

The Influence of Financial Instruments Directive (MiFID) on the Macedonian Capital Market

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Abstract

The securities market, as an integral part of the financial market, is a mechanism that allows for the allocation of long-term financial assets, by the legal and natural persons who own the assets, to those subjects that need additional assets for financing their investments plans and programs. A basic precondition for creating a competitive and profitable securities market is having favorable financial environment, which means primarily a quality legal framework, stable currency, as well as “healthy” public finances.

The actual Macedonian Securities Law was adopted in 2005. With several amendments and modifications that were made in the meantime. Some provisions in the current law complies quite closely with MIFID – (Markets in Financial Instruments Directive)

The aim of this paper is to determine the current level of compliance with regard to some crucial provisions, regulated by the Securities Law, and simultaneously to analyze the MIFID provisions regarding this issue, that should be implemented yet. In this direction, we consider that, based on actual research, we would be able to determine the effects of the implementation of MIFID to the securities market participants, as well as overall effects of MIFID to the existence and development of regulated Macedonian securities market. Thus, we would be able to contribute to the process of the standardization of the Macedonian legislation related with the securities market, with the hope that the appropriate and proper implementation of EU directives will give a positive impulse to the functioning of the Macedonian Capital Market.

Key words: MIFID, securities market, Securities Law of the Republic of Macedonia, implementation, regulative

1. Introduction

The process of European Union market integration is long and difficult. At the beginning, establishing an integrated financial market is based on minimum harmonization and the supervisory role is left to the EU member-states, while later this process dictates a reinforcing of thorough harmonization and establishing a centralized regulatory system. In order to create this kind of regulatory system sooner and, at the same time, simultaneously follow the dynamics of the capital markets on one side, while implementing successfully and coordinating the regulatory bodies of the member-states on the other, it was necessary to apply the so called *Lamfalussy* process. This process includes the four FSAP¹ Directives: Directive 2003/6/E3 on illegal stock trading and market manipulation (illegal market activities and fraud), Directive 2003/71/E3 on publishing a brochure for public placement of securities and their acceptance in trading, Directive 2004/39/E3 on financial instruments market, and Directive 2004/109/E3 on transparency of data on the regulated markets. Despite different levels of development of the individual member-states' financial systems, after 2002 the *Lamfalussy Process* was accepted and supported by the European Parliament, thus applying to the whole financial system. The pan-European trading would have been almost impossible, if MiFID² had not been put in place and accepted by all member- states. Many³ have called this Directive the revolution of the European securities market as well as a foundation of the Action Services Plan (FASP) of the European Commission. MiFID led to a higher level of harmonization of investment services and

¹Financial Services Action Plan (акциски план за финансиски услуги), http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm#actionplan , last accessed on 06.03.2012.

² Directive 2004/39/EC of the European Parliament and the Council of 21 April, 2004 on markets and financial instruments which amends and adds to the directives 85/611/EEC and 93/6/EEC of the Council, and Directive 2000/12/EC of the European Parliament and the Council which annuls the Directive of the the Council 93/22/EEC.

³ Jean- Pierre Casey – Vice-President in Product and Technical Compliance at Barclays Wealth in London and Karel Lannoo - Chief Executive of the Centre for European Policy Studies (CEPS) in Brussels and directs the European Capital Markets Institute (ECMI).

transactions with securities within EU; it increased the competitiveness of the financial services, which, in general, originate from the globalization. Yet, the harmonization of the member-states with the MiFID Directive has taken more than three years⁴. Despite the belated enforcement of the MiFID Directive, it has proved an effective instrument in overcoming barriers, integrating the European capital market and increasing the competitiveness.

In the process of MiFID adoption, the European Commission went through a broad range of consultations and public debates between the potentially interested parties. The *ex ante* analysis based on the surveys conducted by KPMG⁵, showed that out of 199 directors of financial institutions included in the survey, over 40% thought that MiFID would: 1) improve the transnational access to national markets, 2) improve the transparency of the European capital markets, 3) facilitate the transnational distribution of financial services, 4) provide uniformity in the investment societies within EU, 5) speed up the process of integration of the European capital markets, 6) create a harmonized regulatory system within the EU member-states, and 7) increase the liquidity of the European capital markets.⁶ At the same time, 60% of those surveyed answered that the work of the national regulatory agencies during the consultation process related to the obligations ensuing from MiFID, was poor or very poor.

The main precondition to create competitive and profitable securities market is the presence of a favorable financial environment, which primarily presupposes a solid legal framework, stable currency, and healthy public finances. Brokerage houses have the leading role in developing this environment. KPMG 's survey pointed out that the "winners" from the MiFID implementation process were the IT consultancy firms, the investment banks and the investment fund managing societies, while the "losers" were the small investors and institutions affiliated to them, such as the small brokerage houses. Brokerage houses, as securities markets participants, have a specific role as mediators between the investors and the capital beneficiaries. They are simply institutionalized agents who work for their clients.

⁴ The MiFID Directive was enforced in the EU and the European Economic Zone on 01.11.2007, a few years after its adoption.

⁵ KPMG International is a Swiss cooperative that serves as a coordinating entity for a network of independent firms operating under the KPMG name

⁶ KPMG International report written in co-operation with the Economist Intelligence Unit „Capturing value from MiFID”, 2006 .accessed in http://www.kpmg.at/uploads/media/Capturing_value_from_MiFID_2006.pdf

Due to the specific role of the brokerage houses in the security market, their establishment and operations are regulated by the Securities Law⁷ and strictly controlled by a specific government body, the Commission on Securities. The Securities Law (SL) has been considerably harmonized with MiFID, though further work remains. This article proposes to determine the present degree of harmonization of the SL regulations regarding the brokerage houses and, analyze the MiFID provisions related to this field which are pending implementations as part of the Republic of Macedonia's obligations on the road to the EU membership. On the basis of the research we have conducted, we will determine the effects of the implementation of the MiFID Directive within the SL, making a concrete contribution to the normative process of the Macedonian regulation related to the securities markets, anticipating that an adequate and correct implementation of the EU Directive will provide a positive impulse in the work of the brokerage houses.

Taking into consideration the large scope and influence of the MiFID Directive, the research in this paper is focused only on the influence upon one type of investment firms operating on the territory of Republic of Macedonia – the brokerage houses. The other entities were excluded from the research, as a result of the time and material expenses restraints. There is a plan to conduct a study that should provide a chronological and comparative presentation, as well as descriptive statistics of the MiFID's influence upon each institution.

2. Current Situation with the Normative and the Actual Position of the Authorized Participants on the Capital Market in the Republic of Macedonia

According to the current SL, an authorized participant on the security market can be any individual or legal entity participating in the work of the securities market which has an adequate permit, issued by the Securities and Exchange Commission. These participants include for example securities depositories, stock exchanges, banks, brokerage houses, investment fund managing societies, investment funds, brokers and investment consultants.

⁷ The Law on Securities, "The Official Gazette of R. Macedonia", No: 95/05; 25/07; 7/08; 57/10; 135/11 The Decision of the Constitutional Court, C No. 48/2006-0-1 of 07.11.2007.

With regard to the operational activities of the brokerage houses, it is important that new provisions have been included in the Law which harmonize the SL with the Directive, aimed at greater transparency and efficiency in their work with clients. In that regard, the SL prescribes a range of rules for the brokerage houses, including such issues as protection of clients' interests, solving conflict of interests, registration of clients' work orders, informing the clients.

The Law on Amending the SL of 2008⁸ stipulates one more service which the authorized participants at the securities markets (the brokerage houses and the banks⁹), can offer. Namely, it is stipulated that they can offer the service of "custody of securities". This would mean opening and managing securities accounts for clients at depositary, and other related securities services upon requests of clients. For this purpose, the authorized participants on the capital market sign a special agreement with their clients, the so-called custodial agreement for safe keeping securities, which regulates the mutual responsibilities and the rights in providing this service.

The expectations are that MiFID will lead to further consolidations on the brokerage industry. However, the costs of MiFID implementation will affect the small brokerage houses, which, in the previous decade, were numerous in Macedonia, as well as many European countries¹⁰. In that respect, it is important to consider the situation with the number of authorized participants in the Macedonian securities market. In 2005 there were 16 participants, 10 brokerage houses and 6 banks; in 2006, there were 17 members, 11 brokerage houses and 6 banks; in 2007, the so-called "year of records", there were a total of 22 members, 16 brokerage houses and 6 banks at the Macedonian Stock Exchange Skopje. The year of 2009, witnessed the largest number of authorized participants, a total of 27 active members. At the end of the same year, the number of authorized participants decreased to 25. During 2010, the total of 24 members were functional, while at the end of the same year, only 20 remained active; in 2011, 19 members functioned at

⁸ Official Gazette of R. Macedonia No. 07/08 of 15.01.2008;

⁹ When we speak about the authorized participants in the security market, we refer to the brokerage houses and the banks which have a separate organizational unit for trading with securities, upon approval of the regulator (KS);

¹⁰ It should be noted that some of the analyses made (The Frankfurt University study) in the German and the British markets (Gomber and Reininger 2006, LEGG 2006) point out to the fact that the costs should not be taken as a key factor for opening brokerage houses, because the costs needed of the MiFID are in correlation to with the size of the houses.

the market. At the beginning of 2012, 18 participants were active of which 12 brokerage houses and 6 banks with departments that work with securities.

On the basis of the above records, there is an obvious trend of decrease in the number of brokerage houses in the Republic of Macedonia, especially in the last 3 years (after the period of their expansion until 2009). It should also be mentioned that one of the main reasons for the increase in number of brokerage houses in the Republic of Macedonia up to 2008-2009 was the remarkably large trading on the Macedonian Stock Exchange, especially during the period of 2006-2007. This encouraged a certain number of domestic and foreign investors to open new brokerage houses. Then the beginning of the world financial crises in 2008, contributed to a dramatic drop in the exchange and trading at the Macedonian Stock Exchange, which logically led to closing down a certain number of brokerage houses. Actually, it was not only the case with R. Macedonia, but this trend emerged in the other countries of the region and the broader EU territory.

3. Certain Specifics of the Regulation Related to the Brokerage Houses as Authorized Participants of the Securities Market in the Republic of Macedonia

As mentioned, SL legal entities offering services related to securities include brokerage houses, the banks and the branches of foreign brokerage houses. A brokerage house (or a special organizational unit of a bank) is established to offer the following services or operations related to securities: a) buying and selling securities upon the client's request and for the client's account; b) buying and selling securities on personal behalf and for the personal account; c) managing securities portfolio upon a request and for the account of an individual client; d) doing transactions and activities on account of an issuer of securities, needed for a successful public placement without the mandatory buy off the unsold securities; e) doing transactions and activities on account of an issuer of securities needed for a successful public placement with a mandatory buy off the unsold securities; f) acting as a sponsor in listing; (g) investment advice; g) doing transactions and taking activities on behalf of third persons in a takeover of a shareholding company in accordance to the Law on Takeover of Shareholding Companies; and h) keeping securities which includes opening and managing securities accounts in personal name but on behalf of their clients at depositary, and opening and managing securities accounts for third clients which are not the owners of the securities, but on behalf of their clients, and other services related to securities on request of

clients (settling received claims by security issuers for the received securities; interest rates and dividends on behalf of security owners; notifications of and representation at shareholders' meetings, payment of tax on securities owned by their clients, and similar).¹¹

A brokerage house to offer services under the items a), f) and g) must have a basic capital of EUR 75,000. A brokerage house wishing to offer services under the items: a), c), and g) must have a base capital of EUR 150,000. Finally, a brokerage house wishing to offer all the above-mentioned services must have the base capital of EUR 500,000. Six banks and the one brokerage house as listed participants¹², have the authorization to offer all services, having a base capital of EUR 500,000 in accordance with the SL. The remaining 10 brokerage houses have a base capital of EUR 75,000, maintaining the legally required minimum of a base capital for their operation. No operative brokerage house has base capital of EUR 150,000 in Macedonia at the present moment. It should be noted that, brokerage houses with this amount of base capital had been founded in Macedonia, but the negative trends at the Stock Exchange and the considerably decreased scope of trading, forced them to decrease their base capital to EUR 75,000. Actually, this was confirmed by the research conducted for the aims of this paper.¹³

The SL regulation has been fully harmonized with the part of the Directive with the heading "investment services and activities". The SL requires that a brokerage house have a work permit issued by the Security and Exchange Commission of the Republic of Macedonia (SEC), also in accordance with the Directive. In this direction, the Law lists and specifies all the necessary documentation to be submitted to the regulator enclosed with the application to establish a broker firm.

The situation with the procedure for appointing a director of a brokerage house is similar, the regulator's approval is necessary. Article 9, paragraph 4 of the MiFID, lists the principle prerequisites which a candidate for a director of a brokerage house, with an emphasis on a good reputation and relevant experience. Adjusting this part, the Macedonian legislature has specified in considerable detail the necessary documentation and preconditions. Research has shown that this procedure does not present difficulties to the brokerage houses in the Republic of Macedonia.

¹¹ Article 94 of the Law on Securities;

¹² See *Supra* page 8 of the paper;

¹³ *Infra* in the text, item 3;

The SL also regulates the establishment of brokerage houses in the Republic of Macedonia by foreign physical and legal entities or branches of the entities, as part of harmonizing the domestic legislation with the MiFID. Thus, a foreign brokerage house, authorized to offer all or some of the security related services in any of the OECD countries, can offer the same services on the territory of the Republic of Macedonia via a branch, after having obtained a work permit from the SEC. Besides opening a branch of a foreign brokerage house, the law provides for the domestic brokerage houses to open branches within the territory of the Republic of Macedonia. In the period of increased trading on the Macedonian Stock Exchange (2006 and 2007), several brokerage houses headquartered in Skopje, opened branches in major Macedonian towns. Unfortunately, with the downturn of the stock exchange, these branches have been gradually closed, so that today no domestic brokerage houses have any branch locations. It should be noted that in the period of economic growth, several brokerage houses were established in the Republic of Macedonia by foreign physical and legal entities. Unfortunately, we note again that the negative trends in trading at the Macedonian securities market, led to the closing of a number of the brokerage houses with predominantly foreign capital.

The SL inaugurated the principle of protection of client's interests, thus determining that the brokerage house shall be responsible to inform the client immediately about all the circumstances leading to the client's decision-making in buying or selling securities, and/or for other the services offered, as well as information to the client about security investment risks. The brokerage house shall be responsible to try to obtain all the necessary information from the clients about their experience in security investments and their financial conditions and goals, important for protection of their interests¹⁴. It seems that this requires an additional legislation, since current laws do not fully implement the requirements of the Directive.

According to Article 122 of the SL, the brokerage house shall be responsible to carry out any legal request of client immediately after the market conditions allow it. The brokerage house shall carry out requests of clients to sell and/or buy securities in accordance to the order of requests registered in the register. It is important to point out that the brokerage house cannot buy or sell securities for its account or for the account of a person employed by that brokerage house if this impedes a client's request to buy and sell, or if it results in an unfavorable realization of client's request. This provision of the legislation, granting a priority to

¹⁴ Article 117 of the SL;

the client over that of the brokerage house and its employees, is fully understandable and in accordance with the Directive.

In 2005 the SL passed a law in accordance with Article 13 of the MiFID, establishing a protection mechanism related to client's financial resources allocated to buying securities.¹⁵ The brokerage house shall be responsible to keep these financial resources in a separate account opened for that purpose only, that is, client's account registered in the Central Bank of the Republic of Macedonia. The financial resources of the client can be used only in accordance with client's instructions. The brokerage house cannot make payments related to security transactions in its own name and for its own account with financial resources that belong to the clients. In addition, the financial resources of the clients do not enter the total assets of the brokerage house in case of bankruptcy or a liquidation and cannot be used to settle the financial liabilities of the brokerage house.

4. Analyses of the Research Findings in the Area of Current Domestic Regulation, Related to the Capital Markets in the Republic of Macedonia

During 2011, the work of the Macedonian Stock Exchange was affected by many factors and circumstances of international, regional and local character, which influenced the trading of securities on the stock exchange. In this respect, we should mention first that the growth of the world economy fell significantly in 2011, though a majority of the developed economies avoided recession. The EU countries reported 1.6% growth in 2011, bolstered primarily by Germany's 3% growth.¹⁶ The debt crises in some of the countries in the Euro-zone caused the euro to drop in value resulting in restraint and pessimism among investors to invest in the Euro-zone, waiting for outcomes of the stabilization and support measures to the most indebted countries in the euro-zone, to give results.

During 2011, the Macedonian economy gradually recovered from the consequences of the world economic crises, which resulted in the slowdown of the growth of the developed economies, economies that are main partners of the Macedonian companies.

During this time, the National Bank of the Republic of Macedonia (NBRM) kept the same monetary policies from the previous year, maintaining the interest

¹⁵ Article 123 of LS;

¹⁶ World Economic Outlook Update, IMF, 24.01.2012

rates of the treasury notes at the same level of 2010, as well as maintaining the same level of actual cash flow available to credit the economy and the population. At the same time, the banks continued to lower the passive interest rates, while the government maintained the same level of the interest rate of the treasury notes, which resulted in the relative balancing of the income of the most secure financial instruments with the income of the capital markets. However, the slow recovery of the Macedonian economy and the geo-political instability of surrounding countries, resulted in investor being less willing to invest in the Stock Exchange, which affected the liquidity of the stock exchange trading.

The debt crises of some of the Euro-zone countries and the world economic trends in 2011 influenced the trading and price levels at the security markets, with few foreign institutional investors.

Unfortunately, 2011 did not witness significant changes related to the open issues posed as preconditions of Macedonia's becoming integrated into the Euro-Atlantic organizations. This had implications upon the expectations of the stock exchange investors and their business and investment decisions. The favorable tax environment, the low inflation rate and the currency exchange rate of the Macedonian denar, were certainly positive factors.

For the purposes of this paper, a survey questionnaire was put together and distributed among the authorized participants in the financial market. Out of 18 market participants (12 brokerage houses and 6 banks with specialized organizational units for trading with securities), we had a response rate of 72.2%, receiving the answers from 13 participants (7 brokerage houses and 6 banks). Thus, we can conclude that the responsiveness to the survey was 72.2%. We believe that this is a satisfactory percentage to produce relevant survey results.

The first question: are you fully familiar with the SL provisions? A high percentage of the surveyed brokerage houses, 84.6% answered that they were familiar with the provisions, while 15.4% answered that they were only generally familiar with these provisions. None of the brokerage houses answered that they were not sufficiently familiar or that they were not familiar at all, which we believe is understandable and expected. For the sake of comparison, at the beginning of 2006, the Frankfurt University conducted a similar analysis of 55 investment firms established in Germany, of which only 14% answered that they were familiar with the new rules and half that they had begun the necessary internal preparations for adjustment with the MiFID. Generally speaking, the postponement was a result of the lack of financial resources of the investment firms. During the same period, KPMG conducted an analysis of 199 financial institutions throughout EU, and the

results were similar: 48 percent were in preparation, while only 29 percent of the surveyed firms had appointed a project manager.¹⁷

The second question: are you familiar with the part of the MiFID Directive which deals with brokerage houses (and the authorized participants at the market)? Again a high percentage, 89.1%, of the surveyed participants answered that they were generally familiar with it; 5.5% answered that they were familiar with it in details; 5.4% answered that they were not familiar with it sufficiently.

The third question: do you think additional adjustments should be made to the SL with the indicated Directive in the area of brokerage houses? All of the surveyed firms, 100%, indicated that further laws were necessary, and that a thorough analysis of how these laws would affect the securities market should be done beforehand, due to the current situation in the market.

The fourth question: would the conditions of the Macedonian securities market (especially the work of the brokerage houses) improve with the full implementation of the MiFID Directives? Of the respondents, 54% answered "I do not know", while 23% of the surveyed participants answered "yes, they would be improved partially" and another 23% answered "no".

The fifth question: how do you assess the work of the regulator (CS) from the perspective of the development of the security market, especially the work and the functioning of the brokerage houses in the Republic Macedonia? The largest number of the surveyed, 46.1%, answered that the regulator's work is unsatisfactory, that is, poor; 30.8% assessed that the work is satisfactory; 23.1% described it as good. It should lead to strengthening the cooperation with the brokerage houses, joint drafting on legislation (Laws) and subordinate regulation, consultations and undertaking of other joint activities in a bid to contribute together to the development of the capital market which is of certain benefit to both concerned parties and the state.

The sixth question: what were the business results in the performance of the brokerage houses in the last 3 business years? To which 69.2% of the participants answered that they were not satisfactory, they had suffered losses; while 30.8% answered that they had satisfactory business results. None of the participants answered that they had solid results in their performance.

¹⁷ Jean-Pierre Casey and Karel Lannoo: *The MiFID Revolution*, Cambridge University Press, 2009, p. 12

The seventh question: whether the broker houses find adherence to the provisions of the SL and the sub-legislation difficult in their day-to-day work? 69.2% answered that adherence to the provisions presented difficulties to a certain extent; while 30.8% of the surveyed answered that it was not a problem to adhere to the SL provisions and sub-legislation.

The eight question of the survey questionnaire is dedicated to the penal policy against the brokerage houses and brokers, to which 38.4% of the surveyed answered that the penal policies were not adequate at all and they should be completely amended; while 23.2% answered that the penal policy was generally well regulated, but certain improvements were still necessary.

At the end of the survey questionnaire, the participants were given a chance to give general opinions about the present situation in the domestic legislation, sub-legislation and decisions related to the capital market, and offer suggestions and remarks for their improvement. One important remark indicated a need for a higher level of adjustment and harmonization of the provisions are necessary among the Company Law, the Law on Securities, the Law on Banks, the Law on Takeover of Shareholding Companies, the Law on Investment Funds, the Law on Financial Societies, the Law on Supervision of Insurance.

Regarding the question of adjustments with the relevant (MiFID) directive, their general impression is that these standards, generally coming from highly developed capital markets, if simply implemented in our country without taking into account the financial situation of the brokerage houses, the present conditions and the level of development of the market itself, could lead to retrograde processes such as closing down of some of the authorized market participants. These standards should be implemented gradually and adjusted adequately to the development of the domestic financial market.

Responses concerning the penal policy stipulated by the SL indicated that the policies do not contribute to the development of the capital market, and are an obstacle to further development, enhancement of liquidity, brokers' inventiveness and do not encourage broker skills and abilities. These comments, of course, do not mean that the penal provisions should not exist at all, but they should be adequate to the offences. Unfortunately, in reality, the regulator punishes the broker for insubstantial or formal-technical irregularities. Undoubtedly, the accent should be placed on revealing more substantial irregularities, manipulations and frauds perpetrated by the brokers, for which, harsher sanctions should be imposed, including temporary and permanent loss of the broker's licenses, and perhaps even criminal charges.

One of the more substantial remarks from the survey, certainly is the suggestion to include the brokerage houses and the other participants in the capital markets in the process of drafting the legislative and sub-legislative acts. This is important because they can convey their experiences and problems encountered daily. At the same time, some of the brokerage houses pointed out certain ambiguities and possibilities of differing interpretation of some of the SL provisions, which leaves room for arbitrariness in imposing sanctions.

Another very important objection refers to the huge number of sub-legislation (rules and regulations) in the SL which, in certain situations, go beyond the provisions of the Law, generating provisions which are not in nature of the SL. The legislative regulations are the main foundation in the development of the industry (the brokerage industry), however they can be a hindrance to the development and growth at the same time. In that respect, the question remains whether the laws and the regulations are one of the main limiting factors for advancement and the development of the securities market to reach the level of other countries in the region.

5. Conclusion

MiFID is a framework for rules designed to promote competitiveness among trading partners, increase the competitiveness, create new trading markets and new financial services, increase the transparency and investors' protection, possibilities of best execution of requests and lower transaction costs, cooperation between regulatory bodies, simplification of transnational transactions as a result of the regime of unified licensure for investment firms, overcoming the problem of asymmetric information and better risk management. We have already stressed that the implementation of the EU Directive is necessary in the process of harmonization of the Macedonian legislation, having in mind the Macedonian aspirations to the EU membership. However, it is our opinion that the Directive should not be immediately, unconditionally and fully implemented. It should be a gradual process with adequate assessments as to whether the extent and the conditions for its implementation are right in the Republic of Macedonia.

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