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## Capital Markets Project

**ANALYSIS AND RECOMMENDATIONS REGARDING  
DEMATERIALIZATION INITIATIVES UNDER UKRAINE'S LAW ON JOINT  
STOCK COMPANIES AND LAW ON THE NATIONAL DEPOSITORY SYSTEM  
AND SPECIFICITIES OF THE COMPUTERISED SECURITIES CIRCULATION  
SYSTEM OF UKRAINE**

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## I. Introduction

Article 20.2 of the Law of Ukraine on Joint Stock Companies (JSC Law) provides that by October 29, 2010, all shares of a joint stock company (JSC) “shall be registered ones” and shall “exist exclusively in non-documentary form”. Article 20.2 applies to shares of newly established JSCs as well as to all shares of approximately 10,000 open and 20,000 closed JSCs. The JSC Law also provides a deadline of April 30, 2011 by which all existing JSCs must determine whether they wish to be public JSCs under the JSC Law, private JSCs which may have no more than 100 shareholders, or transform themselves into another form of legal entity not subject to the JSC Law. Unfortunately, the JSC Law does not include any sanctions for failure to comply with these requirements.<sup>1</sup>

In a separate initiative, which makes no reference to the JSC Law’s dematerialization requirements or deadline, the Securities and Stock Market State Commission (SSMSC) has issued and proposes to amend a Regulation on the Procedures for Converting Physical Registered Shares Issue into Book-Entry Form (Dematerialization Regulation).<sup>2</sup> Unlike the JSC Law’s dematerialization requirement, the SSMSC’s initiative does not impose an absolute deadline for dematerialization. Instead, it envisions that individual JSCs would hold general meetings of shareholders where they adopt dematerialization resolutions that provide deadlines for dematerialization.

The Explanatory Note accompanying the Dematerialization Regulation indicates that the SSMSC is basing its authority to adopt the Regulation on the second paragraph of Section 1, Chapter 6 of the Law on the National Depository System (hereinafter – NDS) and Specificities of the Computerised Securities Circulation System of Ukraine (Depository Law), which provides that:

“All such issuers as may have released securities prior to the enactment of the Law of Ukraine "On the National Depository System and Specificities of the Computerised Securities Circulation System of Ukraine" shall be under the obligation to decide, within six months from the date of publication of this Law, on the form of issue of their securities, provided their issues are legally acknowledged, and bring every such issue in conformity with this Law. The State Securities and Stock Market Commission shall define the requirements to be imposed on the certificates of securities released in the documentary form.”

Despite the fact that the Depository Law was adopted in 1997 and the six months deadline envisioned for issuer compliance was over eleven years ago, the Explanatory Note indicates that the consequences of an issuer’s failure to comply with the above provision is now “a problem that cries for immediate solution.” However, four paragraphs later, the Explanatory Note also indicates that “a gradual transition to a book-entry form of issues is the next step of the market that the Commission should endorse”.

The conclusion that is suggested by the Dematerialization Regulation and Explanatory Note is that the SSMSC is adopting a gradual “carrot and stick” approach to dematerialization. The carrot is reflected in the Explanatory Note’s explanation that the Dematerialization Regulation “offers issuers an opportunity to convert their securities to a book-entry form provided that there is a resolution of the general meeting to convert 100% of the securities issue to be dematerialized.” The stick is the SSMSC’s reference in the Explanatory Note to an issuer’s failure to comply with the second paragraph of Section 1, Chapter 6 of the Depository Law as being subject to the SSMSC’s authority under item 18, Article 7 of Section 2 of the Law of Ukraine on State Regulation of Securities Market in Ukraine to “develop and organize the implementation of actions intended to prevent the violations of current securities laws in Ukraine.”

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<sup>1</sup> The only sanctions included in the JSC Law relate to a JSC’s failure to amend its charter and other governing instruments to conform to the law.

<sup>2</sup> The Dematerialization Regulation was adopted pursuant to SSMSC Resolution No. 398 (September 14, 2004) and amended pursuant to SSMSC Resolution No. 955 (August 29, 2008). The discussion of the Dematerialization Regulation in this paper refers to the current regulation and the SSMSC’s proposed amendments to the current regulation.

The Dematerialization Regulation requires all share issues that are dematerialized pursuant to a dematerialization resolution adopted by an issuer's general assembly to be included in Ukraine's NDS. This is to be accomplished by establishing a register termination date by which the issuer's registrar is required to transfer a list of registered shareholders as of the termination date to a bank or securities trader custodian selected by the issuer. The custodian must be a member of a depository that is member of the NDS. The depository also is selected by the issuer. The effect of this requirement is to eliminate share registrars for issuers of dematerialized shares included in the NDS notwithstanding the fact that Article 1 of the Depository Law indicates that registrars along with custodians and depositories are direct participants in the NDS, and Article 9.1 provides that ledgers of registered securities holders shall be kept by registrars if the number of registered holders of an issuer exceeds a number determined by the SSMSC that would prevent an issuer from maintaining its own ledger. The Dematerialization Regulation and Explanatory Note do not address these apparent inconsistencies between the Depository Law and the Regulation.

## **I. Purpose and recommendations**

The purpose of this paper is to:

1. Explain why neither the JSC Law nor the Depository Law and Dematerialization Regulation provide a sufficient legal basis for dematerialization and the establishment and implementation of the NDS;
2. Explain why the JSC Law with appropriate amendments and adoption with appropriate amendments of the draft Law on the System of Depository Record Keeping (Draft Depository Law) should serve as the legal foundation for dematerialization of securities and implementation of the NDS;<sup>3</sup> and
3. Provide these explanations in the form of nine recommendations that should be considered by Ukrainian authorities if they wish to have an effective NDS that will fulfill the needs of capital market participants.

**The recommendations are:**

- 1. In attempting to create the NDS, Ukrainian authorities should consider the differences between the depository and clearing and settlement function of such a system, which international best practices recommend for publicly traded securities, and the registration function that such a system may provide for a broader class of securities, even though central registration is not required by international best practices.**
- 2. To accomplish dematerialization and inclusion of dematerialized securities in the NDS, statutory deadlines with sanctions for noncompliance are essential. Dematerialization should not require a shareholder vote in most circumstances. However, rights of holders of physical securities must be protected.**
- 3. The depository and clearing and settlement component of the NDS should be market driven and limited to securities of JSCs that have a realistic possibility of being publicly traded. Private JSCs and JSCs with no more than 100 holders of any class of securities should not be included in the clearing and settlement component of the NDS system.**
- 4. Notwithstanding the fact that the JSC Law requires all shares of public JSCs to be listed, experience in neighboring countries indicates that Ukraine should not expect to have more**

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<sup>3</sup> Item 30 of the Action Plan to Implement the General Guidelines of Ukraine Stock Market Development in 2006-2010, adopted by the Cabinet of Ministers pursuant to Decree 131-r of March 7, 2006, specifically directs the SSMSC "[c]ontinually, until passed" to "follow through the passage in the Rada" of the Draft Depository Law.

than 500 JSCs with shares that are publicly traded, plus shares of publicly owned closed-end investment funds and corporate and municipal debt securities that were publicly offered. This is the universe of securities for which dematerialization and inclusion in the clearing and settlement component of the NDS is essential.

5. In order to implement international best practices for the depository and clearing and settlement, there should be only one central depository for corporate equity and debt securities, as is currently proposed under the Draft Depository Law.
6. The NDS would be better structured and operate more efficiently with a fairer allocation of costs if the system's securities registration function were a separate component of the system. Under this approach, a broader class of JSCs, many whose securities will not be publicly traded, could have their securities registers maintained electronically at the JSCs' expense. Only costs of operating the clearing and settlement component of the system would be borne by market participants (banks and securities traders) who may be expected to recover these costs from investors who trade securities.
7. The Dematerialization Regulation's requirements that shareholder registers be transferred from registrars to securities custodians and that shareholders enter into individual account agreements with custodians at the shareholders' expense are conceptually flawed and should be changed. When many JSCs will be part of the NDS, even though there is no public trading in their securities, it is both illogical and unfair to expect the shareholders of such JSCs to incur the trouble and expense of entering into agreements with a securities custodian as required by the Dematerialization Regulation when such shareholders have no need for a securities custodian. A more logical solution, given what has already taken place in Ukraine, is to require publicly owned JSCs to have their security holder registers kept in electronic form at the NDS but to permit registrars that are currently authorized to perform registrar functions to serve as the single point of input for entries into the electronic registers.
8. In determining which securities should be dematerialized and included in the registration component of the NDS, Ukrainian authorities should make a distinction between public and nonpublic companies. It is likely that the costs of requiring private JSCs with no more than 100 holders of a class of securities to dematerialize their shares and participate in the NDS may outweigh any potential benefits. However, instead of the no more than 150 shareholder limit that the SSMSC now requires for JSCs that wish maintain their own share registries, a more logical limit would be no more than 100 shareholders, as used for private JSCs in the JSC Law.
9. The law should provide for conversion of physical bearer shares into a book-entry form.

## **II. Explanation of recommendations**

1. In attempting to create the NDS, Ukrainian authorities should consider the differences between the depository and clearing and settlement function of such a system, which international best practices recommend for publicly traded securities, and the registration function that such a system may provide for a broader class of securities, even though central registration is not required by international best practices.

The principal purpose of a central securities depository is to facilitate through the depository the clearing and settlement of publicly traded securities. The Group of Thirty's 1989 Report, which includes nine best practice recommendations for clearing and settlement of securities, explains this function as follows:

“A Central Securities Depository’s (CSD) principal function is to immobilise or dematerialise securities, thereby assuring that the bulk of securities transactions are processed in “book entry” form. The depository system provides the basis for achieving efficient and low-risk securities settlement.”<sup>4</sup>

The Group of Thirty Report also indicates:

“The CSD **may** have the capability for trade clearance, safe custody, and settlement/post settlement processing of securities and information, such as corporate actions and dividend/interest processing.”<sup>5</sup> [Emphasis added]

The above reference to post-settlement processing of securities includes the function of recording a transfer of ownership in an issuer’s register of security holders, either as a result of a settlement of a transaction effected through the CSD or other circumstances, such as issuance of additional securities by the issuer or securities transfers that do not arise from public trading; e.g. transfers arising from gifts or inheritance. This function also may be described as a securities registration function.

Since the Group of Thirty’s 1989 Report, there have been a number of additional best practice recommendations issued by the Group of Thirty and other organizations, such as the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions (hereinafter – CPSS-IOSCO), the International Securities Services Association (ISSA), the Committee on European Securities Regulators (CESR) and the European Central Bank (ECB), regarding clearing and settlement and the operation and regulation of central securities depositories. However, there is still no single, generally accepted international best practice recommendation for the securities registration function regardless of whether securities are dematerialized or exist in physical form.

Some countries have central depository systems that also include a central securities registration function; this appears to be the intent in the Ukraine. Some countries have separate central depositories and central registries. In countries that have central registry functions, practice varies regarding whether shareholders may deal directly with the registry or are required to use intermediaries for such purposes. Many countries do not centralize securities registration. In such countries, companies (usually those that have publicly traded securities) may be required by law or stock exchange regulations to have a register that is separate from the company whereas in others it left up to the company as issuer of the securities to determine whether it will maintain the securities register or use a third party registrar. In countries that provide for both separate and company registers, thresholds vary, usually based upon the number of security holders, as to whether the registers must be separate or may be maintained by the company.

How does this affect Ukraine’s capital market? Ukraine currently has about 200 JSCs whose securities are publicly traded plus a number of issues of corporate and municipal debt securities with limited trading and several publicly traded closed-end investment funds. At a minimum, these are the securities whose immobilization in the central securities depository and whose clearing and settlement via electronic book-entries is the most critical in order to fulfill the clearing and settlement functions of a central securities depository.<sup>6</sup>

However, Ukraine also has approximately 10,000 open and 20,000 closed JSCs, which will soon have to decide whether they wish to become public or private JSCs under the JSC Law, or transform themselves into another form of legal entity not subject to the JSC Law. Even if it is assumed that the number of

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<sup>4</sup> Group of Thirty Report, p. 7.

<sup>5</sup> *Id.*

<sup>6</sup> Ukrainian government securities are not considered for these purposes since these securities are cleared and settled through a separate depository.

JSCs that become public JSCs will be significantly less than 10,000, and even if it is assumed, as recommended below, that only JSCs that are public JSCs or have more than 100 holders of a class of securities should be included in the NDS,<sup>7</sup> it is clear that there will be substantially more JSCs included in the NDS for which the system will have to provide securities registration than the few hundred securities for which the system will be required to provide clearing and settlement.<sup>8</sup>

If Ukraine expects to have an efficient NDS that fulfills both depository and clearing and settlement functions and registration functions, it is essential that Ukrainian authorities recognize and address the significant difference in the number of JSCs whose security holders will benefit from use of each of these functions. In particular, if the securities clearing and settlement function, which should be the system's top priority, is burdened by the costs of a securities registration function, capital market participants will be forced to use an inefficient, high cost system for clearing and settlement.<sup>9</sup>

Neither the JSC Law nor the Depository Law and Dematerialization Regulation recognize this problem. The JSC Law merely provides for dematerialization of all JSC shares without addressing NDS requirements. The Dematerialization Regulation may be read literally to apply to all JSCs. However, because shareholder approval is required for JSCs to dematerialize their shares, the Regulation essentially remains voluntary unless and until the SSMSC takes additional action to make dematerialization mandatory. In this connection, Article 6.1 of the Depository Law provides:

“The State Securities and Stock Market Commission shall adopt lists of securities to be serviced by the NDS.”

However, rather than using this provision to specify JSCs that should be included in the NDS, the SSMSC has simply used this provision to describe the types of securities that may be included in the NDS; e.g. shares, bonds, etc. It is doubtful that this guidance is what is envisioned by Article 6.1.

Under the Draft Depository Law, there is no provision comparable to Article 6.1. It appears that all issuers' securities are to be included in a central securities depository. Potentially, this could mean the securities of nearly 30,000 JSCs.

None of the above alternatives produces a satisfactory result. The Draft Depository Law should be amended so that as adopted it provides that only public JSCs and JSCs with a class of securities (equity or debt) held by more than 100 persons are required to be included in the NDS. Inclusion of all such public JSCs appears warranted as long as JSC Law requires that the shares of all public JSCs must be listed on a stock exchange. However, since the number of JSCs whose securities actually trade publicly will be substantially less (see Recommendation 4 below), the law should provide the SSMSC with authority to specify the number of JSCs within this universe that are required to be included in the depository and clearing and settlement component of the NDS.

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<sup>7</sup> The references throughout this paper to private JSCs or JSCs with no more than 100 securities holders may seem redundant because the JSC Law provides that private JSCs may not have more than 100 shareholders. However, the author is advised that since the JSC Law fails to include enforcement mechanisms to ensure adherence to the no more than 100 shareholder threshold, some JSCs with more than 100 shareholders have already amended their charters to claim that they are private JSCs. Also, it would be possible for a private JSC to make a public offering of securities other than shares, which might be held by more than 100 purposes. Therefore, for purposes of this paper and any statutory or regulatory changes that Ukrainian authorities may decide upon regarding which JSCs should be included in the NDS, it is respectfully suggested that the above wording is advisable.

<sup>8</sup> The CMP understands that of the approximately 14,000 JSCs filing reports with the JSC and holding general meetings, it is estimated that 50-60% do not have more than 100 shareholders. Based upon this estimate, if only JSC's with more than 100 shareholders were included in the NDS, at least 7,000 JSCs still would be subject to the securities registration function of the NDS.

<sup>9</sup> Avoiding unnecessary costs to JSC shareholders is also issue, which is discussed under Recommendations 6, 7 and 8 below.

**2. To accomplish dematerialization and inclusion of dematerialized securities in the NDS, statutory deadlines with sanctions for noncompliance are essential. Dematerialization should not require a shareholder vote in most circumstances. However, rights of holders of physical shares must be protected.**

A plain reading of the JSC Law indicates that it requires dematerialization for the shares of all JSCs by October 29, 2010. However, the JSC Law does not include any sanctions designed to enforce this requirement and it does not address inclusion of dematerialized shares in the NDS. Moreover, the SSMSC, the Ministry of Justice and the State Committee of Ukraine for Regulatory Policy and Entrepreneurship (SCRPE) have compounded this problem by issuing interpretations indicating that existing open and closed JSCs do not have to comply with **any** of the JSC's Law's provisions until they amend their charters.<sup>10</sup> The JSC Law gives JSCs until April 29, 2011 to amend their charters and bylaws to conform to the JSC Law.

If all other provisions of the JSC Law are interpreted as being dependent upon adjustment of charter provisions, it appears that if a JSC that fails to submit adjustment of charter provisions for a shareholder vote, or fails to obtain a three-fourths vote required under the Civil Code to amend the JSC's charter, the dematerialization requirements and other provisions of the JSC Law do not apply to the JSC. In many instances, a controlling shareholder or a group of shareholders with at least 25% voting power will be in a position to block applicability of the JSC Law. In effect, the Ukrainian authorities' interpretation of the JSC Law has transformed it from a law with mandatory requirements and deadlines into to a law that depends on a 75% shareholder consensus in order to be applicable to a JSC.

The Depository Law does not require a shareholder vote in order to dematerialize an issuer's shares. However, in its Dematerialization Regulation, the SSMSC has elected to require a shareholder vote on adoption of a dematerialization resolution before dematerialization may commence. The SSMSC has not stated why it considers a shareholder vote to be necessary. Dematerialization does not change the substantive rights of a holder of securities. It is possible that the SSMSC may be of the opinion that a right to hold physical securities is a right that is part of the terms and conditions of the security and that a shareholder vote is required to change such terms and conditions. This would only be true, however, if the JSC's charter specifies the form of the security that is required.

Moreover, what is being described in the Dematerialization Regulation as dematerialization is, in fact, an immobilization of securities because one global certificate for securities would remain in the NDS.<sup>11</sup> This distinction is explained by CESR and the ECB in their May 2009 "Recommendations for Securities Settlement Systems and Central Counterparties in the European Union" as follows:

"To promote the immobilisation of all certificates of a particular issue, a jurisdiction could encourage the issuance of a global note, which represents the whole issue. A further step away from circulating physical securities is full dematerialisation of a securities issue. In this approach, no global note is issued, as the rights and obligations stem from book entries in an electronic register."<sup>12</sup>

Similarly, the Glossary in the 2001 CPSS-IOSCO Report on Securities Settlement Systems defines dematerialization as "[t]he elimination of physical certificates or documents of title that represent ownership of securities so that securities exist only as accounting records. Whereas, immobilisation is

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<sup>10</sup> SSMSC Clarification No. 8 of July 14, 2009 as amended in line with SSMSC Resolution 712 dated July 21, 2009; Ministry of Justice Interpretation dated October 5, 2009; and SCRPE Letter No. 5224 of July 5, 2009.

<sup>11</sup> Since Article 20.2 simply requires shares to exist in non-documentary form and does not indicate how this is to be accomplished in the context of the NDS, it is impossible to conclude whether the JSC Law envisions dematerialization or immobilization.

<sup>12</sup> P. 46.

defined as “[p]lacement of physical certificates for securities and financial instruments in a central securities depository so that subsequent transfers can be made by book entry, that is, by debits from and credits to holders’ accounts at the depository.”

Accordingly, except in those limited instances where a Ukrainian JSC’s charter may have to be amended because it specifically provides that the JSC’s securities must be in documentary form, there appears to be no reason for requiring a shareholder vote on dematerialization (or immobilization).

The unfortunate consequence of Ukrainian authorities’ interpretation of the JSC Law and the SSMSC’s inclusion of a shareholder vote requirement in the Dematerialization Regulation is that Ukraine is left without a timely and efficient alternative for building the NDS. It could take years (without any assurance of success) to obtain shareholder approval of dematerialization resolutions for even the 200 publicly traded JSCs whose inclusion in the clearing and settlement component of the NDS is critical to encourage in-country trading of these issues.

Other countries wishing to implement dematerialization have used a statutory solution that mandates the result. Ukraine should adopt this approach. This is not a complex matter. All that should be necessary are several brief paragraphs in amendments to the JSC Law or the Draft Depository Law, including a provision that sets a separate deadline for dematerialization regardless of when other provisions of the JSC Law become applicable. The intent of the JSC Law clearly was to make this deadline October 29, 2010. However, since Ukrainian authorities and market participants have spent over a year discussing the problems associated with this deadline and whether dematerialization should apply to all JSCs, it may be appropriate for an amendment to provide for a later deadline. If dematerialization is required only for public JSCs, a delay beyond 2011 seems unnecessary.

While some implementing regulations also will be required, they should be much less cumbersome than the Dematerialization Regulation, which includes many unnecessary procedures. The amendments should address the following points:

- Identify the JSCs that are subject to dematerialization; *i.e.* all JSC that are public JSCs or have a class of securities held by 100 or more persons).<sup>13</sup>
- Specify that these JSC issuers with physical shares, including bearer shares, issued prior to the law becoming effective must dematerialize as of specified date (not later than December 31, 2011) and impose the restrictions described below on any shares in physical form that are being dematerialized effective as of the same date (“dematerialization date”).
- Provide that debt securities issued after the dematerialization date must be in registered, dematerialized form. Over time, maturity will take care of bearer debt securities issued prior to the dematerialization date.
- Specify that the JSC issuer’s decision on dematerialization is to be made by the JSC’s board of directors and does not require shareholder approval except in those instances where the charter of the JSC issuer must be amended because it specifically requires the securities to be in documentary form.
- Require publication of the decision and that copies of the decision are submitted to the SSMSC and the central depository for the NDS.
- Require the JSC issuer to send notice to all the owners of physical shares to hand them in to the central depository through the facilities of the JSC’s registrar, the JSC issuer if there is no registrar, or a securities trader or bank custodian member of the central depository, and specify a deadline for doing so which is at least [30 days] after issuance of the notice and not less than [15 days] before the dematerialization date.

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<sup>13</sup> See Recommendation 8 below, explaining why there may be no practical value in including private JSCs or JSC’s with no more than 100 holders of any class of security in the NDS.

- Provide that the central depository of the NDS shall specify by rules, subject to approval of the SSMSC, the procedure for exchanging physical shares for book-entry shares.
- Provide for a form of global certificate for each dematerialized issue to be submitted to the central depository of the NDS with a copy to the SSMSC for their approval.<sup>14</sup>
- Require registrars for JSCs subject to dematerialization and JSCs subject to dematerialization that do not have separate registrars to submit to the central depository for the NDS certified copies of the JSC's register for shares to be dematerialized, reflecting outstanding ownership of all issued shares in dematerialized form and any shares still in physical form as of the dematerialization date.
- Require JSCs subject to dematerialization that do not have a registrar to appoint a registrar to serve as an interface with the registry component of the NDS.<sup>15</sup>
- Direct the registrars for a JSC issuer to establish electronic linkages with the NDS registry function in accordance with NDS regulations.
- Provide that in the event of any conflict between the records of the JSC's registrar and the electronic registry records of the NDS, the latter shall be controlling.
- Require the JSC's registrar to advise the JSC issuer, each stock exchange on which the shares are admitted to trading and the SSMSC not later than the close of the next working day when the electronic register has been established and of any failure to establish such register within the prescribed deadline.
- Prohibit securities traders the central depository, registrars and JSC issuers from effecting transfers of physical shares after the dematerialization date.
- Provide appropriate penalties and sanctions for failure of the central depository, JSC issuers and registrars to comply with the above deadlines. For example, the SSMSC may fine a JSC issuer an amount ranging from 10% to 100% of the nominal or stated value of the share issue for every month after the deadline that the JSC issuer fails to complete the dematerialization process.
- Provide that no holder of physical shares required to be dematerialized and for which a dematerialization date has been properly established shall have any rights to vote, transfer, convert or exchange the shares or receive dividend payments with respect such documentary securities after the dematerialization date and that it shall be unlawful for the JSC issuer or any other person to permit or facilitate the receipt or exercise of any such rights.<sup>16</sup>
- Provide that the only right of such holder of physical shares after a dematerialization date is the right to tender such securities to the central depository through the facilities of a securities trader or bank custodian member of the central depository or the JSC issuer's registrar (see Recommendation 7) in exchange for an equivalent amount of book-entry shares.
- Prohibit JSC issuers and other persons from delaying or charging such holders for tendering their physical shares to the central depository. Specify appropriate penalties for noncompliance.

The last three bullet points above are extremely important. It is a fundamental pre-condition to exercise of shareholder rights that a shareholder's ownership of shares must be recognized, recorded and protected. Neither the JSC Law nor the Depository Law or Dematerialization Regulation address what

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<sup>14</sup> The number of dematerialized shares covered by a global certificate will increase as more shares are turned in for dematerialization. However, absent an action by the issuer that reduces issued shares, the number of shares represented by the global certificate should not decrease because the JSC Law prohibits further issuance of physical shares.

<sup>15</sup> See Recommendation 7 below.

<sup>16</sup> Upon conversion to dematerialized form, the shareholder's rights would be fully restored. Dividends would continue to be declared by a JSC issuer with respect to all issued shares, but dividend payments would not be made to shareholders who have not turned in their physical shares. Instead, they would be reflected as a liability on the JSC issuer's balance sheet. Because the identity and/or address for a number of JSC-issuers' shareholders may have been lost as a result of the privatization process or for other reasons, it is quite possible that the book-entry shares and any dividends to which such shareholders are entitled will become abandoned property, which should be subject to disposition in accordance with Ukraine's abandoned property laws. The author has not researched such laws in the Ukraine, but notes that the practice in most countries is that if additional efforts to find the shareholder are unsuccessful, the property should be turned over to the state.

happens to the rights of a holder of physical shares after a deadline for dematerialization has passed. For example, Article 1.8 of the Dematerialization Regulation simply provides that shares of a dematerialized issue are not permitted to trade using securities certificates. The Regulation fails to address how the rights of a holder of physical shares are preserved. This is also a matter of some concern because of the Dematerialization Regulation's requirement that shareholders for whom securities accounts have been opened with a securities custodian must reenter into agreements with the custodian at the shareholders' expense. The Regulation does not address what happens if a shareholder fails to do so. Would it be possible, for example, for a custodian having accounts for shareholders who have not reentered into agreements with the custodian to levy charges for maintaining the shareholders' account even though the shareholder has never appeared and agreed to use the account?

**3. The depository and clearing and settlement component of the NDS should be market driven and limited to securities of JSCs that have a realistic possibility of being publicly traded. Private JSCs and/or JSC's with no more than 100 holders of any class of securities should not be included in the depository and clearing and settlement component of the NDS system.**

There are inconsistencies among the Depository Law, the Draft Depository Law and the Dematerialization Regulation regarding how the registration function should be handled. None of these documents sufficiently addresses the issue. For example, while the Depository Law (Articles 1 and 12) envisions that registrars are part of the NDS, the Dematerialization Regulation, which purports to be based upon the Depository Law, eliminates registrars and requires dematerialized share accounts to be established with custodians who must be securities traders or banks licensed for such purposes. The Draft Depository Law clearly envisions that the central depository established under such law would also provide a central registry function, and does not provide for separate registrars. Resolution of these inconsistencies is of critical importance to the development of the NDS.

For reasons explained in more detail under Recommendation 7 below, the SSMSC's proposals under the Dematerialization Regulation are illogical and flawed because they have combined the depository and registry functions. The result is that the custodian banks and securities traders, whose direct participation in a central depository and the NDS is essential for the purpose of efficient clearing and settlement of the securities of a limited number of JSC's that are publicly traded, may eventually be required to take over a securities registration function for thousands of JSCs whose securities have no prospect of ever being publicly traded.

There are two key steps that should be taken to solve this problem. The first step is for Ukrainian authorities to recognize that a central depository of the NDS that is also intended to provide registration services should have two components or divisions because not all JSCs' shareholders included in the system will require both clearing and settlement and registration services. The first division would be a central depository function intended to facilitate efficient clearing and settlement of the limited number of securities of Ukrainian JSCs that may be expected to be publicly traded. The direct participants in the central depository division should be the securities traders and banks that hold dematerialized, publicly traded securities as custodians for their clients. The second division should be a securities registry division. This division should be responsible for electronic registries of a broader group of all public JSCs included in the NDS. However, inputting of entries in the registries should still be done by currently licensed registrars. The cost of these registrars' activities including use of the electronic registry facilities of the NDS should be borne by JSC issuers. A registrar should be considered an agent of the JSC issuer and should be the only party authorized to deal with the central registry division of the NDS on behalf of the JSC issuer or the JSC issuer's security holders. See Recommendation 7 below.

The second step is for Ukrainian authorities to recognize that for nonpublic JSCs, the costs of participating in a central registry may exceed any potential benefits. For example, under current practice it is understood that a JSC issuer that has no more than 150 shareholders is permitted by the SSMSC to

maintain its own share register. It is suggested under Recommendation 8 below that the 150 shareholder limit should be reduced to 100 to conform to the JSC Law. As adjusted, however, there are no good reasons to require nonpublic JSCs to dematerialize their securities or to be part of the NDS because the expenses of doing so are likely to exceed any potential the benefits.

More generally, securities regulators, central depositories and central registries, are intended primarily to provide safeguards for investors in securities of publicly traded and publicly owned JSCs. Involving the NDS and the SSMSC in unnecessary activities relating to nonpublic JSCs will only detract from what should be their mission.

In this regard, the Government of Ukraine's intentions with respect to funding of the NDS should be considered. Paragraph 2 of Chapter V of the Depository Law provides in relevant part that the Cabinet of Ministers of Ukraine shall:

“- envisage expense items, in the current and subsequent national budget programmes, to finance the institution and maintenance of the NDS and provide for monitoring the stock market until both can be placed on a self-accounting footing;”

If the Government is prepared use budgetary revenues to fund the cost of operating the NDS indefinitely until such system can be placed on a self-funding basis, it is possible that notwithstanding how costly operation of the currently proposed system may be, capital market development will not suffer if the high operating costs are not borne by issuers and market participants. However, even if this assumption were plausible in 1997 when the Depository Law was adopted, it seems most implausible in 2010 when Ukraine is in the midst of a very severe macroeconomic crisis.

Fifteen years have elapsed since Ukraine's capital market development began. Even though the results have been less than spectacular, the time has been reached where issuers and market participants should be expected to bear the costs of operating an efficiently structured NDS. Ukrainian authorities should bear in mind that it not the function of a central depository or NDS to provide a national ownership registration function, as some statements by Ukrainian policymakers have suggested. In most countries, central securities depositories, including those that provide registration services, are limited to participation of companies that have a public class of security holders.

**4. Notwithstanding the fact that the JSC Law requires all shares of public JSCs to be listed, experience in neighboring countries indicates that Ukraine should not expect to have more than 500 JSCs with shares that are publicly traded, plus shares of publicly owned closed-end investment funds and corporate and municipal debt securities that were publicly offered. This is the universe of securities for which dematerialization and inclusion in the depository and clearing and settlement component of the NDS is essential.**

Ukraine does not require more than one central securities depository for the clearing and settlement of transactions in corporate equity and debt securities. It is also unrealistic to expect that Ukraine ultimately will have more than 500 share issues of JSCs that will be actively traded on its stock exchanges plus a limited number of corporate and municipal debt issues and shares of closed-end investment funds.<sup>17</sup> While the JSC Law provides that the shares of all public JSCs shall be listed, this will not affect the number of JSCs whose shares are publicly traded. Public trading requires that an issue of securities must be attractive to investors.

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<sup>17</sup> The debt securities may or may not be listed, but they are likely to be traded over-the-counter (OTC) unless one or more of the exchanges can offer a dealer-based trading system that market participants find acceptable for trading of debt securities.

This recommendation is documented by looking at other countries with market development and privatization experiences similar to Ukraine. These include Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Russia, Slovakia and Slovenia. None of the stock exchanges in these countries has more than 500 listed share issues. Poland's Warsaw Stock Exchange, which is the most successful of the exchanges, has less than 400 share listings. Even Russia, which privatized more than 14,000 state-owned enterprises, has less than 400 listed share issues on all of its stock exchanges.

One of the reasons there are a limited number of shares listed on the above exchanges that are in EU member countries is that there are very few companies in these countries that are capable of meeting the rigorous disclosure and financial reporting requirements of EU securities legislation which apply to companies whose shares are admitted to trading on EU "regulated markets" as that term is defined in the EU Markets in Financial Instruments Directive.

This should serve as a counseling point for Ukrainian authorities. By requiring in the JSC Law that all public JSCs must be listed on a stock exchange, and having to lower listing standards to accomplish this result, Ukraine's exchanges may become less likely to qualify as EU regulated markets. Most of the companies listed do not come close to meeting EU disclosure and financial reporting standards. Therefore, the steps that have been taken to require listing of all public companies actually may cause Ukraine to move further away from one of the underlying objectives of the 2006-2010 Action Plan; harmonization with EU securities legislation.

**5. In order to implement international best practices for the depository and clearing and settlement, there should be only one central depository for corporate equity and debt securities, as is currently proposed under the Draft Depository Law.**

Recommendation Three of the Group of Thirty's 1989 Report provides:

"Each country should have an effective and fully developed central securities depository, organized and managed to encourage the broadest possible industry participation (directly and indirectly) in place by 1992."<sup>18</sup>

In explaining this recommendation, the Report indicates:

"Each country should have only one CSD. More than one CSD is acceptable, if a link exists between the entities"

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The rationale for a single central securities depository is that one entity can offer the efficiencies of immobilisation and dematerialisation of physical securities, reliable and simultaneous money and security settlement, and the economies of scale that lead to significant cost reductions. The centralisation of securities data within one CSD also improves operating efficiencies in post-settlement functions for the member/participants and the investing public (by accelerating the payment of dividends, for example).<sup>19</sup>

Subsequently, ISSA augmented the Group of Thirty's references to CSD linkages by providing:

"If several central securities depositories exist in the same market, they should operate under compatible rules and practices with the aim of reducing settlement risk and enabling efficient use of funds and available cross-collateral."<sup>20</sup>

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<sup>18</sup> Group of Thirty Report, p. 7.

<sup>19</sup> *Id.* pp. 51-52.

<sup>20</sup> Group of Thirty and ISSA Recommendations, Annex B, p. 160.

While Ukraine's Draft Depository Law envisions only one central securities depository, the current Depository Law and the Dematerialization Regulation envision that the NDS will include several depositories. NDU was made a part of the upper level of the NDS without the NDU fulfilling any of the requirements that Article 2.1 requires other depositories to fulfill. These are: "keeping accounts for custodians' benefit and making clearing and settlement transactions and payments under securities contracts." Even though the NDU was subsequently licensed by the SSMSC to perform depository and clearing and settlement functions, as a practical matter, the NDU is still not operating under compatible rules and practices with the other licensed depositories.

AUSD was established as the clear depository choice of market participants and has been licensed as a depository by SSMSC. With no more than 200 publicly traded securities issues, and the likelihood that this number will not exceed 500 issues, Ukraine has no need for multiple securities depositories for corporate equity and debt securities. Permitting more than one depository to operate under these circumstances is a disservice to securities market participants in terms of the increased costs that they may incur in having to deal with two or more depositories.

**6. The NDS would be better structured and operate more efficiently with a fairer allocation of costs if the system's securities registration function were a separate component of the system. Under this approach, a broader class of JSCs, many of whose securities will not be publicly traded, would have their registries maintained electronically at the JSCs' expense. Only costs of operating the depository and clearing and settlement component of the system would be borne by market participants (banks and securities traders) who may be expected to recover these costs from investors who trade securities.**

By separating the depository and clearing and settlement and registration functions within the central depository of the NDS, it should be possible to minimize clearing and settlement costs and require these costs to be borne only by market participants who use the system's clearing and settlement function to settle their securities transactions.

The establishment of a separate registration division within the central depository for the NDS should permit a separate allocation of costs of maintaining electronic registries of shareholders for JSCs and performing corporate actions, the costs of which should be borne by the JSCs.

The critical question that remains is how should the registration function of the system be administered? As pointed out under Recommendation 1 above, there is no generally accepted best practice regarding securities registration. Some systems deal directly with shareholders and others deal indirectly by using registrars or other intermediaries or permitting issuers to maintain share registries.

In Ukraine's circumstances, there are currently about 200 JSCs with publicly traded securities whose shareholders have an incentive to hold securities through custodians, which should minimize the number of registry entries for these JSCs. As pointed out under Recommendation 4, this number of publicly traded JSCs is unlikely to grow beyond 500. On the other hand, there may be several thousand JSCs with more than 100 holders of a class of shares or other securities included in the registration component of the system. The many shareholders of JSC's whose securities will not be publicly traded have no incentive to enter into custodian relationships with securities trader or bank custodians as proposed by the Dematerialization Regulation.

**7. The Dematerialization Regulation's requirements that shareholder registers be transferred from registrars to securities custodians and that shareholders enter into individual account agreements with custodians at the shareholders' expense are conceptually flawed and should be changed. When many JSCs will be part of the NDS, even though there is no public trading in their securities, it is both illogical and unfair to expect the shareholders of such JSCs to incur**

**the trouble and expense of entering into agreements with a securities custodian as required by the Dematerialization Regulation when such shareholders have no need for a securities custodian. A more logical solution, given what has already taken place in Ukraine, is to require publicly owned JSCs to have their security holder registers kept in electronic form at the NDS but to permit registrars that are currently authorized to perform registrar functions to serve as the single point of input for entries into the electronic registers.**

It is logical to assume that most holders of JSC securities for which it is realistic to expect public trading may wish to have these securities held by a securities custodian that is a bank or securities trader who will be involved on their behalf in the trading process. It is not logical or necessary to require holders of JSC securities that may not be expected to be publicly traded to have these securities held by a custodian at the holder's expense. The Dematerialization Regulation's requirements that shareholder registers be transferred from registrars to securities custodians and that shareholders reenter into individual account agreements with custodians at the shareholders' expense are conceptually flawed and should be abandoned because they have mistakenly combined the depository and registry functions as part of the dematerialization process. The result is that the custodian banks and securities traders, whose direct participation in a central depository is essential for the purpose of efficient clearing and settlement of the securities of a limited number of JSC's that are publicly traded, may eventually be required to take over a securities registration function for thousands of JSCs whose securities have no prospect of being publicly traded.

The SSMSC has overlooked that the primary motivation of securities traders and banks to serve as custodians for publicly traded securities is that such custodianship facilitates their involvement in the secondary trading process. Securities traders and banks receive commissions for handling trades for the persons whose securities are in their custody and banks receive compensation for serving as custodians for the shares of institutional investors, such as investment and pension funds. In such capacities, banks and securities traders normally would provide securities custodianship services only for shareholders with whom they have a customer relationship. This does not include all of the shareholders of a JSC.

While it is certainly possible for banks and securities traders to undertake a securities registration function, normally they would not do so as part of the above-described custody function.<sup>21</sup> For these reasons, it is unlikely that banks and securities traders will find it attractive as part of the custodianship they provide to facilitate clearing and settlement to take on a registration function for potentially thousands of JSCs for whom there will not be any trading or clearing and settlement. It is also unlikely that shareholders of JSC's whose securities are not publicly traded will find it attractive to enter into accounts at the shareholders' expense with these custodian when they have no need for the secondary trading services of the custodian.

The currently proposed method of implementing dematerialization and establishing the NDS is likely to result in both unnecessary costs and an inequitable allocation of costs among market participants, which will have adverse effects on Ukrainian capital market development. In order to appreciate why this is the case, it is essential to understand that the costs of using the depository for clearing and settling securities transactions are an important component of the transaction costs incurred by market participants.<sup>22</sup> If the transaction costs of using a particular market are high, investors will take this into consideration in determining whether the market offers attractive investment opportunities.

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<sup>21</sup> In many countries, banks provide a securities registration function, but normally this is not part of their custody business. It is a separate function where they serve as authorized registrars or transfer agents.

<sup>22</sup> Transaction costs also include commissions on brokerage transactions or markups and markdowns on dealer transactions, stock exchange transaction fees, and, in some cases, governmental transfer taxes. In some markets, clearing and settlement costs for using the clearing and settlement facilities of a securities depository are included in broker-dealers' transaction costs charged to clients and the broker-dealer pays the central depository's charges. In some markets, the clearing and settlement charges of the depository are shown separately on the confirmation or contract notes of the trade, and the broker-dealer

Normally, the introduction of a central securities depository to facilitate clearing and settlement of securities transactions may be expected to add efficiencies and reduce the clearing and settlement component of transaction costs. However, this is unlikely to be the result with Ukraine's NDS as it is currently envisioned under the Dematerialization Regulation because Ukrainian authorities have introduced into the system the costs of maintaining share registries for thousands of JSC's whose shares will not be publicly traded and they have not taken into consideration how those costs should be fairly allocated in order to avoid excess transaction costs being incurred by market participants.

The normal practice in most securities markets is that the costs of maintaining a share register should be borne by the issuer, regardless of whether the register is maintained in a central depository system, with a separate registrar or directly by the issuer. This is not to say that individual shareholder may not be charged separately for a specific registry service.

However, Section 1.9 provides:

“Securities accounts are opened and maintained, shares in these accounts are kept at the expense of the issuer until the agreement on opening a securities account is reentered by and between the securities owner and the custodian.”

The purpose of this costly, burdensome and seemingly redundant second step is not readily apparent. As pointed out under Recommendation 2 above, dematerialization is not a process that can be accomplished in a timely and effective manner on a voluntary basis.

It is respectfully suggested that the dematerialization steps envisioned by Section 1.9 and Chapter 5 of the Dematerialization Regulation will not work for the large number of JSCs whose securities will not be publicly traded and whose shareholders will have no incentive to reenter into accounts with a custodian that they do not need. Indeed, no dematerialization process that expects shareholders to bear the costs is likely to be workable. The costs of dematerialization and maintaining registries of shareholders under the registration function of the NDS should be borne by JSCs, not by the JSC's shareholders.

A more logical solution, given what has already taken place in Ukraine, is not to abandon the current registrar system but to strengthen it by establishing additional safeguards. All JSCs with a class of securities held by more than 100 persons should be required to have a security holder register for these securities maintained in electronic form in the NDS system. This electronic register should be controlling with respect to determination of securities ownership. However, in lieu of the custodians proposed under the Dematerialization Regulation, each JSC subject to this requirement should be permitted to designate a registrar currently licensed under the securities law to serve as the central point of input for all entries made in the electronic register. The registrars should be required to enter into a standard form contract with JSC issuers who should bear the registrar's and other expenses of maintaining the register; for example, obtaining a list of shareholders from the register in order to hold a general meeting or to pay dividends. Under this approach the problem of requiring individual shareholders of JSCs to contract separately with a securities custodian is avoided.

While there have been shareholder abuses under the current registrar system, under an enhanced system of electronic registers in the NDS system, it should be possible to minimize the potential for abuse. For example:

- Duplicate or pocket registers would be prohibited;
- The JSC's registrar would be required to establish an electronic linkage with the NDS so there would be an electronic audit trail for all entries in the register;

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simply collects these charges from its clients and pays them to depository. In either case, the costs of using the depository for clearing and settling a securities transaction are ultimately borne by the client.

- Other registrar procedures, including documentation requirements and contracts with JSC issuers would be standardized;
- The ability to oversee the registration process by a limited registry division staff at the central depository within the NDS, and by the SSMSC would be strengthened.

**8. In determining which securities should be dematerialized and included in the registration component of the NDS, Ukrainian authorities should make a distinction between public and nonpublic companies. It is likely that the costs of requiring private JSCs with no more than 100 holders of a class of securities to dematerialize their shares and participate in the NDS may outweigh any potential benefits. However, instead of the no more than 150 shareholder limit that the SSMSC now requires for JSCs that wish maintain their own share registries, a more logical limit would be no more than 100 shareholders, as used for private JSCs in the JSC Law.**

At present it is understood that the SSMSC does not require JSCs with less than 150 shareholders to have a separate registrar. It would appear that the rationale for not requiring a separate registrar also should carry over to not requiring such JSCs to include their securities in the NDS because the costs of doing so may exceed the benefits.

However, it would make sense to reduce the 150 threshold to 100 so that it would correspond to Article 5.1 of the JSC Law, which provides that a private JSC may have no more than 100 shareholders. In this way, all private JSCs and JSCs with no more than 100 security holders of any class of securities would all be excluded from the NDS and all public JSCs and JSCs with a class of securities held by more than 100 persons would be included in the NDS.<sup>23</sup> The use of the private vs. public distinction for NDS purposes also makes sense because many private JSCs may elect to avail themselves of Article 7.2 of the JSC Law which would permit the private JSC's charter to provide the JSC and other shareholders with a preemptive right of first refusal to purchase the shares of any shareholder wishing to sell his shares. This would further minimize the need to have a share register included in the NDS for private JSCs.

**9. It is possible to provide by law for conversion of physical bearer shares into a book-entry form.**

As pointed out under Recommendation 2 above, all that is required is an article in a law providing that after a specified date, the holder of bearer shares shall not be entitled to exercise any shareholder rights or receive any of the benefits of security ownership (e.g. dividends) until such time as the holder tenders the bearer shares in exchange for an equivalent number of registered, book-entry shares.

Use of bearer securities is a bad practice, which should be eliminated as soon as possible in the case of bearer shares and prospectively in the case of bearer debt securities. Bearer securities increase the risk of loss and counterfeiting and are often used to evade taxes. Moreover as a member of IOSCO, the SSMSC has an obligation to use its best efforts to become a signatory to the IOSCO Multilateral Memorandum of Understanding on enforcement cooperation not later than 2010. One of the requirements of that MMOU is the ability to identify all beneficial holders of securities.

### **III. Conclusion**

None of Ukraine's current proposals to dematerialize shares and create the NDS have a sound legal basis that will result in the timely creation of a sound and cost-effective a system that will meet the needs of capital markets participants. Several of the current proposals also do not reflect international best practices in the creation, operation and regulation of a central securities depository. Ukrainian authorities should consider the recommendations in this memorandum if they wish to fix these problems.

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<sup>23</sup> See note 8 above regarding the reasons for using this terminology.