



Hussaini & Hussaini

Attorneys and Counselors at Law

**FINANCIAL DISCLOSURE
AND CORPORATE GOVERNANCE
A CHALLENGE AT THE
PALESTINE SECURITIES EXCHANGE**

Prepared by: Attorney Dr. Hiba Hussaini

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53 Irsal St. Awwad Bldg, 3rd Floor, Ramallah, Palestine
Tel (970/972) (2) 296-1733, Fax (970/972) (2) 296-0244
info@hussaini.com, www.hussaini1.com



Husseini & Husseini

Attorneys and Counselors at Law

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53 Irsal St. Awwad Bldg, 3rd Floor, Ramallah, Palestine
Tel (970/972) (2) 296-1733, Fax (970/972) (2) 296-0244
info@husseini.com, www.husseini1.com



FOREWORD

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EXECUTIVE SUMMARY

This paper examines the development of capital markets in Palestine with emphasis on the role of the Palestine Securities Exchange (PSE) in equity formation by attracting foreign and domestic investors. The PSE, the only secondary market in Palestine, was established under license from the Palestinian Authority (PA). In mature markets with well-developed stock markets, the market plays a significant part in capital formation and economic growth. Well-established multinationals continue to raise equity through market operations to expand existing operations, and start-ups have the opportunity to raise capital at lower costs through initial public offerings (IPO). An equity market allows companies to rely more on equity and less on debt or internal financing. The access to equity capital provided by a stock market helps create a less risky financial structure in the event of economic downturns, because the company is not as dependent on internal financing or external credit. Scrutiny by analysts and investors of companies whose shares are publicly traded on a stock market can also help increase the efficiency of investment and management decisions, enhancing corporate governance.

To generate sustained liquidity and volume it is essential that markets observe fundamental international norms that provide the conditions for investor confidence. These fundamental norms include:

- An appropriate legal framework;
- Competent regulatory authority with licensing and enforcement powers;
- Accounting laws and rules that comply with international standards; and,
- Strong disclosure requirements to ensure that investors receive timely and adequate financial information.

Markets that observe these fundamental international norms usually have a larger capitalization in terms of GDP than do markets where some or all of these fundamentals are missing. Unless all of these fundamentals are present, the market will be inefficient and the cycle of business development and economic growth is hampered.



The establishment of the Palestine Securities Exchange further underscored the need for disclosure and creation of an appropriate legal and regulatory regime. The elements of such a regime have now been articulated in various pieces of draft legislation, including the Securities Law, Accounting Standards Law, Capital Market Authority Law, and Companies Law. These laws are now pending for the Palestinian Legislative Council, the legislative body of the nascent Palestinian state.

Today, five years after its creation, the PSE remains an inefficient mechanism for capital formation. Although offering state-of-the-art electronic facilities and well-trained staff, the absence of most of the basic fundamentals have hampered efficiency, growth, investor confidence and a steady stream of investment. An additional constraint on development of the PSE has been the ongoing political uncertainty and country risk factors that have also hindered investment and growth.

This paper will focus on the development of strong disclosure and accounting standards. It will identify the elements of disclosure necessary for the PSE, and assess the impact on PSE trading activity, performance of listed companies, and behavior of investors if appropriate disclosure requirements were to be adopted. The move toward international norms comes at a time when Palestinian corporate culture is undergoing transformation from small family-owned businesses to large publicly held corporations with institutional shareholders. Family businesses were reluctant to disclose and protective of sharing information. As these businesses grow into corporations with a larger pool of shareholders, disclosure based on international standards of accounting has become more and more crucial. Demand for information about the securities, issuer, track record, risk factors, and continuous transactional disclosure have come to increasingly characterize investor behavior.



Chapter 1 briefly surveys the political background of Palestine and gives an overview of the country, its geography, demography, religion, and other related profiles. Chapter 2 analyzes the economic development of Palestine since 1994, including the effects of internal and external constraints on the development of financial and securities markets. Chapter 3 presents the Palestine Securities Exchange, its establishment, services, and nature of activities. Chapter 4 focuses on corporate governance, financial disclosure and accounting standards under international best practice and benchmarks these factors to the international best practice. Chapter 5 provides quantitative analysis on the performance of the Al-Quds Index at the PSE. Five variables were assessed, namely, turnover ratio, return on equity, family domination of equity, political risk and disclosure. This quantification was performed using a regression model. Three categories of companies were sampled: best, average and least performing. Concluding remarks on the future requirements for an appropriate disclosure regime to that would permit better performance and more development of financial markets in Palestine are offered.



Chapter 1 Introduction

The Palestinian Stock Exchange was established and has been operating in adverse political and economic conditions. There were periods of improved conditions in 1998, 1999 and the first part of 2000, but the anticipated growth and normalization following the advent of the peace process in the early 1990s and the signing of the Paris Protocol, which formalized the Palestinian-Israeli economic relationship, remained modest at best and the economy suffered periods of sharp decline.

The political uncertainty resulted in a deep recession in 1995-1996 stemming from the Israeli security closure measures, which effectively cut off the West Bank and Gaza Strip from each other and from Israel. The closures created an environment of uncertainty and risk. The security measures were reinstated in 2000 and remain in effect. Palestinian productivity and growth were curtailed, the export market beyond Israel and with Israel has been stemmed, transaction costs rose, the productive capacity of the Palestinian economy was restricted, the labor market shrunk, the development of the legal and regulatory was hampered, private sector and financial institutions were severely diminished and the entire civil society weakened.

In these conditions, the PSE did not grow. It recovered after the 1995-1996 closures, but diminished since September 2000 when the Palestinian Intifada broke out. The PSE has a great potential judging from its brief recovery. During the period 1997-2000, it attracted foreign investors, its performance improved and was ranked first among Arab regional stock markets. Since 2000, the PSE has regressed and the present political risks have restricted investment and limited the capacity of companies to raise capital. The PSE has been shut since June of this year, opening only intermittently when the Israeli Defense Forces lifted the curfew from the city of Nablus where the PSE is located.



1.0 Political Background

The Palestinian political context, which has such a profound effect on economic development, is highly complex, with claims and interests of protagonists and antagonists both converging and diverging. Interests and claims notwithstanding, the essence of the conflict is about control. The conflict in reality is about who controls what, where, when, and whom, even though the two sides speak of other factors including mutual rights, e.g., right to Jerusalem, right to water, right of return and so on. Therefore, a brief historical background for what today seems an insurmountable obstacle is necessary.

The question of Palestine has its roots in the Arab-Israeli conflict, which dates back to the early 20th century. In 1917, the Balfour Declaration¹ set off a series of events that, 85 years later, continues to drain the two peoples who live side by side. The conflict has led to several wars (1948, 1956, 1967, 1973) and to the brink of war on many other occasions. The Balfour Declaration culminated in the establishment of the Jewish State in Tel Aviv in May of 1947, when the Jewish Agency declared statehood. This caused an intensification of the Arab-Israeli conflict leading to the outbreak of war in January 1948. Thousands of Palestinians were expelled from their homes and massacred during the conflict. Four months later in May, the United Nations, led by the United States and Britain, recognized the State of Israel. In December 1948, the UN General Assembly passed Resolution 194 (III) calling for the right of Palestinian refugees to return to their homes in Israel. In response, the All-Palestine Government issued a Declaration of Independence in 1949. Only the Arab states recognized this State of Palestine.

The 1948 War raged until July 1949 when an armistice agreement was signed between Egypt, Lebanon, Transjordan, Syria, and Israel. In December 1949, the UN General

¹ A letter sent by British Foreign Secretary Arthur Balfour to a British Zionist leader approving the establishment of a “national home for Jewish people” in Palestine. This initiated a strong wave of Jewish immigration into Palestine. By 1947, international support for a Jewish state led to UN Resolution (181), a partition plan calling for the division of Palestine into two states, one Jewish and one Arab state. Arabs rejected the plan and violence between the Palestinians and the existing and immigrant Jewish community erupted.



Assembly passed Resolution 303 calling for the internationalization of Jerusalem. In 1951, Jordan declared the annexation of the West Bank, and the Arab League placed Gaza under Egyptian custody. This arrangement remained operative until the June 1967 War when Israel occupied the West Bank and Gaza, thus ending Jordanian and Egyptian custody. Israel continued to occupy the Occupied Territories (West Bank and Gaza Strip) until 1994. As a result of the peace process launched in 1992 at Madrid (Madrid Conference) and the Declaration of Principles in 1993, the two sides recognized each other's right to exist side by side and agreed to negotiate a final solution on the basis of UN Resolutions 242 and 338. UN Resolution 242 of 22 November 1967 calls for the "withdrawal of Israel armed forces from territories occupied in the recent conflict" [1967] and the "termination of all claims of state belligerency". UN Resolution 338 of 1976 calls for the implementation of UN Resolution 242 and for negotiations to start to establish a just and durable peace in the Middle East.

Establishment in 1994 of the Palestinian Authority, first in Gaza and Jericho, culminated in the historic arrival of Palestinian Liberation Organization Chairman Yasser Arafat, to head the PA and lead further negotiations which were intended to result in establishment of an independent Palestinian state. In 1995, an Interim Agreement was signed between the two sides detailing the principles governing economic and civil affairs and setting a period of 5 years to reach final resolution of the conflict. Israel withdrew from parts of the Gaza Strip, reserving major pockets for settlements, deemed illegal under international law, and security zones. It also withdrew from part of the West Bank. The parts from which Israel withdrew became isolated pockets of limited Palestinian self-autonomy. See Map page iv.

Various reasons prevented the two sides from moving to final status discussions, which were to address Jerusalem, borders, refugees, international relations, settlements, and water. The protracted state of affairs continued without any significant progress during 1996-2000. As a consequence, positions on both sides hardened. An attempt at final



status negotiation was launched in early 2000, which culminated in July 2000 in the Camp David Summit in the United States. Former U.S. President Bill Clinton played host to Yasser Arafat and former Israeli Prime Minister Ehud Barak, but time run out and Camp David failed to produce the desired results and meet the aspirations of either side.

At the same time, disappointment on both sides unfolded in a series of critical steps. First, Arie Sharon, then a member of the right-wing Likud Party, entered the court-yard of the Haram Al Sherif, the third most sacred place to Moslems on September 28, 2000. Second, on this same day, an already agitated and restless Palestinian populace launched the mass uprising. For months, the uprising raged with no end in sight. Israel sealed the Gaza Strip and the West Bank, in effect imposing a full seizure over these territories and hemming in the inhabitants. The Palestinian civil uprising turned militant and a series of suicide bombings followed.

As the level of discord between the two sides mounted, Israel set out on military action launching air strikes against major West Bank and Gaza Strip cities. Then it escalated this action into a combination of ground and air forces dealing Palestinian cities and villages heavy blows of physical and human losses. In December 2001, the Israeli government prevented Yasser Arafat from moving within the territories and abroad. Three months later, on March 29, 2002, Israel invaded the West Bank cities and imposed a heavy curfew and a direct attack on Arafat's headquarters. The situation has not abated to date.

Mediation efforts by the international community under the auspices of the so-called quartet, i.e., US, EU, UN and Russia have floundered. The efforts yielded no more than preventing an all out regional war. Palestinians want statehood with defined borders demarked along the 1967 borders, subject to mutually acceptable land swaps; a capital in East Jerusalem; and an equitable solution of the refugee problem. Israel's demands for



land, including settlement blocks in West Bank and Gaza, and control of borders and security, are unacceptable to Palestinians.

1.1 Country Profile

1.1.1 Topography

The Gaza Strip is a coastal plain with sand dunes (up to 40 m high and 15-43 km wide). Average rainfall is 150-300 mm/year. The Jordan Valley, bordering the Jordan River, consists of about 400 sq. km. of fertile plains lying 200-300 meters below sea-level, and receives rainfall of about 150 mm/year. The Eastern Slopes, which lead to the dead sea, cover about 1,500 sq. km., ranging from about; 800 meters above sea-level to 390 meters below sea-level, and consisting of rocky, semi-desert, with rainfall of about 250 mm/year. The Central Highlands are 3,500 sq. km in area, about 1000 meters above sea-level, consisting of terraced hills that receive 400-700 mm/year of rainfall. The Semi-Coastal Zone (west-north west) consists of 400 sq. km., ranging from 100-300 meters above sea-level, and receives 550 mm/year of rainfall.

1.1.2 Location

Palestine is bound by Israel on the north, the Mediterranean Sea and Israel on the west, the Egyptian Sinai Peninsula and Israel on the south, and Israel and the Dead Sea on the east. These represent existing interim borders. The final shape of the borders of the State of Palestine have yet to be drawn, pending the outcome of final status discussions with Israel. The Palestinian side holds the position that the 1967 borders with limited, mutually acceptable land swaps, should constitute the basis for this final borders map.

1.1.3 Area

Total land area of Israel and Palestine is 26,323 sq. km. The Occupied Territories are 6,170 sq. km. total, with West Bank at 5,800 sq. km. (130 km long and 40-65 km in



width); and the Gaza Strip 365 sq. km. (45 km long and 5-12 km in width). The current self-rule area within the Occupied Territories is only 210 sq. km.²

1.1.4 Climate

Palestine's climate is Mediterranean, with summers that are hot and dry winters that are wet and cool. Temperature and rain fall vary with altitude and distance of the climatic elements including the coastal plain, hills, Jordan valley and Naqab desert.

1.1.5 Religion

Palestine has a majority of Moslem (97%) and a Christian minority (3%).³

1.1.6 Population

The total population of the West Bank and Gaza was around 2.9 million in 1999 and roughly around 3 million if the Palestinians living in east Jerusalem are included. In addition, there are approximately 2.3 million Palestinian refugees (stemming from the 1948 war) living in Jordan, Lebanon, and Syria according to UNRWA records. There is another large number of displaced Palestinians stemming from the 1967 war. PCBS assumes that around 500,000 would be returning by 2010 (subject to final status political developments between Palestine and Israel).

² Source: PCBS, 2000 [Is PCBS spelled out anywhere?]

³ Source: Christians in the Holy Land. Ed. By Prior, Michael & William Taylor, London: The World of Islam Festival Trust, 1994.



Chapter 2 The Economy of the West Bank and Gaza

2.0 Overview

For the past 35 years, the predominant factor shaping Palestinian economic patterns, policies, growth, and development has been the Israeli economy. The Palestinian economy is dependent on and subordinate to Israeli economic and security policies in all sectors including labor, trade, imports/exports, tax, monetary, and fiscal measures. This subordination and dependency makes the Palestinian economy always vulnerable to programs and policies adapted to advance Israeli economic and security interests, despite agreements intended to lead to greater economic independence.

The 1993 Declaration of Principles (DOP)⁴ has not reduced this vulnerability. The DOP, which called for the establishment of the Palestinian Authority as the self-governing political body, was followed by the Gaza-Jericho Agreement signed in 1994 (known as the Cairo Agreement). The Cairo Agreement set the stage for the first transfer of political authority to the PA. Another agreement, namely, the Paris Economic Protocol signed in 1994 set out a transitional arrangement on economic affairs. The Paris Protocol suffers from many drawbacks and has been severely restricted in implementation as a result of harsh Israeli policies. For example, Palestinian economic relations with foreign countries and Palestinian public revenues have been placed in the hands of Israel.⁵ As the political context shifts, most often for the worse, the Palestinian economy suffers from one shock after another. Intermittent periods of positive political outlook have been accompanied by brief periods of economic growth, which revert back to a downturn when the political environment deteriorates. This is evidenced by the upturn in economic performance experienced between 1997-99 where the economy expanded as reflected by increases in

⁴ The Declaration of Principles signed in 1993 constitutes the first formal agreement signed between the Palestinians and Israelis declaring peace between the two sides. In the DOP various principles were laid down intended to lead to further negotiations and agreements.

⁵ Since the outset of the Al Aqsa Intifada, Israel has frozen the revenues of the PA totaling over US\$700 million.



PA fiscal revenues, bank deposits, and bank credit to the private sector only to deteriorate sharply as of the last quarter of 2000 when the Al-Aqsa Intifida (uprising) erupted.

As to trade matters, currently, Palestine is in a custom union status with Israel, as set out in the Paris Protocol. A customs union was the only trade regime that could satisfy both Israel's insistence on controlling Palestinian borders and the Palestinian demand for continued access to Israel's markets.⁶ The external tariff rates and some excise tax rates, such as the purchase tax, as well as quality and safety requirements are all decided by Israel, with a few exceptions. Israel's average Most Favored Nation tariff rate is 8.8 percent.⁷ Most of Israel's trade goes through its free trade agreements with the United States and the EU, so its effective tariff is very low (around 2.5% in 1999).⁸

The Paris Protocol grants the Palestinian Authority some limited trade policy autonomy, however, on the goods specified on its lists: A1, A2 and B. Since Israel does not have trade or diplomatic relations with several countries in the region, Palestinian trade with these countries is also restricted, or severely limited to the above-mentioned lists.

Before the turmoil that started in late September 2000, the Palestinians and Israelis appeared ready to agree, as part of the final status negotiations, to replace the customs union with a free trade arrangement. A free trade arrangement would require the establishment of a customs border between the two economies.⁹ Before the outbreak of the Al Aqsa Intifada in September 2000, and despite the near total dependence on the Israel economy, the Palestinian economy was benefiting from relative political stability and reasonable optimism regarding the future.¹⁰ It was set to enjoy its fourth consecutive

⁶ Kleiman, E. "The Economic Provisions of the Agreement between Israel and the PLO", *Israel Law Review*, vol. 28, nos. 2-3, Jerusalem, 1994, p. 355.

⁷ *Ibid*, at 356.

⁸ West Bank and Gaza, Economic Performance, Prospects and Policies, IMF 2001, p. 93

⁹ These talks remain stalled pending progress on the political front.

¹⁰ According to UNSCO (2000), only seven work days were lost because of closures in 1999 and roughly the same in 2000. In 1995, 1996, and 1997, 83.5, 89.5 and 57 days were lost, respectively, because of closures.



year of positive per capita income growth, even though growth had decelerated from its peak in 1998 as the recovery effects from the recession in 1995-1996 (also induced by closure policies) petered out. In 2000, the gross domestic product (GDP) was projected to grow at about 5 percent and gross national income (GNI) at 4.5 percent, both in real terms.¹¹

This economic expansion is also reflected in the growth in the Palestinian Authority's fiscal revenue, bank deposits, and bank credits. In 1997-1999, fiscal revenues increased by an average of 17 percent a year in nominal terms. Bank credit to the private sector increased by 22 percent of GDP on average in 1997-1999. Private-sector deposits in the banking system expanded by 15 percent for the same period.¹²

Economic growth between 1997 and September 2000 appears to have been broad, although labor market data suggest that the construction and commerce sectors (retail and wholesale trade, hotels, and restaurants) were the main sources of economic growth. Construction investment was driven by the need to improve the infrastructure and an increased demand for housing and services resulting from the rapidly growing population.¹³ From 1996-1999 there was also substantial investment in the tourism industry, with the number of hotels in the West Bank and Gaza increasing by almost 50 percent and another 25 percent in 2000.

Since then, however, the economy has severely declined. In addition to the heavy human toll, the closures and restrictions on movement of the labor force, goods and services have caused, since September 2000, a very sharp decline in economic activity and income in Palestine. Israeli policies brought about distortions to labor, land, and capital

¹¹ The projections are from Economic Policy Framework: Status Report (Palestinian Authority 2000), prepared by the PA and IMF; website www.pna.net.

¹² West Bank and Gaza, Economic Performance, Prospects and Policies, IMF 2001, pp. 5-9

¹³ Palestine has the highest population growth worldwide. Years of high fertility rates have created a very young population structure, with roughly half of the population under the age of 15. The fertility rate is projected to decline.



markets in Palestine and have restrained the expansion of private productive sector capacity. According to the most recent World Bank report¹⁴ (June 2002), the Palestinian economy suffers from severe recession caused by Israeli closure of the Palestinian Territories. Since September 2000, the situation has been characterized by unprecedented levels of conflict and most server restriction on mobility imposed on the West Bank and Gaza since 1967. According to the World Bank, real GDP declined by 6% for the year 2000 and by an additional 12% in 2001. The decline in GNI reached 15% (US\$1.2 billion) as worker remittances from Israel fell significantly. Physical damages to the infrastructure reached US\$305 million. Lost investment opportunity in tourism and export sectors reached US\$1.2 billion. Unemployment reached 55%.¹⁵

When the DOP was signed, both signatories clearly envisioned that a process of increasingly autonomous economic development of the West Bank and Gaza was being launched. The present economic crisis and previous setbacks result from a prolonged series of disappointments and failures on the political front. The so-called peace process “dividends” were never paid and the hopes and aspirations of the Palestinian people remained unfulfilled, both politically and economically. The border closures, the security check points, the permit policies and clearances superimposed by Israel have suffocated movement, stifled growth, and is now on the verge of destroying the Palestinian private sector.

The loss of employment both in Israel¹⁶ and in the WBG represents one of the major effects of these closures. Other effects stem from the disruption of exports and tourism earnings, the decline in investment demand due to increased risk, blockage of intermediate imports, and the general disruption of economic activity that arise from the turmoil and closures, especially in some key commercial centers like the West Bank

¹⁴ Fifteen Months-Intifada, Closures and Palestinian Economic Crisis, An Assessment, World Bank, March 2002.

¹⁵ Ibid.

¹⁶ Since September 2000, 75-80,000 Palestinians have lost jobs in Israel and settlements. Another 100,000 jobs have been lost inside the WB/G as demand collapsed and businesses were forced to lay off workers.



cities of Hebron, Ramallah, and Nablus. The Gaza Strip has been cutoff completely from the West Bank, and villages and cities in the West Bank have been under extensive internal closures, during which Palestinians do not have access to the main road network. Even the Gaza Strip has been subject to these so-called internal closures, which have divided Gaza into three isolated parts. In the best case, Palestinian producers are able to get their products to internal markets at greatly increased cost and after much delay. In the worst case, nearby markets are simply inaccessible.

The near complete blockage on imports of raw materials since October 2000 has badly damaged the economy, because Palestine relies heavily on imports for much of its manufacturing production and investment. The export side has also sustained heavy damage by the inability to reach markets. For some sectors, like stone and marble, the loss of earnings is temporary, because export is possible during intermittent periods when closures are lifted. In sectors like agriculture, which produce perishable products, delays destroy the product, and the income is irretrievably lost. The long term is also bleak because agricultural lands are being destroyed and farmers are unable to get to their lands to maintain them. Other capital assets are similarly affected, as repair and maintenance becomes more costly and sometimes impossible. This will make economic recovery slower. The client base also continues to erode, as customers find new, more reliable suppliers to replace Palestinian producers.

2.1 Labor Market and Employment

A well-educated labor force of renowned entrepreneurial talent is often cited as a main factor behind Palestine's potential. However, the chronic inability to create sufficient employment for a rapidly growing population is seen as one of the strongest macro imbalances currently featured in the Palestinian economy. During the occupation period, over one-quarter of the labor force was employed in Israel. As employment in Israeli declined starting in 1993, it was not offset by a commensurate increase in domestic



employment. The number of Palestinian employment in Israel fell from 116,000 in 1992 to a low of 25,000 in 1996.

The domestic market failed to completely absorb the large inflow of labor and unemployment levels soared in 1995-96. This came at a time when over 30,000 new entrants were joining the labor market per year. In 1998, the employment outlook improved, with joblessness dropping to an estimated 16% in Gaza and 8.8% in the West Bank by June 2000. At the same time, private sector employment grew to 64% of total domestic employment, up from 51% in 1997, underscoring improvement in the labor-absorbing capacity of the private sector. Public-sector employment also improved its labor-absorbing capacity, increasing by 81% between 1995-1998, although the achievement was deemed counterproductive by many in the private sector and donor community.¹⁷

2.2 Trade with Israel and Foreign Trade

Foreign trade is probably the single most important opportunity to support the growth and development of the Palestinian economy, given its small size. Studies¹⁸ have shown that there is potential for an overall increase of trade in the Palestinian economy that could significantly increase welfare and economic growth.

The realization of this potential depends on the type of trade policy implemented by an independent Palestine. While Israel is likely to remain a key economic partner for the Palestinian economy, it will be critical to establish a customs border between the two entities.

¹⁷ While public sector employment provided a needed safety net to the labor market during times of acute unemployment, a continued rapid expansion of the PA wage bill will make it impossible for the PA to allocate sufficient resources to non-wage expenditures in the areas of health, education and infrastructure.

¹⁸ Astrup and Dessus (2000) in a study of trade options for Palestine closely examine the potential for Palestinian trade. They advocate a most-favored-nation (MFN) for the relationship between Palestine and Israel and argue against the existing customs union.



Palestinian trade performance started when the Palestinian Authority began to exercise its functions in May 1994. The development path for Palestinian trade was based on equitable economic cooperation between the Palestinian and Israeli economies, especially greater openness in mutual trade flows, and expansion of trade with Jordan and Egypt, as well as pursuit of new markets in the Gulf Region and EU. It was hoped that the macro-economic and microeconomic policy instruments delegated to the PA during the interim period (1995-1999) would allow it to pursue a policy targeting growth in agriculture and industry and geared towards creating domestic employment, expanding exports and curtailing imports.

Palestinian foreign trade relations are addressed under the Paris Protocol. This protocol restricted Palestinians customs and trade policies and linked all activity directly to Israel. As a result, Palestinian economic relations with foreign countries were extremely restricted.

Over 90% of Palestinian total imports come from Israel or through Israeli ports and are subject to Israeli customs. Over 95% of Palestinian exports are to or via Israel.¹⁹ Palestinian imports and exports with countries other than Israel but sent via Israeli ports face discriminatory measures that delay the arrival of exports at their destinations and the delivery of imports to Palestinian merchants. Moreover, there is much anecdotal evidence of Israeli monopoly shippers coercing Palestinian producers to buy from favored, higher-cost suppliers. The result is higher costs and disruption to the production of goods that depend on imported raw materials. The agricultural, industrial and construction sectors depend on Israeli raw materials. The service sector relies on Israeli raw materials or goods imported via Israel. Other sectors of the economy are totally dependent on the Israeli economy. This includes electricity, international

¹⁹ Palestinian goods exported to Israel are subject to a number of procedures not normally applied in foreign international trade. The additional measure are implemented under the pretext of security and standards but aim to delay goods in ports, which increases transactional costs and reduces competitiveness with Israeli and foreign products.



communications, fuel products, and water.²⁰ Food items including wheat, flour, rice, and sugar come from or via Israel.

The deleterious effects of Israeli control over imports and exports shows up in a massive imbalance between imports and exports. Existing data²¹ suggest that exports of Palestinian goods and services in 1999 amounted to roughly US \$740 million, constituting 18 percent of GDP, and representing a 60% increase over 1994 levels. Imports for 1999, by contrast, are estimated at US \$3.4 billion, higher by 140 percent than in 1994. Palestinian exports are low compared with other countries and regions. According to IMF reports (2000), the value of Palestinian exports per capita is about half of that in Jordan. Imports of goods and services currently equal approximately 80 percent of GDP, a high level by international standards.

Because the bulk of Palestinian trade today is with Israel, there is a case for trade distortion, but the better case can be made that the security restrictions and very complex and costly trade and transportation procedures for trade with other countries have tended to favor trade with Israel. The transaction costs that the impediments on the ground have caused can only lead to trade diversion not trade creation.

Studies show that trade diversification will be essential as the trade infrastructure improves. There is need for free access to a seaport and a better functioning airport. However, trade with Israel will remain significant.

2.3 Trade Accords

The Palestinian Authority and the European Union signed an Interim Agreement on Trade and Cooperation in February 1997. Palestinian exports also benefit from the preferential treatment and duty-free access agreement with the U.S. signed in November

²⁰ Israel consumes 85% of Palestinian water resources. CITE.

²¹ Figures are from the PCBS and IMF



1996. Jordan and the PA signed a trade agreement in January 1995, which came into force in 1996 and exempts specified commodities from customs duties. An interim cooperation agreement was signed between the PA and Egypt. Several Arab countries have announced that Palestinian products can enter their markets free of customs duties, and two countries, Saudi Arabia and Yemen, have formalized these arrangements.

2.4 International Aid

Palestine receives considerable amounts of foreign aid assistance each year. Since 1993, the donor community has committed and disbursed US \$4.4 billion to the WBG out of US \$6.5 billion in pledges.²²

2.5 Public Revenues and Fiscal Policies

Today, the Palestinian Authority is close to bankruptcy. Tax revenues have decreased only 60 percent of what they were in 1999.²³ Since its creation in 1994, the PA has successfully increased public revenue collection, which reached a high of 23% of GDP in 1999, compared to 17% in 1996, declining to 22% in 2000.²⁴ The slow down in 2000 was due to the political and economic deterioration in the fourth quarter, after the outbreak of the Intifada. Structural reforms in the fiscal area in the past few years have focused on tax administration, expenditure management, and treasury operations. On the revenue side, income tax rates were reduced and the tax base was broadened to include 70,000 taxpayers in 1999. Tax administration reform has been delayed. Outstanding tax arrears are estimated to equal roughly 9 percent of the GDP.

2.6 Investment and Savings

The household sector has historically played a central role as a source of investment in Palestine, despite the uncertain investment climate and the lack of an efficient system of

²² See note 16.

²³ According to Directorate of Income Taxation, Ministry of Finance.

²⁴ The West Bank and Gaza Economic Performance, Prospects and Policies, International Monetary Fund, Middle Eastern Department, 2001.



financial intermediation. With private consumption exceeding GDP for most of the period since 1967, the ratio of domestic savings to GDP has been mostly negative. Yet, in spite of the shortfall in domestic savings, positive national savings (dependent on income earned in Israel and abroad) have generated significant investment flows. The exceptionally high rates of GNP growth during the 1970s were accompanied by a rise in private investment from 14% of GDP in 1969 to 30% in 1979-86 when the first uprising erupted. Investment flows were expected to experience substantial growth, yet despite the fast-paced development of the financial sector in the post 1993 period, the uncertainty and considerable risk to investors, the impediments on the ground, and the absence of a clear legal and institutional framework did not give the required impetus for anticipated growth, thus private sector investment remained precarious.

2.7 Main Sectors of the Economy

2.7.1 Agriculture

Agriculture has historically played a central role in the Palestinian economy, yet recent trends point to a contraction in the share of agriculture in both GDP and exports. Agricultural contribution to domestic output fell from over a quarter of GDP in the 1980s to 13.7 percent in 1994 and further down to 12.2 percent in 1996. Agricultural production in 1997 amounted to US \$786.5 million, 67% of which originated in the West Bank. Growth in agriculture has been subdued as a result of a number interlinked factors that include Israeli restrictions on the use of water and other natural resources, which raised the cost of production and led to loss of competitiveness in foreign markets.

2.7.2 Industry

The industrial sector in Palestine contributes significantly less to domestic output than industry does in comparable economies. Its share of GDP amounted to only 14% in 1996. The sector is fragmented and dominated by small-scale production units that account for over 16% of total employment, suggesting low productivity. Export activity in this sector is limited. Over 80% of exports go to Israel. In 1997, the industrial sector



launched several ventures that have started to meet domestic demand for consumer goods. The overall outlook for the industrial sector remains limited.

2.7.3 Construction and Real Estate

Construction has been dominated by private investment. In the last two decades, the construction sector witnessed considerable growth standing at 17% of the GDP. This expansion mirrored a lack of investment opportunities in other sectors and an increase in the relative price level of housing. A boom in 1993 boosted the sector's contribution to GDP to over 20%. The housing market is characterized by restricted supply and increasing demand. Highly priced building materials, imported mainly from Israel, compel higher prices. The rapid population growth and household formation continue to exert pressure on the demand side.

2.7.4 Tourism

Tourism is poised to emerge as one of the fastest-growing sectors of the economy. However, an insecure political climate and an Israeli monopoly of the sector during occupation has had a detrimental effect on the growth of Palestinian tourism and the development of most subsectors including hotels, restaurants, transport companies, travel agents and tourist guides as well as the handicraft businesses. Growth in the post 1993 period has been relatively slow. The number of hotels rose from 75 in 1996 to 85 in 1997 and to 92 in 1998. The economy has yet to harvest the benefits of tourism, one of the fastest-growing industries regionally and globally. Tourism constitutes one of the most attractive opportunities for domestic and foreign investment provided there is improvement in the political climate.

2.7.5 Banking

Considerable growth in the banking sector ensued after the 1993 peace process. Today, 23 banks operate a total of 114 branches in Palestine (2000 totals).²⁵ In this same period,

²⁵ Based on Palestinian Monetary Authority statistics, 2000.



there was a surge in bank credit and deposits. The sectoral average loan to deposit ratio rose to 38 percent in 2000 versus 18 percent in 1994. The Palestinian Monetary Authority (Central Bank) was created in 1994 and has made considerable progress in improving such areas as accounting, statistics, bank licensing and regulation, as well as the clearing and payment system. Despite the rapid growth, the loan to deposit ratio is still low by international standards. Most credit including both business and consumer loans, is very short-term, and is usually grossly over-collateralized. There are limited loans for investment. The banking sector in Palestine is risk averse.

2.7.6 Private Investment

The investment sector in Palestine expanded at the onset of the peace process. However, investment remained well below expectations even though some 80,355 companies were operating in the WGB by September 2000.²⁶ The private sector employed some 321,000 workers with an annual payroll amounting to US\$1.4 billion.²⁷ High risks and low returns have led to decreased investment and withdrawal of capital from the WGB market. The risks included political instability, inability to meet export orders, restrictions on imports and movement of goods and labor, and increased PA inability to provide services. As to the returns, they have decreased because of low demand and high transactional costs.²⁸

2.7.7 Infrastructure and Institution Building

Almost three decades of Israeli occupation has led to a severe decay of basic infrastructure in Palestine. Almost 60% of the Public Investment Program of the PA (about US \$767 million) between 1995-1998 was allocated to infrastructure projects with

²⁶ Palestinian Central Bureau of Statistics, 2000.

²⁷ UNSCO, "Special Report on the Palestinian Economy", 2000.

²⁸ The Palestinian private sector suffers from a high level of transaction costs involved in the conduct of trade in WGB, which for the most part is a result of Israeli security considerations. The Israeli considerations are excessively high thus impeding the economy. Transaction costs refer to all costs involved in creating and operating institutions underlying the process of production and exchange in the economy, including search and bargaining costs, and costs of coordination between and within institutions and organizations. See IMF Report 2001.



emphasis on roads, water system improvement, sewerage repair, electricity distributions, housing.

2.7.7.1 Water and Wastewater Management

Water and sanitation remain the first priority within the infrastructure sector. The current water supply system is near obsolete and there remain over 120 villages on the West Bank with no drinking water networks. Future projects include the construction of main transmission and trunk pipelines, and replacement/rehabilitation/expansion of water network and wastewater collection systems. Special plans are underway to rehabilitate water wells as well. A desalination water project is underway in Gaza to ease the health hazards of water shortages there.

2.7.7.2 Transportation

Existing transport facilities in Palestine are largely deficient and in dire need of rehabilitation. The West Bank has over 2000 km. of roads, and the Gaza Strip has close to 168 km. Over 45% of these roads require rehabilitation with focus on local, rural, regional and access roads. Travel between the West Bank and Gaza is obstructed, preventing free movement between the two self-rule areas. Based on the 1998 Wye River Memorandum, safe passage routes were to be constructed. An airstrip in Gaza was officially opened in 1998. It was destroyed in December 2001 by an Israeli military incursion into Gaza. A Gaza seaport was under construction, but it, also, was destroyed in the same incursion.

2.7.7.3 Telecommunications

The provision of telecommunications has to a large extent been delegated to the private sector. In May 1995, the privately owned Palestine Telecommunications Company, plc. (Paltel) was established and awarded a 20-year license to operate a fixed-line telephone service in Palestine. It was also awarded the cellular service license for a period of 5 years starting in 1998. Paltel established a subsidiary operating at arm's length to operate



the cellular service. In the fixed-line service, Paltel, in two years, expanded the network capacity from 70,000 to 160,000 lines. Today, it has capacity for 300,000 lines. The cellular business uses the latest GSM technology under contract with Ericsson. Currently the network has capacity for 270,000 lines with a total number of users standing at 220,000, just in two years. Paltel has also expanded into value added services to include public interest, data transmission and other related services. The telecommunications sector is supervised by the Ministry of Post and Telecommunications.

2.7.7.4 Energy

The energy subsector is another area where the PA has encouraged private sector participation. A private power-generating plant in Gaza is under way. Otherwise, Palestine relies on the purchase of its power supply from the Israeli Electric Company. Palestinian municipalities operate distribution systems. The current distribution network is overloaded and investment efforts concentrate on rehabilitating and expanding to meet current and future demand.

2.7.8 Capital Markets

In Palestine, the need for efficient capital markets and the critical role they can play in channeling investments towards much needed, viable, and profitable projects in the economy are particularly important, especially because of conservative bank lending practices. In general, an organized securities market is a regulated exchange where companies can solicit and secure equity financing, and investors can trade previously issued securities. A securities market, sustained by the basic fundamentals discussed earlier, provides securities buyers, sellers, issuers and their agents with an efficient mechanism for finding and consummating transactions. Among the many ways in which an organized securities market contributes to the growth of a vibrant Palestinian economy are the following:



- A securities market provides an investment vehicle for Palestinian citizens, whose only options now are savings deposits at very low rates in local banks who export most of the deposits to foreign markets, or under the mattress.
- Public and private pension reform is urgently needed in Palestine today. A well-regulated securities market supports development of “Pillar Two” and “Pillar Three” investment vehicles, individual accounts where workers’ savings are invested in local companies.
- The accumulated savings of numerous citizens creates large pools of capital that can be put to use to build the Palestinian economy.
- Securities markets provide an efficient mechanism for Palestinian companies to raise capital for expansion and job creation in initial public offerings or secondary offerings.
- A well-regulated exchange with sufficient volume and liquidity also provides an “exit mechanism” for strategic and institutional investors, making Palestine a more attractive place in which to invest.
- A securities exchange also provides a “price discovery mechanism,” permitting the market to value the listed company’s shares.

Price discovery also plays an important role in corporate governance, providing feedback on management performance. Securities holders can sell their shares if they are unhappy with the way the business is being conducted, thereby allowing prices to rise and fall depending on investor satisfaction.²⁹

²⁹ C. Seeger, H. Patton, Background for Financial Markets Development in Ukraine (FMI 2000), pp. 64-65.



Chapter 3 Palestine Securities Exchange³⁰

3.0 Background

The Palestine Securities Exchange (PSE) was incorporated as a private shareholding company in early 1995, with the Palestine Development & Investment Company (PADICO) and Samed³¹ organization as its major investors. After the Palestinian National Authority (PNA) approved a PADICO-sponsored design and work plan in July 1995, a project team was put together by the PSE and entrusted to establish a fully electronic exchange and depository. By August 1996, the Exchange was operational and on November 7 that year, the PSE signed an operating agreement with the PNA, allowing for the licensing and qualification of brokerage firms to take place. On February 18, 1997, the PSE conducted its first trading session.

3.1 Market Overview

Ownership of exchange	The PSE is a private sector-public sector venture. PADICO owns 81% and Samed 19%. Samed being an investment arm of the Palestinian Authority.
Trading sessions	The trading sessions are held three times a week Monday – Wednesday 9.30 a.m. – 11.00 a.m (modified hours are in force at due to the present political crisis).
Number of Markets	One regular secondary market dealing with equities only. The primary market is beyond the operations of the PSE and is supervised and regulated by the Ministry of Finance.

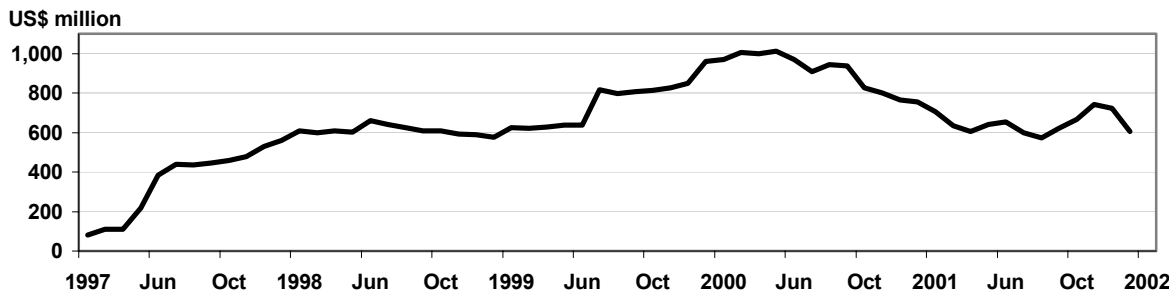
³⁰ This Chapter was prepared with the assistance of the Palestine Securities Exchange management and staff. Author is indebted for this contribution.

³¹ Samed is a commercial investment arm of the Palestinian Authority.



Regular market	The regular market passes through the following trading stages: Pre-open: 9.30 a.m. – 10.00 a.m. Open: 10.00 a.m. – 11.00 a.m. Pre-Close: 11.00 a.m. – 12.00 noon Close: 12 noon
Types of Securities	Equities Only
Regulatory body	The PSE is currently governed by the Palestinian National Authority (PNA) - PSE agreement of 7 November 1996. The agreement allows PSE to act as a Self-Regulatory Organisation (SRO) and undertake regulation of its operations and accreditation of its members.
Market capitalisation	US \$589,945,554 as at September 2002
Average daily turnover	US \$767,072
Year-to-Date %	-20.64%
Number of member firms	7 brokerage companies
Number of listed companies	25
Palestine Stock Price Index	Al-Quds Index
Index ownership	PSE
Trading method	Order-driven continuous auction
Guarantee fund	None

Trading was halted in March 2002 when the Israeli Defense Forces entered Nablus. Since there has been intermittent trading. Between June-present, the PSE is operating well under capacity and trading is limited to one session per week—at best due to the and imposition of a prolonged curfew on the city of Nablus. The graph below illustrates the decline since the peak of 3rd and 4th quarters 2000.



3.2 Capitalization

Market capitalization at the PSE continued to exhibit steadfast growth during the period March 2000-September 2001. However due to the political instability in the Palestinian Authority areas because of the Israeli-Palestinian conflict, the year 2001 recorded a dramatic decline. The market capitalization stood at US\$1 billion in mid 2000, only to go down to US\$723 million by the end of 2001 down to US\$589,945,554 as at September 2002. This is a decline by nearly $\frac{1}{2}$ of the capitalization. The year 2002 also has witnessed fluctuations in volume and value, again, due to the political situation. This year has been very difficult for the capital market in Palestine, thus it has been difficult to predict the financial performance for companies. Total trading volume for September 2002 reached 136,000 shares compared to 1,680,651 in September 2001. The total trading value for September 2002 is JD271,715³²(US\$388,164) compared to JD2,043,924 (US\$2,919,891). The Al Quds Index in September 2002 is 154.70 points compared to 163.42 in September 2001.

The number of listed companies has risen from nine companies when the exchange first started operations in February 1997, to 25 by the end of 2000. The Palestine Electric Company, which had one of the largest IPOs ever in Palestine last year, is expected to list soon. Several sectors of the economy are represented on the market including manufacturing, investment, insurance, banking, and services. The two largest companies are PADICO and

³² The Exchange rate is JD .70 = USD 1.



Paltel (Palestinian Telecommunications Co), which together represented approximately 75% of total market capitalization.

3.3 Liquidity and Performance

Trading at the PSE has been weak and liquidity thin since the outbreak of the Intifada in September 2001. Total turnover for the year 2001 was \$74.5 million, down from \$189 million in 2000, a 61% decrease. Average daily turnover decreased by 48% in 2001. The number of trades in 2001 also decreased to about 8,000 a decrease of 59% from 2000. Activity is concentrated in a selective number of shares, with trading in PADICO and Paltel shares accounting for about 85% of total turnover for the year 2001.

3.4 Listing

By end of 2001, there were 25 listed companies on the Exchange. As soon as the Securities Law is passed, which will oblige all public shareholding companies qualified for listing on the Exchange to be listed, there will be approximately 40 companies listed.

Only equities are traded on the PSE, in one single market. Companies must meet the following requirements in order to be listed on the PSE:

- The company's subscribed capital must exceed US \$750,000 and at least fifty percent (50%) of the subscribed capital must be paid-up.
- The number of outstanding common shares must exceed 100,000 and at least 25% of the shares must be held by the public.
- The company must have at least 100 shareholders.

Listed companies are required to maintain the following requirements throughout the duration of listing:

- At least 25% of outstanding shares must be held by the public.
- A minimum of 100 shareholders, with a minimum holding of \$100 of shares, based on par value.



- Shareholders' equity must not fall below 50% of the subscribed capital.
- The company must adhere to all rules and regulations and decisions of the Exchange including rules of the Clearing, Depository and Settlement Department.
- The company should commit itself to implement the listing agreement signed with the PSE.

Presently, more than one half of the listed companies attempt to follow the International Accounting Standards and International Auditing Standards. Once the Securities Law is passed, all listed companies will be obliged to follow International Accounting Standards.

3.5 Members

There are seven member firms in Palestine. PSE membership is only allowed to brokerage companies registered at the Palestinian Monetary Authority as financial companies. Commercial banks are not allowed to apply for a brokerage license. The brokerage companies must fulfill two requirements:

1. At least 50% of the company's board of directors must be residents in Palestine.
2. The company's paid-in capital may not be lower than US \$1 million.

3.6 Foreign Investment

In May 1999, the HSBC became the first foreign bank in Palestine licensed to provide full custody and clearing services to foreign institutional investors. HSBC acts as a sub-custodian to the custodian bank State Street & Trust Co. of Boston. The services include safe custody, receipt and delivery, cash and corporate action reporting and the collection of dividends. There are currently no ceilings on foreign investments in the exchange, and investors enjoy full repatriation of income and capital.



3.7 Regulation

The PSE currently acts as a self-regulating organization and is governed by an eight-member board of directors representing the exchange itself, investors, and securities firms. According to the agreement signed between the PNA and the PSE, the exchange is responsible for enforcing its own rules and regulations covering listing requirements, secondary trading, settlement and clearing, and the conduct of member securities firms. The Ministry of Finances oversees the PSE as the regulator.

3.8 Trading

The Palestine Securities Exchange Electronic Trading System (PETS) is a state-of-the-art, high-performance, computerized exchange management system allowing for advanced automated management of trading, while encompassing user-friendly features. The trading system of the PSE is order-driven, under which share trading originates from an order by a client, at either a market, limit or range price. The system also allows hidden orders to be entered with part of the share volume undisclosed to other traders adding stability to prices and protection to clients in case of block orders. Order entry is conducted via remote terminals located at member's offices through out Palestine. The trading workstation provides the broker with up-to-date market information, order status inquiries, and reporting, as well as user-friendly facilities to enter and manage orders.

Orders that enter PETS are given queue priority based on many factors. Price is the primary factor in determining queue priority of an order where the best price (highest bid or lowest offer) takes priority over other orders. For orders entered at the same price level, the time of entry of an order governs its priority on a first in, first out (FIFO) basis. All orders, which enter PETS, are time stamped with their time of arrival at the Exchange. An order is considered for execution based on the time of its arrival at the Exchange.



PETS is able to trade multiple instruments such as equities, bonds, money market instruments, warrants and rights within a number of various trading books such as an odd lot book for orders less than the round lot board size and a special terms book for orders with special settlement or fill terms. PETS also allows instruments to be traded in different currencies.

Trading information is stored on the AS/400 database. In addition to storing the trading Engine files run on the UNIX environment, the AS/400 keeps a detailed record of all orders, trade history, reporting, and other activities entered into the System. The two platforms communicate with each other using the MQSeries software allowing for immediate storage of data.

The advanced nature of the system allows the PSE to divide trading sessions into various stages. Currently, the PSE employs the following stages during a given trading session: Pre-open, Open, Continuous trading, Close.

PETS allows for various modifications to the system during a given trading session. During the *Pre-open* stage for example, PETS does not allow for the transaction of trades to take place but does allow for the entry of orders. This stage, lasting one hour at the PSE, allows for the discovery of a security opening price. Participants may also view the market via the various inquiry options available. The objective of this stage is to obtain an opening price, which is more reflective of up-to-the-minute market sentiment of a security's value. Prices of the majority of shares are quoted in Jordanian Dinar with a few quoted in US dollar. A maximum change of $\pm 5\%$ from the last closing price is allowed. This ceiling is applied to prevent large price fluctuations, eliminate unnecessary speculation, and protect the interests of small investors.

3.8.1 Trading Rules



Securities trading on the Exchange is governed by the rules of the Exchange, some important rules are:

- Within the same house, the interests of the clients shall be given priority over all other considerations.
- Best price affords an order the highest priority.
- Orders with the least trading restrictions (i.e. time and/or fill restrictions) will be given priority over orders encumbered with trading restrictions.
- A market order begins trading at the current market price and can move through a series of price levels to be filled. The Exchange will limit the number of price levels. When a market order reaches its price level limit and still has remaining volume, it will be queued at that price level as a limit order. The market order being queued at a limit price will have normal limit order priority; it will be queued behind all current orders at the limit price.
- Time of arrival of an order at the PSE will be time stamped. The sequence of arrival as reflected by this time stamp may affect the sequence in which the order is considered for execution.
- In each trade, there is an “aggressive” order and a “passive” order involved. The aggressive order is the one that causes the trade to occur, normally on entry of the order. The passive order is the one previously queued.
- Changes made to orders will affect the effective queue priority only if the change advances the status of the order in the marketplace (i.e. in terms of volume). Changes that would not cause advancement would not be re-time stamped.
- Time stamp changes should only occur when the price, quantity or terms of the order change.

3.8.2 Commission Fees and Charges

Brokerage fees at the PSE are fixed at 1% irrespective of the size of the transaction. One third of the commission fee goes to the PSE. This commission is subject to an additional 17% VAT.



3.9 Clearing, Depository and Settlement

The Clearing, Depository and Settlement (CDS) department of the PSE is involved in a number of operations geared towards enhancing the efficiency of securities trading. The department's prime areas of responsibility center on the conduct of clearing and settlement, as well as providing depository and registry services.

Among the department's primary functions are the tracking of funds and securities settlement to ensure that settlement occurs according to procedures and within the time frames designated by the PSE. The CDS system allows transactions to begin the processing procedure thirty seconds following a trade. The system handles the daily cash settlement process between trading members and the associated tracking of the movement of shares related to the settled securities. A number of procedures serve as safeguards in tracking the transaction through the process leading up to *Delivery versus Payment* three days following the trade date (T+3).

In addition, the CDS department is the sole record of ownership of securities (registered form). Issuer sharebooks are maintained within the CDS registry system, thus any changes resulting from settlement or other actions that change ownership of securities will be supplied to the issuing company by the CDS department. Acting as a register, the CDS department maintains details of the beneficial owners of securities listed on the Exchange.

As a Depository, the CDS department serves as an area of safekeeping for securities as well as the records of such securities. Securities deposited within the depository are held under the identification of the depositing member as well as the concerned shareholders. The department maintains a safe and secure environment for all of its sensitive documents.



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Attorneys and Counselors at Law

In addition to the above areas of operation, the CDS department of the Exchange facilitates the use of listed securities for pledging activities. The CDS system allows owners of securities to use those securities as collateral against bank loans and ensures that all parties' interests are protected.



Chapter 4 Financial Disclosure and Corporate Governance

4.0 Disclosure at the Palestine Securities Exchange

The absence of a regulator, a securities law, and other secondary and tertiary legislation and, rules, required the PSE to take on the role of market regulator from its inception. As a self-regulatory organization (SRO)/regulator, it was incumbent on the PSE to issue regulations and or guidance rules on what should be expected of listed companies, member brokerage firms, internal management controls, operating procedures and to enact a code of ethics for all managers and employees of member firms. As a new institution, the PSE faced an initial dilemma in finding the proper balance between the kind of rigorous regulatory requirements necessary to attract international investment on the one hand, and the need for rules that were not so draconian that they deterred Palestinian enterprises from listing.

Without an adequate regulatory environment, international investment will go elsewhere. Broker member firms frequently reported on contacts with international investment entities who said they would invest when an appropriate legal framework. On the other hand, without companies willing to list, there is no exchange. The PSE attempted to adopt a middle approach. Initial rules were acceptable to listing companies, though enforcement of compliance has been problematic, given the political environment. Simultaneously, the PSE worked with the Palestinian Authority and international donor projects to create a regulatory body and pass a securities law that mandate compliance with international standards. In anticipation of enactment of the Capital Markets Authority Law, establishing a unified regulator, and the draft Securities Law, the PSE is presently working on amending and improving its own regulatory framework to require timely and adequate disclosure of listed company financial information, to develop a stronger code of conduct for its management, listed companies, and member firms. At a minimum, the new PSE regulations must require:



- financial statements audited in accordance with international standards to be supplied annually, without delay;
- periodic unaudited financial statements on a semi-annual and quarterly basis;
- forward-looking information such as statements of future economic performance, including known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the company's liquidity increasing or decreasing in any material way, including: description of known material trends, from year to year, in the company's capital resources and expected changes in the mix and cost of such resources;
- disclosure of known trends or uncertainties that the company reasonably expects will have a material impact on net sales, revenues, or income from continuing operations;
- disclosure on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial conditions; and,
- disclosure about the amounts and certainty of cash flows, short or long-term liquidity, debt agreements, failure to maintain certain minimum ratios and levels of working capital and shareholder equity, capital expenditure over the next 12 months; disclosure about problems and efforts to remedy the problems;
- provision of a statement of cash flows as part of a full set of financial statements which reports net cash provided or used for operating, investing, and financing activities;
- disclosure about the impact of discontinued operations and of extraordinary gains and losses; events that materially affect the amount of reported income from continuing operations;
- interim disclosure about internal and external sources of liquidity, expected material changes in the mix and relative cost of such resources and unusual or infrequent events or transactions that materially affected the amount of reported income from continuing operations;



- segment disclosure if the company is multi-segment, to the extent that any segment contributes in a materially disproportionate way to revenues, profitability and cash needs;
- creditworthiness, solvency, relative liquidity, potential market losses, vulnerability to rising interest rates and economic downturns;
- involvement with high yield or highly leveraged transactions; and
- ratings of securities issued which cover debt instruments and stock.

4.1 Benchmarking Disclosure to International Standards

Understanding that attracting investment requires disclosure and transparency and, in order to ensure its proper development into a more mature market, the PSE is benchmarking the development of its rules to models from the United States and Sweden. Based on extensive studies, and with technical assistance from U.S. and Swedish donor projects, the PSE is developing a hybrid standard for Palestine. The PSE' approach to rewriting its rules recognize that access to the kind of information that investors require is essential for managers to guide their own company performance, and that Palestinian enterprises suffer not only from a reluctance to disclose, but also from an understanding of how to report their financial information in a way that they can use themselves. Accordingly, the PSE is attempting to provide clear rules and standardized forms and analytical tools that will assist managers in understanding their own company performance and provide investors with the information they require. Specific issues the PSE is stressing in rewriting its rules include the following:

- Disclosure, under international standards, includes information about the corporation's financials, transactions, management, and all related dealings as defined in the various laws and regulations concerning securities dealings and capital markets. Securities disclosure involves each of the following:
 - prospectus
 - periodic financial information



- event information
 - material changes
 - annual report
 - officers and directors
 - ownership of securities
 - public offers
- Disclosure encompasses not only availability, but also equal access to information. This means that all potential investors become aware of the information as close to the same moment as possible. As explained above, disclosure at the Palestine Securities Exchange is not a well-established principle. It is therefore incumbent upon the PSE to work closely with listed companies to urge timely and proper disclosure. As it develops the rules, the PSE is giving focused attention to the structure and content of financial statements.

4.1.1 Financial Statements

Financial information is provided in the financial statements and, for purposes of securities disclosure, in reports of changes in financial position. Financial statements are a representation of the enterprise's position, its performance and its cash flows. This information is important for a wide range of uses including investment decisions by potential investors, management decisions by company officials, credit decisions by lenders and suppliers, and management accountability by shareholders. The management of the corporation is responsible for the preparation of the financial statements. They also make decisions about the method, accounting tools, and nature of information to be included. By contrast, the external auditor is responsible for providing an opinion and issue a report about the quality of the financial statements prepared by management. The auditors conduct the audit report in accordance with some recognized standard. There are various standards worldwide, including International Accounting Standards (IAS) and Generally Accepted Accounting Principles (GAAP). In addition, however, individual countries may have their own national standards. These national standards are subject to



laws, rules, and regulations that are issued by the official supervisory and regulatory authorities. The trend, however, is for nations to adopt the IAS, as globalization increases, and regulators recognize the need for one international standard.

Financial statements must include a comparative statement to the end of the corresponding period in the last financial year in accordance with requirements of the applicable standards. Financial statements are either annual or periodic (semi-annual, quarterly or monthly). The annual statement must include an income statement, a statement of cash flow, a statement of changes in financial position, and a balance sheet. Only the annual statement must include an auditor's report. The standards contain the basic principles and essential procedures together with related guidance in the form of explanatory notes and other materials.³³

The foregoing forms the core of financial disclosure. A number of jurisdictions have expanded the range of disclosure documents which issuers are either required or urged to produce, as reflecting best practice, to include the so-called management discussion and analysis report (US practice) or Cadbury Committee Recommendations (UK practice).³⁴

Financial statement users include:

- Managers who use the financial statements to assess company performance and make intelligent decisions about future course of action;
- Investors who need the financial information to determine risk associated with the purchase or sale of securities;
- Lenders who use the financial information to assess creditworthiness of borrowers;
- Suppliers concerned about the ability of their customers to pay for goods and services delivered on long or short-term credit; and,

³³ 2001 IFAC Handbook of Auditing and Ethics Pronouncements.

³⁴ Ibid.



- Government regulators, revenue officials, and policy makers need the financial information to plan resource allocation, set and enforce tax policies, and carry out their regulatory responsibilities.

Financial statements must be prepared according to criteria that supply information objectively and qualitatively. Qualitative characteristics are characteristics that make the supplied information in financial statements useful for users. The criteria³⁵ developed by PADICO, the owner of the PSE includes:

- **Understandability** of the financial statement is a must. They have to be clear to anyone with reasonable level of business knowledge.
- **Relevance and usefulness** of the information is key to forecasting future performance and for risk assessment. This allows users to evaluate past, present and future performance.
- **Materiality** covers changes in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer. It also includes any decision to implement such a change made by the board of directors or senior management. The nature and timing of disclosure of such information is critical for users. Omission or misstatements of material information can constitute grounds for severe civil and criminal penalties.
- **Reliability** of information is a must for users. Financial information must be consistent and honestly represented. It cannot be reliable if it contains serious mistakes, or is not based on concrete data. Therefore, uncertainty must also be disclosed.
- **Faithful representation** of financial transactions and other operations is critical to users.

³⁵ Adapted, in part, from the Director General of PADICO and a board member of the PSE, Dr. Farouq Zuaiter, "The Elements of Disclosure", 2000.



- **Neutrality** of information is key and it must be presented free from subjective analysis and presented without bias.
- **Conservatism** in preparing the financial statement is sometimes prudent but cannot be the rule. Conservatism is a reasonableness standard, in that corporations have to make assumptions about many factors including doubtful debts, shortages, political risk, exchange rates, interest rates and so on. Reasonableness requires that financial statements are reliably but prudently prepared.
- **Completeness** is key to accurate financial statements. Omission of information can render the financial statement incomplete and therefore unreliable.
- **Comparability** is key to users who must be able to compare financial statements from year to year to determine the financial position.
- **Proper timing** as to disclosure of information is key so that it is meaningful.

The PSE further recommends that to achieve the objectives of financial disclosure, accountants, auditors, and analysts grapple with the nature of what, how and when to disclose. The level of required disclosure ranges from “full” to “fair” to “adequate.” The global trend is toward full disclosure, although many issuers prefer and provide adequate disclosure.

“Adequate disclosure” includes only certain items and specific transactions. It is regarded as the minimum level that must be included in a financial statement so as not to be considered misleading. “Fair disclosure” amplifies the legal requirements that all users have equal access to financial information. “Full disclosure” furnishes information about the entire corporation and its transactions. Notes and explanations are also provided. The latter permits users to receive clearer and more comprehensive information and facilitates decision-making in a meaningful way. Full disclosure also includes information about management compensation and related information, including mistakes and unlawful transactions.



As to the question on what to disclose, this depends on various factors, which include:

- Complexity of the business;
- Timing of presenting information; and,
- Accounting method.

The process of disclosure can take place in a number of publishing conventions, including:

- Financial statements;
- Concepts and detailed presentation;
- Information between two brackets;
- Illustrative notes;
- Tables and enclosed lists;
- Auditors' comments; and,
- Board's report.

Footnotes are a very important part of the financial statement. Notes and illustrations are added explain the information in a financial statement, and are a requirement under the GAAP. The notes give additional information on corporate operations, the method of accounting, assumptions about present or future values, and projections made by the management. They also supply additional disclosure about long-term assets and taxation. Essentially, they allow users to better understand and judge a company's performance and financial position.

Various transactions will take place after the financial statements are prepared that may be critical to users' decision-making. Disclosure of the so-called prospective transactions becomes essential and such information must be included before issuing the auditor's report. Otherwise, the report cannot be considered a full report. Examples of such transaction include:



- Transactions that directly affect the numbers reflected in financial statements;
- Transactions that change, in a material way, the balance sheet or shareholder equity; and,
- Actions that may influence, in a material way, the operational transactions or future projections.

Some explanatory information cannot be included in the audited financial statements. The narrative annual report serves as a supplement to the financial statements and provides an additional vehicle for disclosure of such information. This report is called the Board of Directors report. It includes:

- Non-financial transactions;
- Changes that impact transactions;
- Future projections that are industry-specific;
- Economic forecasts and impact on performance;
- Future growth plans;
- Size and impact of present and future capital expenditures; and,
- Other related information.

The recent collapse of Enron is symptomatic of the financial irregularities and improper reporting that occurred in the U.S. bubble economy of the late 1990s and, indeed, of its entire capital market. A large number of companies in the U.S. artificially boosted their earnings and consequently their share price.³⁶ Investors feel that they can no longer rely on a company's financial information, which will significantly affect US stock market performance. Disclosure of manipulation of financial information by Enron was followed by reports of similar questionable accounting practices by Tyco, WorldCom, and Elan followed. The effect of this debacle means lower equity valuation of all U.S. stocks, not just the offenders.³⁷

³⁶ Marc Faber, "The bullish side of the Enron scandal", Forbes Global, March 18, 2002.

³⁷ Ibid.



In the Palestinian context, little information is publicly available on listed companies. It is difficult, if not impossible, for brokerage firms to offer investment advice on the merits. What information is obtained tends to come from personal contacts and in many cases could be deemed and give the appearance to be insider knowledge or possibly inaccurate information planted to influence the share price. Palestinian accounting standards, discussed below, are not well regulated, which leads to questionable accounting practices. The PSE cannot thrive under these conditions of uncertainty for investors.

4.2 Overview of Disclosure Under the Securities Law and Capital Market Authority Law

This section provides a brief treatment of disclosure under the draft Palestinian Securities Law and Capital Markets Authority Law. Other related legislation is also addressed where appropriate.

4.2.1 The Interplay between the Draft Securities Law and the Capital Market Authority Law

In virtually all securities markets, there is some degree of both direct government regulation and self-regulation by the securities industry. As part of the dual trend of more reliance on market forces and the expansion of domestic securities markets around the world, it has become more prevalent to formalize the respective regulatory responsibility of government and industry. The Palestinian Authority has, since 1996, embarked on a program to enact financial sector legislation to regulate its securities market. The two main pieces of legislation are the Securities Law³⁸ and Capital Authority Law (CMA).³⁹

³⁸ The Securities Law was a PSE/IFC initiative launched in 1996. Today, as the law is pending before the Palestinian Legislative Council, the legislative branch of the PA, technical assistance is being provided by Financial Markets International, Inc., the contractor for the USAID-funded Capital Markets Development Initiatives Project.



The cornerstone of the securities regulations under the draft Palestinian legislation is financial sector structure and its relation to government and industry. The relative roles of the non-banking financial system and the securities markets in pooling domestic savings and allocating financial sector resources to business is dealt with in the CMA law. The securities law addresses the market structure of the securities industry, providing a regulatory framework with clear requirements and enforcement mechanisms, including the adequacy disciplinary proceeding taken against listed companies and brokers; and what investor redress mechanisms are available.

Company information is key to the securities law. The scope of disclosure has been benchmarked against international standards. However the CMA law is yet to be enacted and a regulatory body is yet to be formed, and there are concerns about oversight over company disclosure and the enforcement of the securities law. Another concern is the adequacy of price discovery and whether market mechanisms are reliable and can be regulated. Another major concern relates to the nature of methods for supplying liquidity to the market.

The policy approach of the securities and CMA laws is aimed at protecting investors from fraud, hype, and irrational exuberance. To achieve this objective, the laws require companies selling stocks and bonds to the public to disclose detailed information about their financial strength and weaknesses. Without accurate and complete information, investors cannot make rational decisions and the market cannot allocate funds to the most productive users. Ill-informed investment choices hurt individual investors, but there are also costs to the national economy in terms of wasted resources and jobs not created. If investors decided that they cannot trust corporate disclosures, they will be less likely to buy stocks and bonds, raising the cost of capital for all firms, good and bad.

³⁹ This Capital Markets Authority Law is an IFC/PSE initiative supported by the Swedish SIDA donor agency, with technical assistance provided by FMI under contract to USAID.



The Securities Law is concerned with the offer and sale of securities. The scope of the securities law is far-reaching; every offering is subject to the jurisdiction of the Capital Market Authority (CMA). The Securities Law offers a mechanism to mobilize domestic capital, investor protection, attract foreign portfolio investment by means of disclosure, audited financial statements, transparency, protection of security-holders, corporate governance rules, integrity of market participants, competition, effective dispute resolution, civil remedies to investors, effective government enforcement authority, and punishment of transgressors.

Transactional disclosure requirements relate to specific events such as a public offering of securities and are governed by the Securities Law. Continuous disclosure obligations are imposed related to securities traded at the Palestine Securities Exchange. In addition to specific disclosure obligations of the Securities Law and the PSE Regulations, both contain general disclosure standards that apply to all filings and upon which civil and criminal liability may be based. This standard requires that documents governed by the Securities Law and PSE regulations not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made in those documents not misleading.

4.2.2 Supplemental Legislation

Supplemental legislation is a bundle of laws that interact with each to govern the full scope of the securities industry. They include the following:

- Companies law covers disclosure issues, corporate governance of securities issuers and accountability to security holders. It also specify the accounting standards for audited financial statements and set the parameters for regular disclosure;



- Banking and commercial laws that facilitate timely and reliable settlement of obligations, allow cash and other financial assets to be held by non-bank intermediaries, and permit extension of credit collateralized by stocks and bonds;
- Laws on financial accounting and auditing that would ensure quality control and ethics standards, maintain records that support findings, provide concurring partner approval, ensure inspection of public accounting firms, launch investigation and disciplinary proceedings, allow for the suspension and revocation of licenses, set accounting standards, ensure auditor independence, set conflict of interest rules and address fraud.
- Laws on property rights and transfer thereof is critical for a thriving securities industry;
- Bankruptcy law that fairly address the interests of holders of debt and equity securities in reorganization or liquidation proceedings and the interests of securities customers of failed financial intermediaries;
- Commercial arbitration law to facilitate dispute settlement in the securities industry especially since the securities market is dynamic and fluid and cannot withstand lengthy litigation procedures.
- Tax laws with the right incentives for a sensible balance sheet structure and tax regime that would not levy inequitable taxes on securities market transactions, or discourage issuers from revealing their true financial performance;
- Regime for enforcement of contracts to safeguard the interest and rights of security holders and permit proper legal redress;
- Criminal law to impose criminal penalties including fines and jail sentences against violators.

The interplay between these laws is important for the proper functioning and conduct of a securities market. The soundness of these laws and rules, and the capacity of both the government and the exchange to enforce them will affect the ability of portfolio managers to realize their key objectives—increasing returns, minimizing transaction



costs, and managing risk. The laws and regulations are a precondition to the efficiency, transparency and credibility of securities market operations. As a market grows and becomes more sophisticated, the demand by regulators for quality reporting often stimulates the emergence of information services that compete on the basis of their capacity to deliver useful information to investors, including foreign investors.

The principal regulatory objectives that must be balanced by securities regulators include market integrity, fairness and efficiency. Market integrity includes regulatory activities that minimize systemic risk and encourage participation in the market, including prudential measures to safeguard the solvency of individual financial institutions, thereby maintaining confidence in the financial system as a whole and protecting individual savers; the encouragement of an effective and stable payments system, which can reduce risks and the ability of financial institutions to manage their risk exposure; and, prevention of fraud, manipulation, insider trading and other such market abuses that threaten the market's integrity.

Fairness is a regulatory concern, not only for political and social reasons, but also as a means to protect a market's competitiveness and integrity. For example, competition within the financial system should be encouraged by allowing easy entry, operations and exit for participants.

Efficiency is key to the ability of the financial sector to perform its principal function of pooling and allocating financial resources to economically viable businesses. As many countries open their economies and adopt a more market-based approach to the development and operation of industrial enterprises, the allocation of capital and credit to industry must be responsive to new and shifting economic opportunities.

As proposed in the various laws and regulations in Palestine, the international benchmarks outlined above are met. However, as Palestine is looking to meet existing



international benchmarks, the world is moving towards more stringent regulation and oversight. Lawmakers and regulators realize that many companies have a desire to avoid or postpone declines in share prices, creating a powerful incentive for corporate management to engage in accounting practices that conceal bad news. The cases of Enron, Worldcom and a growing list of others suggest that companies engage in deceptive financial reporting that escapes watchdog mechanisms.

The Palestinian securities market can learn from the present problems facing the larger markets and counter any sort of irregular activity and improper information by stringent disclosure requirements. To institute confidence in corporate reporting, financial accounting and disclosure must be enhanced. Palestine has not created the regulatory body yet, allowing to meet the critical need of ensuring that CMA rules reflect the newly established international rules.

4.3 New International Developments in Corporate Disclosure and Accounting and Auditing

The recent corporate accounting debacle in the US gave rise to recently enacted laws. This section highlights this new legislation and underscores the emphasis on setting very stringent accounting and auditing requirements for corporate disclosures. At the same time, it examines the draft Palestinian Accounting and Auditing Law.

4.3.1 Recent US Developments

Congress passed two laws to address accounting irregularities. The first bill, entitled “An Act To Protect Investors by Improving the Accuracy and Reliability of Corporate Disclosures Made Pursuant to the Securities Laws and for other Purposes,” known as the “Sarbanes-Oxely Act of 2002,” passed in January 2002. The second is a bill, passed in July, is entitled “Act on Auditing and Accounting”.



The Sarbanes-Oxley Act of 2002 sets stringent rules and creates oversight bodies. It addresses:

- public company accounting oversight board
- auditor independence
- corporate responsibility
- enhanced financial disclosure
- analyzed conflicts of interest
- enhanced SEC resources and authority
- studies and reports
- corporate and criminal accountability
- white-collar crime penalty enhancements
- corporate tax returns
- corporate fraud and accountability.

The Act on Auditing and Accounting creates a new oversight body to regulate independent auditors. This new body is regulated by the SEC. The bill addresses:

- new auditor oversight body
- auditor independence
- enhanced accounting disclosure requirements
- stock analysts
- corporate executive accountability
- corporate boards
- increased penalties for securities law violations

This bill specifies new requirements for the content of the annual report, procedures for submission of the annual report to Congress, stringent requirements for the sale of securities, improved transparency of public disclosure, improved reporting on insider transactions, code of conduct, enhanced oversight of periodic disclosure, retention of records, barring certain persons from serving as directors or officers, disgorging insiders



profits from trades prior to correction of erroneous financial statements, rules on analyst conflict, review of corporate governance practices, enforcement actions, credit ratings, rules for attorneys and issuers, exclusion of certain investment companies in certain transactions, and rules for SEC enhanced supervision.

4.3.2. Draft Palestinian Accounting and Auditing Practice Act

Palestine does not have an accounting standard. Accounting and reporting requirements vary depending on the size of operations, reporting through monthly, quarterly, semi-annually or annual financial statements, industry specific schedules, aging schedules of receivables and payables, petty cash and bank reconciliation in US dollars, Jordanian Dinar (JD) or New Israeli Shekel (NIS), job order costing, full cost/revenue analysis, budgeting and budget variances, and trend analysis. In Palestine, there is no seamless free flow of information.

The accounting and auditing profession in Palestine suffers from structural and cultural problems. The structural issues, although, significant are easier to identify and fix. The cultural issues are more complex to identify. The structural issues include computer compatibility, English language skills, payroll and social security issues, and price differentials. These are straightforward and can be improved. Cultural issues are more difficult to address. Many businesses are unwilling and often unable to adapt their business practices. Family businesses and existing associations impose an unwritten code that is difficult to change.

This translates into lack of transparency even though many discuss openness. Although it is also well understood by companies traded on the PSE that the Exchange would perform better in a system of disclosure, the existing direction is to back away and resist. Listed companies argue that in the absence of a Palestinian standard of accounting and mandated full and periodic disclosure under the operative Companies Law, companies



are unable/unwilling to comply with either GAAP or IAS. They also argue that the absence of a securities law warrants non-compliance.

At present various methods and standards apply. Some of the more established companies use either the GAAP or IAS with various deviations in practice. A draft Accounting and Auditing Practice Act (Annex 2) is pending before the PLC. The enactment of this legislation will give Palestine a uniform standard. Debate, however, rages on the adequacy of the law as drafted.

At the same time, a code of ethics is being developed. The Association of Palestinian Accountants and Auditors is presently adopting the IFAC's Code of Ethics. This step aims to enhance the required integrity, objectivity, and competence of Association members.

The Palestinian draft law, however, has many shortcomings and must be significantly improved to meet the minimum international standard. (See Appendix 4). It is inadequate in its present polices and scope on responsibility of auditors and accountants. It falls short on many aspects including the setting of standards. Section (5), Paragraph (A) (1) states that the Auditing Standards Board⁴⁰ will issue "Palestinian auditing standards in light of the International Auditing Standards". The draft law does not create a standard. The fact that it only aspires to be guided by International Accounting Standards is illustrative. For an existing accounting and auditing profession and a nascent securities market, this is dangerous because it continues to keep the financial reporting in the securities market without regulation.

By contrast, international accounting and auditing practices are well developed and increasingly stringent, as outlined above in section (4.3.1). Moreover, during the last decade of the millennium and increasingly over the past two years, many different types

⁴⁰ Note that this board is proposed under the draft law, but does not currently exist.



of financial instruments were developed and put into use throughout the world. The accounting standard boards in other countries have begun efforts to develop comprehensive standards to meet these new challenges. For example, the International Accounting Standards Committee (IASC) undertook a joint project with the Canadian Institute of Chartered Accountants (CICA) in the year 1989 to establish, in two phases, standards on recognition, measurement, presentation and disclosure of financial instruments. The project resulted in two finalized standards: IAS 32⁴¹ and IAS 39⁴².

4.4 Corporate Governance

Corporate governance is an integral part of the securities markets. It entails various responsibilities among the various members of the corporate structure with differing degrees of reporting duties. Palestine has not developed this corporate culture in practice, and the applicable legal framework is sparse. There are general references in the Companies Laws of the West Bank and Gaza, but no implementing regulations. The draft companies and securities laws address these issues. There are firms in Palestine that “self-regulate”, as we shall see below in the quantitative analysis of companies listed on the PSE. However, these firms are limited in number.

4.4.1. International Benchmark on Corporate Governance

A wide body of literature and rules has developed concerning corporate governance issues. All capital markets in developing and emerging markets have instituted such rules with various degrees of responsibility. Boards of Directors and management have special duties and responsibilities and, accordingly, are held accountable to both shareholders and regulators.

4.4.1.1 Responsibilities of the Board of Directors

⁴¹ IAS 32, which dealt with presentation and disclosure, was phase one of the project. It was issued in 1995, went into effect in 1996, and was revised in 1998 and again in 2000.

⁴² IAS 39 was phase two. It dealt with recognition and measurement of financial instruments. This standard was issued in 1998, revised in 2000, and made operative in 2001. In effect, IAS 39 complements IAS 32.



Board members should scrutinize the financial books and records. The relevant standard is that of care and loyalty to the shareholders. The duty of loyalty is implicated when a director enters into a transaction with, or has conflict of interest with the company he serves. The duty of loyalty to the company is a higher standard for listed companies.⁴³ The duty of care, which relates to a director's responsibility to exercise appropriate diligence and act in good faith, requires active participation and an understanding of the company's accounting issues. Members of the Board must become and stay informed about the business and affairs of the company and inquire into potential problems when alerted by circumstances and events. Companies must have a system of internal controls reasonably designed to prevent violations of law and corporate policy and to permit the company to prepare accurate financial reports.

In this regard, Board members should verify that the company's information and reporting procedures and controls are adequate to ensure that appropriate information comes to them from management in a timely manner. They must insure that the outside auditor is independent, understands that it is accountable to the board of directors, is properly staffed, and adequately scopes its audit services.⁴⁴ At a minimum, the Board should consider adopting a policy governing the provision of non-audit services by an outside auditor.⁴⁵ The fees paid for audit and non-audit services and the nature of non-audit services must be discussed. Board members should meet regularly with senior financial management and with independent auditors. The Board must assess the professionalism, responsiveness, and candor of the outside auditors. The audit scope and plan must be assessed, and the audit personnel must be questioned. The board must

⁴³ The New York Stock Exchange and Nasdaq rules on disclosure of conflicts of interest are very strict.

⁴⁴ The Enron debacle has reopened the debate about the provision of non-audit services by outside auditors and its effect on independence. Enron paid outside auditor, Arthur Andersen, over \$50 million in 2000, \$27,000 million of which constituted compensation for "non-audit" services, including risk management and internal audit services.

⁴⁵ In the US, several corporations have instituted policies that address the categories of prohibited and permitted services. *The Panel on Audit Effectiveness: Report and Recommendations* (the "O'Mally Panel Report") (Aug. 31, 2000).



ensure that the audit team has the experience in the relevant market and be certain that it has access to the relevant technical experts.⁴⁶

One of the central themes to emerge from the Report of Investigation by the Special Investigative Committee⁴⁷ of Enron's Board of Directors was the failure of communication among the company's management, board of directors, audit committee, and outside auditors. As a result, boards are reexamining their practices and procedures for communicating with management, internal financial and accounting staff, and outside auditors. Advisors are recommending that, in reviewing their practices, boards seek active engagement and give-and-take discussions with management and auditors.

Many companies in the US and Europe have installed audit committees. Palestinian companies are advised to install such independent committees.⁴⁸ Audit committees are comprised of independent members of the board. (A blueprint of duties and responsibilities and a draft charter is attached. See Appendix (1)).

The board and audit committee should consider whether the company has in place an effective mechanism for company employees, particularly financial and accounting staff and lower level officers, to voice concerns or register complaints about internal control or financial irregularities. See Appendix (2) for an outline of the channels of communications that the audit committee should have in place to best perform its duties.

4.4.1.2 Responsibilities of the Auditors

The auditors' duty is to review and assess the conclusions drawn from the financial statements. The review and assessment process means an examination of whether the

⁴⁶ The Enron case raised concern about certain Securities and Exchange Commission (SEC) rules on disclosure. Then-applicable SEC rules did not require disclosure between management and directors. There is a strong proposal today before the SEC from shareholder groups mandating disclosure of all personal, family, business, political, and philanthropic connections between directors and management.

⁴⁷ Ibid, note 11.

⁴⁸ Today only one company has installed an audit committee, namely, the Palestine Telecommunications Company, PLC (Paltel). Paltel is listed on the PSE.



financial statement has been prepared in accordance with an acceptable financial standard. It can either be IAS, GAAP or a national standard. Auditors give either an unqualified report or a qualified report.

In Palestine, the auditing profession is divided into two groups: local affiliates of international accounting and auditing firms on the one hand, and unaffiliated local auditors. The first group applies international auditing standards. The second group is at liberty to apply the standard of its choice so long as it declares it in the audited statement. The discretion in application opens the door for negligence and abuse, especially in the absence of a supervisory body. This vacuum has created gaps and results in adverse outcomes that have affected the nature of disclosure and its quality.

4.4.1.3 Responsibility of Management

The Board of Directors is dependent on management for information. Individual directors do not have the time or resources to obtain information from the corporation relevant to board decisions. They cannot be certain of the information they do need or should ask for. The directors are totally dependent. Therefore, management's responsibility is to provide constructive information to enable the board to make well-informed decisions. The board must set procedures for the CEO/GM to prevent management abuse, conduct proper oversight over management actions, maintain management discipline, and prevent speculation.⁴⁹

The management has a responsibility to ensure that the board and shareholders understand the business of the corporation. This will create confidence and provide a more stable shareholder base. Management must provide accurate and reliable information. The release of information must be timely.

⁴⁹ "Where are the Directors?", Guidelines for Improved Corporate Governance in Canada, the Toronto Stock Exchange Committee on Corporate Governance in Canada, 1994.



Management must supply the board with full information for disclosure purposes, be it for the prospectus in the event of a new issue or for continuous disclosure. The board must act with due diligence and be certain to have full disclosure because it is liable for any misrepresentation.

4.4.1.4 Codes of Conduct and Related Party Transactions

Related-party transactions are one element of disclosure. Failure to disclose such transactions lay at the core of the Enron debacle. The lesson from Enron is that the board waived parts of the company's code of conduct on at least two occasions, allowing the company's chief financial officer to become involved with private partnerships that did business with Enron. The SEC's recent statement concerning Management's Discussion and Analysis of Financial Condition and Results of Operations flagged related party disclosures as warranting particular attention. *See* Release Nos. 33-8056, 34-45321 (Jan. 22, 2002).

In Palestine, corporations are strongly encouraged to establish codes of conduct or conflict-of-interest policies with particular focus on related-party transaction practices and procedures. To the extent that waivers or deviations from such policies are permitted, they should be carefully documented and monitored. Company approval procedures should be scrupulously followed, and the audit committee should insist on follow-up reports, just like in the U.S.



Chapter 5 Palestine Securities Exchange Efficiency Assessment with respect to financial Reporting and Disclosure.

In this chapter, the effect and extent of existing disclosure practice on the PSE's efficiency is examined. Efficiency is the ability of the financial sector to perform its principal function of pooling and allocating financial resources to economically viable businesses. As illustrated in the discuss of Chapter 4, a critical prerequisite for an exchange to attract investment is the ability to obtain disclosure from listed companies of their financial reports in a qualitative and timely manner.

5.1 Efficiency of Disclosure Hypothesis

To study efficiency at the PSE a hypothesis was developed. This study proposes is that the liquidity of a company's shares (measured by turnover ratio), and the profitability of a company (measured by return-on-equity), family structure and political risk have a positive impact on disclosure. A multiple regression model is used to see how the independent variables (Turnover Ratio, ROE, Family Dominated, Political Risk) combine to predict the dependent variable (Disclosure Score). By measuring exactly how large and significant each independent variable has been historically in relation to the dependent variable, the future value of the dependent variable can be predicted. See Table (1).

Data is based on 35 observations taken from nine listed companies from the years 1997 through 2000. They include the three best performing: Palestine Telecommunications Company (PALTEL), Palestine Development and Investment Company (PADICO), and Jerusalem Cigarette Co. (JCC); three medium performing companies: Palestine Real Estate Investment Co. (PRICO), Gaza Ahliea Insurance Co (GAIC), and Jerusalem Pharmaceutical Co. (JPH) ; and three of the worst performing companies : Palestine



International Bank (PIB), Palestine Investment & Development Co (PID), and Arab Co. for Paints Products (APC). The observations are outlined in Tables (1), (2), (3) and (4).

The assumption under the null hypothesis states there is no relationship between the four predictor variables and the response variable (disclosure score): $H_0: \beta_1 = \beta_2 = \beta_3 = \beta_4 = 0$. The coefficients of all four predictor variables = 0).

The alternative hypothesis states the contrary, that there is a relationship between the predictor variables and the disclosure score: H_A : At least one of the four coefficients $\beta_i \neq 0$. See Appendix (3).

F-ratio is large when the predictor variables explain much of this variability of the response variable, and hence has a small p-value as measured by the F-distribution. A small value for this ratio indicated that much of the variability in Y (disclosure score) is due to random error (as estimated by the residuals of the model) and is not due to the regression. If the null hypothesis is true the F-ratio (in the ANOVA Table (3)) follows the F-distribution; with 4 numerator degrees of freedom and 30 denominator degrees of freedom. One can test the null hypothesis by seeing if this observed F-distribution is much larger than one would expect in the F-distribution. The significance F gives a p-value of 0.0313 representing the probability that an F-ratio with 4 degrees of freedom in the numerator and 30 in the denominator has a value 3.0669 or more. This p-value is less than 0.05, so the regression is significant at the 5% level. One can also say that the null hypothesis is rejected at the 5% level and the alternate hypothesis is accepted.

Unlike the results of the null hypothesis, under the alternative hypothesis, the findings suggest that ROE, Turnover Ratio, Family Dominated and Political Risk are positively associated with Disclosure Score. They are summarized below.

- There are other factors that also have some impact on the disclosure at the PSE, including: legislative framework, enforcement of PSE rules and regulations,



- insider trading, corporate governance, accounting and auditing standards, and transaction costs (commissions).
- In order to have good disclosure levels at the PSE (and thereby a more efficient market), the focus must be to remedy those illiquid nonprofit making companies. The PSE must continue to explore applicable mechanisms to encourage companies to improve their disclosure measures. One example is the Uniform Financial Reporting System (UFRS), a USAID product that was developed by Financial Markets International in collaboration with the Palestine Securities Exchange's Disclosure Initiative. The UFRS is a business management tool that provides a uniform format for financial reporting that complies with International Accounting Standards (IAS). Key financial ratios essential for managers, investors, and lenders are automatically calculated from the financial statements.

5.2 Deterrents and Future Prospects

The PSE is a small market attempting to operate in a legal vacuum. It suffers from lack of depth in trading, high volatility, and a small number of market participants. The absence of an independent regulatory to supervise coupled with the absence of a legal regime has affected transparency. For all practical purposes, the PSE is the only regulatory authority, and evasion of its requirements is relatively simple – just don't list. Without a supportive legal framework, the PSE is caught between the devil and the deep blue sea. Investors require better disclosure, but the attempt to compel listed companies to comply will result in delisting and an even smaller exchange.

5.2.1. Legal and Regulatory Framework

Palestine is missing virtually all of the attributes of an adequate legal framework to support securities markets. It now has no securities law, accounting and auditing standard, modern companies law, or related modern legislation such as tax, banking, contracts and property laws. It lacks a formal certification process for brokers, dealers, and financial analysts. The lack of these fundamentals has had adverse effects on the



performance, efficiency and development of the PSE. The promulgation of an adequate legal framework that requires companies to comply with conventional international norms. will have a significant impact on the performance of the PSE. The PSE will have to concentrate on being an exchange rather than attempting to enforce regulatory requirements that are not legal norms, and can be evaded simply by delisting. Legal norms will also improve investor confidence and help to attract foreign and domestic investors. An essential factor in gaining international recognition will be establishing and retaining a credible reputation with those who form market opinions. The international investment managers and the institutional investors need to be convinced about the regulatory pedigree of the PSE and the overall regulatory framework.

5.2.2 Political and Economic Issues

The current political crisis, restrictions on movement and closure policies has led to a downturn in the economy and a decline in foreign and domestic investment due to the lack of confidence in the future prospects of Palestinian companies. Many foreign investors have pulled out of the market. The securities market is challenged by extreme political and economic uncertainty.

5.2.3 Ownership of the PSE

As pointed out in Chapter 3, the PSE is privately owned under license from the PA. PADICO, the primary shareholder, established the PSE for four basic reasons: (1) as a long term investment opportunity, (2) it saw that a securities exchange would be beneficial for the economy by creating a financial market, (3) the PA was not in a position to fund the development and operational costs of a securities exchange, and (4) a securities exchange would attract foreign investors.

Effectively, the PSE is a subsidiary of PADICO, the parent. Because the PA was unable and the no one else willing to fund the development and operational costs of an exchange, PADICO took on the risk; it committed itself to the initial losses of establishing and



operating the PSE. PADICO understood that the operations and management of the PSE must be independent. Today, the Board of the PSE includes independent members and industry representatives. To ensure accountability and transparency, PADICO is not involved in the day-to-day operational and regulatory matters.

5.2.4 Independent Regulator

The promulgation of the Capital Market Authority law and the establishment of the independent supervisor will significantly alter the existing relationships between the PSE, listed companies and brokerage firms. Rules for surveillance and enforcement are essential, and without them a securities market cannot grow. Since its establishment, the PSE has been overly burdened with a dual role, a quasi-governmental supervisor and an SRO. This in turn, augments the problems inherent to an SRO. This duality must soon end because it is stifling the entire securities market. It also creates resistance by the listed companies and brokers to abide by the rules of the PSE, as discussed below. If Palestine wants to mobilize equity capital in the territories, institutional capacity must be established.

5.2.5 Governance at the PSE

To provide added investor confidence and set the stage for post-crisis growth, the PSE and its parent, PADICO are working on a business plan that includes a divestment to industry representatives and an internal reorganization. The reorganization included the creation of various independent committees:

- Management Committee
- Corporate Governance Committee
- Listing and Membership Committee
- Ethics Disciplinary Committee
- Arbitration Committee
- Market Participants



These committees will include permanent and ad hoc independent members. Their task is to ensure that the PSE operates independently from the parent and at the same time has clear enforcement power to apply the rules of the PSE and resolve disputes with the listed companies and the brokers. The absence of the independent regulator has harmed the securities industry and tied the hands of the PSE in its ability to enforce its rules. Listed companies and brokerage firms have been reluctant to comply in the absence of a regulator. Moreover, they often argue that the ownership structure creates potential conflict of interest and are thus often wary of the PSE's enforcement power. While the argument has merit, the non-compliance is more a function of absence of legal framework and regulator.

5.2.6 Investor Base

The investor base and its potential growth at the local level is limited. The number of local private individual portfolio investors is few. Palestinian individuals keep their assets either in a very liquid bank deposit, or make direct tangible investments in housing and land, or in small, usually family or extended family enterprises. This behavior is typical in political uncertainty.

When the PSE was established, certain initial assumptions were established. The initial assumptions have proven to be overly optimistic. The PSE has missed its target of having 50 of the public shareholding companies listed by 40% in the first two years. If the securities law passes as proposed, i.e., require all public shareholding companies to list either on the main board or at the CDS, perhaps, the exchange can capture initial targets. This means, however, that the PSE would have to be recalculated the initial ratio.

The assumption regarding turnover ratios was optimistic. The PSE set a ratio of 10.6% for the first five years. Experience in emerging markets should have indicated that this target would be difficult to achieve, especially during the first three years.



In Palestine there are 90 public shareholding companies. Based on the PSE listing criteria 50 are eligible. Only 30 meet all listing criteria described in Chapter 3 above. Today, there are 25 listed companies. Two are suspended from trading. The current economic crisis has affected the financial position of at least 5 additional companies, though no concrete financial information has been made available on the impact of the present political/economic crisis.

5.2.7 Listed Companies, Corporate Governance and Disclosure

Little information is publicly available on listed companies and therefore, it is very difficult for brokerage firms to offer investment advice on the merits of a certain security. This is certainly true of most listed companies with few exceptions. What information is obtained tends to come from personal contacts and it is not unfair to deem it insider information. This is not to say that insider trading is a practice. It is more a function of an absence of formal disclosure mechanisms as described in Chapter 4. To avoid such pitfalls, it is fundamental that regular publishing of full and accurate information is systematically provided. Also absent are research and information centers that analyze information and disseminate it to brokers and investors. The PSE does not offer this service either.

Corporate governance is another issue of concern with respect to listed companies. Most listed companies continue to be dominated by family members, as demonstrated in the alternative hypothesis above, even though these companies have met the threshold of having 100 shareholders. The majority of the shares are held by a small number of shareholders. Management is often a related party, being either a shareholder or relative. This opens the door for questionable corporate governance and leads to interested-party transactions. Many shares remain illiquid even though there is demand. Some shareholders do not want to sell irrespective of the offer price because they deem this as loss of majority control.



As to audit committees, management committees and other internal control mechanisms discussed in Chapter 4, only two listed companies have them, PADICO and Paltel. The majority of listed companies do not meet the minimum international benchmark requirements for either corporate governance or disclosure.

5.2.8 Accounting and Auditing

The rules of the PSE require that listed companies provide annual reports including financial statements in accordance with international accounting standards. The PSE faces two problems in enforcement. First, listed companies do not submit the reports in a timely manner. Second, when reports are submitted, they do not comply with international accounting and auditing standards. As outlined above in Chapter 4, this detracts from the quality and reliability of information. At the same time, annual statements by themselves are insufficient sources of information and fall far below international benchmarks, which require at least quarterly financial statements and continuous disclosure.

It is expected that the promulgation of the Accounting and Auditing Law and the establishment of a Palestinian standard along the lines of IAS or GAAP should improve disclosure at the PSE.

5.2.9 Member Brokerage Firms

There are seven member brokerage firms registered with the PSE. These members are licensed by the PSE. In the absence of a regulator, the PSE set the rules and guidelines, however, it encounters enforcement issues similar to those faced with listed companies. Other concerns include the capital requirement of each brokerage firm. The PSE has set the minimum capitalization at USD1 million. It also requires an additional JD75,000 (USD107,142) Letter of Credit. Market risk concerning brokerage firms is critical because many firms are facing financial problems and have become illiquid themselves.



The PSE is working on introducing more stringent enforcement of capital adequacy requirements.

Procedures at member firms vary greatly. Some have not segregated client accounts even though they are instructed to do so by the PSE. Management control and adequate training for staff analysts are limited but vary from firm to firm. Brokerage firms are highly motivated but need significant skill enhancement.

5.3 Conclusions

Overall, the PSE has made a very credible effort in its first three years of operation (1997-1999). Considerable thought has gone into the formation and establishment of the PSE. International best practice has shown that the best way to establish and manage a new exchange is a gradual approach, with certain circuit-breakers in place at first, so that trading is fair and orderly, to enable investors and other market participants to learn to operate the market, and at the same time, to build up liquidity in the securities traded. The PSE has succeeded well in the formation stage.

Although quantitative information available is sparse, the lesson from the hypothesis is that there is in fact a positive correlation between liquidity and profitability on the one hand and the quality of disclosure on the other.

The current challenges facing the PSE come from three different directions. The first is the political/economic environment in which it operates, but over which it has no control. The second is the perception of local and international investors about the growth and future prospects of a sound securities market, based on the overall development of a sound legal and regulatory framework. The PSE has significant opportunities to influence this development. The third source of challenges is the PSE's own internal rules and regulations over which it has full control.



The PSE's future success then hinges as much on external factors as on internal factors.

The way forward in the current environment is to strengthen its core along the following lines:

- One advantage that the PSE has that is missing in other emerging markets is that the far-flung Palestinian diaspora has become quite wealthy, and its members deeply desire to invest in a Palestinian homeland. However, wealth has brought financial sophistication, and potential Palestinian investors have made it clear that they would not send their money home until an appropriate legal and regulatory environment is in place.
- The PSE must continue and push forward with its cooperation with PA executive and legislative officials and international donor projects to ensure promulgation of an appropriate legal framework.
- In tune with the development of the external legal and regulatory framework, the PSE must address its own internal rules and regulations. As the developing legal environment toughens, the PSE must strengthen its own requirements and enforcement mechanism with an eye on the goal of creating a world class securities exchange in which investors feel confident.



APPENDICIES

Appendix 1

AUDIT COMMITTEE CHARTER

1. Members. The Board of Directors shall appoint an Audit Committee of at least (three) members, consisting entirely of "independent" directors of the Board, and shall designate one member as chairperson. For purposes hereof, "independent" shall mean a director who meets the Palestine Securities Exchange (PSE) definition of "independence".
2. Each member of the Company's audit committee must be financially literate, and at least one member of the audit committee shall have accounting or related financial management expertise, both as provided in the PSE rules.
3. Purposes, Duties, and Responsibilities. The Audit Committee shall represent the Board of Directors in discharging its responsibility relating to the accounting, reporting, and financial practices of the Company and its subsidiaries, and shall have general responsibility for surveillance of internal controls and accounting and audit activities of the Company and its subsidiaries. The Audit Committee does not itself prepare financial statements or perform audits, and its members are not auditors or certifiers of the Company's financial statements. Specifically, the Audit Committee shall:
 - (i) Recommend to the Board of Directors, and evaluate, the firm of independent certified public accountants to be appointed as auditors of the Company, which firm shall be ultimately accountable to the Board of Directors through the Audit Committee.
 - (ii) Review and discuss with the outside auditors with the independent auditor their audit procedures, including the scope, fees and timing of the audit, and the results of the annual audit examination and any accompanying



management letters, and any reports of the outside auditors with respect to interim periods.

- (iii) Review with the independent auditor and discuss the written statement from the outside auditor of the Company auditor, required by Independence Standards Board Standard No. 1, concerning any relationships between the auditor and the Company or any other relationships that may adversely affect the independence of the auditor and, based on such review, assess the independence of the outside auditor.
- (iv) Review and discuss with management and the independent auditor, outside auditors the Company's annual audited financial statements of the Company, including a discussion and analysis of the auditors' judgment as to the quality of the Company's accounting principles.
- (v) Recommend to the Board of Directors whether, based on the review and discussions described in paragraphs (ii) through (iv) above, the financial statements should be included in the Annual Report on Form.
- (vi) Review and discuss with management and the independent auditor the outside auditors: (a) any material financial or non-financial arrangements of the Company which do not appear on the financial statements of the Company; and (b) any transactions or courses of dealing with parties related to the Company which transactions are significant in size or involve terms or other aspects that differ from those that would likely be negotiated with independent parties, and which arrangements or transactions are relevant to an understanding of the Company's financial statements. The results of any significant matters identified as a result of the independent auditor's interim review procedures prior to the filing of each Form 10-Q equivalent at PSE or as soon thereafter as possible. Review and discuss with management and the outside auditors the adequacy of the Company's internal controls.



- (vii) Review and discuss with management and the outside auditors the accounting policies which may be viewed as critical, and review and discuss any significant changes in the accounting policies of the Company and accounting and financial reporting rule changes proposals that may have a significant impact on the Company's financial reports.¹²
- (viii) Establish policies and procedures for the engagement of the outside auditor to provide non-audit services, and consider whether the outside auditor's performance of information technology and other non-audit services is compatible with the auditor's independence.
- (ix) Review material pending legal proceedings involving the Company and other contingent liabilities.
- (x) Review the adequacy and appropriateness of the Audit Committee Charter on an annual basis, and recommend changes if the Committee determines changes are appropriate.

3. Meetings. The Audit Committee shall meet as often as may be deemed necessary or appropriate in its judgment, generally [four] times each year, either in person or telephonically. The Audit Committee shall meet in executive session with the independent outside auditors [and Internal Auditor head of internal audit] at least annually. The Audit Committee may create subcommittees who shall report to the Audit Committee. The Audit Committee shall report to the full Board of Directors with respect to its meetings. The majority of the members of the Audit Committee shall constitute a quorum.

4. Outside Advisors. The Audit Committee shall have the authority to retain such outside counsel, experts, and other advisors as it determines appropriate to assist in the full performance of its functions.

5. Investigations. The Audit Committee shall have the authority to conduct or authorize investigations into any matters within its scope of responsibilities and shall have the authority to retain outside advisors to assist it in the conduct of any investigation.



Appendix (2)

Communications Channels within the Corporation to Ensure Proper Governance

- *Communications with management:* The audit committee should meet regularly with the chief executive, chief financial and chief accounting officers, not only to discuss accounting and reporting issues, but also to assess the quality and effectiveness of these officers. Committee members should ask thought-provoking questions: What policies and risks concern you? What financial reporting practices are our competitors following? What financial commitments is the company reliant on? What are your contingency plans if things do not go as you expect? Committee members should make it clear that they expect to be alerted to potential areas of concern *before* they become significant problems.
- *Communications with internal auditors:* There should be regular private sessions between the audit committee and the head of internal audit. If the company does not have an internal audit staff, similar conversations should be held with the staff responsible for financial reporting. The head of internal audit should be directly accountable to the audit committee, which should oversee the hiring, compensation and career path of employees in the internal audit function. If an outside firm is retained to perform this function, the audit committee should be comfortable that the company has sufficient expertise to oversee the contractor's performance.
- *Communications with outside auditors:* Audit committee members should make it crystal clear to the company's outside auditors, as required by the PSE rules, that the outside auditors are accountable to the board of directors through the audit committee, *not* to management. Audit committee policies and procedures should encourage communications between the outside auditors and the audit committee. The outside auditors should be encouraged to disclose all significant areas of concern or discussion with management as to accounting principles or controls, even if the area of concern was resolved with management to the auditor's



satisfaction. The audit committee members should not leave it to the auditors to raise issues, but rather should ask their own questions. For example, audit committee members might ask whether the outside auditor has made any recommendations that management has not followed, whether issues have arisen that the auditor discussed with its national office, and whether the auditor would make any changes to the financial statements if it were in management's shoes. In both private sessions and meetings involving management, the audit committee should solicit the auditor's views on the overall quality of the company's financial reporting, including financial disclosures and important accounting principles. Although these discussions are required in connection with the annual audit, more frequent communications may be appropriate.



Appendix (3)

Multiple Regression Model: $Y = A + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + E$

where Y = Dependent Variable – Disclosure Score

X₁ = Independent Variable - Turnover Ratio

X₂ = Independent Variable - Return-on-Equity

X₃ = Independent Variable – Family Dominated

X₄ = Independent Variable - Political Risk

E = Random Error



Table (1)

Year	Company	Turnover Ratio	ROE	Family Dominated	Political Risk	Disclosure Score
1	1997 PALTEL	13.18%	23.55%	0	2	57
2	1998	16.35%	13.58%	0	3	57
3	1999	17.50%	9.04%	0	4	57
4	2000	29.92%	8.96%	0	3.5	57
5	1998 PADICO	8.96%	6.88%	0	3	66
6	1999	25.75%	2.45%	0	4	66
7	2000	65.06%	1.73%	0	3.5	66
8	1997 JCC	2.41%	5.04%	1	2	33
9	1998	2.86%	25.33%	1	3	33
10	1999	5.09%	17.95%	1	4	33
11	2000	14.08%	17.20%	1	3.5	33
12	1997 PRICO	0.04%	25.61%	0	2	53
13	1998	10.94%	48.00%	0	3	53
14	1999	16.04%	105.18%	0	4	53
15	2000	30.71%	105.82%	0	3.5	53
16	1997 GAIC	7.54%	10.92%	1	2	38
17	1998	10.58%	0.25%	1	3	38
18	1999	22.91%	16.11%	1	4	38
19	2000	13.21%	-1.10%	1	3.5	38
20	1997 JPH	1.02%	3.97%	1	2	2
21	1998	2.52%	4.59%	1	3	2
22	1999	6.16%	8.82%	1	4	2
23	2000	3.89%	14.54%	1	3.5	2
24	1997 PIB	9.78%	0.00%	0	2	0
25	1998	14.10%	0.00%	0	3	0
26	1999	9.67%	0.00%	0	4	0
27	2000	0.03%	0.00%	0	3.5	0
28	1997 PID	1.14%	-1.29%	1	2	39
29	1998	2.47%	-0.78%	1	3	39
30	1999	0.53%	-1.16%	1	4	39
31	2000	2.71%	-0.65%	1	3.5	39
32	1997 APC	7.75%	7.08%	1	2	0
33	1998	14.60%	-7.68%	1	3	0
34	1999	16.97%	-9.90%	1	4	0
35	2000	19.01%	0.00%	1	3.5	0



Disclosure Scores: Source from the 2000 Annual Report Review of Listed Companies, Accounting and Auditing Sector Program (USAID), 2002.

Turnover Ratio is used as an efficiency or liquidity indicator of a listed company. It is defined as the ratio of the value of total shares traded and market capitalization. It measures the activity or liquidity of a company relative to its size. A small but active company will have a high turnover ratio whereas a large, while a less liquid company will have a low turnover ratio. (See Appendices 6 and 7)

Return-on-Equity was selected to use as a measure of company profitability. Return-on-Equity is defined as the ratio of net income (or loss) to shareholders' equity. It indicates the rate of return that management has earned on the capital provided by the owners. (See Appendices 6 and 7)

Family Dominated is measured as a dummy variable, 1 = company structure is family dominated; 0 = company structure is not family dominated. (See Appendices 6 and 7)

Political Risk was measured on a scale of 1 – 5, 1 being the highest risk and 5 the lowest. (See Appendices 6 and 7).



Table (2)

Regression Statistics	
<i>Multiple R</i>	0.5387
<i>R Square</i>	0.2902
<i>Adjusted R Square</i>	0.1956
<i>Standard Error</i>	21.6627
<i>Observations</i>	35

Table (3)

ANOVA					
	<i>Df</i>	<i>SS</i>	<i>MS</i>	<i>F-Ratio</i>	<i>Significance F</i>
			1439.197		
<i>Regression</i>	4	5756.7883	0	3.0669	0.0313
<i>Residual</i>	30	14078.1831	469.2728		
<i>Total</i>	34	19834.9714			

Table (4)

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
<i>Intercept</i>	34.1700	17.2434	1.9816	0.0567	-1.0457	69.3856	-1.0457	69.3856
<i>Turnover Ratio</i>	54.5439	34.5901	1.5769	0.1253	-16.0985	125.1862	-16.0985	125.1862
<i>ROE</i>	23.7009	15.5679	1.5224	0.1384	-8.0930	55.4949	-8.0930	55.4949
<i>Family</i>								
<i>Dominated</i>	-10.5950	8.5788	-1.2350	0.2264	-28.1152	6.9252	-28.1152	6.9252
<i>Political Risk</i>	-2.1643	5.3865	-0.4018	0.6907	-13.1651	8.8365	-13.1651	8.8365



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