for developing the government bond market through improving market infrastructure and broadening the investor base. The TA will focus on, among other things, upgrading the primary auction system and developing financial intermediaries. The TA will conduct a comparative analysis of the various options for the primary auction system and provide policy recommendations for improving the current system.

Equities Market

49. The lack of large and quality issuers, a narrow investor base, and a limited product range are key impediments for equity market growth. A low equity culture and a low level of investor literacy have deterred investor confidence in the stock market.

50. The government’s strategy of privatizing state-owned assets through listings on MSE provides a unique opportunity for growth of the MSE. Attracting quality issuers to list on the MSE would require a market-based price discovery process instead of pre-determined
This is because pre-determined valuation by the government potentially affects the listing process and distorts the price discovery that is critical to the success of any IPO. It is also important to ensure that key elements of the legal and institutional framework are in place prior to any major listings.

51. **Recommendations with regard to strengthening domestic bond and equities markets include the following:**

   a. Improve debt issuance strategy to support the development of the risk-free yield curve (MOF—short-term);

   b. Review the pricing methodology of government bonds to ensure that they are properly priced and market-based, so as to avoid distortions (MOF—medium-term);

   c. Build a central repository of information relating to the issuance, outstanding amount and terms of government and corporate bonds to promote transparency that could facilitate investors’ decisions about investment in corporate bonds and other financial instruments (MOF—medium-term);

   d. Review the suitability of using the MSE auction system for primary issuance of government and corporate bonds, and consider the feasibility of introducing a primary dealer system (MOF—medium-term);

   e. Identify a pool of large and high-quality issuers to expand the issuer base, including channeling privatized, formerly state-owned enterprises that are financially viable for listing on MSE (SPC, FRC, MSE—medium-term);

   f. Provide a framework that facilitates foreign listings or dual listings (FRC, MSE—medium-term);

   g. Broaden the product range of MSE, including depository receipts (MSE, FRC—short-term);

   h. Enhance investor education and awareness in order to build an equity culture, and enhance investors’ confidence (FRC, MSE, Ministry of Education—medium-term).

E. **Developing a Sound Institutional Investor Base**

52. **One of the most important dimensions of domestic capital market development in Mongolia is the need to develop a diversified institutional investor base in the economy.** Institutional investors, consisting of mutual and investment funds and other contractual savings institutions, such as pension funds and insurance companies, play a critical role in financial market development. They provide an institutional framework for long-term capital

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29 For example, in the listing of ETT, GoM has decided that 20 percent of ETT shares shall be given free of payment to Mongolian citizens prior to its listing. It has been announced that Mongolian citizens can sell their shares to the government for MNT 1 million, which suggests that each ETT share has already been valued at MNT 933 ahead of the IPO.
accumulation and act as a stable source of demand for long-term debt securities and equity investments.

53. The government should set up a high-level task force to review how contractual savings institutions, particularly pension funds and perhaps sovereign wealth fund-type entities,\(^{30}\) can be developed as a viable domestic institutional investor base for Mongolia. The experience of East Asian countries such as Malaysia, Singapore, South Korea and Thailand should be highly useful. Contractual savings institutions can affect securities markets development through several channels. First, they provide institutional set-ups for accumulation of long-term capital, because they may have longer time horizons than other investors. Second, they may be active traders of securities, thereby contributing to greater liquidity. Also important, the mutual fund industry can cater to retail investors with different needs and risk appetites. From the chart below, it can be seen that South Africa has the largest domestic investor base relative to its GDP due to the existence of pension funds, insurance companies and mutual funds. South Korea’s National Pension System is one of the largest in the world. Malaysia’s Employee Pension Fund is the major institutional investor in the country, and it has played an important role in developing the domestic capital market. The existence of a collectively-managed, large pool of long-term investment funds has enabled countries such as Malaysia and Singapore to finance large infrastructure projects in their domestic bond markets. This is a perhaps the most critical challenge in capital market development in Mongolia, which needs to be addressed.

**Figure 7. Institutional Investors as Percent of GDP, 2009**

![Graph showing institutional investors as percent of GDP for various countries](image)

54. Developing a sound investor base is a challenging endeavor that will require, among other things, actions on three fronts: (i) creating the conditions for the more active role of banks in the growth of institutional investors; (ii) ensuring that regulations of commercial banks, insurance and pensions are consistent with the expansion of capital markets to private

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\(^{30}\) Even though SWFs mainly invest off-shore rather than invest at home.
enterprises; and (iii) monitoring eventual regulatory arbitrage opportunities created by the fast-growing wealth management products. In this regard, authorities should review the current regulatory framework of institutions such as commercial banks,\textsuperscript{31} insurance companies,\textsuperscript{32} and pension funds to identify any requirements that might limit their participation in capital markets.

55. **From the perspective of investors, a legal and regulatory framework that promotes good governance and transparency, and effective enforcement are essential.** The regulatory system must adequately address corporate governance and disclosure, especially financial disclosure. Price discovery in turn depends on adequate reliable information. In addition, the accounting and auditing standards that underpin financial disclosure are crucial to build this credibility. Lack of reliable information on bonds, issuers and bonds market is a deterrent to investment, because investors need quality information for their investment. With the recent enhancements to corporate governance and disclosure requirements, the challenge is for the FRC to effectively enforce these requirements in order to build confidence. Other measures to strengthen and broaden the investor base include measures that facilitate cross-border investment. This makes it urgent to ensure that regulations on investment funds and custodians are introduced, and that these are benchmarked against international best practices.

56. **Recommendations with regard to developing a sound institutional investor base include the following:**

a. Undertake further analytical work to understand demand dynamics in the equities and bond markets, with a view to widening the investor base (MOF, FRC, MSE—medium-term);

b. Set up a high-level task force to review how contractual savings institutions, particularly pension funds and perhaps sovereign wealth fund-type entities, can be developed as a viable domestic institutional investor base for Mongolia (MOF, BOM, FRC—long-term).

c. Review the current regulatory framework of institutions, such as commercial banks, insurance companies, and other contractual savings institutions, to identify any requirements that might limit their participation in capital markets (BOM, FRC, MOF—medium-term);

d. Enhance the quality of financial information, particularly for entities that raise funds in capital markets, by enhancing enforcement capacity of FRC and developing an audit oversight system (FRC, MICPA, MOF—medium-term).

\textsuperscript{31} For example, banks’ investments in corporate bonds are deemed to be loans for purposes of calculating the single-customer limit.

\textsuperscript{32} Recently, insurance companies are allowed to invest 20 percent of their assets in shares, and they have no limitations in government bonds.
e. Introduce investment fund and custodian regulations that are benchmarked against international best practices (medium-term).

F. Building Capacity of Regulators, MSE and Market Participants

57. **Capacity of the FRC, MSE and other market participants needs substantial strengthening to meet the challenges and sophistication that come with capital market development.** Systematic training should also be planned for each level of member staff of the FRC, MSE and SCH to keep up with developments and new products in the marketplace. With the clearing and settlement system moving from a pre-settlement system to T+3, it is imperative for a risk-based supervisory approach and the requisite skill sets to be built for the staff of FRC, MSE and SCH.

58. **Further, the FRC would need to be substantially equipped with enforcement skills with a much expanded enforcement mandate that is conferred on the FRC.** Experience in developing and emerging economies has shown that regulators are the main line of defense for shareholders. Under the new Companies Act, the FRC now has powers to: (i) file claims to court to liquidate listed companies; (ii) receive statements on distribution of dividends; and (iii) receive complaints from shareholders concerning shareholders’ meetings. In addition, the FRC has power to impose administrative penalties, such as fines for certain breaches of the Company Law committed by listed companies. It is essential for FRC to have the resources, independence and integrity to play an effective role in ensuring that regulatory requirements related to disclosure, shareholder rights and other corporate governance arrangements are respected. FRC can also play an important role in ensuring that stock exchanges and other self-regulatory bodies observe high ethical and professional standards. With enhanced corporate standards introduced by the new Companies Act, there is the need for listed companies to prepare their financial statements accurately and on time with full accountability and transparency, and to publish on a timely basis all company information that needs to be in the public domain. Local audit companies need to be trained to audit their financial statements accurately, on a timely basis, and in accordance with their responsibilities, as laid out in the International Accounting Standards.

59. **Given the lack of institutional investors, individual investors are poised to play a substantial role.** Efforts to build a strong investor protection system and improve public awareness and investor education should complement market development efforts. There has not been much discussion in the public domain of the investor protection framework that can promote interest and trust in the stock market. The public’s lack of understanding of stock market investments and its lack of trust in the formal financial system suggest that a comprehensive financial literacy program and investor protection measures should be formulated and delivered as a priority.

60. **Recommendations with regard to building capacity of regulators, MSE, and market intermediaries include the following:**
a. Provide structured and systematic training and capacity-building programs for staff of FRC, MSE and SCH in risk-based supervision, market surveillance, and corporate finance (FRC, MSE—short- and medium-term);
b. Enhance FRC’s enforcement capacity, especially in the implementation of the new reforms to the Companies Law and the new SML (short and medium-term);
c. Enhance financial literacy and promote investor education programs on stock market investments (medium-term).

61. **Prioritization of the reform measures in the capital market would ensure greater success in implementation.** Without careful prioritization and implementation, the government’s ambitious goals for the capital market could potentially be undermined, and scarce resources may be diverted to less urgent areas in market development. In this regard, it would be useful for the authorities to develop a roadmap for the next five years of capital market development in Mongolia, as it would be useful to document the relevant development strategies to meet these challenges, as well as to ensure readiness of stakeholders. A five-year time horizon can be considered normal based on the experience of other East Asian countries. In addition, an implementation plan should be created that prioritizes and sequences the necessary development initiatives.

Nominal GDP (2010): US$6,244 million 1/
Population, end-year (2010): 2.78 million
Poverty incidence (2007/08): 35.2 percent 3/
Quota: SDR 51.1 million

### Real sector

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
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<tbody>
<tr>
<td>Real GDP growth</td>
<td>10.2</td>
<td>8.9</td>
<td>-1.3</td>
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<td>Mineral</td>
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<tr>
<td>Non-mineral</td>
<td>11.6</td>
<td>10.3</td>
<td>-1.6</td>
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<tr>
<td>Consumer prices (period average)</td>
<td>8.2</td>
<td>26.8</td>
<td>6.3</td>
<td>10.2</td>
<td>10.2</td>
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<tr>
<td>Consumer prices (end-period)</td>
<td>14.1</td>
<td>23.2</td>
<td>1.9</td>
<td>14.3</td>
<td>11.1</td>
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<td>GDP deflator</td>
<td>11.6</td>
<td>21.4</td>
<td>1.6</td>
<td>20.0</td>
<td>9.8</td>
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### General government budget

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<tr>
<td>Revenue and grants</td>
<td>37.9</td>
<td>33.1</td>
<td>30.2</td>
<td>36.5</td>
<td>40.6</td>
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<td>Expenditure and net lending</td>
<td>35.3</td>
<td>37.6</td>
<td>35.2</td>
<td>35.3</td>
<td>44.2</td>
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<tr>
<td>Current balance</td>
<td>13.1</td>
<td>5.9</td>
<td>2.6</td>
<td>9.2</td>
<td>10.8</td>
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<tr>
<td>Primary balance</td>
<td>3.0</td>
<td>-4.2</td>
<td>-4.5</td>
<td>1.7</td>
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</tr>
<tr>
<td>Overall balance (including grants)</td>
<td>2.6</td>
<td>-4.5</td>
<td>-5.0</td>
<td>1.2</td>
<td>-3.6</td>
</tr>
<tr>
<td>Non-mineral overall balance</td>
<td>-9.8</td>
<td>-13.9</td>
<td>-11.8</td>
<td>-10.4</td>
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<tr>
<td>Structural balance 4/</td>
<td>...</td>
<td>...</td>
<td>-6.6</td>
<td>-2.7</td>
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### Money and credit

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<th>2011</th>
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<tbody>
<tr>
<td>Broad money</td>
<td>55.6</td>
<td>-5.1</td>
<td>26.9</td>
<td>61.6</td>
<td>37.1</td>
</tr>
<tr>
<td>Broad money velocity (GDP/BM)</td>
<td>2.1</td>
<td>2.9</td>
<td>2.3</td>
<td>1.8</td>
<td>1.7</td>
</tr>
<tr>
<td>Interest rate on 7-day central bank bills, end-period (percent)</td>
<td>8.4</td>
<td>9.4</td>
<td>10.0</td>
<td>11.0</td>
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</tr>
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### Balance of payments

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<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
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</thead>
<tbody>
<tr>
<td>Current account balance (including official transfers)</td>
<td>265</td>
<td>-722</td>
<td>-410</td>
<td>-931</td>
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</tr>
<tr>
<td>(In percent of GDP)</td>
<td>6.3</td>
<td>-12.9</td>
<td>-9.0</td>
<td>-14.9</td>
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</tr>
<tr>
<td>Trade balance</td>
<td>-54</td>
<td>-613</td>
<td>-194</td>
<td>-278</td>
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</tr>
<tr>
<td>Exports</td>
<td>1,949</td>
<td>2,534</td>
<td>1,876</td>
<td>2,899</td>
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<tr>
<td>Imports</td>
<td>-2,003</td>
<td>-3,147</td>
<td>-2,070</td>
<td>-3,177</td>
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</tr>
<tr>
<td>Foreign direct investment</td>
<td>360</td>
<td>836</td>
<td>496</td>
<td>1,574</td>
<td>...</td>
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<tr>
<td>Gross official international reserves (end-period)</td>
<td>1,001</td>
<td>658</td>
<td>1,328</td>
<td>2,288</td>
<td>...</td>
</tr>
<tr>
<td>(In months of next year’s imports of goods and services)</td>
<td>3.2</td>
<td>3.0</td>
<td>4.0</td>
<td>4.2</td>
<td>...</td>
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### Public and publicly guaranteed debt

<table>
<thead>
<tr>
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<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
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<tbody>
<tr>
<td>Total public debt</td>
<td>36.5</td>
<td>31.0</td>
<td>46.6</td>
<td>42.2</td>
<td>...</td>
</tr>
<tr>
<td>Domestic debt 5/</td>
<td>0.5</td>
<td>0.0</td>
<td>3.4</td>
<td>12.0</td>
<td>...</td>
</tr>
<tr>
<td>External debt</td>
<td>36.1</td>
<td>31.0</td>
<td>43.3</td>
<td>30.2</td>
<td>...</td>
</tr>
<tr>
<td>(In millions of US$)</td>
<td>1,529</td>
<td>1,602</td>
<td>1,977</td>
<td>2,023</td>
<td>...</td>
</tr>
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### Exchange rate

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Togrogs per US$ (end-period)</td>
<td>1,170</td>
<td>1,268</td>
<td>1,443</td>
<td>1,257</td>
<td>...</td>
</tr>
<tr>
<td>Togrogs per US$ (period average)</td>
<td>1,170</td>
<td>1,169</td>
<td>1,441</td>
<td>1,348</td>
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</tr>
<tr>
<td>Nominal effective exchange rate (end-period; percent change)</td>
<td>-3.3</td>
<td>-2.7</td>
<td>-15.8</td>
<td>3.4</td>
<td>...</td>
</tr>
<tr>
<td>Real effective exchange rate (end-period; percent change)</td>
<td>6.7</td>
<td>18.1</td>
<td>-11.1</td>
<td>11.3</td>
<td>...</td>
</tr>
<tr>
<td>Nominal GDP (In billions of togrogs)</td>
<td>4,957</td>
<td>6,556</td>
<td>6,591</td>
<td>8,415</td>
<td>10,830</td>
</tr>
</tbody>
</table>

Sources: Mongolian authorities; and IMF staff projections.

1/ Based on period average exchange rate and NSO revisions.
2/ Estimate, based on period average exchange rate and NSO revisions.
3/ Based on The Household Socio-Economic Survey 2007-08.
4/ As defined in the fiscal responsibility law, which uses smoothed instead of actual commodity prices to calculate revenue.
5/ Domestic debt in 2009 includes the Oyu Tolgoi tax-prepayment while the estimates for 2010 and the projections for 2011 additionally include the estimated fiscalization cost of bank restructuring and the financing of the government’s equity share in Oyu Tolgoi.
### Annex 2. Implementation of Prior FSAP Recommendations on Capital Markets

*Selected observations in line with focus of Development Module*

<table>
<thead>
<tr>
<th>Objective</th>
<th>Recommended Action</th>
<th>Status of Implementation</th>
</tr>
</thead>
</table>
| Capital market development | Expand and upgrade capital market supervision. | • The Securities Market Department has 19 staff out of which only 5 member staff is dedicated to supervision responsibilities.  
• The proposed Securities Markets Law (which is expected to come into force in June 2012) is expected to pave the way for a more risk-based approach to market surveillance.  
• The new MIT system that would be installed in the Mongolian Stock Exchange in partnership with London Stock Exchange has an automated surveillance system. It will monitor trading activity, settlement obligations and exposure daily. This system will be shared by MSE, SCH&CD and the FRC and has the following capabilities:  
  - Price Watch - monitors intra-day price fluctuations and signals unusual changes. Insider Detection - identifies changes in price, volume & activity level before and after news.  
  - News Pending Trading Halts - initiates a trading halt if important company news is pending.  
  - Volume Watch - monitors intra-day trading volumes and signals unusual increases. Block Watch - monitors block trading.  
  - Market Replay - can replay trade by trade.  
• Capital requirements for broker-dealers would be increased to US$250,000 on the coming into force of the new Securities Markets law but there is no risk-based capital framework as yet. The supervision staff of FRC would need extensive training and capacity building in order to be able to implement the new Securities Markets Law effectively. |
|          | Expand the capacity of the SCHCD. | • The SCHCD has 30 officers in 5 departments namely Administration & Finance Department, Public Relations Department, Internal Control Department, Depository & Registration of Ownership Right Department and Settlement & Risk Management Department.  
• SCHCD has since November 2010 signed partnership agreement with Association of National Numbering Agencies and started allocating ISINs to financial instruments in Mongolia.  
• With the modernization of the Mongolian Stock Exchange and the installation of Millennium IT Software Ltd., a software platform provide by the London Stock Exchange Group that would facilitate trading, surveillance, clearing & settlement, & CSD systems. With this, SCHCD would be migrating from pre-funded settlement to T+3 settlements. SCHCD is in the preparatory phase of the project. Main weakness in the proposed structure is the lack of a central guarantee fund to protect the risks of default from counterparties as well as the accompanying legal protection that is given to the clearing house as the CCP as a preferred creditor and its claims to collateral posted by |
participating members should not be impaired in the event of the insolvency of a participating member. Furthermore, brokers are not sufficiently trained in Know Your Customer approach to manage counterparty risks with the doing away of the pre-funded clearing arrangements.

| Delist noncompliant companies from the MSE. | • Out of 336 companies currently listed on the MSE, 118 are suspended from trading. For the year 2010, 19 companies were delisted and for 2011, 22 companies were delisted. |
| Improve corporate governance. | • A new Companies Act was introduced in 2011 which ushered in major changes on corporate governance standards. For the first time, the new Act introduced and defined the concept of ‘group of companies’ (Article 6.13) and ‘connected companies’ (Article 6.14). In recent years, number of corporate groups increased in Mongolia and their legal status has not been clear. The significance of this is that any member of a ‘group of companies’ is can be considered as an ‘affiliated party’ in the scenario of conflict-of-interest transactions.  
  * The parent company can be liable for insolvency and loss of the affiliate or subsidiary company that was caused by a decision of the parent company (Article 6.6 and 6.7). The definition of and the duties, responsibilities and liabilities of ‘governing officers’ of a company have become more specific and clear. Now the ‘governing officers’ are required to provide a list of parties affiliated to him/her within 10 days after its appointment (Article 85.1).  
  * Definition of parties subject to conflict-of-interest transaction is broadened. Article 89.1 now says ‘If a shareholder who, independently or jointly with party affiliated to him/her, holds 20 or more percent of a company’s ordinary stock, and a company’s governing officer and/or his/her affiliated party are engaged in the following relationship with the company for which he/she works and/or of which he/she holds shares shall be considered as a party subject to conflict-of-interest transaction with that company or with that company’s affiliate or daughter company:…”.
  * Amendments were also made to strengthen the responsibilities and accountability of the Board of Governors (BoG) in number of ways by adding new responsibilities that, in certain areas, are subject to penalty as well as intervention by the FRC.  
  * Significant changes were made to the composition and structure of BoGs. The Act requires the BoG of listed companies to have 3 committees, namely audit committee, remuneration committee and nomination committee. It also provides for additional control responsibilities to independent members of BoG.  
  * Companies are obliged to inform the public of its ‘major transactions’ via the quarterly and annual financial statements (Article 88.4). Failure by listed companies to carry out its obligations to report, inform and notify is subject to administrative penalty (Article 100.1.1).  
  * Two significant amendments serve to enhance protection of minority shareholders. First, provisions were introduced to ensure that shareholders’ meetings are convened in timely and due manner. Shareholders, irrespective of the size of their shares, now are empowered to resort to
court and to FRC. For example, Article 70 permits shareholders of a listed company who did not participate in the shareholders’ meeting or who participated, but held opposite vote may file a complaint with the FRC on the ground that the meeting discussed issues that are not included in the agreed agenda. Second, reporting and notification obligations of listed companies have been strengthened and increased, and failure to do so is now subject to penalties and liabilities.

- The new Companies Act introduced several new provisions concerning the role of FRC over listed companies. For example, the FRC now has rights to: (i) file a claim to court to liquidate a listed company (26.6, 31.5), (ii) receive statement on distribution of dividends (46.1433[1]), and (iii) receive complaints from shareholders concerning shareholders’ meeting (70.2). Please see below the translation of major new provisions related to FRC.

- A new Article 100 gives the court and the FRC the right to impose administrative penalties i.e. fine for certain breaches of the Company Law committed by listed companies.