



USAID
FROM THE AMERICAN PEOPLE

Capital Markets Project

Ukraine's Securities Depository System: Risk and Recommendations



Harry Cartner
International Securities Depository Specialist
Capital Markets Development

May 19, 2006

Preface

This paper presents a snapshot of the current status of the development of one of Ukraine's capital market institutions, the securities depository. A depository is one of the most critical institutions required for a vibrant capital market to develop. Its importance can be seen by the continuing struggle in Ukraine for control of the Interregional Securities Union (MFS), a Ukrainian depository established by market participants in 1997.

I would like to acknowledge the assistance of the staff of MFS, Mykola Shvetsov, its President, and Yuriy Shapoval, his Deputy, and their extraordinary candor in responding to my many questions. In addition, I would like to extend a special thank-you to Anatoliy Holovko, Deputy of the National Depository of Ukraine, who provided valuable information on the operation of this institution.

My meetings with market participants provided additional context for the information in this report in terms of the current problems and challenges they face in establishing a functioning market economy in Ukraine. I would like to thank the following Ukrainian experts for their valuable input: Mykhailo Nepran, Chief-of-Staff of the State Securities and Stock Market Commission (SSMSC); Ihor Seletskiy, President of Troika Dialog Ukraine; Ihor Seliverstov, First Deputy Chair of the Board of Directors of the Ukrainian Interbank Currency Exchange; Irina Zarya, President and CEO of the First Ukrainian Trading System (PFTS); Bohdan Lupiy, Executive Director of the PFTS; Serhiy Oksanych, President of Kinto; Anatoliy Fedorenko, Vice President of Kinto; Volodymyr Scherban, Chair of the Supervisory Board of the Professional Association of Registrars and Depositories (PAR); Andriy Kazakov, President of the Kyiv International Stock Exchange; Hanna Yatsiuk, Chair of the Council of Directors of the Ukrainian Stock Exchange (USE); Denis Butenko, Operations Manager of the USE; and Dmytro Tarabakin, Director of Dragon Capital.

Table of Contents

	Page
Executive Summary	3
1. Understanding Depositories, Registries and Clearinghouses	4
2. Background on Ukraine's Depositories	8
2.1 The Interregional Securities Union	8
2.2 The National Depository of Ukraine	12
2.3 Recent GOU Actions Concerning Ukraine's Depository System	13
2.4 The NDU Annual Meeting in December 2005	15
3. Conclusions and Recommendations	16
Appendix 1	21
Appendix 2	23

Executive Summary

The inherently complex functions and operations of share registrars, depositories, and clearinghouses in Ukraine are not well understood, even by securities regulators, and other market professionals. Yet, taken together, these institutions provide the climate of confident expectations essential to the success of the securities market:

- Reliability that accurate ownership records will be maintained, and that shares will not be lost, challenged or diluted.
- Reliability that shareholder ownership rights can be protected.
- Reliability that trades will clear and settle, meaning that shares will transfer and payments will be received.

Without accurate and reliable performance of these essential securities market functions, investor confidence will evaporate and the securities market will stagnate.

This paper first clarifies the roles and functions of depositories, registrars, and clearinghouses in the operations of securities markets. It then examines the development of depositories in Ukraine's capital markets, focusing on the Interregional Securities Union (MFS), which is modeled on the Canadian depository and is owned and operated by market participants. Besides routine depository functions, the MFS Depository efficiently handles clearance and settlement for Ukraine's securities markets, although its operations could be improved by several recommended steps to bring its procedures in line with internationally recognized best practices.

The paper also analyzes the controversy created by the Government of Ukraine's (GOU) recent decision to abrogate a 1999 Memorandum of Understanding among the GOU, the United States, and the World Bank on the development of a market owned central depository. Market participants have been nearly unanimous in voicing strong objections to the National Depository development plans of the Yushchenko government, including warnings of a loss of confidence in the depository function, a loss of confidence in the efficacy of shareholder rights, and a loss of confidence in Ukraine's securities markets by investors.

The paper concludes by emphasizing that the independence and integrity of the depository system is essential to the development of Ukraine's securities market, supporting the investment requirements of pension reform, and the attraction of investments. It provides a set of recommendations regarding ownership of a central depository, actions required to strengthen the MFS, and enhanced regulatory oversight by the Securities Commission of the registry and depository system.

An old Ukrainian proverb states that, *"The way to a good well is foot worn."* Applied to Ukraine's depository, registry, and clearance and settlement systems, this suggests that a central depository should be built upon the basis of MFS.

1. Understanding Depositories, Registries and Clearinghouses

Securities markets involve two basic instruments: ownership instruments (stocks/equities) and debt instruments (bonds). Handling these instruments involves three functions: custodial, fiduciary, and clearing. Because different entities (banks, corporate issuers, broker-dealers, exchanges, clearinghouses, depositories, registrars, etc.) can, and do, perform these three functions, the operational implementing procedures can become confusing. Thus, it is important to clarify what is actually done by *depositories*, *registrars*, and *clearinghouses*, and how their activities are mostly distinct.

This section briefly reviews the critical responsibilities that need to be performed by depositories (guaranteeing indices of ownership); registrars (protecting shareholder rights); and clearinghouses (ensuring that shares are exchanged or cleared for money).

Ownership Attributes. It is imperative to guarantee the ownership of securities. Historically, that was done by physically holding fancily engraved pieces of paper that noted who owned a specific number of shares. That method has largely been replaced by “book-entry,” or computerized/dematerialized, record keeping. Confidence in guaranteeing ownership is essential for anyone to purchase securities.

Shareholder Rights in Stocks. Ownership conveys certain rights, and these must be provided to the shareholder and honored. Ownership rights must be registered and include the following:

1) *Voting.* This includes electing Directors and voting on fundamental changes affecting the company, such as mergers and acquisitions.

2) *Financial Transparency.* Company financial records are provided to shareholders, as is the opportunity to inspect corporate books and records.

3) *Asset Claim.* Shares entitle the owner to a claim on a portion of the assets owned by the company.

4) *Dividend Entitlement.* Ownership, and a claim on assets, entitles shareholders to profits the company generates through increased value of shares, or any dividends a company may distribute.

5) *Rights to Transfer Ownership.* The ability to sell shares for value is the critical exit strategy.

6) *Suing for wrongful acts.* Shareholders have an enforcement mechanism in the event of manager actions that harm the company.

Clearing. Securities markets fail if there is not total confidence in the clearing process: shares and money must transfer fully and promptly. Both the buyer and seller must know that they will receive money for shares, and that shares will be transferred to receive money.

Operational Entities. Three types of entities help achieve these custodial, fiduciary, and clearing functions.

Depository

This is an organization entrusted with the safekeeping, deposit, and withdrawal of securities certificates, or ownership rights, of its clients. It can perform the following activities:

- *Safekeeping*: securities may be in dematerialized form, book-entry only, or in physical form, immobilized within the depository.
- *Deposit and Withdrawal*: supporting deposits and withdrawals involves the relationship between the registrar and/or issuers, as well as its role within the underwriting process or listing of new issues in a market.
- *Dividend, interest and principal processing, including corporate actions and proxy voting*: paying agent and registrar agents, as well as issuers are involved in these processes, depending on the level of services provided by the depository and its relationship with these other entities.
- *Other services*: depositories can offer additional services aside from those considered core services. These services may include securities lending and borrowing, matching, and repo settlement.

Registrar

This is an organization that maintains a registry of the share owners, and number of shares held, for a mutual fund, bond issuer, or stock company issuer.

- Once *registered*, a security includes certain rights, and this includes the previously described shareholder's rights.
- The transfer of registered securities occurs by amending the registry.
- A registrar is usually a company, or bank, charged with the responsibility of keeping a record of the owners of a corporation's securities, and preventing the issuance of more than the authorized amount.

Clearinghouse

This is a financial services company that provides, and guarantees, clearing and settlement services for financial transactions.

- The clearinghouse becomes the buyer to each seller (and the seller to each buyer) and assumes responsibility for protecting buyers and sellers from financial loss by *assuring performance* on each contract.
- The clearinghouse may also offer novation, which is the substitution of a new contract or debt for an old, or provide other credit enhancement services to its members.

Actual Practice

As just illustrated, different important activities and responsibilities are accomplished by depositories, registrars, and clearinghouses. In actual practice however, one business entity may take on a *combination* of depository, registrar, or clearinghouse activities and responsibilities.

For example, in the U.S. the Depository Trust Company (DTC) is the world's largest securities *depository*, holding \$20 trillion of securities assets in custody at any time. It *also* acts as a *clearinghouse* facility through which its members electronically transfer stock and bond certificates. The DTC was set up to provide an infrastructure for settling trades in corporate securities, municipal securities, and mortgage backed securities, and do so in a cost efficient and timely manner. The DTC is a member of the Federal Reserve System, registered with the SEC, and owned by the Depository Trust and Clearing Corporation, which in turn is owned by leading banks, brokerage houses, and securities exchanges.

For a European example, Clearstream Banking S.A., a division of Deutsche Börse, based in Luxembourg, was created in January 2000 to act as a *depository, registrar, and clearinghouse*. Deutsche Börse's strategy is to be a vertical securities silo, providing facilities for the front and back ends of securities trading. By 2004, Clearstream handled 50 million transactions and was custodian of securities worth €7,593 trillion.

Clearance and Settlement

Stated simply, clearance and settlement is the process by which trades between two parties are reconciled. It ensures that each party to the transaction gets the benefit of the deal: securities are delivered and payments are made. The mechanics of this process begin once two parties contract to trade a particular security at a particular price. Following the executed trade, the parties—usually the broker-dealer intermediaries for each side—confirm the details of the trade and their respective obligations. The details of the trade are sent to the clearinghouse, which compares the two sides of the transaction and confirms to the broker/dealer for each party whether the trade has been successfully compared or whether there are open questions on the transaction that must be resolved.

“Although largely invisible to the end investor, clearing and settlement lie at the core of all securities markets. In concept, there is nothing mysterious about this process; yet in practice, it is quite complex. Matching transaction terms, confirming and settling the many millions of trades taking place every day in major markets is complicated enough in a purely domestic context. But the process has become even more complex with the rapid growth of cross-border trading, which spans many clearing and settlement systems and legal and regulatory jurisdictions.”

*The Group of Thirty*¹
2003

Once a transaction is successfully matched, the settlement obligations are calculated. This can be done on a “gross” basis for each individual trade, but general practice today is that the settlement obligation is made on a “net” basis for trades between the broker/dealers in a particular security. Netting simplifies the process by reducing the number of shares and the amount of funds transferred. In primitive markets, brokers settle transactions directly with one another bilaterally.

¹ Global Clearing and Settlement, A Plan of Action, Group of Thirty (G30), Washington, D. C. 2003.

One of the important functions that a clearinghouse performs in a developed economy is to act as a guarantor of the broker/dealers in the market. It typically establishes a guarantee fund from among the broker/dealers using its services, based on the amount and volume of transactions conducted on the exchange. The existence of a guarantee fund, no matter how it is structured, avoids the process of constantly checking the creditworthiness of traders in the system. On an active securities exchange, it is impossible for each member to know the other party to a particular transaction. This guarantee function protects the integrity of the market and promotes investor trust in it.

In summary, the goal of clearance and settlement is to have a “seamless trade.” The guarantee system is designed to eliminate, to the extent possible, any systemic risk by establishing the necessary guarantees at the clearing and settlement stage. The guarantee acts as a substitute for each party to the transaction having to know the other party to the transaction and allows each party to have confidence that the other party will fulfill its obligation. Such risks are mitigated by a delivery versus payment (DVP) system. Under a DVP system, the delivery of securities occurs **simultaneously** with the transfer of funds.

2. Background on Ukraine's Depositories

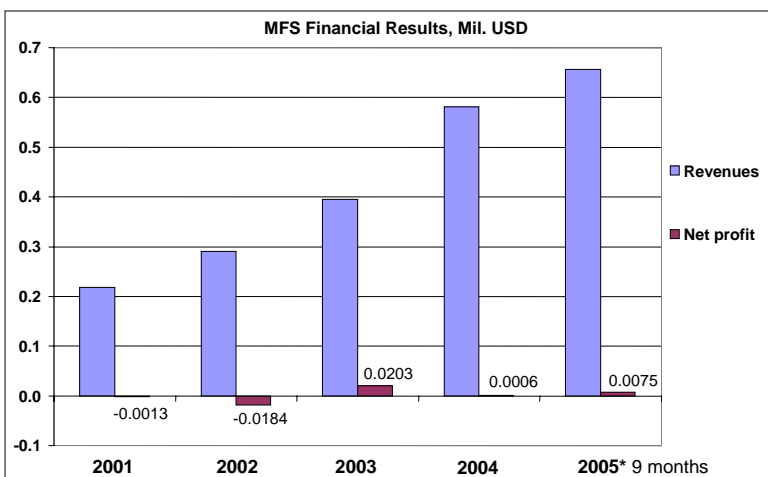
Currently, there are two depositories in Ukraine, the National Depository of Ukraine (NDU) and Interregional Securities Union (MFS). (For a chronology of the development of Ukraine's depository system, see Appendix 1).

2.1 The Interregional Securities Union

In 1997, market participants established MFS. The international donor community, with technical assistance provided by USAID, supported the further development of this market initiative. MFS is the only depository servicing equity and corporate fixed income instruments in Ukraine. The major services offered by MFS are: custodian ownership records; matching; clearing; immobilizing services; and notifications. In addition, MFS acts as a nominee for immobilized securities and is the sole central registrar for securities in dematerialized form. It also transfers dividends from issuers to custodians for a further transfer to beneficial owners.

MFS was established as an open joint stock company under Ukrainian law. MFS has 352 shares currently outstanding, nearly 50% of which are owned by eight participants: Ukrsofsbank (21 shares); First Ukrainian International Bank (PUMB) (22 shares); Oschadny Bank (the state savings bank) (22 shares); Privatbank (21 shares); Business Invest (22 shares); Sea Transport Bank (20 shares); Slavutysh Capital (14 shares); and PFTS (35 shares). An additional 142 market participants, including other Ukrainian stock exchanges, broker-dealers, and foreign and domestic banks, own the remaining shares. The ownership structure of MFS can also be classified thusly: 220 shares (62.5%) to banks, 91 shares (25.9%) to broker/dealers, 38 shares (10.8%) to exchanges, and 3 (0.8%) to others. This structure matches international practice, where banks play a key role as custodians and act on behalf of their clients as broker/dealers.

MFS currently has a 10-member board of directors which includes representatives of several market participants: Ukrsofsbank, Oschadny Bank, PFTS, Business Invest, Privatbank, First Ukrainian International Bank, Komeks Brokerage, the Ukrainian Interbank Currency Exchange, PromInvestbank, and Tekt Investment. The Board of Directors holds regular meetings and sets the policy for the operation of the company. The President of MFS is Mykola Shvetsov and he has one Deputy, Yuriy Shapoval. MFS has a staff of 35 who handle the daily work of the depository. The major departments are: financial (accounting) – 5, customer relations – 5, information technology (IT) – 6, operations – 5, and legal – 4.



As an open joint stock company, MFS files its annual report with the SSMSC and makes it available to the public. Because cost of transaction execution is a critical factor for all market participants—investors, broker/dealers, banks and custodians—, based on the policy of the MFS Board of Directors, the fees charged and operating costs are kept at a minimum. While MFS revenues have

substantially increased over the past five years, it has reported minimum profits and for two years it even reported a small loss as a result of this policy.

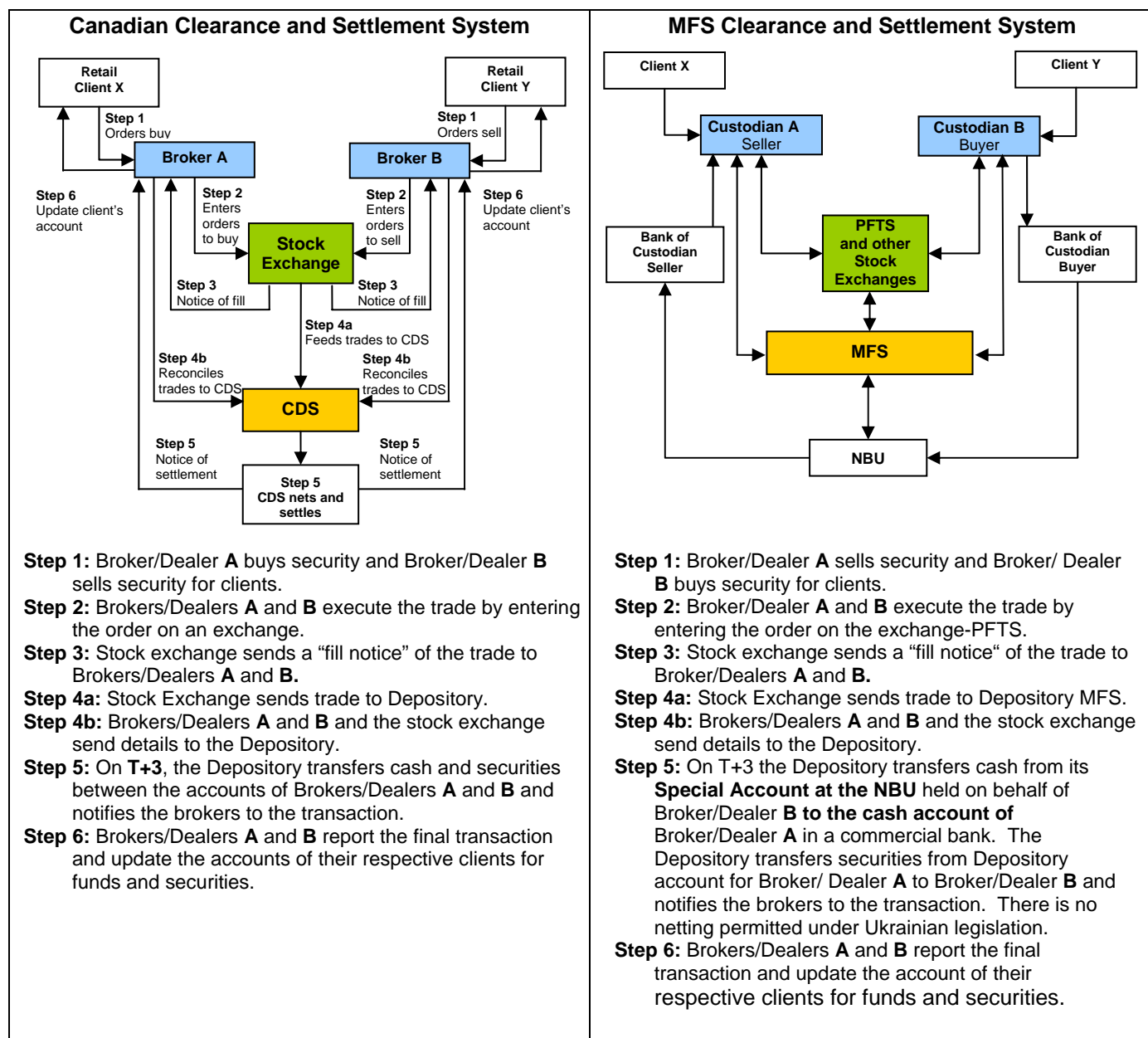
MFS performs depository and clearance and settlement functions only for electronic (dematerialized) securities. It services the accounts of over 1,100 market participants including issuers, banks and custodians who hold securities, equity and debt. In compliance with international norms, MFS has established a Delivery versus Payment (DVP) system and uses an account at the National Bank of Ukraine (NBU) to handle the money settlement portion of the transaction. However, there are apparently fewer than 20 DVP transactions a year. It is reported that, due to currency transaction restrictions, most major transactions are settled offshore in euros or US dollars. Adding to this problem is the fact that existing regulations do not require that all transactions be conducted on the regulated market, and existing regulations do not require that transactions be settled at the clearing depository. These problems are among the reasons that the regulated market in Ukraine is one of the smallest in the region.

MFS's Operations Department is the main department of the Depository. This Department handles the accounts of custodian/broker-dealers and issuers who have elected to establish electronic registries and place a global certificate with MFS representing shares held in the electronic registries. MFS's clearance and settlement system is handled through an electronic interface with Ukrainian exchanges and electronic trading systems. A review of the activities of the operations department showed that transactions are handled promptly and effectively in accordance with international standards. MFS enjoys an excellent reputation among key market participants for its honesty, competency and transparency of operations.

MFS's operations are modeled on those of the Canadian Depository for Securities (CDS). The accompanying flow diagram comparing the clearance and settlement procedures of the CDS and the MFS indicates the high degree of correspondence between the two systems. However, one major difference is that MFS does not have sufficient market demand to require that it handle the money settlement portion of transactions. As noted above, MFS has a special account at the NBU for clearance and settlement (MFS Special Depository Account).

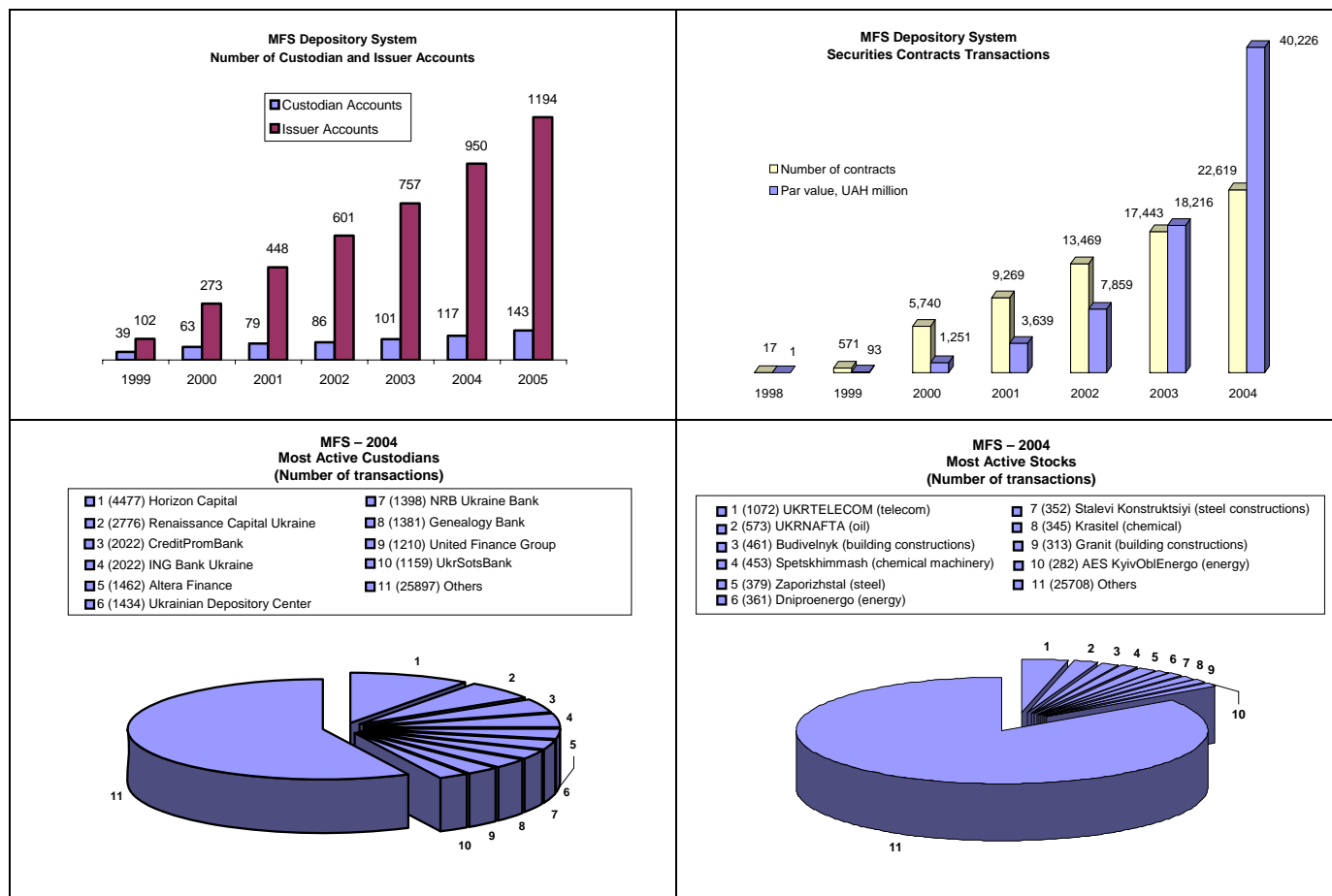
Transactions on the exchange or individually negotiated transactions are noticed to MFS by the exchange or the individual parties. MFS then immobilizes the securities in its nominee account for the custodian/broker-dealer. Once the custodian/broker-dealer representing the buyer electronically wires the funds to the MFS Special Depository Account at the NBU, MFS matches the order and the funds. It then transfers the securities to the custodian/brokers account for the purchaser and electronically transfers funds to the custodian /brokers account for the seller from the MFS Special Depository Account. If the custodian is a bank the funds are wired to its account at the NBU. If it is not a bank, then the funds are wired to the broker/dealers account at its bank.

Process of Clearance and Settlement



MFS interfaces with one trading platform (PFTS) and five Ukrainian stock exchanges. The First Securities Trading System (PFTS) and Kyiv International Stock Exchange (KISE) currently conduct more than 95% of MFS transaction volume. It appears that about 90% of all securities trades in Ukraine are executed off organized markets. Of the remaining 10%, PFTS does 86% of that volume, the majority being ‘blue chip’ Ukrainian issuers. According to KISE, their volumes increased due to the use of electronic transfer of ownership through MFS.

MFS’s volume of transactions has steadily increased. Since January 1999, the number of accounts opened for custodian/broker dealers has increased from 39 to 143 in 2005. The number of accounts opened for issuers has increased from 102 in 1999 to 1,194 in 2005.



The Information Technology (IT) Department is the backbone of the depository and clearance and settlement operations performed by MFS. The current staff, which has been with the Depository since its founding, developed the core software based on programming methodology provided by USAID-supported technical assistance. The software appears to be effective and operates in compliance with internationally-recognized standards. The Depository also has an off-site IT office, in Dnipropetrovsk, that has four additional software developers. As required by the laws of Ukraine, the National Bank of Ukraine has certified the MFS software as acceptable.

To facilitate foreign investment and transactions in foreign securities for Ukrainian investors, particularly non-state pension funds, MFS representatives met with representatives of EuroClear to investigate a correspondent relationship to handle clearance and settlement of foreign transactions. EuroClear is the world's largest settlement system for equities and bonds. EuroClear raised two major issues regarding establishment of a correspondent relationship with MFS. First, although MFS is the only institution in Ukraine providing depository and clearing and settlement operations, EuroClear was concerned that MFS did not have an official designation as a central depository. Second, EuroClear expressed concern with the lack of a guarantee fund at MFS to insure effective delivery versus payment for foreign transactions.

The Group of Thirty (G30), in conjunction with the International Securities Services Association (ISSA), recommends nine standards to assess and evaluate clearance and settlement systems in the global securities markets. As shown below, MFS currently meets six of the nine recommendations. Because Ukrainian legislation is currently not in compliance with certain international standards, MFS cannot meet the other three.

Nine Standards for Clearance and Settlement	MFS Scorecard
• T+1 trade confirmation and affirmation	✓
• Confirmations extended to clients, especially large institutions	✓
• Multilateral netting	x
• Central stock depository	x
• Delivery vs. payment	✓
• Irrevocable payment	✓
• T+ 3 settlement	✓
• Stock borrowing and lending procedures	x
• Coding Standards	✓
<i>The Group of 30 (G30)</i>	

☒ Lack of internationally compliant Ukrainian legislation prohibits compliance.

MFS meets all the requirements of existing securities legislation in Ukraine. It is also regularly inspected by the Ukraine Securities Commission (SSMSC). The SSMSC conducted an unannounced inspection of MFS due to alleged fraud by a Registrar, but the SSMSC found nothing irregular at MFS. In addition, in 2003, the Ministry of Economy and the tax authorities conducted a special inspection of the depository, based on allegations that Ukrainian law was violated in the transfer of assets to MFS as a result of the technical assistance provided by USAID in 2000. However, the authorities found that MFS was in compliance with the law.

In April 2004, MFS called a stockholders' meeting to increase its statutory capital, to allow about 40 custodians who are not stockholders to participate. Attempts to address the issue failed due to the actions of some groups of stockholders, related to banks, to take control of the depository. Existing shareholders agreed to purchase all of the issue. However, the new share issue was not approved at the shareholders' meeting. Another MFS shareholders' meeting was scheduled for June 2004. The meeting failed to gain a quorum. Subsequently, several attempts were made by the Association of Ukrainian Banks to mediate and attempt to resolve the problem. One of the recommended solutions was to place a mandatory limit of 5% on ownership in the statutory capital of MFS and sell excess amounts to minority shareholders. Following these efforts, the parties maintained the status quo and there was no increase in the statutory capital of MFS.

It is clear that the control of MFS by one or more market participant groups could have a serious adverse effect on current and future development of an honest and well-regulated market in compliance with international standards.

2.2 The National Depository of Ukraine

In May 1999, two years after MFS was established, the SSMSC took steps to set up the NDU. It was established as an open joint stock company, with the State owning 86% (managed by the SSMSC), the NBU owning 4.4%, and the remaining shares owned by market participants, including one share owned by MFS. Then SSMSC Commissioner, Viktor Ivchenko, served as Chair of the Supervisory Board of the NDU.

Prior to the establishment of the NDU, a Memorandum of Understanding "On the Development of Securities Industry Owned Clearing Depository" was signed by the

Government of Ukraine, the World Bank, and the US Government (See Appendix 2). Acting on behalf of the GOU, the MOU was signed by Deputy Premier Serhiy Tyhypko, SSMSC Chair Oleh Mozgoviy, and NBU Governor Viktor Yushchenko. The MOU, signed on January 25, 1999, was to be binding on all parties through January 25, 2010.

The stated objective of the MOU was to cooperate in developing an open, competitive, well-regulated, private sector-based market for securities in Ukraine. It was further agreed that the signatories would assist Ukraine's securities industry in:

- *Building a securities industry-owned Clearing Depository capable of serving all licensed securities markets (stock exchanges, trading and information systems) and serving all appropriate market participants (issuers, registrars, custodians, broker-dealers and licensed securities markets);*
- *Effecting the voluntary merging, in the shortest period of time, of all existing or planned Ukrainian depositories into a single, centralized clearing depository, predominantly privately owned and operated by securities market participants;*
- *Developing a strategic development plan for Ukraine's securities market infrastructure that was to rationalize and optimize its scarce resources.*

The MOU further provided that, although the Parties did not object to the establishment of a National Depository by the GOU, it was agreed that any such entity *would have no commercial functions whatsoever and would engage in only three functions: codification, standardization and international relations* within the effective period of the MOU.

Under the Presidential Decree "On the General Operating Principles of the National Depository of Ukraine," dated June 22, 1999, the NDU was not permitted to perform any depository, clearance and settlement operations until the state's stake in its statutory capital was reduced to 25%. To date, the NDU has not engaged in commercial activities as a fully operational depository and has carried out only the three functions authorized in the MOU. In 2001, the Ministry of Finance was given the power to manage the state's share in the NDU. However, by December 2005 control over the State's 86% stake had been returned to the SSMSC.

2.3 Recent GOU Actions Concerning Ukraine's Depository System

Beginning in 2004, the Government of Ukraine undertook several steps regarding the NDU, in contravention of the spirit 1999 MOU. First, in December 2004, acting premier Mykola Azarov approved the State Program for the Development of the National Depository System. This program proposed to significantly expand the powers of the NDU and included:

- A development budget, to be funded by UAH 900 million from the State Budget, and UAH 1.1 billion from private market participants over 2005-2010;
- Establishing from scratch a system of ownership records that is not coordinated with the other infrastructure components of the market;
- A number of activities (a separate national information network, a separate data transfer system, a separate safekeeping vault) of little importance to securities markets;
- Controversial new functions to the depository system e.g., the development of a real estate market and risk-hedging in commodity markets, which are not accepted international practice for a depository;
- The exclusion of market participants in the management and direction of the NDU.

Ukrainian market participants voiced strong objections to this program, especially the cost. Following the passage on December 23, 2004 of the State Budget for 2005, 66 market

participants, including 26 domestic and international banks and 40 broker/dealers and other market participants, signed an open letter dated February 9, 2005 to the Cabinet of Ministers and the Verkhovna Rada of Ukraine opposing the significant State Budget support to the NDU.

The letter expressed the signatories' objection to the use of public funds to address problems that they stated were either non-existent or that had already been resolved and paid for by market participants. The letter also expressed concern that the State's national depository program would very likely result in substantial increases in the cost of securities transactions, and that Ukrainian securities might move to alternative record-keeping systems abroad. Finally, the letter noted that the State's program for a government-owned depository system would make it impossible to continue developing the system under the principles of market needs and self-regulation.

Second, on November 24, 2005, President Yushenko signed a Decree (November 2005 Decree) containing two resolutions of the National Security Council "On Measures to Improve the Investment Environment in Ukraine" dated June 29, 2005, and "On Measures to Ensure Guarantees and to Improve the Effectiveness of the Protection of Property Rights in Ukraine," dated October 28, 2005.

The November 2005 Decree provides a broad and sweeping package of government actions and programs. The Decree addresses the needs for judicial and regulatory reform, the speedy establishment of the State Agency of Ukraine for Investments and Innovations as a central executive body with special status, the implementation of a detailed action plan for improving the investment climate in Ukraine, the establishment and empowerment of the National Depository of Ukraine, and guidelines for stock market development.

The November 2005 Decree provides for the National Depository of Ukraine to maintain the central register of owners of registered securities. It also indicates that a Central Depository for securities, based on the National Depository of Ukraine, would eventually be established, *"to be controlled by the State and independent of the influence of financial and industrial groups and professional participants of the stock market."* This Decree also directs the Cabinet of Ministers to undertake the preparation for canceling the Presidential Decree of June 22, 1999, which supported the implementation of the MOU.

In support of the Presidential Decree, on January 18, 2006, the Cabinet of Ministers decided to terminate the MOU between the GOU, the World Bank, and the U.S. government concerning the establishment of a Central Depository owned by the securities industry. On February 2, 2006, Ukrainian market participants signed a letter to the President of Ukraine, the Cabinet of Ministers and the SSMSC requesting that the GOU reconsider the cancellation of the MOU and rescind its decision to create a central depository based on the NDU. The Ukrainian Banking Association, the Ukrainian Association of Investment Businesses, the Professional Association of Registrars and Depositories, PFTS and 38 other market participants signed this letter. Market participants clearly identified the problems with state ownership: loss of confidential information, loss of confidence in Ukraine's securities market by foreign investors, and a loss of competitiveness in world markets.

The international donor community supported the concerns of these market participants. USAID issued a press release stating that it was very disappointed with the GOU decision to unilaterally terminate the Memorandum of Understanding regarding the NDU. The statement expressed concern over the Cabinet of Ministers' decision to terminate the MOU without consulting with international experts and without any discussion with USAID.

USAID stated that it was concerned that such unilateral actions on the part of the GOU would adversely affect the market and investors, including non-state pension funds.²

On February 1, 2006, The World Bank sent a letter to the Premier of Ukraine expressing its concern with the recent steps on the part of the GOU to develop a state-owned depository. The letter stated that this action “seems inconsistent with the pronounced intentions of the Government of Ukraine to improve the investment climate and consolidate financial and capital markets in the direction of a conducive and transparent environment for investments.” The letter went on to state that the establishment of a central depository should result in enhanced corporate governance and dominant private ownership of the depository, in line with current international practice where, at most, the state might own a blocking share of a unified depository.

Finally, on March 21, 2006, President Yuschenko signed a Decree “On Cancellation of the Presidential Decree dated June 22, 1999 “On General Principles of Operations of the National Depository of Ukraine.” The 1999 Presidential Decree, issued by former President Kuchma, implemented the MOU.

2.4 The NDU Annual Meeting in December 2005

In this environment, on December 13 and 23, 2005, the NDU held its annual shareholders’ meeting to consider several major issues. On the agenda were: (1) the election of management, (2) the revision of the charter and by-laws, (3) an increase of share capital, (4) the establishment of a central vault for keeping documentary securities, and (5) the approval of its action plan for 2006. At the meeting, Viktor Ivchenko was re-elected chair of the Supervisory Board and his First Deputy, Volodymyr Ulianov, was elected President.

In addition, the shareholders approved a proposal to change the status of the NDU from a quasi-state agency, return it to a joint stock company and to revise its charter and by-laws, granting it authority to perform all of the commercial functions of a depository. Shareholders also approved an increase in the statutory capital of the

“The [share increase] will not come into force until a separate line item is added to the State Budget for 2006 specifying the amount of funds earmarked for the acquisition of the additional NDU shares.”

Mykhailo Nepran
SSMSC Chief-of-Staff
December 26, 2005

NDU, subject to the availability of GOU financing to maintain the State’s 86% interest. Statutory capital was to be increased six-fold, to EUR 5 million. Accordingly, the State will have to allocate at least USD \$4.25 million to maintain its ownership at 86%. At the meeting, shareholders also voted to approve the NDU’s action plan for 2006, which essentially is to implement the November Presidential Decree on the development of the NDU. To reiterate, this Decree calls for “... *[E]stablishing, on the basis of the National Depository of Ukraine, a Central Depository of securities, controlled by the State and independent of the influence of financial and industrial groups and professional participants of the stock market.*”

² “Cabmin to Set Up Depository,” *Kommersant-Ukraine*, January 20, 2006.

3. Conclusions and Recommendations

Securities market development in emerging economies hinges on meeting investor needs and providing the conditions for profit-making. This means providing reliability in three critical areas:

- An independent shares registry and depository system that ensures the investor that accurate custody of ownership records is maintained; that shares will not be diluted, wrongfully lost, or challenged. Ownership verification is also the first step toward meaningful corporate governance.
- A dependable clearance and settlement system that provides the investor confidence that the bargain made will occur – that shares will transfer and payments be received.
- Market liquidity gives the investor confidence that shares that have been purchased can be readily sold. There must be sufficient buyers and sellers available to provide easy entry and exit from the market.

Together, these three requirements create the climate of confident expectations essential to securities market development.

Share registries and depositories provide an essential custodial function of accurate ownership records. A registry provides the record of who owns the company's shares. A depository maintains for each market participant, both buyer and seller, a record of share holdings. Once a trade has been successfully cleared and settled, the depository records the share transfer from the seller's ledger to the buyer's, and then reconciles the books with the registry of shareholder records and the accounts of each market participant involved.

In order to achieve credibility – and maximum investor confidence – it is important that the independence of the share registrar and depository be assured. Ideally, the share registry should be maintained by an independent third party, not the company itself. Similarly, the depository should be independent of the government and control of private groups. As the Russian experience amply demonstrates, lack of independence of these key market institutions can foster distrust, inhibit investment, and impair effective corporate governance.

“Governments in emerging economies should want to encourage the effectiveness of the registry and depository systems, but often believe this will be best enhanced by installing them within a state agency. Governments need to be careful of this approach because in some of the emerging markets public cynicism about state ownership runs so high that state ownership or operation of these functions, even initially, may discourage citizen participation in share ownership and capital markets development. “

The World Bank
1996

In Ukraine, the 1999 MOU was intended to address the issue of the credibility and independence of the depository. It was in response to several investor disputes concerning share dilution, wrongfully lost share ownership records, and other abuses and fraud. In part, this was the reason why the MOU barred the NDU from engaging in commercial activities, and why it explicitly endorsed an independent, private sector solution to the depository function.

In order to achieve the GOU's stated objectives regarding investment, financial sector reform, and meeting European Union standards, it is essential to assure the integrity and independence of Ukraine's depository system. This can best be accomplished by building

on the demonstrated strengths of MFS. The GOU, the Ukrainian private sector, and the international financial and donor community should work collaboratively to develop an action plan to establish a central depository, with dominant participation and ownership by market participants. The following recommendations are offered in support of this goal.

Recommendation 1: Establish a Predominately Privately Owned Ukrainian Central Depository

In order to assure independence and to meet internationally-recognized standards, the depository should be created with predominantly private ownership. ***The ideal solution would be complete ownership by all market participants with no state ownership, i.e. the Canadian system.*** If state ownership is insisted upon, the State should have a passive minority position in which its ownership is controlled by the National Bank of Ukraine. Ownership should be widely distributed among market participants, with no one market participant owning, directly or indirectly, more than 5% of the outstanding voting shares of the depository. This would avoid inappropriate interference by one group in the activities of the depository.

Since MFS has been operating commercially as the Ukrainian Depository since 1997, and because it has earned the trust and respect of the marketplace, ***it is recommended that any central depository be established on the basis of this entity.*** MFS operations are substantially in compliance with international norms, and strengthening this institution further would not disrupt the operations of the market or require additional funding from an already overextended State Budget. Equally important, this institution has both the necessary software and human capital trained and effectively implementing the critical depository function for Ukraine.

An informal review of the ownership of depositories in 48 countries, both developed and emerging markets, shows that only in five countries was the depository controlled or partially owned by a government body. These five countries, all former members of the Eastern bloc, have depositories with some or a portion of ownership held by the Ministry of Finance: Bulgaria, Croatia, the Czech Republic, Poland and Slovakia. However, Poland has appointed an international team of experts to privatize the Warsaw Stock Exchange, currently owned by the Polish Treasury, and has also commenced planning the privatization of the national depository for securities. The other countries have various ownership structures that involve primarily stock exchanges, banks, broker-dealers, investment funds, and other market participants, with some ownership by the central bank of the particular country.

Recommendation 2: Strengthen the Operations of MFS

Although MFS operations are generally in accordance with international best practice, there are several key areas where its operations could be improved. These include:

- ***That MFS acquire an 'off-site' location, within Kyiv, and set up a fully redundant back-up system. This redundant system should include ALL electronic data within MFS, including any future plans. This would allow MFS to immediately move, electronically, to the off-site location in case of a disaster.***

Currently, MFS is fully redundant with database backups kept ***only*** on-site. The fully redundant backups should also be kept off-site as well to permit MFS to maintain full operations.

- ***That requests for ownership registries be converted to an electronic system. It should also be mandatory that all registrars use this electronic system upon payment of a service fee established by market participants.***

At the present time, there is a large volume of manual paperwork handled by the Customer Relations Department in interfacing with custodians and registrars, related to requests by Registrars for ownership registries. This Department communicates with custodians for their ownership records, supplied in paper format, which are then consolidated electronically by MFS and then forwarded to the registrars, also in paper format.

This process is very time-consuming and very expensive, as staff use the postal system to send ownership registries to the registrars. While some registrars pay for this service, the majority do not. MFS does not have the authority to make payment mandatory under current SSMSC regulations.

- ***That MFS be granted the right to incorporate all types of money settlements into the depository system. This would allow MFS to institute internationally recognized standards.***

The majority of all money settlements for transactions are handled custodian-to-custodian, with the vast majority of these transactions conducted off-shore, in hard currencies. In this connection, the international clearance and settlement practices provide for settlement in local currency, euros or US dollars. Offshore settlement reportedly grew after the National Bank of Ukraine changed its currency rules three times in less than four months, possibly leaving market participants with little choice but to settle outside Ukraine.

- ***That MFS institute a guarantee fund for money settlements, to ensure that it is protected from settlement failures.***

Currently, MFS does not handle significant money settlement transactions, but it needs to establish a guarantee fund to protect the market from settlement failures. If money settlements were to be implemented as recommended, then a guarantee fund would be a necessity, bringing MFS in line with internationally- recognized best practice.

- ***That MFS staff establish a program, initially with international donor support, for ongoing international training with exposure to international depositories. As MFS is operationally very similar to the Canadian Depository for Securities, this institution might be an appropriate “partner” for training.***
- ***That the MFS website provide an English version, as do all other international depositories, to promote transparency and attract foreign transactions.***

In order to conform to international standards, the MFS website should be translated into English. This would make it compliant with other international depositories and promote increased foreign investment.

Recommendation 3: Strengthen the Regulatory Oversight of SSMSC

- ***That the SSMSC be immediately given the legal authority, by Presidential Decree or otherwise, to investigate all of the problems within the Registrar system and take all necessary steps to improve the system in accordance with international best practice.***

Attempts to manipulate ownership records among the various registrars continue in Ukraine. The first step to reform this process would be to eliminate “pocket registrars,” address inappropriate “telephone justice” leading to double registries, and impose heavy penalties, including the withdrawal of licenses of registrars who illegally sell registries.

The SSMSC should improve its oversight by strengthening the self-regulatory organizations with the necessary powers to eliminate these machinations for the safety and soundness of the system.

In addition, the SSMSC should establish effective oversight of the central depository based on IOSCO principles of international best practice. Regulations should require that all transactions in securities be reported over the organized market and that all transactions in securities be cleared and settled at the MFS Depository.

Appendix 1

Chronology of Ukraine's Depository Development

- 1996—Verkhovna Rada adopts a Concept for the Development of the Capital Markets in Ukraine.
- March 1997—Interregional Securities Union (MFS) is established as an open joint stock company by market participants in order to serve as a depository for Ukrainian companies and trading systems.
- December 1997—The Law “On the National Depository System” is approved. The Law provides for the establishment of the National Depository of Ukraine (NDU).
- 1999/2000—USAID provides technical assistance to MFS to strengthen its work as a fully functional, privately owned, clearing depository that can support the development of a capital market in Ukraine.
- January 1999—Memorandum of Understanding among the Government of Ukraine, the World Bank, and the Government of the United States of America “On the Development of a Securities Industry-Owned Clearing Depository” is signed.
- May 1999—The NDU is established as an open joint stock company with the State Securities and Stock Market Commission (SSMSC) controlling 86% of its shares, the National Bank of Ukraine holding 4.4%, and the remaining shares, 9.6% owned by 21 market participants, including 1 share owned by MFS. SSMSC Commissioner Viktor Ivchenko is appointed to head the NDU.
- May 1999—Cabinet of Ministers Resolution is adopted, based on the recommendation of the SSMSC, to transfer management of the State's 86% ownership in the NDU to the Ministry of Finance (43%) and NBU (43%).
- June 1999—Presidential Decree “On the General Basis for the Operations of the National Depository System of Ukraine” is issued supporting the provisions of the MOU.
- July 2001—Cabinet of Ministers adopts a resolution transferring NDU shares under the management of NBU (43%) to the Ministry of Finance resulting in the Ministry of Finance managing the State's 86% ownership in the NDU.
- December 2005—Cabinet of Ministers adopts a resolution to transfer management of State's 86% ownership in the NDU back to the SSMSC as provided in the 1997 Law “On National Depository System.”
- December 14 and 23, 2005—NDU holds a general meeting of shareholders that, among other issues, approves a decision to empower NDU to operate as a fully-functioning depository, including authority to clear and settle transactions on Ukrainian exchanges.
- January 18, 2006—Cabinet of Ministers passes a resolution to terminate MOU with US Government and World Bank.
- March 21, 2006—Presidential Decree issued on “Cancellation of Presidential Decree #703, dated June 22, 1999, “On General Principles of Operations of the National Depository of Ukraine” which implemented the MOU.

Appendix 2

Summary of the 1999 Memorandum of Understanding On Development of a Central Depository

In 1999, a Memorandum of Understanding was signed among the Government of Ukraine, the International Bank for Reconstruction and Development, and the Government of the United States of America, “On the Development of Securities Industry Owned Clearing Depository” (1999 MOU). Acting on behalf of the GOU, it was signed by Deputy Premier Serhiy Tyhyhko, SSMSC Chair Oleh Mozgoviy, and National Bank of Ukraine Governor Viktor Yushchenko. Signed on January 25, 1999, it is valid through January 25, 2010. The stated objective was to cooperate in developing an open, competitive, well-regulated, private sector-based market for securities in Ukraine. It was further agreed that the signatories would assist Ukraine’s securities industry in:

- *building a securities industry-owned Clearing Depository (CD) capable of serving all licensed securities markets (stock exchanges, trading and information systems) and serving all appropriate market participants (issuers, registrars, custodians, broker-dealers and licensed securities markets);*
- *effecting the voluntary merging, in the shortest period of time, of all existing or planned Ukrainian depositories into a single, centralized clearing depository, predominantly privately owned and operated by securities market participants;*
- *developing a strategic development plan for Ukraine’s securities market infrastructure that will rationalize and optimize its scarce resources.*

The MOU further provided that, although the parties did not object to the establishment of a National Depository by the GOU, it was agreed that any such entity *would have no commercial functions whatsoever and would engage in only three functions: codification, standardization and international relations* within the effective period.

It was also understood that the cost of the economic restructuring and development of a securities market was beyond the individual financial and operational capabilities of the GOU, the donor institutions, or market participants. Thus, the donor institutions undertook to augment the resources of the private institutions to build a world-class depository system. The parties agreed to combine their resources to further develop the securities market in Ukraine and to accelerate the development of a market structure for securities in Ukraine.

To this end the parties to the MOU undertook the several obligations:

- *The GOU undertook to* (1) refrain from creating unequal conditions for market participants and institutions, (2) reject government ownership positions, especially controlling or blocking positions, in commercially-viable capital market institutions, (3) protect and promote the full rights of the private owners of capital market institutions to exercise their corporate rights. This, in particular, includes protection against imposing any structure set up by the Government or Rada, such as a National Depository with more than the three functions, upon private market participants, (4) refrain from (a) merging or amalgamating private-sector depositories with the National Depository or any other state-owned institution; (b) changing the legal and operational status of private sector depositories unless such depositories have their shareholders’ consent for such action, (5) rectify certain legislative and regulatory impediments to developing and implementing a functional CD in Ukraine, such as the lack of legal recognition of electronic documents and electronic signatures, requirements for dematerialized securities to be placed only in the depository, high taxes on capital gains and dividends, and so on.
- *The NBU undertook to* provide technical assistance to the CD specialists.
- *The SSMSC undertook to* develop the regulation of depository, clearance and settlement functions that support the objective of the MOU and in full cooperation with market participants and other parties to the MOU. It also undertook to implement provisions (3), (4) and (5) noted here.
- *USAID undertook to* (1) provide legal and technical expertise to facilitate the Market Structure Strategy Working Group and the establishment of the CD, (2) provide legal and technical training for all parties involved in setting up the CD including the GOU, NBU, SSMSC, and the securities industry, as well as limited ongoing support to the Ukrainian Broker-Dealer Association and Trading System (PFTS), (3) provide financial assistance and equipment to establish the CD, (4) help the SSMSC, in cooperation with the securities industry, to develop regulations and methodological standards on depository, clearance and settlement activities.
- *The World Bank undertook to* provide access to world best practice and know-how in areas relevant to the CD project and to seek additional commercial and donor sources for financing and technical assistance to the CD.

Harry Cartner is a Securities Operations Executive with over thirty years' extensive experience in clearing, settlement and depository operations and systems. Mr. Cartner has worked internationally in such countries as Canada, Mexico, Algeria, Cote d'Ivoire, and Bulgaria.