
Transition from Brokerage Companies to Investment Companies on the Croatian Capital Market

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DOI: 10.26352/CJ02F5018

Abstract

The purpose of this paper is to describe the position of mediators in the Croatian stock market as well as to point out the need of repositioning due to essential changes caused by the EU acceptance and new development possibilities. Different social, political and economic changes and developments in Croatia reflected on the capital market, its institutions, players, dynamics, size and strengths. Through the Zagreb Stock Exchange, and the Varaždin Equity Market which gradually turned in to the Varaždin Stock Exchange, and later became a part of the Zagreb Stock Exchange, all positive and negative field lines are reflected as well as their results. The paper starts with describing the position and function of the capital market as an integral part of the overall financial market. Many players saw the developed capital market as a chance for a rapid progress of the Croatian economy, as well as catching up to more developed democratic economies. The following part describes the role of mediators and brokerage companies as significant factors in the Equity market. The third part is focused on the condition of the Croatian capital market development, with a special review of an essential change in the legislation, following the Croatian acceptance in the EU, by which brokerage companies transitioned into investment companies, substantially changing the role of mediators in the equity market. The brokerage company repositioning strategy from the role of “wholesale” agents into investment companies is described in the fourth part. The paper is completed by showcasing the business methods of conventional investment companies which exist on the still undeveloped Croatian market, without significant influence on the overall Croatian economic progress.

Keywords: capital market, brokerage companies, Investment Company, transition, Croatia

Introduction

The process of transformation and privatization of the ownership of the Croatian economy started in 1991 and considered the capital change in economic thought but also all other social processes in the young country.

The introduction of capital markets as an important part of the financial markets means the introduction of alternative sources of economic development financing, rapid and efficient allocation of capital and the possibility of attracting significant amount of foreign capital. The creation of the capital markets prompted formation of companies for securities trading. Brokers are supposed to increase the market dynamics and accelerate market processes so that a market could fulfill the intended functions. The role of brokerage companies, i.e. companies, almost exclusively,

amounted to the mediation in securities trading with a very narrow range of other activities for which they were registered. The new legal amendments from 2009 have significantly changed the role of brokerage companies, which were given new opportunities on the one hand, but they were imposed new organizational, staffing and capital requirements on the other. Due to the mentioned, brokerage companies have grown in investment companies.

With all the options that are consequently provided for brokerage companies, they are still inadequately influencing the development of the market, i.e. using provided possibilities. It is quite clear that it is impossible to survive by pursuing classic brokerage or so-called “discount” brokers whose primary function is to mediate in securities exchange. There has been a restructuring of brokerage companies with few powerful brokerage companies persisting in the market, who managed to reposition, and are currently operating as investment companies under the new Law on Capital Market.

The first part of the paper tries to define a difference between capital markets and money markets, both making an integral part of the financial market. Second part of the paper aims to clarify the role of brokerage companies as participants in the capital markets and their functioning in terms of the investment company. The third part shows the Croatian capital market in the various stages of its development over the past 20-years, and the impact of the legal aspects. Consequently, fourth part presents the strategy of brokerage companies repositioning that were until recently “discount” brokers and should now act as an investment companies with the purpose to act in harmony with enterprises using all possibilities for development provided by the capital market.

Fifth part presents the investment companies which have to fulfill are required staff, organizational and capital conditions adapted from the market.

Capital Market as a Part of the Financial Market

Financial market can be defined as the place of supply and demand of funding. Turnover is carried out by using certain financial instruments. Financial instruments are, in the broadest sense, contracts which contain rights and obligations arising out of a financial relationship. Therefore, the financial market can be defined as a place of turnover of financial instruments.

Capital market is important for analyzing of the role of investment companies, which are an important part of the financial market and enable the connection of financial and real investment.

In this regard we highlight the importance of capital market functions, as part of the financial market, that allows alignment of different interests of various market participants so that the value of shares becomes a fundamental motive of business of public limited companies. Capital market by its size and diversity plays an increasingly important role in present-day global economic development because it enables to the countries, natural persons, citizens, financial institutions and all interested parties' numerous positive effects. [1] Capital market can be defined as a set of relationship between long-term demand and supply of funds. [2] It is the most important from the point of view of long-term funds acquiring necessary for business and expansion of joint stock companies and other companies. Companies require funds for various purposes. Furthermore, working capital is needed for daily business operations and long-term financing requires formation of fixed funds, financing of expansion and development of new processes or products. [3] A company can create long-term funds in the following ways:

- Internally, through the internal cash flows, or
- Externally, through banking system or public capital markets, according to the size and nature of a company [4].

In developed market economies, with developed financial systems, when a company is listed in the stock exchange corresponding development will be faster compared to non-listed companies due to the fact that funds will be more available. Decision on going public presumes publication of company information which imposes additional costs of data collection or audit [5]. Institutions operating in the Croatian capital market, regulatory, service and other institutions must prepare necessary infrastructure for efficient work and supervision of capital market. Capital market institutions in Croatia are as follows:

- Central Depository and Clearing Company (hereinafter SKDD);
- Croatian Financial Services Supervisory Agency (Hanfa);
- The Agency for Market Competition Protection;
- The Directorate for Supervision of Insurance Companies;
- Croatian National Bank (hereinafter HNB);
- Stock exchange. [6]

Increase of economy efficiency, portfolio diversification and financial development possibility many attributes to the development of capital markets.

The development of capital markets can be seen from the point of view of market regulation, but also as preferences of companies raising funds in the capital market. The development of the market can be revealed in the types of securities traded. It is well known that the European stock markets are more conservative than the stock markets in the US when using certain types of derivatives etc.

In Table 1 it can be seen that according to the valuation criteria Zagreb Stock Exchanges can be compared with regional stock exchanges. Therefore, it can be concluded that the growth potential of the domestic capital market is limited. Also, inflow of fresh capital is conditioned by valuations which are not underestimated, but in “fair” levels compared to the region. To sum up, some additional concrete conditions should be created, compared to the region which could influence attracting the fresh capital to the domestic market. [7] To put it short, the economy has to grow in order to use positive market influence in attracting additional capital for faster and more efficient investments.

Table 1. Valuation indicators of regional indexes compared to Crobex on 31 December 2014

INDEX	P/E	P/B	P/S	ROA	ROE
ATX Indeks (Beč)	24,71	0,91	0,63	-0,13	-0,97
WIG20 Indeks (Varšava)	25,38	1,31	0,93	1,37	5,15
CROBEX	20,02	0,9	0,72	1,95	4,81

Source: <http://www.bloomberg.com/markets/stocks/world-indexes/> (2 February 2015)

Despite the good legal framework, functional training and considerable progress in market development and efficiency, for the majority of transition countries it could be assessed as shallow, narrow, non-transparent and insufficiently developed. Dominant form of financial intermediation in these countries is done by banks which makes those countries more bank oriented to the rest of the Europe.

According to current legislation, companies operating with securities that are primarily intermediaries in the capital market are called investment companies. Investment companies are legal persons whose regular business is the provision of one or more investment services to third parties that perform one or more investment activities on a professional basis.

Brokers and brokerage companies is the colloquial name for the companies operating with securities. Such a name for a company operating with securities was used under the application of the Securities Act. Until then, brokerage companies have performed only the simplest tasks on the capital market and operated as so-called discount brokers. Companies trading with securities receive additional possibilities for operating in the capital markets according to the Capital Market Act (CMA) [8], which was applied from 1st January 2009, and were expected to become generators of positive developments in the capital market.

By adopting the CMA and the full harmonization of Croatian legal framework to that of the EU, brokerage companies have now become investment companies with more opportunities to develop new services that have so far been generally reserved only for banks, or were not present *et al.*

Securities trade company or now investment company in Croatia is registered to perform the purchase or sales of securities by order of a client, investment consultancy, trading in speculative purposes, the operations of special stock exchange trade, portfolio management, agent for the IPO process, underwriting and transference agent services.

More recently, brokerage houses offer some services and activities that are traditionally provided by banks. Investment companies' activities maintain liquidity in the financial market and encourage events necessary for the functioning of the market.

Brokerage houses in time, enabled by legislative changes, gained a lot more space and become investment companies. They should be included more in the investment processes. Investment companies should encourage investment processes to be financed through the capital markets and encourage new issues of shares. There is a wide range of activities and services in the capital market that could improve business processes in companies and in which investment companies could find its role. [9]

Investment companies should take initiative and show to the business entities advantages that could be provided to them through the capital market, especially in financing investment projects.

In the US, until 1975 brokerage companies were achieving fixed provision which didn't make it possible to create competition among brokers. Until that, the Congress enabled for the brokers to charge fees to their clients. That decision brought to the development of two different types of brokerage houses:

- Offering full service and
- Discount brokerage houses.

Discount brokers are simpler and trade according to client's demands. If an investor wants to buy securities, he or she calls a discount broker and files a request. He or she does not offer any advices or services of market research. The main reason why discount brokers remained in the Croatian capital market and why most of the investment companies also operated are relatively good turnovers and yields on the Zagreb Stock Exchange by 2008. Some try that even today when the market turnovers have reduced to only 10 percent of turnover from 2007, but it is evident that in the future this will not be possible. The main sources of revenues for those brokerage houses were:

- fee per client order, i.e. the percentage of mediation in trade;
- property investments, i.e. the acquisition of shares in a brokerage company and
- portfolio management, where it is possible to charge a management fee, or a percentage of the profits that the client receives on the basis of growth of the portfolio value over time.

Classic expenditures of discount brokers are:

- staff costs,
- material costs and

- services of market infrastructure (Stock Exchange, SDKK, Hanfa).

It is clear that this is only a basic simplest activity that a brokerage company can perform in the market.

Unfortunately, such a bad situation continues until today. From 2008 until today many brokerage companies were closed, more than 30, who have not managed to reposition themselves as a successful investment company. For commercial banks, brokerage activities were abolished only if a shutdown of the entire banking system happened (Center Bank, Credo Bank).

Re-positioning of brokerage companies to become viable investment companies depends on the environment (the degree of market development, entrepreneurial climate and the economic cycle phase, and power and possibilities of competition, both between investment companies and the other participants of the capital market: banks, leasing companies, funds, etc.).

According to the Companies Act, investment company is a legal person whose regular business is the provision of one or more investment services to third parties, i.e. performing one or more investment activities on a professional basis. Investment services and activities are:

- reception and transfer of orders in relation to one or more financial instruments,
- execution of orders on behalf of clients,
- trading for own account,
- portfolio management,
- investment consulting,
- services of underwriting, i.e. financial instruments sales on a company commitment basis,
- services of underwriting, i.e. financial instruments sales without a company commitment basis,
- management of multilateral trading platform. [10]

Support services referred to in Article 5, paragraph 2 are: storage and administration of financial instruments for the account of clients, including custodianship and related services such as cash management, or collateral, granting credits or loans to an investor to enable him to conclude a transaction with one or more financial instruments; if the transaction includes the company granting the credit or loan, consulting on capital structure, business strategy and related issues, as well as consulting and services related to mergers and acquisition of shares in companies, foreign exchange services if are related to the provision of investment services, investment research and financial analysis, as well as other recommendations relating to transactions in financial instruments. [11]

Investment companies should, on the narrow and shallow capital markets such as Croatian, provide a wide array of services that could be registered. Specialization is simply not possible, nor the survival of so called “discount” brokers. Investment companies send to their clients weekly and monthly reports on the state of the market and a variety of information, information and recommendations which encourage them to invest in securities or in various corporate actions in the capital market.

The fall in clients’ fees and investment income on own equity caused by the fall in turnover on the Zagreb Stock Exchange was offset by some new revenues so that companies could operate positively. Interests on loans granted have become especially significant and which, according to the old legislation could not be granted, then the sales of financial instruments and charged interests on financial instruments, investment research and financial analysis.

Investment companies are usually established within the commercial banks as independent units for securities trading. In this case the investment company easier cover operating costs due to the fact that banks have created the infrastructure to support the operations of such organizational unit (accounting, compliance, IT, internal audit). Investment company that now operate as separate

companies (Ltd. or joint stock companies) have a much heavier task when it comes to positive financial operations of the company as they have significant organizational, personnel and capital requirements to be met on the very shallow and underdeveloped capital market in Croatia.

In the process of EU accession and in compliance with the acceptance of *acquis communautaire*, as *conditio sine qua non* of successful process of accession, for the further progress of negotiation process it was especially important settlement of financial capital market in Croatia which practically implied adoption of European legal norms, directive for capital market settlement – Markets in Financial Instruments Directive [12], 2004/39/EC (hereinafter MiFID) and other relevant legal regulations; and finally adoption of new legal regulation that would integrally and in detail regulate capital market in Croatia. The goal of MiFID is to adjust the level of protection of investor and enable cross-border services in whole European Union by ensuring greater price transparency at the same time.

On 1st January 2009, Croatia adopted a new regulation, the CMA, which fully replaced former Law on Securities Market and put in order, in a very different way, business practice of entities authorized to conduct transactions with financial instruments, conditions for organized financial instruments trading, the issuance of securities through public offering process, investor protection and holders of the securities protection, dematerialized securities and the organization and powers of the central Depository and Clearing Company (former central Depository agency), the stock market etc. CMA regulates the following areas:

- provision of investment services, investment activities and related ancillary services,
- establishment, operation, supervision and termination of investment companies,
- fund for the protection of investors,
- establishment, operation, supervision and termination of market operators,
- rules of trading on regulated market and multilateral trading platform (MTP)
- offer of securities to the public and regulated market listing,
- information about issuers of securities listed on the regulated market,
- prohibition of market abuse,
- operation and control of the operator clearing and/or settlement,
- storage of financial instruments as well as clearing and settlement.

The organizational implications of applying CMA reflected in:

- establishment of the compliance function with the law “Compliance”,
- establishment of the internal audit function,
- organization of the department of risk management,
- establishment of a strict control of the process of decision-making, information flow,
- protection of business secrets,
- integration of “up to date” protection of computer systems,
- implementation of the “disaster recovery” plans etc.

CMA significantly enhances price transparency requirements before and after the transaction, especially for companies that frequently and systematically trade on its own account.

CMA sets new and stricter organizational requirements regarding conduct of business in regulated companies, particularly in the area of:

- internal audit,
- risk management,
- outsourcing, systems and
- control, and

- area of data storage.

The challenge of CMA is in the coordination of information technology department and front, middle and back office of financial markets which would help to harmonize business with regulations.

According to the above mentioned genesis of creation, objectives of implementation, ways and terms of adjustment of the EU Member States, as well as those in the process, it can be stated that new legislative framework was formed that completely sets new rules of the game trying to protect investors and seeking to provide them with the best services at the best price with a maximum protection by the trading venue, to the supervisory agencies that are catalysts of application of the directives. All this puts in front of the entities, to which the directive relates, considerable expenditures regarding material and personnel and therefore necessarily financial expenditures, which in its extensiveness undoubtedly threaten the existence of small, weak financial companies, which will not be able to fulfill all the requirements of the regulator. The mentioned ultimately leads to the consolidation of the market of these financial services.

This means higher costs for investment and other financial companies, and possibilities that are opened for strong investment companies in conducting trade will also impose strong competition with the stock exchanges. The introduction of MiFID through the CMA inevitably leads to reduction in the number of investment companies but companies that can successfully adapt will be given greater operating space.

List of investment services, financial instruments and trading venues which will be regulated is expanding, duties of the competent control authorities are being explained and specific operating and implementing business requirements for companies that provide services trade are being prescribed.

The need for new regulations resulted from the increased number of financial and investment services for clients and the increasing sophistication of financial instruments. Companies that provide these services under the same conditions as the others will have greater access to cross-border clients within the European Union, which may result in an increased volume of transactions in the investment company large enough for the establishment of competitive price transactions and the corresponding promotion of its services. With more transparent financial market investors will have a far greater choice.

Many investment companies might find in this an opportunity for greater use of shared services within the group in order to reduce costs and make best use of existing information technology, infrastructure, back-office and at the same time remain cost-competitive. The benefit of the increased volume of transactions will also direct the investment companies to increased cross-border mergers as they will try to increase the customer base faster than their competitors.

The practice of developed markets showed that investment companies are an extremely important link between financial markets and the real sector, necessary for development and well-functioning. They are important only from that point of view and they can stay on the market only in that way.

The investment potential of the Croatian capital market in addition to individual investors make banks, insurance companies, pension funds, domestic mutual funds and other institutional investors. Croatian market is still not interesting to foreign investors. Given the current investment potential of domestic institutional investors, surprisingly the turnover on the Zagreb Stock Exchange is still very weak if we consider the last 10 years and that fact that primary securities market in Croatia is still extremely underdeveloped.

The initiative of the European Commission for the development of a single EU capital market, the so-called Union Capital Markets (UTK), could significantly affect the future of the Croatian capital market. The priorities of the European Commission are presented in the documents on the UTK, on which the country is currently conducting a public debate:

- revision of the Prospectus Directive,
- expanding the base of investors in small and medium-sized enterprises (SME),
- revival of securitization,
- promotion of funds establishment for long-term investments, so-called. ELTIF,
- strengthening of the market for private placement securities.

In accordance with the Companies Act, in Croatia, investment services and investment activities and related ancillary services are provided and performed by investment companies, credit institutions and companies for managing open investment funds with a public offering and that of the investment services may only provide investment consultancy and portfolio management.

There is a notable difference in market position and business operations between investment companies and credit institutions engaged in investment and brokerage business in small organizational units. Credit institutions in the form of domestic commercial banks use its strong position in the financial market and regulate organizational infrastructure, which enables them to achieve greater profits. Namely, the financial results of some credit institutions dealing with investment and brokerage business in the capital market are presented within financial statements of the credit institutions. Investment units of credit institutions use previously organized services of credit institutions for their business and investment companies must build the entire organizational structure. All this requires additional costs which is the main reason why in the last five years the number of investment companies, active in the capital market, rapidly reduced.

Investment companies, capitally and organizationally smaller companies are given the opportunity to develop by the fact that credit institutions are larger companies, more lethargic and reluctant to change, especially if they are part of a larger system, and will therefore introduce innovations more slowly and, more importantly, lower the costs of services.

The near future will be difficult for the entire financial industry and will be marked as a period of strong steps forward in technological and organizational terms, but also in the efforts of taking significant market share on the domestic market by a few major companies.

Ambitious investment companies understood the situation and adopted new business rules very quickly and concluded that they have to survive and reposition for two basic reasons:

- negative market tendencies that led to general distrust of investor to the capital markets, on both the domestic and the global market, and because of
- the request to adapt the new legislation in terms of organizational, technological, human and capital requirements.

In order to achieve strategic advantages in the new conditions the goals had to be clearly defined, both in the sphere of risk and profitability.

Strategic advantage, from the point when investment companies started to operate, was possible to achieve in two basic ways:

- low operating costs that enable to the investment companies to become competitive in defining prices of services,
- synergy with the group of stable partners, significant institutional investors with high-quality sales network on the territory of Croatia [13].

With the fall of the market, since 2008, number of investment companies in Croatia started to decrease, so that investment companies that have managed to survive have increased customers and increased market share at the Zagreb Stock Exchange.

Some investment companies have not been able to adapt to the requirements of complex regulation, nor could position themselves as investment companies and were forced to closure or mergers with larger companies to reduce costs. This will affect the further increase in the already high concentration on the level of industry brokerage services and all above mention is likely to contribute to the growth opportunities that the market will provide. The new environment in which the industry will operate in the future will certainly be very exciting and very challenging [14].

This investment company claimed a new, very demanding role in the capital market and successfully operated, should meet the appropriate organizational and capital requirements.

The new environment in which the industry will operate in the future will certainly be very exciting and very challenging.

For an investment company to take new, very demanding role in the capital market and to successfully operate in the market it should meet the appropriate organizational and capital requirements.

In accordance with the provisions of the CMA, an investment company should set up such internal organizational structure which ensures the lawful and proper performance of tasks for which it is licensed by Hanfa.

The largest novelties in the terms of organization occurred with the establishment of new organizational units as follows:

- Department for compliance with the law – (compliance function);
- internal audit (internal audit);
- Risk Management Board (risk management).

Responsibility of the investment company is to establish an adequate, efficient and effective system of financial management and control and that includes the responsibility for the establishment and development of the risk management process. [15] Investment companies are exposed to operational risk, credit risk, market risk and liquidity risk. In the new circumstances, investment companies cannot survive as discount brokers and inevitably have to continuously develop new products and services. The basic premise of this development and tracking trends in the capital market is to use the internet as much as possible. [16] Investment companies should encourage issuance of new series of securities and stimulate the cooperation with their institutional clients. Unfortunately issues of equity securities in Croatia are rare, but also when they occur, such jobs are normally carried out by credit institutions, i.e. commercial banks licensed to operate as investment companies. Investment companies have better chances in issuing the corporate debt securities. [17]

Obtaining sources of financing is particularly important. Unlike loans as a source of financing, the market can offer a lot more flexible and more acceptable forms of financing. From that point of view domestic investment companies have a lot free space for action and it is very likely that such jobs will eventually create a significant portion of the revenues of the investment companies in Croatia. Success in business and a good business plan can be achieved by promotion and other marketing activities, primarily by market segmentation and by determining target groups. [18] For investment companies on the Croatian capital market is illogical to omit any market segment from the entire spectrum of services.

Well-organized and dynamic capital market plays an extremely important role in global economic development. It enables efficient transfer of funds that could be invested by the entities

with financial surplus to those with financial deficiencies. Companies acquire cheaper funds for business and development in the mentioned way and depositors are given the possibility of long-term investments in accordance to their risk preferences. Despite fully functional market infrastructure and settled legislation, the impact of the Croatian capital market on economic growth is weak.

By adjusting the legislation to the *acquis communautaire*, investment companies as intermediaries in the capital markets receive some new opportunities and inevitably change their role, which creates a need for their market repositioning. The transition from being the passive discount broker to becoming an investment company that seeks and creates jobs in the capital market and accelerates market processes is only possible by strengthening the organizational and capital base and with a more active market approach. According to market movements, which are the most visible indicators of the Zagreb Stock Exchange, it is clear that there is no satisfactory dynamics, which means that we still do not have sufficiently strong and active investment company.

The Croatian financial system is extremely “bank oriented”. Banks are universal and thus the ratio of commercial and investment banking services directly affect the intensity of the development of the capital market. Banks used the opportunity and focused the companies towards financial products that are most profitable for them.

Croatia has not taken any effective actions so far, nor used instruments and measures at its disposal to increase the importance of the capital market. Firstly, it is necessary to speed up privatization, where strategic companies are not in questions, so that Zagreb Stock Exchange would become a channel for carrying out such processes. Also, we lack a healthy atmosphere and favorable investment climate to become more attractive destination for foreign investors. The organizational separation of investment from commercial banking would significantly help the rapid development of the Croatian capital market. For the stronger market development are lacking:

- independent institutional investors, grown without the impact of strong banks, and
- a strong, well-positioned investment companies with capital, that would encourage events, but also engagement in the capital market.

Venture capital funds are especially missing that would seek investment opportunities, and more active role of pension funds to invest in equity securities.

Investment company need to be aware of the enormous potential of the Croatian capital market, which is easily possible to run in a time of low interests and taxable yields, and they are expected to actively link financial resources on the one hand and development needs of the economy on the other.

Certainly, the Croatian capital market has a bright future due to market potentials that are now unused and because of the initiative of the European Commission for developing the mutual capital market of the EU (UTK).

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