

BSE-Sofia AD

2008

**Analysis of Bulgaria's capital market
and strategy of BSE for its
development by 2010**

March 2008

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LIST OF ACRONYMS

MoE – Ministry of Economy

MoF – Ministry of Finance

FSC – Financial Supervision Commission

BNB – Bulgarian National Bank

CD – Central Depository AD

GDP – Gross Domestic Product

EU – European Union

CI – Compensatory Instruments

IPO – Initial Public Offering

REIT – Real Estate Investment Trust

CIS – Collective Investment Schemes

SEC – Securities

INTRODUCTION

The purpose of this document is to provide an overview of Bulgaria's capital market during the past three years and systematize the strategic aspects of BSE's development in the midterm (2008-2010).

The historical period examined in this document covers the lifetime of the Strategy, adopted by BSE-Sofia in January 2005, for development of the capital market by 2007. The document analyses the results achieved in implementing the Development Programme of BSE-Sofia and outlines the major trends that have been characterizing the market during the recent years.

Creation of this Analysis and Strategy document was initiated by the senior management of BSE-Sofia as an expression of its commitment to the midterm perspectives of the capital market. Thus, the present material reflects the belief of the senior management that BSE-Sofia is a leading institution in the efforts for achieving a sustainable change as regards the public policies of Bulgaria's market economy as well as the transparency and openness of the capital market.

The present Strategy reflects the vision of BSE's senior management on the main challenges as well as the actions to be taken for achieving the envisaged midterm objectives in the context of the increasing interest in the capital market. During the past two years BSE-Sofia has been in the focus of public and professional attention alike and in order to meet the expectations of the investment community, the Exchange must maintain high operational standards, 'steer' the market and be a generator of changes.

Although the Exchange plays a primary role, other participants also have an impact on the development of the capital market. These include official institutions of the State (MoE, MoF, FSC), the Central Depository as well as banks, investors and issuers. Therefore, the efficient collaboration among these stakeholders together with their appropriate initiatives in implementation of this Strategy are key factors for accomplishment of the envisaged goals.

The capital market development tendencies presented in this document are based on its current status and on the expectations for its development in the mid term. BSE's development strategy by 2010 is a stepping stone for elaboration of a concrete business plan.

1. POSITIONING THE CAPITAL MARKET IN THE WIDER CONTEXT OF THE NATIONAL ECONOMY

While Bulgaria's non-banking financial sector was characterized by a relatively lower level of development prior to 2005, the recent three years have seen an appreciable increase in the quality of financial intermediation channels, deepening diversification and restructuring processes, stronger steer towards non-banking investments and savings, and greater significance of the capital market. The latter has boosted competition and increased the quality and diversity of available services. The factors underlying these processes were: establishment of a regulatory framework for mutual funds, reform of the pension insurance system, the state's tax policy, higher activity of the market players, BNB's restrictive lending policy vis-à-vis commercial banks and so forth.

The growing significance of the capital market as an alternative financial intermediation channel can be gauged by a generally accepted indicator, namely market capitalization to GDP ratio. This ratio has increased remarkably during the period, reaching almost 55% by the end of 2007.

Table 1: Depth of the financial intermediation sector, in % of GDP at yearend

	2005	2006	2007
Assets of the banking system (in % of GDP¹)	76.76%	85.94%	113.05%
Balance-sheet assets of pension insurance companies	2.61%	3.10%	4.45% ²
Gross premium income of insurance companies	2.50%	2.55%	2.44% ³
Assets of Collective Investment Schemes (CIS)	0.22%	0.64%	1.72%
Market capitalization of BSE-Sofia	19.71%	31.20%	55.46%

Sources: BNB, FSC, BSE-Sofia

With an extremely successful year 2007, the Exchange became visible by the business community. Thus, the capital market is ever more clearly recognized as an efficient funding and development option.

A significant factor for strengthening BSE's role in the financial intermediation sector has been the recognition by the majority stockholders of many companies that going public does not mean losing control on their business. Furthermore, the series of successful public offerings during the period demonstrated that access to funding through the capital market is a competitive alternative to bank lending both in terms of costs and future benefits.

Public disclosure of information and its positive impacts have translated in wide media presence and strong interest on the part of the investment community in the listed companies.

The increased popularity of Bulgaria's capital market has also led to a sizeable growth of the financial resources allocated to investments in tradable financial instruments. Bulgaria's fiscal framework, which is strongly supportive of investments at the Exchange, in particular by allowing for generation of untaxed gains, the proactive approach of mass media, which cover

¹ GDP values at 2007 yearend are based on BNB estimates.

² FSC estimates.

³ As at November 2007.

developments at the Exchange, and the success of many public offerings have all caused the number of individual investors to increase considerably.

Recognition by the business community that obtaining access through the capital market is both a must and an advantage has made the Exchange a strong driver of Bulgaria's economic development. The ubiquitous activity of the Exchange as a propeller of the overall capital market development process in Bulgaria has been properly appreciated and in 2007 BSE-Sofia AD was awarded the Mr/Mrs. Economy prize in the top category – Overall Contribution to the Development of the National Economy.

Development of the capital market during the recent years has been driven by a number of factors, which will be examined in the following paragraphs.

One of the main factors for promotion of the capital market among non-professional investors was certainly the regulatory framework of mutual funds, which was laid down with the amendments to the *Public Offering of Securities Act* introduced in 2005. The relatively simple procedure for establishment of mutual funds together with similarities with open-ended investment companies have made them a preferred form for concentration of investment capital on the part of managing companies. By the end of 2007 there were already 30 managing companies, which provide professional management services for assets worth almost BGN 900 million⁴ through 60 mutual funds.

The strong uptake of mutual funds and investment companies has had a positive impact on the capital market as a whole by increasing the quality level of asset management services and leveraging the behaviour of non-professional investors. At the same time however, the amount of financial resources placed under management has become a source of increased system risk at times of adjustments or downward movements. Market developments during the last months of 2007 have shown that a strong outflow of individual investors from mutual funds can expose the market to significant pressure at times of crisis due to its still low liquidity.

In the wake of the recent pension reform, during the past year BSE-Sofia became the focal point for investments by pension funds as well. The amendments to the *Social Insurance Code* in the beginning of 2006 increased the thresholds for equity investment and led to significant shifts in the investment portfolios of these funds. Equity investments of pension insurance funds⁵ in the end of 2007 reached BGN 664 million (see Table 2), which accounts for nearly 30 percent of their assets. To compare with, equity investments at 2006 yearend were ca. BGN 300m, or less than 20% of the assets under management.

The expected regulatory changes concerning multifunds with different venture capital will have a significant bearing on the capital market in the medium term. Examples in this respect demonstrate that in countries with multifunds, pension funds are actively investing in mutual funds and investment companies. Furthermore, multifunds will provide access to the capital market for persons with lower income, which are not a target group of mutual funds as well as for individuals with lower risk preferences and longer investment timelines. Tax allowances for investments in additional pension insurance, which can reach 10% of the taxable base, will be crucial for the development of the multifunds.

⁴ Data by BNB.

⁵ Preliminary data of the FSC.

Table 2. Investment portfolio and balance-sheet assets of pension insurance companies (in BGN '000)

Investment instruments	31.12.2007	31.12.2006	31.12.2005	31.12.2004
Investments in total, of which:	2 224 415	1 452 043	1 082 462	785 781
Securities issued and guaranteed by the State	356 609	419 940	559 871	438 151
Equities	664 224	299 242	80 179	25 826
Corporate bonds	269 229	179 388	104 838	56 666
Municipal bonds	4 044	5 863	7 379	5 646
Bank deposits	361 792	317 373	187 650	152 808
Mortgage bonds	74 676	80 576	83 301	89 800
Derivative securities	0	0	42 231	1 530
Investment properties	77 620	26 071	6 149	13 240
Investments abroad	416 222	123 591	10 865	2 114
Equity investments vs. total investments	29.86%	20.61%	7.41%	3.29%

Source: Financial Supervision Commission

Another important factor for fostering the capital market in 2005-2007 were the investment intermediaries. The growing interest in the capital market has been a strong incentive for increasing the quality and diversity of their financial services. Recruitment of highly qualified experts, including international ones, in the area of assets management and consulting services has become a regular practice. This last development also stems from the opening of EU markets and from the increasing interest of international investors in the local market.

Investment intermediaries also demonstrated strong commitment to BSE's initiatives and forums for attracting new issuers. Consequently, this commitment evolved in close cooperation with various businesses in organizing and conducting their public offerings.

Another positive development has been the active contribution, which investment intermediaries provided in raising the investment culture of individual investors. Participation of investment intermediaries at workshops and discussion forums dedicated to the investment opportunities provided by the capital markets is also gaining momentum.

During the last two years, the banking system also acquired a stronger foothold in the area of investment banking – a typical practice for investment banks in the developed markets. Bulgarian banks are particularly active in providing services as issue underwriters, debt issuers, bondholder trustees, providers of depository as well as trusteeship services.

Another important market driver is the emerging tendency for commercial banks to offer structured products based on key market performance indicators. This is a stepping stone for banks to act more actively as institutional investors and also to diversify the range of products available from the Exchange in case these products are structured as financial instruments and listed for trading.

A major determinant of capital market development during the past three years has been harmonisation of the national legislation with the EU *acquis*. The dynamic changes called for finding new approaches for regulating the work of institutions and capital market participants. This being said, the regular meetings, which the Financial Supervision Commission began to organize, have proven to be an appropriate format for discussing current issues and finding solutions on the fundamental aspects of market development. The very active input of

professional associations has been essential for commencing a broad-format dialogue and a factor for greater transparency of market participants' activities.

Another important factor for the stronger recognition and development of the market as a whole during the past period has been the State's policy of promoting higher business activity through tax preferences. One of the most business-friendly moves was the government's decision to reduce the corporate tax rates, which became as low as 10% in 2007. While concerns were voiced from some quarters that such a rate would decrease corporate tax revenue to the national budget, this change actually resulted in an unprecedented rise of budgetary revenues from this type of tax, also with a strong steer towards increased business transparency. Indirectly, this also influenced the decisions of certain companies to opt for a public status. Maintaining a sustainable long-term government policy in this respect will be vital for making the business community trustful and for economic development as a whole.

The tax-exempt capital gains derived by both natural and legal persons from transactions with financial instruments listed for trading at the regulated market together with the low tax rate on dividends present direct stimuli for investments in the capital market. The government's decision to reduce the dividend tax rate by a further 5% in 2008 will make the capital market even more attractive. Introduction of a 10% flat rate on personal income from 2008 will uplift the investment activity of Bulgaria's middle class.

The year 2007 saw increased international interest in Bulgaria's capital market as well. A convincing piece of evidence in this respect was the acceptance of BSE as a full member of the Federation of European Securities Exchanges (FESE) – an organisation, which admits only regulated EU markets recognized by the European Commission.

The gearing of Bulgaria's capital market to the international ones was felt quite strongly in the end of 2007. As more and more foreign investors are entering the local market (in the beginning of 2007, 41.67%⁶ of the market capitalization was held by foreign investors), especially after accession to the EU, Bulgaria's capital market is becoming more sensitive to changes in the market situation at Paneuropean and worldwide level. This could be seen by the impact that the local market experienced from factors such as the mortgage crisis in the US and the subsequent liquidity crisis on international scale, which led to the withdrawal of many international investors from Bulgaria⁷.

The market adjustment, which began in November 2007 and is continuing in the first months of 2008, has been aggravated by the negative symptoms pointing to a downslide of the global economy.

The downward movement of securities prices met a very negative response especially from individual investors, who joined trading at the Exchange in 2007. Assumption of unreasonable risks, speculative behaviour and quicksilver aspirations of many such investors additionally aggravated the market situation as a whole.

The aftermath in the beginning of 2008 is that the capital market needs more resilience and stability. Thus it is highly important on one side to raise the investment culture of retail investors and curb their speculative behaviour, and on the other side – step up the measures for improving the liquidity and depth of the market by increasing the number, volume and variety of the financial instruments traded at BSE, etc.

⁶ Data by the FSC.

⁷ By data of Central Depository AD, at 2007 yearend the aggregate share in the capital of public companies held by foreign investors dropped to 22,56%.

2. CURRENT STATUS AND MAIN TENDENCIES

The current status and the main tendencies that characterize the development of the capital market can best be measured and analysed by using traditional metrics such as turnover, market capitalization, liquidity and number of listed securities. The present analysis covers the period 2005 – 2007. It presents the main market status and performance indicators for each of the three years within this period, identifies the main tendencies that characterize BSE's development and defines the top priorities to be pursued by the Exchange in the midterm.

2.1. TRADING

Trading at BSE-Sofia during the period 2005-2007 was influenced by numerous factors, the most important of which include: using the Exchange as a vehicle for privatizing 35% of the Bulgarian Telecommunication Company, listing of new companies and issues, sale of majority stockholdings in certain companies, increase of prices of almost all traded companies and last but not least – the higher activity of both local and foreign investors.

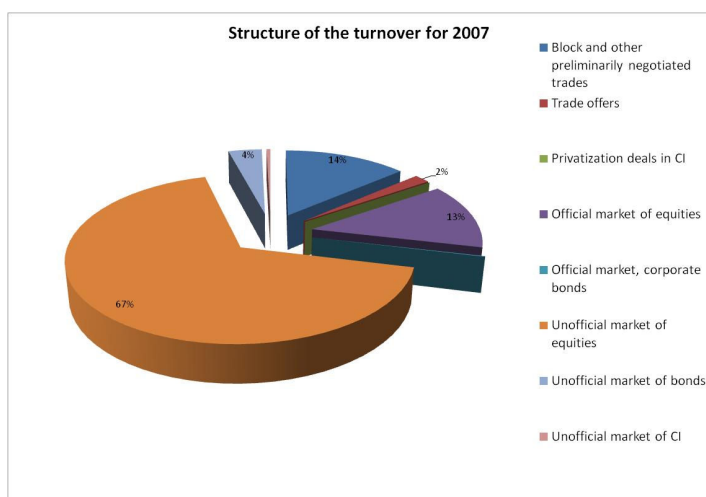
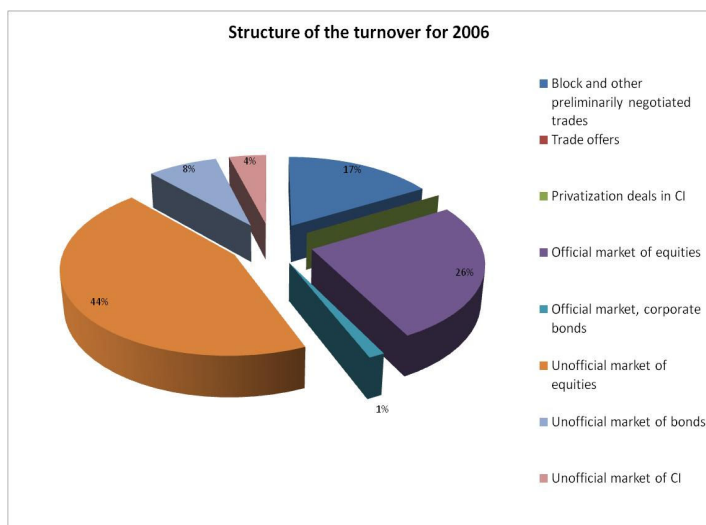
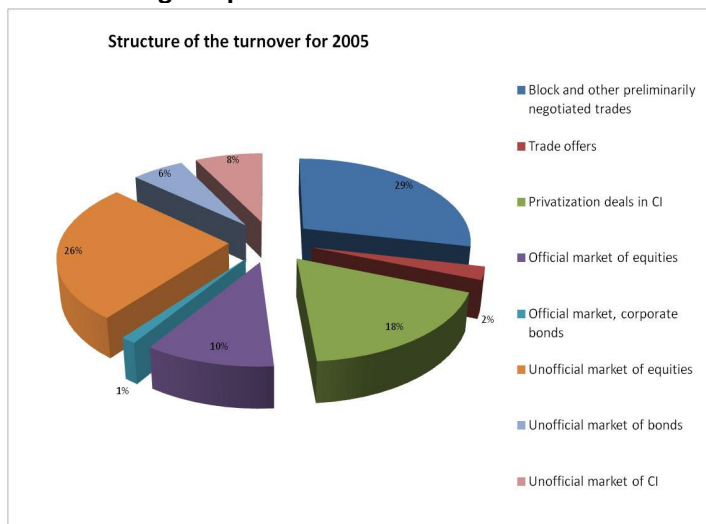
Table 3. BSE-Sofia trading indicators – Turnover

Market	Turnover (BGN million)					
	2005	2006	Change (2006 vs. 2005r)	2007	Change (2007 vs. 2006r)	Change (2007 vs. 2005r)
Block and repo trades	1 012	543	-46.34%	1 330	144.96%	31.44%
Auction offering	87	1	-98.66%	172	14 538.94%	96.35%
Buyback	0	0	-100.00%	0	-	-100.00%
Privatization deals in BGN	0	0	0.00%	0	-	-
Privatization deals in CI	633	0	-100.00%	0	-	-100.00%
Official market, segment A	52	31	-41.18%	150	390.75%	188.66%
Official market, segment B	56	670	1 095.52%	1 124	67.63%	1 904.10%
Official market, segment C	262	143	-45.60%	6	-95.71%	-97.67%
Official market, corporate bonds	44	43	-3.57%	12	-71.63%	-72.65%
Official market, municipal bonds	0	0	-84.08%	0	-100.00%	-100.00%
Official market, government securities	0	0	0.00%	0	-	-
Unofficial market of equities	930	1 450	55.98%	6 516	349.40%	600.96%
Unofficial market of bonds	208	255	22.61%	362	42.19%	74.33%
Unofficial market of CI	268	136	-49.24%	42	-69.32%	-84.42%
Unofficial market of other securities	6	46	659.50%	74	60.50%	1 119.00%
Trades under Art. 54(5)	0	0	0.00%	0	-	-
IPO market of equities	5	12	125.59%	0	-100.00%	-100.00%
IPO market of bonds	0	0	0.00%	0	-	-
IPO market of other securities	2	10	477.04%	25	150.54%	1 345.73%
IPO market of government securities	0	0	0.00%	0	-	-
Large volumes of shares	8	42	405.12%	122	193.50%	1 382.54%
Centralized public auction	5	3	-45.69%	11	290.58%	112.13%
Remote public auction	3	0	-85.84%	0	-91.37%	-98.78%
Total:	3 581	3 384	-5.51%	9 946	193.89%	177.70%

Source: BSE-Sofia

In the beginning of the period under examination, trading at BSE received a strong impetus from MoE's decision to privatize the State's remaining interest in the Bulgarian Telecommunication Company via the Exchange. This decision demonstrated that privatization via the capital market is a successful approach and played an important role for stepping up trading activity at the market.

Chart 2. Structure of the turnover achieved at BSE Sofia during the period 2005 – 2007



During the first six months of 2005, the most liquid securities at BSE-Sofia were the Compensatory Instruments (as the main means of payment used in the BTC privatization deal) with traded volumes in excess of BGN 630m, which accounts for nearly 70% of all Compensatory Instruments traded during the year.

The highest turnovers were recorded at the Unofficial market of equities, where securities worth BGN 930m were transferred in 2005, and the total turnover during the period under examination exceeded BGN 3.5 billion.

The Unofficial market of bonds also achieved an important growth due to the growing number of listed issues – 53 at yearend compared to 31 in the beginning.

In absolute value, the turnover in 2006 was by 5.51% lower compared to that in 2005, but in actual fact, excluding the single BTC deal from the general statistics, there was an increase of 14.76%.

Increase of the turnover was highest at the Official market, which grew by 128% vs. 2005. The main reason for this was the transfer of 75% DZI Bank AD stock in December 2006. Trading activities increased significantly in the second half of 2006, when 2/3 of the annual turnover was achieved mainly by

exchange of large packages of equities.

The market was influenced positively also by the expectations related with the report of the European Commission, which recommended Bulgaria to become full EU member from 01.01.2007.

The month of October 2006 saw the biggest Initial Public Offering (IPO) in the entire history of the Exchange⁸, and that entailed a series of other successful IPOs, which were in the focus of investors' attention during the entire year 2007.

Last but not least, it is worth to note the stronger activity of Collective Investment Schemes, which were an important vehicle for bringing non-professional investors to the Exchange and for increasing the level of trading.

In 2006, more than 10 Bulgarian companies were included in Dow Jones indices, which reflected favourably on the recognition of BSE internationally and is self-explanatory of how foreign investors assess the local capital market and its growth potential.

117.67 million lots worth BGN 1.45 billion in total were transferred at the Unofficial market of equities against BGN 929.56 one year earlier. The number of trades in this segment increased by the modest 4.11%, however this is a consequence of the much higher average volume, which grew from BGN 8,622 per trade in 2005 to BGN 12,918 per trade in 2006.

In **2007** the Exchange achieved the best performance in the entire history of Bulgaria's capital market. The BGN 9.946 billion turnover was three times the one registered in 2006. Many reasons underpinned this stronger interest, but generally that year was dominated by the optimism related with Bulgaria's accession to the EU, the increased inflow of foreign investments, the ubiquitous promotional activities of the Exchange and the intensified trading on the part of all market participants. Reducing the corporate tax rate from 15 to 10 per cent also was a strong incentive for companies to perform well and bring to their business results "broad daylight". Successful implementation of BSE's Strategy for attracting new issuers and promoting the Exchange in a general sense was yet another factor, which contributed to the increase of trading volumes. The roundtables and meetings conducted with businesses in various regions prove to have had major influence on the decisions taken by some companies to acquire a public status.

Turnover at the Unofficial market of equities grew by more than 600% vs. 2005 and surpassed BGN 6.5 billion. The 293,972 trades in 2007 were by 161.92% more than the ones registered in the previous year. The activity of institutional investors, the entry of foreign investors and the rising price levels during the year also resulted in increasing the average volume per trade, which reached BGN 22,165 in 2007.

Turnover at the Official market was nearly 250% up vs. the 2005 level, even though there was a restructuring of segments in the beginning of 2007 and 12 companies were downgraded to Segment A of the Unofficial market.

Bond markets achieved a turnover of BGN 374 million in 2007 thus surpassing the 2005 level by 48.52%. However, the bond segment still remains modest – it accounts for only 3.76% of the overall turnover. During the period under examination, the number of listed securities grew from 55 to 87 mainly due to the large number of new issues at the Unofficial market of bonds.

⁸ Initial Public Offering of Chimimport AD.

The period 2005-2007 also featured more block and repo trades, both in terms of number and average trade value. From BGN 1,012 million in 2005, this segment grew to more than BGN 1,330 million in 2007. The main factor for this growth was the increased popularity of repos during the last year.

Despite the higher volumes, the share of blocks and repos within the total turnover dropped significantly due to the increased trading activity at the Exchange and the higher traded volume. While block and repo trades were 28.25% of the total turnover in 2005, this segment dropped to 13% of the total turnover in 2007.

Table 4. BSE-Sofia trading indicators – Number of trades

Market	Number of trades					
	2005	2006	Change (2006 vs. 2005)	2007	Change (2007 vs. 2006)	Change (2007 vs. 2005)
Block and repo trades	404	386	-4.46%	13 047	3 280.05%	3129.46%
Auction offering	55	9	-83.64%	86	855.56%	56.36%
Buyback	2	0	-100.00%	0	-	-100.00%
Privatization deals in BGN	0	0	-	0	-	-
Privatization deals in CI	1 466	0	-100.00%	0	-	-100.00%
Official market, segment A	10 523	15 860	50.72%	38 813	144.72%	268.84%
Official market, segment B	7 252	25 558	252.43%	126 180	393.70%	1639.93%
Official market, segment C	84 083	37 180	-55.78%	800	-97.85%	-99.05%
Official market, corporate bonds	226	172	-23.89%	225	30.81%	-0.44%
Official market, municipal bonds	1	1	0.00%	0	-100.00%	-100.00%
Official market, government securities	0	0	-	0	-	-
Unofficial market of equities	107 803	112 236	4.11%	293 972	161.92%	172.69%
Unofficial market of bonds	729	1 065	46.09%	995	-6.57%	36.49%
Unofficial market of CI	44 179	15 615	-64.66%	7 609	-51.27%	-82.78%
Unofficial market of other securities	1,335	4,051	203.45%	6 489	60.18%	386.07%
Trades under Art. 54(5)	0	0	-	0	-	-
IPO market of equities	233	433	85.84%	0	-100.00%	-100.00%
IPO market of bonds	0	0	-	0	-	-
IPO market of other securities	348	575	65.23%	384	-33.22%	10.34%
IPO market of government securities	0	0	-	0	-	-
Large volumes of shares	55	279	407.27%	1,875	572.04%	3 309.09%
Centralized public auction	469	164	-65.03%	72	-56.10%	-84.65%
Remote public auction	26	16	-38.46%	4	-75.00%	-84.62%
Total:	259 189	213 600	-17.59%	490 551	129.66%	89.26%

Source: BSE-Sofia

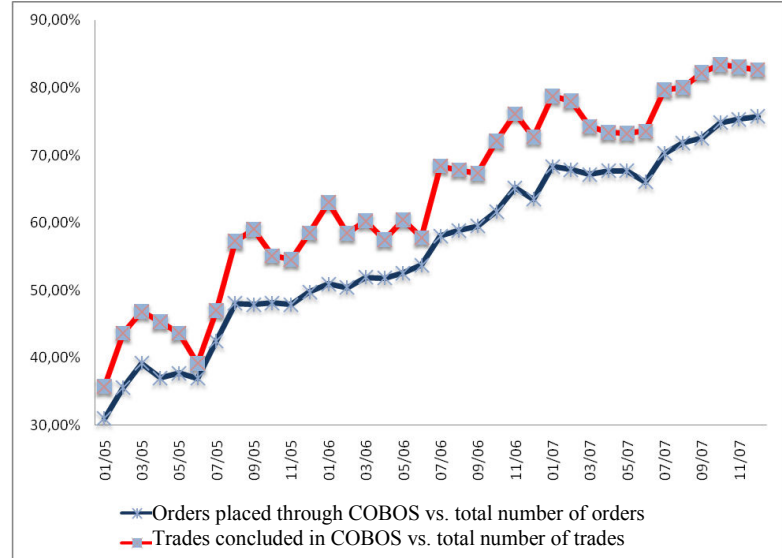
The progress made by Bulgaria's capital market also led to a significant increase of the participants using BSE's web-based Client Order-Book Online System (COBOS). During the past year the number of COBOS users grew by almost ten times reaching 5,142 in the end of 2007. The increasing importance of COBOS was one of the main tendencies, which characterized the market during the period 2005-2007. While the orders placed through the COBOS system in 2005 were about 40% of all orders, in 2007 this ratio reached 70%. At the same time, the number trades concluded in COBOS reached more than 80% of all trades (see Chart 3). Even so,

the volumes traded in COBOS are traditionally low compared to the overall turnover at the Exchange – 10.76% in 2006 and 11.59% in 2007, which confirms the conclusion that for the time being the system is being used mainly by petit investors and individual clients.

The active trading and the growing price levels during the year resulted in record-high levels of the indices calculated by BSE Sofia. Indeed, in October SOFIX reached the highest value since it was first published – 1952.40 (almost 87% up on annual basis). The wide index BG40 also achieved record values, reaching 619.19 points in October (nearly 243% increase on annual basis). The unreasonably high expectations of investors and the massively speculative behaviour of market players, which led to these high levels, triggered broad discussions with representatives of the investment community and FSC in an effort to curb the possibilities of engaging in behaviour that threatens the stability of the capital market. In the beginning of October the indices changed to a downward trend, losing 9% (SOFIX) and 16% (BG40) of their values.

The market was quite strongly affected by the decision of some institutional investors to withdraw their investments from the Bulgarian capital market – these moves exerted additional pressure on the market and aggravated the negative trend, which continued during the first months of 2008.

Chart 3. Percentage of orders and trades placed/concluded in COBOS



Source: BSE Sofia

MARKET CAPITALIZATION

The market capitalization of the Exchange kept growing at an impressive rate during the period under examination. The greatest increase was measured at Segment A of the Unofficial market, where the number of listed securities is the highest. While the listing of the BTC was the main reason, due to which the Unofficial market doubled its capitalization in 2005 (compared to 2004), in 2006 and 2007 the impact of newly listed issues was strongly enhanced by more active trading levels and increased prices of most companies. The capitalization of this segment grew by more 112% during the last year alone.

Table 6: Market capitalization of BSE-Sofia during the period 2005-2007

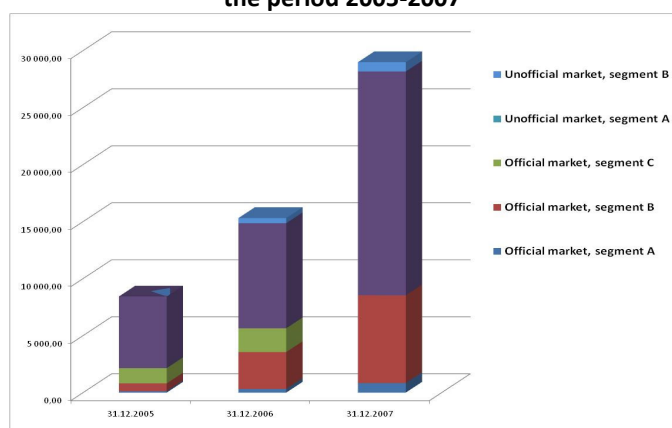
	31.12.05	31.12.06	Change 2006 vs. 2005	31.12.07	Change 2007 vs. 2006	Change 2007 vs. 2005
	BGN '000					
Official market, segment A	122.10	319.26	161.47%	837.28	162.26%	585.74%
Official market, segment B	688.46	3 239.13	370.49%	7 700.30	137.73%	1018.48%
Official market, segment C	1 337.70	2 084.15	55.80%	-	-	-
Official market, total	2 148.26	5 642.54	162.66%	8 537.59	51.31%	297.42%
Unofficial market, segment A	-	9 220.11	-	19 632.78	112.93%	-
Unofficial market, segment B	-	451.36	-	816.49	80.89%	-
Unofficial market, total	6 285.70	9 671.47	53.86%	20 449.27	111.44%	225.33%
Total:	8 433.96	15 314.01	81.58%	28 986.86	89.28%	243.69%

Source: BSE-Sofia

Market capitalization of the companies included in Official market segments grew even more impressively (by more than 290% vs. 2005) despite the restructuring exercises and the delisting of 13 companies from these segments in the beginning of 2006.

In 2006 the total capitalization of the Official market grew by more than 162%, and by another 50% strong in 2007. The good financial performance achieved by most of the companies included in the Official market and the higher quality of their corporate governance were among the main factors for the active trading in their securities.

Chart: Market capitalization by types of BSE markets during the period 2005-2007



Source: BS Sofia

LIQUIDITY

During the entire period under examination, low liquidity continued to be one of the major problems faced by the capital market. The strong demand side of the market in 2007 led to rocketing equity prices, which was mainly due to the fact that the market as a whole is still unable to offer sufficient trading volumes of the various stocks. The low liquidity of many companies results from the limited proportions of their freely tradable shares⁹, which makes it difficult and sometimes even impossible for institutional investors to set foot in these companies,

⁹ Free float.

Table 7: Free float of the equities traded at BSE-Sofia

	2Q '06	3Q '06	2006	1Q '07	2Q '07	3Q '07	2007
Free float of the equities traded at BSE-Sofia	15.62%	15.91%	17.89%	20.45%	19.58%	25.01%	24.73%

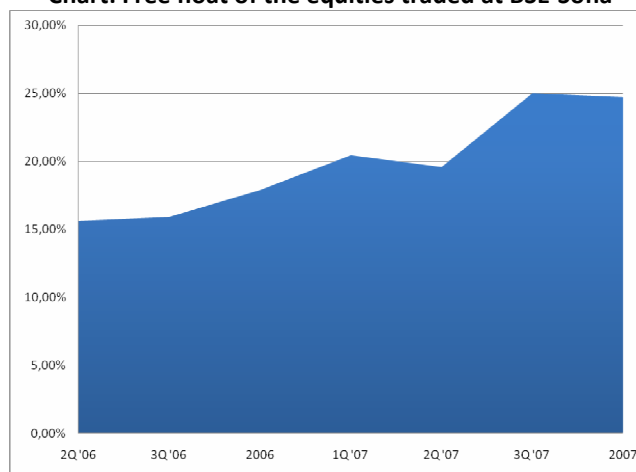
Sources: FSC and CD

The capital-increase policies undertaken by many companies, together with the splits made by many of them (which were also favoured by the high price levels achieved) are part of the solutions to the low free float and liquidity issue.

85 companies increased their capital during the period under examination. 54 of these were REITs (including mandatory increase of the capital), 1 was an investment company and the remaining 30 increases were made by other public companies. The amount of the subscriptions to these increases adds up to BGN 600 million in nominal value, which is more than 55% of the total nominal value of the issues listed for trading during the period.

In general, since the beginning of 2006, there is tendency for companies to increase the proportion of their free-floated shares at the Exchange. By the end of 2007, the average free float rate reached 25% (see Table 7), however these values do not provide a realistic picture as concerns the market standing of these companies. A good example in this respect are the companies included in Segment B of the Unofficial market, which segment was created late in 2006. This market restructuring was undertaken exactly with regard to the liquidity and free float levels of many such companies, i.e. the companies that were moved to this new segment were those, whose equities are either traded to a limited extent or not traded at all.

Chart: Free float of the equities traded at BSE-Sofia



Sources: FSC and CD

To improve market liquidity levels, BSE-Sofia should be more proactive in promoting the means for increasing the proportion of free-floated shares and stimulating the corporate pattern of thinking across public companies. Another vital factor for further development of the market is finding new solutions for optimizing trade with the least liquid companies in the market.

INDICES

The stable macroeconomic environment in Bulgaria and the high economic growth rate achieved during the period 2005-2007 logically led to a strong growth of the main BSE indices. The blue chip index (SOFIX) more than doubled its value during these three years (+41.57% mean annual growth), while the wide index BG40, introduced on 1 February 2005, grew by more than 5 times (+80.80% on average annual basis).

Driven by its commitment to provide a more comprehensive picture of the Bulgarian capital market, in September 2007 BSE-Sofia began to calculate two new indices. The first one,

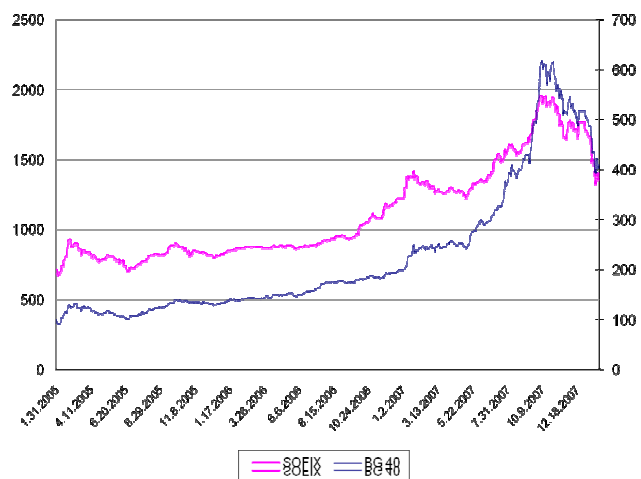
BG TR30, is based on the price movements of the included equities, which all participate with equal weight. The second one, BGREIT, is a sectoral index reflecting the price movements of the companies that invest specifically in real estate.

Real Estate Investment Trusts (officially termed in Bulgarian as *Special-Purpose Investment Companies*) accounted for ca. 70% of all new listings at the Exchange during the period 2005-2007. This fact, in combination with the dynamic development of the real estate and construction sector, made these companies quite appropriate for the first sectoral index of BSE-Sofia.

On the other part, the equal-weight index complemented the family of BSE indices. Indices of this type usually enjoy good interest on the part of investors, because they are a suitable basis for design of structured products. However, this needs a certain period of time, because BG40 has a relative short history and backdated calculations are not available.

The progressive development of Bulgaria's capital market and the increased interest on the part of international investors encouraged several international banking institutions to create structured financial instruments, based on the oldest BSE indicator SOFIX. Thus, three license agreements were signed in 2007 for structuring of SOFIX-based certificates (with Bayerische Hypo- und Vereinsbank and Erste Bank of Germany and with Dutch ABN Amro Bank), followed in the beginning of 2008 by another one with the Italian Unicredit Group.

Chart 1. SOFIX Trend, 01.01.2005 – 31.12.2007



Source: BSE-Sofia AD

2.2. ATTRACTING NEW ISSUERS

The extent, to which the capital market is regarded as a business funding option, is best measured by the number of issued traded at that market. Recognition of the capital market as an additional growth funding source, awareness of the advantages associated with public status and the perceived need for greater transparency in the operations of Bulgarian companies were among the major priorities of the Exchange and its promotional activities in 2006 and 2007.

Table 5. Number of new issues and capital increases listed for trading at BSE-Sofia

	2005	2006	2007
Number of new issues listed for trading at BSE-Sofia, of which:	51	76	81
Equities – Real Estate Investment Trusts (REITs)	8	18	20
Equities – Investment companies	2	1	0
Equities – Other public companies (admission to trading)	5	8	9
Initial Public Offerings (IPOs), of which:	3	2	9
Initial Public Offerings at BSE-Sofia	0	1	1
Initial Public Offerings outside BSE-Sofia	3	1	8
Shares in Mutual Funds	6	19	13
Bonds, of which:	27	28	30
at the Official market	1	1	0
at the Unofficial market	26	27	30
Number of subscription rights (for capital increases) listed at BSE, of which:	16	48	21
REITs (including the mandatory ones)	11	35	8
Investment companies	0	0	1
Other public companies	5	13	12
Number of issues delisted from BSE, of which:	22	20	31
Equities – Other public companies, due to:	17	12	16
deletion from the Register of public companies and other security issuers	17	10	13
deletion from the Commercial register	0	2	2
winding-up without liquidation	0	0	1
matured bonds	4	8	15
government securities	1	0	0

Source: BSE-Sofia

In fulfilment of its Development Strategy adopted in 2005, BSE developed a comprehensive Issuers Programme for attracting new issuers, which envisaged selection of appropriate companies on the basis of predefined criteria and addressing them with dedicated messages via different channels, all this for the purpose of encouraging them to register for trading at the regulated market.

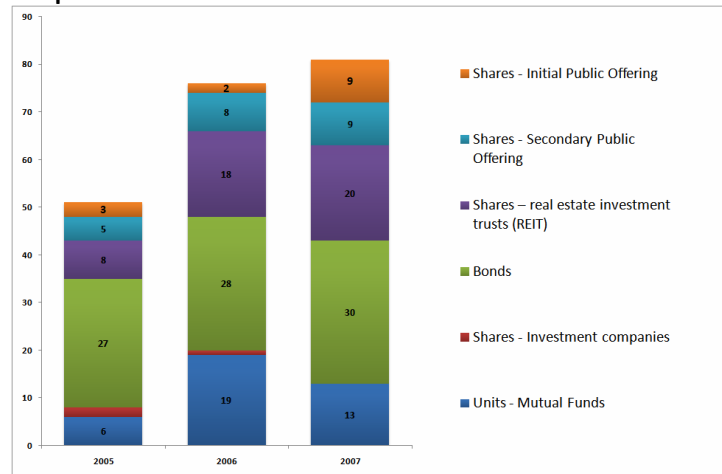
In 2006 BSE-Sofia organized a series of events without analogues until then – Roundtable discussions, which brought together representatives of private businesses, capital market participants, officials from the Financial Supervision Commission and investment intermediaries. These Roundtable events were organized on regional principle and took place in the cities of

Varna, Veliko Tarnovo, Plovdiv and Stara Zagora. A total of more than 80 companies showed interest and attended the Roundtables.

Experts from BSE-Sofia, guest speakers from the Financial Supervision Commission, representatives of investment intermediaries and already listed companies provided information to the potential issuers regarding the additional funding opportunities offered by the capital market, the benefits and responsibilities associated with the public status as well as the

procedure, which a company has to follow in order to be listed at the market. The four Roundtables were widely covered by mass media, including non-specialized publications, thus many companies, which for some reason were not able to attend, learned about these events and later approached the Exchange for individual meetings with BSE staff.

Chart 3. Number of issues listed for trading at BSE-Sofia during the period 2005-2007



Source: BSE-Sofia

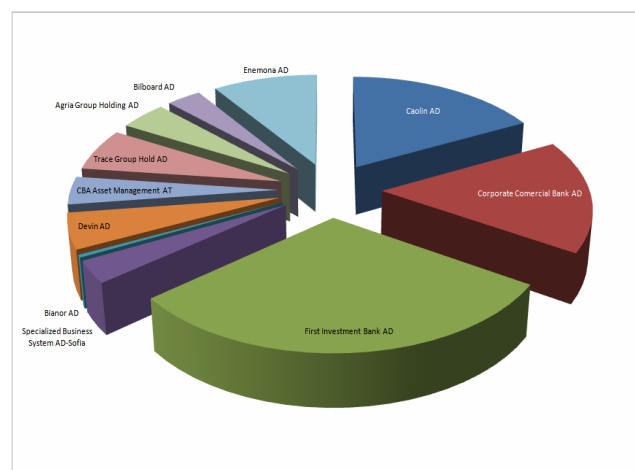
INITIAL PUBLIC OFFERINGS¹⁰

The activities undertaken by the Exchange in implementation of its Programme for Attracting New Issuers as well as the intensified trading following Bulgaria's accession to the EU led to a record-high number of Initial Public Offerings in 2007. As much as 11¹¹ IPOs took place during 2007 alone, actually more than all IPOs during the 9-year history of BSE.

The strong interest on the part of investors in IPOs held during 2007 resulted in many of the new issues being oversubscribed. Especially high was the interest in the Initial Public Offerings of banking institutions, which were oversubscribed by more than 10 times despite the serious volumes offered to the market.

The companies listed at the

Chart 4. Distribution of the IPO capital raised in 2007



Sources: Official press-releases of the relevant companies

¹⁰ Excluding Real Estate Investment Trusts.

¹¹ As a result of these 11 IPOs, 7 companies were listed for trading at BSE-Sofia by the end of 2007. The remaining ones were listed or will be listed in the beginning of 2008.

Exchange as a result of successful IPOs diversified the sectoral profile of the Exchange insofar they come from sectors which had not been present at BSE until then. These new sectors include food and beverages, retail trade, energy, mining of mineral resources, financial services, etc.

Most IPOs were executed off-exchange (using the book-building technique) and the total amount of capital raised by these off-exchange IPOs in 2007 was more than BGN 350 million¹². The IPO auctions offered by BSE-Sofia still remain an unpopular fund raising method.

The average costs of carrying out IPOs in 2007, expressed in per cent of the total amount of capital raised, were as little as 1.70% - much lower compared to exchanges in Central and Western Europe. This makes capital raising through BSE-Sofia especially attractive to potential issuers and is a prerequisite for listing of both local and foreign companies (e.g. for double listing).

SECONDARY PUBLIC OFFERINGS

Traditionally, secondary public offering during the period 2005-2007 were more than the initial ones. 22 companies with a total nominal value of BGN 970 million were listed for trading (excluding REITs). The largest number of secondary listings at BSE-Sofia occurred in 2007, when 9 companies were registered for secondary trading.

During the period, there were examples of successful application of schemes, where IPOs are combined with sale of existing stocks in the same company. Some owners used this scheme to sell part of the shares held by them. This was a win-win situation: on one hand, the owners reaped return on their investments at market price, and on the other hand the scheme generated free float to ensure successful launch of these companies on the Exchange.

REAL ESTATE INVESTMENT TRUSTS (REITs)

The period under examination was characterized by a very active process of setting-up and listing of *Special-Purpose Investment Companies* (REITs) as vehicles for securitization of real estate. This development was a logical follow-up to the surging real estate and construction market.

Being the main vehicle for indirect investment in real estate, some REITs were traded very intensively. The huge interest in this sector prompted BSE in 2007 to structure a special index reflecting the price movements of companies that invest in real property – BG REIT. Pursuant to a survey conducted by Reuters, in 2007 Bulgarian REITs were the most profitable ones in the REIT sector worldwide.

2005 saw the emergence of the first REITs that invest specifically in agricultural land. In practice, the first of them began the process of consolidation of agricultural plots of land across the country. In turn, this is an important factor for efficient land use, development of a modern agricultural sector in Bulgaria and defending the interests of individual farming land owners.

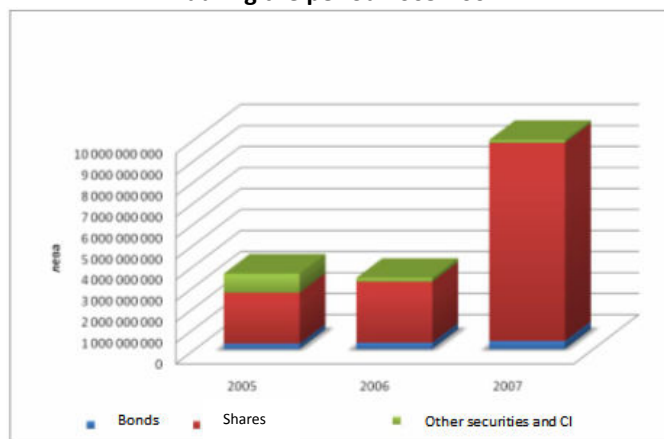
¹² Without Real Estate Investment Trusts.

Furthermore, 5 investment companies specialized in securitization of receivables (claims) were set up in 2006 (4 of them were listed at BSE in the same year). Dynamic development of the credit market, appearance of non-banking financial institutions, widening range of financial products available and the thriving lease industry in Bulgaria were among the main factors, which contributed to the emergence of and the strong interest in these companies.

During the period under examination, 46 REITs were listed for trading at BSE with a total capital of ca. BGN 60m by nominal value. Subsequent capital increases resulted

in the raising of BGN 353m additional capital in nominal terms. The aggregate assets of all REITs at 2007 yearend were nearly BGN 1.2 billion and their aggregate market capitalization exceeded BGN 1.792 billion, which was 6.19% of the total market capitalization at that date.

Chart 5. Traded volumes by different types of securities during the period 2005-2007



Source: BSE-Sofia

BONDS

The Bulgarian debt market continued to grow during the period and the total nominal value of all listed issues exceeded BGN 1.175 billion. 85 issues were listed for trading during the period 2005-2007 (including 2 at the Official market), and 27 issues matured during the same period. However, turnover was growing at a pace much lower compared to overall market growth rates. Despite the increasing number of newly-listed bond issues, their proportion in the total turnover decreased significantly during the past period – from 8.8% in 2006 to 3.76% in 2007.

The analysis indicates that in general bonds are traded quite flaccidly. It is an established market practice that issuers prefer to place their debt issues privately and only then register them for trading at the regulated market. This gives them certainty as concerns placement of the desired amount of issues, but concentrates the debt in a limited number of investors (usually underwriting commercial banks), which subsequently prefer to hold the debt until maturity and reap a guaranteed rate of return.

It is necessary to promote bond IPOs at the Exchange as a method for debt financing. Thus, on one hand issuers will benefit from lower interest levels and diversified bodies of bondholders, and on the other hand such IPOs will spur trading at the Exchange and will help increase its liquidity.

In 2007 some changes were introduced to the methods for floor trading in debt instruments at BSE-Sofia. With these changes, it became possible to begin trading in bond issues at clean prices expressed as a percentage of the nominal value, and also to quote all securities with accuracy up to the third digit after the decimal point.

While mortgage bonds accounted for the main part of new bond listings during the period 2000-2004, corporate bond issues prevailed during the period under examination. This

development demonstrates that bonds are increasingly recognized by Bulgarian businesses as a tool for raising of additional capital. On the other side, this process is also associated with restructuring of banks' assets and the already established practice for banks to purchase the bonds issued by the companies rather than provide them with direct loans.

One of the future challenges to the Exchange will be to popularize internal corporate debt (including convertible bonds) as a funding vehicle, which is widely used at developed capital markets.

It is expected that the bond market will continue to develop at fast pace during the next years as well.

MUTUAL FUNDS

Especially active during the period 2005-2007 were the managing companies, which – through the mutual funds managed by them, attracted significant resources from individual investors. 16 mutual funds were established in 2005 alone and at the end of the same year the total amount of assets under their management exceed BGN 10m. In 2006 there were already 34 mutual funds, which was three times the number of investment companies. In the end of 2006 they were managing assets worth more then BGN 199 million, which was by 70% more than the assets of investment companies, while the aggregate assets of all CIS exceeded BGN 315 million. The year 2007 was especially successful for collective investment schemes as their assets surpassed the BGN 1 billion landmark in the beginning of the fourth quarter. Most mutual funds achieved record-high annual rates of return and indeed some RoRs exceeded 100%. The latter helped attract strong interest from individual investors and made the capital market even more popular as an alternative for generation of tax-free income.

The main risks that threaten the development of mutual funds in the local market include high expectations of investors as concerns the future rate of return levels based on the strong performance observed in 2007, and the increasing number of foreign collective investment schemes offered in Bulgaria. More and more funds diversify their portfolios with international investments, which "drains" resources from the local capital market due to the insufficient offering of high-quality financial instruments at the Exchange.

In 2007 some managing companies began offering shares in their mutual funds abroad, and these initiatives can give a strong boost to the local capital market. The success of these undertakings will setup a frame for attraction of foreign investments to Bulgaria's capital market via the local mutual funds.

Attracting new issuers will remain among BSE's top priorities during the next years as well, because offering of high-quality issues is, among other things, the key to solving the major problem of Bulgaria's capital market – its low liquidity. The new companies, which are already traded at the Exchange, are still insufficient and there is an evident imbalance between demand for good-quality securities and supply of such securities at the Exchange.

2.3. INFORMATION SERVICES AND TECHNOLOGIES OPERATED BY BSE-SOFIA

TECHNOLOGICAL BASE AND INFRASTRUCTURE

As trading at the Exchange continues to gain momentum, and as more and more participants, including international ones, become part of that trading, during the past years BSE-Sofia has been facing every day the challenge to provide information services of high quality and diversity to investors, mass media and the public at large.

Increased trading activity at the main market segments makes it necessary to update the IT equipment of the Exchange each year. Availability of advanced hardware and technology is a paramount factor for efficient market development.

BSE has undertaken many steps in this respect, but perhaps the most important ones are as follows: full audit of BSE's IT systems in 2006, securing a backup Internet provider in 2006 responsible for taking over the traffic generated by market participants in case the service of the main Internet provider becomes unavailable; continuous investments in sophisticated hardware equipment and so forth.

THE CLIENT ORDER-BOOK ONLINE SYSTEM (COBOS)

In 2003, following approval by the regulatory authority at that time – the State Securities Commission, the Exchange began development of a proprietary web-based application to enable the clients of investment intermediaries (Exchange members) submit electronically their orders to the respective intermediaries via the Internet. The main objective of the system was to facilitate end-users in submitting their orders and also to increase the liquidity of the market.

During the period 2005-2007 the Exchange introduced improvements and new features to the Client Order-Book Online System (COBOS). In 2005 the new Client Portfolio module was integrated in the system. The new module displays at any time the current real and virtual balances, in cash and securities (separately per each issue), for each COBOS client of the Exchange member. Further upgrades were introduced in 2006 to improve performance of the system and add new features again, the most popular of which was the option provided to investors to see in real time the brokers (counterparts) to a transaction and the orders entered in the system, which improves the equality between system users. Performance of the application was further optimized and a series of stress tests were carried out to ensure failure-free operation of the system even under extreme workloads. The rules for registration in and use of COBOS were amended in 2007. These changes related to many areas, however the main objective was to prevent some types of market manipulations, which can with a large degree of certainty be attributed exactly to COBOS users.

The seriously increased number of COBOS users, the higher trading activity as well as the additional functionalities, which require the system to process multiple simultaneous events, did lead to a series of technical problems in 2007, which renders it necessary to find new solutions for ensuring proper operation of the system.

INFORMATION SERVICES

Having due regard for the requirements of its clients, each year BSE-Sofia upgrades and updates its standard data packages. The wide spectrum of information services – ranging from subscription to the official daily and monthly publications of BSE to provision of real time data streams by full access to the Exchange database, ensure that full and adequate information is available to all market participants.

The Exchange continues to successfully collaborate in the area of provision and dissemination of information with leading worldwide data vendors such as Thomson Financial, Reuters, Bloomberg, Interactive Data Corporation, etc., and continually widens the circle of data agencies it provides information to.

Similarly, the Exchange maintains long-term cooperation with specialised financial publications (mainly newspapers such as Capital, Dnevnik, Pari, Banker and Cash). During the recent years more and more Internet sites for corporate information have been concluding contracts with BSE dissemination of Exchange information. These include Investor.bg, Profit.bg as well as agencies such as Economedia EAD, Web Media Group AD and others.

THE WEBSITE OF BSE-SOFIA

The information published on BSE's Internet site is very important to the market. For several years now, BSE has been publishing corporate news about public companies in English as well. This practice has played and continues to play a major role in the integration processes, related with opening of the markets, attraction of foreign investors and increasing the confidence in Bulgaria's capital market within the European Union.

Renovation of BSE's official website is an ongoing process. The efforts are focused on optimizing the way, in which the available information is provided and ensuring that it is easily accessible and user-friendly. New solutions are sought to make the menus more interactive, easily navigable and accessible to all potential investors.

Against this backdrop, in 2006 the Exchange also added a series of new features to the information available from its Internet site, such as:

- a forum was enabled on the web page to facilitate communication with the Exchange;
- Index charts were added to the home page;
- the information about issuers was supplemented with the market capitalization of the equities traded at the Official and Unofficial markets on the last trading day;
- the home page was enriched with data about trades concluded in the Trading System and in COBOS during the last Exchange session;
- the home page was enriched with sliders displaying the prices of the companies included in SOFIX and BG40;
- new graphic interface was developed for displaying existing information about issuers (including last date for subscription to capital increase, last date of entitlement to dividend, adjustment factor and adjustment date).

To increase the analytical value of the information available from its Internet site about the listed companies, since the end of 2006 BSE-Sofia has been publishing key financial performance indicators and ratios. Initially, that information was available for companies

included in the Official market, but in 2007 it was extended to cover Segment A of the Unofficial market. An option was provided for automatic import in the system of the reports submitted in the disclosure application EXTRI. A procedure was designed for calculating the key financial ratios of public companies, while keeping a history of past ratios. All the available information is displayed on the Internet site of BSE-Sofia together with ratios calculated on the basis of consolidated or non-consolidated reports, as the case may be.

BSE-ONLINE

In November 2005 an application known as a "Gate" to the trading system was launched in production mode. The Gate Operational Rules enable Exchange members using that application to structure own products for their customers. Together with this, another newly-developed system allows synchronization of the news module of the Exchange terminal with the news published on the Internet site of the Exchange and included in its official daily bulletin.

In 2006 and 2007, three investment intermediaries developed proprietary trading platforms, similar to COBOS, for providing services to their clients. Existence of alternative online trading systems reflects favourably on the market insofar as it spurs both competition and efforts for continual improvement of the products offered.

ENHANCEMENT OF THE MARKET SUPERVISION FUNCTIONALITY

In the first half of 2007, BSE developed a system for monitoring the trades executed during the day, which generates reports to intermediaries and the FSC. Based on predefined criteria, market participants are alerted to possible market manipulations of their clients. Trades are filtered by the following criteria:

- Change, expressed in per cent, of the price of a trade in a given security vs. the opening price of the same security;
- The volume of a trade in a given security vs. the entire traded volume in that security over a predefined period of time;
- Trades in a given security at prices, which are higher or lower than the opening price by a certain percentage;
- COBOS clients, which declared relationship with a certain investment intermediary or issuer;
- Number of trades in a given security during the day, if exceeding by two or more times the daily mean number of trades in that security over a certain period of time.

These changes have, on one hand, increased the capabilities of investment intermediaries to exercise self-control on the trades concluded on behalf of their clients. On the other hand, they provided a possibility for defining quantitative thresholds and thus easily spotting potentially manipulative transactions. Following these changes, it has become easy to identify 'extreme' turnovers or prices of trading with a certain company, which could then be investigated more closely by the Supervision Department.

Besides, these changes made it possible to monitor the trading activities of persons related with Exchange members or issuers. In addition to facilitating the Supervision Department in exercising its functions, this has had a deterrent effect on the monitored persons.

SYSTEM FOR TRADING IN BONDS AT CLEAN PRICES (NET OF INTEREST ACCRUALS)

After making the necessary modifications to BSE's Rules, in the end of 2006 it became possible to trade bonds at clean prices. To support this new trading method, the Exchange developed the necessary software, which converts the clean traded price to the settlement price, i.e. the price inclusive of interest.

Transition to this quoting and trading technique was imposed by the worldwide practice as well as by the nature of bonds as such. This was an important facilitation to the Exchange members and also reduced the probability of errors insofar as trading is based on the profitability (return) generated by the instrument and not on its price.

Bond trading at clean prices started on 01.01.2007.

THE EXTRI SYSTEM

BSE-Sofia works actively with security issuers to assist them with their disclosure obligations. Experts of the Exchange continuously counsel public companies about their disclosure obligations and the options available for discharging of these obligations with a view to continually improving the quality of the information disclosed.

A very positive development in this respect was the commissioning of the integrated information system X3 (EXTRI), which was the result of a joint development effort with the Financial Supervision Commission and the Central Securities Depository. The system was officially launched on 19.01.2007, and in its first year alone more than 250 companies and security issuers availed themselves of the options provided by X3 for issuers to simultaneously discharge of their disclosure obligations to the FSC, BSE-Sofia AD and the Central Securities Depository.

In 2007 the national regulatory framework was amended with a view to aligning it with the EU *acquis*. These amendments led to significant changes as concerns issuers' disclosure responsibilities. Especially important for BSE-Sofia was the change, by virtue of which companies are no longer obligated to disclose information first to the Exchange. Instead, public companies and issuers must disclose information to the public in a way, which ensures fast dissemination to the widest possible circle of persons in all Member-States, and is not discriminatory.

In relation to the legal changes and in response to the growing demand, in the end of 2007 BSE-Sofia developed a new service – X3 NEWS, which is a specialized electronic page in the meaning of Art. 43(2) of *Ordinance no. 2 of 17 September 2003 on public offering prospectuses, admission of securities to trading at regulated markets and disclosure of information by public companies and other issuers of securities* ("Ordinance no. 2"). With X3 NEWS, which is operated by BSE's subsidiary Financial Markets Service EOOD, issuers can disclose to the public any information, including regulatory one, in the meaning of paragraph 1, sub-paragraph 41 of the Additional Provisions to the *Public Offering of Securities Act*.

X3 ANALYSES

X3Analyses is a financial analysis application provided jointly by BSE-Sofia through its subsidiary Financial Markets Service EOOD and the company Balkan Services EOOD. Using

X3Analyses, both professional and non-professional investors can analyse companies that are traded at BSE-Sofia. The product is available in two basic versions depending on the end-user's specific requirements. X3Analyses has a number of advantages, the most important of which include rich selection of financial indicators, possibility to make comparisons between different companies, analysis of dependencies between corporate and market indicators, etc.

2.4. COMMUNICATION POLICY

In the beginning of 2006 BSE elaborated a Communication Strategy as part of its initiatives for promotion of the capital market. This Strategy became the basis of the extremely successful communication policy, which the Exchange has been carrying out for the past two years. The undeniable successes in this area are related with establishment of a new vision and behaviour of the Exchange both within the country and abroad; promotion of the capital market as an efficient business funding option; listing of new issuers at the Exchange and active presence of the capital market in various electronic media.

While it was only specialized printed publications that were interested in the capital market during the transitional period, in the past two years the Exchange became a constantly discussed and analysed theme for many TV and radio programmes, and popular printed publications, which are addressed to the public at large. The emergence of electronic media, which are dedicated to economic and in particular capital market processes, is yet another proof of the results achieved in promoting the capital market.

The broad public already perceives the Exchange as a realistic opportunity for representatives all social groups to invest and obtain long-term profits.

Looking to the future, finding solutions for increasing the significance and impact of the Exchange in resolving the main problems of the capital market will be among the top priorities pursued by the communication policy of BSE-Sofia. Improving the dialogue between institutions and market participants is another major aspect, which should be kept in focus. Greater openness and higher corporate governance culture are key factors, which can vest onto BSE-Sofia the role of an institution, which sets the standards for good corporate governance in Bulgaria.

In international perspective, fortifying the position of the Exchange as a leading market on the Balkans will be the focal point of BSE's communication strategy.

2.5. CORPORATE GOVERNANCE

Increasing the quality of corporate governance of public companies in Bulgaria has always been among the main priorities of BSE-Sofia. Thus, in 2006 and 2007 the Exchange undertook a number of activities for restructuring the existing markets, and also took part in initiatives aimed at promoting corporate governance principles and best practices.

The Rules of BSE-Sofia were amended in 2006 with the aim of redefining the vision of the Official market, insofar as this market must be the trading venue for companies, which adhere to good transparency practices and are a factor for increasing confidence in Bulgaria's capital market in general. The Official market segments were reduced from 3 to 2. Together with this move, the existing criteria for admission to that market were tightened and complemented with new ones, which reflect the quality of corporate governance.

By imposing stronger requirements to the companies traded at the Official market the Exchange seeks to ensure better recognition of these companies by local and international investors through higher appreciation of their corporate governance quality. The fact that many of these companies are included in the nationally representative index SOFIX, which has become

the basis of several structured issues placed abroad, is just another proof of how attractive the Official market is.

Exactly with this objective in mind – namely increasing the confidence of local and international investors as well as of the broad public in the management and supervision of public companies in Bulgaria, in 2006 the Exchange elaborated and adopted officially a Corporate Governance Code as a standard, against which businesses can measure their current standing and preparedness for implementing the generally accepted principles of corporate governance. Application of the principles embodied in the Code is now mandatory for companies listed on the Official market, and has thus become an additional criterion for evaluation of the companies traded at the market.

Together with developing its own Code, BSE-Sofia joined as a co-initiator a major project of national importance – elaboration of a National Code of Corporate Governance.

Other major participants in this project were the International Financial Corporation, the Center of Economic Development, the Bulgarian Investor Association, the Association of Bulgarian Investor Relations Directors, the Bulgarian Investor Relations Society, the Financial Supervision Commission, representatives of the academic community, etc.

The National Code of Corporate Governance was officially presented to the public on 10.10.2007.

BSE-Sofia shares the view that the National Code of Corporate Governance is a step forward along the road of setting modern rules and norms for management of public companies in Bulgaria.

For increasing competitiveness of the market as a whole and for attraction of more foreign investors it is of vital importance that all companies traded at BSE-Sofia have a clear vision and strategy for development as well as defined corporate and social responsibility policies. Therefore, the efforts for promoting the principles of corporate governance among public companies will continue to be a top priority of the Exchange in future, and in this respect it is important that the number of companies listed at the Official market continues to grow. The efforts must pursue a dual objective: on one side, promoting the Official market among public companies and on the other side – improving the recognition for and image of that market.

3. STRATEGY FOR OVERALL DEVELOPMENT OF BSE-SOFIA DURING THE PERIOD 2008-2010

The main mission of BSE-Sofia is related with the establishment and development of an organized capital market, which provides to Exchange members and their clients equal access to market information and equal conditions for trading in securities.

The main strategic objectives of BSE-Sofia are to improve the liquidity of the capital market by technological renovation; increase the number, volume and variety of the traded instruments; and attract more local and international investors.

3.1. TECHNOLOGICAL RENOVATION

INTRODUCTION OF A NEW TRADING PLATFORM - XETRA

The main short-term priority of BSE-Sofia is implementation of the platform used by the Frankfurt Stock Exchange, XETRA, as the main trading system. According to the current plans, XETRA trading should start in the middle of 2008.

The main benefits associated with implementation of the new platform can be summarized along the following main lines:

1. The platform features high capacity and performance, which have been proven by its flawless operation at the exchanges in Vienna, Ireland and Shanghai, the European Energy Exchange in Leipzig and of course Deutsche Börse. Apart from this, once XETRA is implemented, in terms of technological level the Bulgarian exchange will match some of the biggest exchanges in the world, which will be an extremely favourable development.

2. In practice, the system operates in Frankfurt. This will dispense of the need for maintaining expensive redundancy facilities at a Disaster Recover Centre, which is a source of great concerns for market operators worldwide. With this setup, BSE will only have to maintain the remaining part of its IT systems.

3. More than 600 exchange members and 5000 traders are connected to XETRA. Inevitably, this will have a very positive impact on the local capital market because access of international participants will be facilitated to a great extent. In this respect, the Rules of BSE have been amended in order to regulate associated membership and introduce a simplified procedure for notification of foreign investment intermediaries. With these amendments any intermediary connected to XETRA can obtain access to and become a remote member of BSE-Sofia, if the intermediary so wishes, without incurring additional communication costs for connecting its IT systems to those of BSE-Sofia.

4. Given that Deutsche Börse is one of the biggest exchanges in the world and every major investment bank is a member of Deutsche Börse, BSE-Sofia can expect to become much more visible to the global investment community.

6. Although trading rules vary from market to market, trading arrangements at the major exchanges are largely standardized as market participants prefer to operate under the same

rules wherever their trading activities are. As such, transition to the new trading platform will ensure alignment of the local rules with international tendencies.

7. The demanding requirements of international participants to the capabilities of the system will also lead to modernization of local trading systems and to provision of a wider range of functionalities. For example, XETRA supports much more types of orders, which allow for implementation of a variety of strategies even in the area of equity trading, which is a relatively streamlined one.

Implementation of the new trading system raises serious challenges to BSE-Sofia, such as:

- ensure seamless transition to the new trading system XETRA and flawless trading thereafter;
- adapt the existing COBOS system for operation with XETRA;
- generate more business with the new trading system.

RENOVATION OF BSE'S TECHNOLOGY BASE AND IT INFRASTRUCTURE

To stay abreast with markets and especially with the state of play at the capital market, and to support the widening scope of its activities and services, BSE-Sofia will continue to invest in sophisticated and cutting-edge technological infrastructure, which is vital for ensuring flawless operation of the Exchange even at greater workloads and in an environment of increasing market liquidity and trading activity. This being said, it is extremely important to develop and implement policies and measures for managing failure risk and ensuring robust technical administration of the trading system.

OPTIMIZING THE COBOS SYSTEM

In response to the market changes brought about by the new functions and services offered by BSE-Sofia, and to address the growing costs of maintaining the COBOS system, solutions will be sought and implemented for ensuring flawless operation of that system. Various scenarios for the future functioning of the system will be discussed with representatives of the investment intermediaries, including the possibility for externalizing the operation of COBOS to users (Exchange members) on the basis of licensing arrangements.

3.2. INCREASING THE NUMBER, VOLUME AND VARIETY OF THE FINANCIAL INSTRUMENTS TRADED AT BSE-SOFIA

ATTRACTING NEW ISSUERS

The model used for achieving the strategic objective of promoting BSE-Sofia in a general sense brought about very encouraging results during the past two-year period. The Exchange was successful in making Bulgarian businesses interested in the funding opportunities available from the capital market and at the same time made the perspectives offered by a public status visible to the public at large. Personal contacts between experts of the Exchange,

representatives of investment intermediaries and businesses were a key factor, which underpinned the decisions of some companies to apply for listing at Exchange. The successful IPOs in 2007 were broadly echoed by mass media, which in turn prompted many new non-professional investors to start trading as individual participants.

Despite the results achieved so far, attracting new issuers remains a matter of priority for BSE-Sofia. However, the changed market situation equally requires a change in the approach and formats used for achieving this objective. Thus, BSE-Sofia will continue to regularly analyse companies with good potential for going public and maintain an updated database or potential issuers. The focus will be shifted to preparing regular evaluations of promising economic sectors (and accordingly potential issuers in these sectors) as well as to widening the sectoral representativeness of the companies traded at the Exchange.

Other major targets of analytical and communication activities will be equity financing companies and venture capital funds, through which BSE-Sofia will be trying to identify companies eligible for listing.

The Exchange will also be collaborating actively with representatives of the relevant competent authorities as regards eventual privatization of major monopolies through the Exchange. The formats of this collaborative work will include participation in working groups, provision of expertise for development of privatization strategies, etc.

ATTRACTING FOREIGN ISSUERS FOR DOUBLE LISTING AT THE EXCHANGE

Another channel for attracting new issuers will be inviting foreign companies to double-list for trading at BSE-Sofia as well. Bulgaria's membership in the EU is a stepping stone for BSE to enter the Paneuropean capital market. Harmonized legislation in this area, introduction of a single passport and simplified notification procedures all make double listing of EU companies at the Bulgarian exchange a relatively simple exercise.

STIMULATING THE ISSUANCE OF DEBT SECURITIES

When it comes to attracting new issuers and diversifying the financial instruments traded at the Exchange, one of the key priorities is attracting bond issuers. Special efforts must be undertaken to promote debt instruments across companies (both public and non-public). Strong emphasis should be placed on convertible bonds as a capital increase vehicle, which is widely used in countries with developed capital markets. The Exchange will endeavour, together with pension funds, to also promote the issuance of municipal bonds as an additional source of funding the budgets of Bulgarian municipalities.

PROMOTING THE EXCHANGE AS A VEHICLE FOR RAISING ADDITIONAL CAPITAL

Special efforts must be undertaken for promoting the tools and means available to companies for increasing their capital through the Exchange and for prompting companies to take relevant action. In this sense, it is of vital importance to increase the awareness of issuers' managing bodies as concerns the corporate actions that can be undertaken in this regard.

CHANGING THE TRADING REGIME FOR THE LEAST LIQUID COMPANIES

In the midterm the Exchange will endeavour to optimize trading in the least liquid companies. Appropriate solutions will be sought at regulatory and technical level for changing the regime of trading in their issues. Such solutions would be along the lines of changing the criteria for listing of companies at the lowest segment of the Unofficial market and inclusion in BSE's Rules of provisions for delisting from the market of companies that fail to meet these criteria.

INTRODUCTION OF NEW FINANCIAL INSTRUMENTS

Introduction of new financial instruments to the market is another midterm objective, which BS-Sofia will pursue. In this respect the Exchange will endeavour, on one hand, to attract issuers of different types of securities that can be traded with the existing market infrastructure, and on the other hand – try to find partners and/or solutions for setting up clearing/settlement processes, which allow for trading in derivatives.

3.3. ATTRACTING MORE LOCAL AND FOREIGN INVESTORS

The main strategic bearing of BSE's future development remains attracting new investors. The main focus will be placed on attracting foreign, including portfolio investors with long-term investment interest in the Bulgarian market. This being said, introduction of the new trading system XETRA will be a major factor for accomplishing this objective.

Another vehicle for reaching this objective is participation and organisation of international forums and conferences for presenting the current status of Bulgaria's capital market and its development perspectives. Furthermore, various formats will be used for presenting different Bulgarian companies to international investors. As part of the efforts for promoting the Bulgarian market abroad, the Exchange will be endeavouring to ensure greater transparency and continually improve the quality of the information provided.

At local level, popularizing the capital market as an investment alternative will be of paramount importance for the future development of BSE-Sofia. In this respect, serious efforts must be invested in promoting the capital market among non-professional investors.

Increasing the efficiency and quality of the technical environment is of crucial importance for attracting new investors to the market. In this respect, a holistic strategy for the future of the COBOS system must be developed in consultation with the Exchange members.

3.4. INCREASING THE QUALITY OF CORPORATE GOVERNANCE IN BULGARIA

BSE-Sofia will continue to initiate and participate in programmes and projects related with the corporate governance of local public companies. Encouraging issuers to implement the

principles embodied in the National Code of Corporate Governance and apply higher standards of management is of primary importance for improving the image of Bulgaria's capital market, increasing the confidence of investors and attracting foreign investors.

3.5. IMPROVING THE TRADING ENVIRONMENT

GURANTEE FUND

A medium-term, but still strategic priority of the Exchange is restructuring the Guarantee Fund and defining an efficient and working mechanism for operating it. The Exchange relies on active cooperation with its members as well as with the Bulgarian Association of Licensed Investment Intermediaries (BALIP), Central Securities Depository AD, the Association of Bulgarian Banks (ABB) and FSC for implementing this project, which is vitally important for ensuring market stability. Establishing a working mechanism for the Guarantee Fund is especially important in the eyes of international investors when considering their interest in Bulgaria's capital market. Existence of an efficient transaction settlement mechanism will reflect favourably on the image of BSE-Sofia and is yet another means for attracting foreign investors.

MARGIN CONTRACTS AND SHORT SALES

BSE-Sofia is committed and will actively contribute to the process of finding practical solutions for introduction of margin contracts and short sales in the capital market. Equipping market participants with a versatile toolbox for implementing their strategies is very important for the attractiveness of any market and for increasing the number of investors in that market.

3.6. ENHANCING BSE'S DATA SERVICES

Providing a rich diversity of data products and services will continue to be an important part of BSE's ongoing activities and future priorities. Thus, together with the traditional channels for dissemination of data services, high importance will be placed on building additional channels on the basis of strategic partnerships with local and international organisations

Another strategically important task of the Exchange is the strengthening of its subsidiary Financial Markets Service EOOD (FMS), via which BSE will provide a variety information services. Regular provision of new and good-quality data services, adequate to market conditions and investors' requirements, will be the main priority in respect to FMS and its operations.

3.7. COMMUNICATION AND PR STRATEGY

As an extension of its capital market promotion policy, BSE-Sofia intends to optimize its Communication Strategy in order to strengthen public acknowledgment of BSE's leading role in the capital market.

In future the Exchange will endeavour to increase its openness to and presence in the mass media, including non-professional media, as well as advertise the activities, advantages and perspective of the market.

3.8. INTERNATIONAL COOPERATION

One of the important priorities of BSE-Sofia will be to expand its international contacts and relations with other exchange institutions and organisations at regional, European and global level.

As a full member of the Federation of European Securities Exchanges, in future BSE-Sofia will widen its active involvement in joint projects with representatives of leading exchange operators in Europe.

Active cooperation among exchanges is also very relevant for implementation of MiFID¹³ in the light of the upcoming changes to the trading setup. Sharing of experience between different exchanges is highly important for maintaining the competitiveness of regulated markets as pools of liquidity.

Providing assistance to other exchanges in the region is also an important priority aimed at making capital markets in Southeast Europe (SEE) as a whole more attractive to international investors.

Accordingly, BSE-Sofia will endeavour to participate actively in the integration and globalization of capital markets and secure its position of a leading capital market in SEE.

¹³ Markets in Financial Instruments Directive.