

**MANAGEMENT RESPONSE ON THE PROGRAM PERFORMANCE AUDIT REPORT
ON THE CAPITAL MARKET DEVELOPMENT PROGRAM IN BANGLADESH
(Loan 1580-BAN[Sf])**

On 6 July 2005, the Director General, Operations Evaluation Department, received the following response from the Managing Director General on behalf of Management:

A. Overall Comments

1. Management appreciates that OED has done the interdepartmental review process in ADB, as well as the consultation process with concerned government authorities in finalizing the PPAR. Management notes that PPAR's overall rating is largely consistent with that of the Program Completion Report (PCR) of this program loan. It is also noted that ADB provided the Capital Market Development Program (CMDP) in response to a domestic stock market crises at the urgent request of the Government. The PPAR assessed that the CMDP had some mixed results in some areas. However, it also assessed that the CMDP demonstrated notable success in several key areas including (i) empowering the Securities and Exchange Commission (SEC) by strengthening its legal status as an independent and autonomous regulatory institution; (ii) the introduction of a surveillance system, helping avoid another major market failure; (iii) enhancing the accountability of the Dhaka Stock Exchange (DSE) and the Chittagong Stock Exchange (CSE) through strengthening governance system and audit and inspection, and establishing the investor protection fund; and (iv) modernizing capital market support facilities, such as a central depository system and automated trading systems in DSE and CSE.

2. Management heeds PPAR's suggested lessons in ADB's future similar operations. As recommended by the PPAR, ADB will maintain policy dialogue with the Government to follow up some remaining measures under the CMDP, and will continue to monitor the progress of financial market governance in conjunction with the proposed TA loan from 2005.

B. Specific Comments

3. **Stakeholder Consultation** (6th para. of the Executive Summary, paras. 23 and 83). In several paragraphs of the PPAR, it was indicated that there was inadequate consultation with stakeholders during program formulation. The Operations Evaluation Mission (OEM) suggested that a more balanced and market-friendly regulatory environment could have resulted if there had been more stakeholder participation. However, it should be noted that ADB missions have undergone wide-ranging consultations with Government authorities and agencies, development partners, and various stakeholders in preparation of the program and during the processing of the program loan. The Government at the outset convened a donors meeting to ascertain what support could be provided by donors in the wake of the stockmarket crisis besetting the economy. Consequently, donors were fully aware with respect to ADB's program and provided support to ADB as the lead agency on capital market reform. While

ADB was formulating the program to address the stockmarket crisis, the USAID provided a small-scale TA to help the Mission. This was followed by a larger TA funded by UNDP, but administered by ADB leading to the formulation of reform actions. During loan processing, ADB extensively consulted with the Government and various market players and stakeholders, as well as the donors.

4. **Relevance** (Para. 83). The OEM's assessment of the CMDP as 'partly relevant' is arguable considering that the program was launched to address a very specific urgent need at the request of the Minister of Finance. This assessment is also regarded contradictory to the acknowledgement by the OEM of the consistency of the program objective with the Government's strategy over the years, and its view that the comprehensiveness of the scope of CMDP was justified. In fact, the Report and Recommendation of the President (RRP) for CMDP pointed out that financial sector and capital market reforms and privatization were among the Government's priorities at that time.

5. **Key Issues for the Future** (Para. 93–94). The physical separation of dealership from brokerage operations (para. 93) was made necessary during the 1996 scam as the broker-dealers were responsible for preying on the unsuspecting public by booking transactions for their own accounts when those were favorable to them (acting as dealers) and booking transactions for client accounts when prices went adverse (acting as brokers). Since the transactions were done manually, it was relatively easy for brokers to cover their tracks and there was no way to prove their actions. However, now that the trading system has been automated and a central depository has been established, separation is no longer required as the automated system provides a clear audit trail. These were the precise reasons why automation and the establishment of a central depository were recommended. However, the segregation of underwriting from portfolio management as well as from the brokerage function should remain in place for the following reasons: (i) market governance remains relatively poor, (ii) the regulator still has very weak enforcement capacity, and (iii) market still lacks the needed discipline to self-regulate. This matter can be revisited under the proposed Financial Markets Governance TA for processing in 2005.

6. Justification for an independent Regulatory Appeals Tribunal depends on whether there will be a substantial number of cases to be heard, which appears unlikely. Furthermore, such a tribunal is not likely to prosper unless it is provided an adequate budget. In consultation with the Government and SEC, ADB missions have advised that when formulating laws and rules, SEC should ensure transparency and adequate consultation with all stakeholders likely to be affected, and that a process be established for this, such as providing exposure drafts to the public and calling for public meetings and forums where differing views may be properly ventilated and discussed.

7. **Lessons Identified** (Para. 96). We agree with the importance of stakeholder consultations. However, the segregation of dealership and brokerage operations in the CMDP was recommended because the issue of conflicts of interest between dealer and broker were significant under the manual trading system during the capital market scam in 1996, and not because stakeholders were not consulted.