



Capital Markets Project

CAPACITY OF UKRAINIAN CAPITAL MARKETS SROS TO EXERCISE SELF-REGULATORY FUNCTIONS SUBJECT TO REGULATORY OVERSIGHT

Prepared by

**Robert D. Strahota
Theodore W. Urban**

**Senior Capital Markets Specialists
Financial Markets International, Inc.
USAID Capital Markets Project
Kiev, Ukraine**

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I. Introduction

This report has been prepared in response to the following deliverable in our scope of work (SOW):

“White paper on recommendations for delegation of SRO enforcement and compliance authority by SSMSC with programs for effective oversight and sanctions, including withdrawal of SRO license.”

The report would not have been possible without the input received from the persons we interviewed. They are listed in Appendix A. We extend special thanks to them and to the CMP team in Kiev, particularly: CMP chief of party Ann Wallace; Victor Stetsenko; Oksana Gritsay, Alexei Kanikevich, Volodymyr Deyneka and the rest of the translation team; Natasha Lozitskaya, Tatiana Kotukhova, Sophie Lambroschini and Marina Kuligina. Their assistance was indispensable and their hospitality was outstanding.

II. Current SRO Landscape

Since Mr. Strahota’s 2007 report and recommendations for development of Ukrainian capital market SROs,¹ the following significant developments have occurred:

1. The SSMSC adopted Resolution 2411 dated December 27, 2007 on Regulation of Self-Regulatory Organizations of Stock Market Professional Participants.²
2. In May 2009, the SSMSC approved the Ukrainian Association of Investment Businesses (UAIB), the Professional Association of Registrars and Depositories (PARD) and the Association of Ukrainian Stock Traders (AUST) as the sole member SROs for asset managers, registrars and custodians, and securities traders (broker-dealers), respectively. The Commission’s orders provide that professional stock market participants (PSMPs) in each of these categories who are not members of these SROs have 60 days from the date of the SSMSC’s orders to become members.
3. The new Ukrainian Law on Joint Stock Companies establishes a two-year deadline for all securities to be dematerialized and included in a central securities depository.³ This change will significantly reduce the need for separate securities registrars and will have an effect on PARD, whose membership includes registrars and securities custodians.

¹ Robert D. Strahota, “Report and Recommendations for Development, Operation and Regulatory Oversight of Self-Regulatory Organizations in the Ukrainian Capital Market (June 15, 2007) (hereinafter – 2007 SRO Report).

² Since the SRO regulation has now been finalized by the SSMSC, we are not providing comments on it. However, we have described the regulation under “SSMSC Resolution 2411” below.

³ See Articles 20(2), 23(4), 35(1) and Chapter XVII, paragraph one.

4. The Financial Services Regulator (FSR) has now recognized two voluntary SROs, one for pension funds and administrators, and a new one for administrators. The new management of the FSR is considering a separate licensing requirement for asset managers of pension funds.
5. On June 30, SSMSC Commissioner Vladimir Petrenko advised us that as of a result of a reorganization of responsibilities among commissioners, Commissioner Oleg Mozgoviy, who has been reappointed to the SSMSC, will take over responsibility SRO regulation.

We discuss each of the first four developments below.

III. SSMSC Resolution 2411 – Regulation of SROs for PSMPs

The new regulation implements previous authorizing legislation enacted in 2006 directed to the formation of SROs and defining their jurisdiction and authority. In particular, Article I, General Provisions, adopts the legislative principle of: “one SRO for every type of professional activity on the securities market. Such an SRO shall unite over 50% of professional stock market participants in one type of professional activity, other than stock exchanges and depositories.” The provision implements the principle of one SRO for each professional category of industry participant.

While the regulation does not explicitly address the question of whether a securities professional that engages in more than one “type of professional activity” (e.g., securities trading and custodian) must become a member of the unifying SRO for each such activity, Commissioner Petrenko advised us in a meeting on June 30 that such was the intent and requirement of the regulation. He stated that, for example, if a PSMP licensed as both a trader and a custodian joined the traders’ SRO, but did not join the unifying registrar and custodian SRO for depositary activities, it could not continue to function as a custodian.

Article II of the Resolution articulates the Commission functions delegable to SROs as authorized by Article 49 of the 2006 Law, including among the more significant items, the adoption of an Ethics Code and supervising members’ compliance with the Code, establishing requirements for professional qualifications of members’ specialists, implementing mechanisms of resolving disputes among members and among members and their clients (arbitration), and to facilitate investor protection.

Article III establishes criteria and procedures for the Commission’s approval (for a Certificate term of five years) of an application for designation as an SRO. The most significant of such criteria, which on the whole are not particularly rigorous, is a requirement of “sufficient resources” for the SRO to “comply with its statutory commitments, *i.e.*, having assets worth at least UAH 600,000.” The Commission may refuse to issue a certificate if the applicant SRO’s documents and data submitted fail to comply with the Regulation and legislation, are unreliable, upon the presence of valid complaints about the SRO from registered persons, or the resources noted above are insufficient. Certificates may be extended beyond five years upon a similar review process before the expiration of the initial and subsequent terms of the Certificate.

Article IV sets forth the rights and obligations of an SRO, including specific requirements detailing operational and governance information to be filed by each SRO quarterly with the Commission. Article V establishes standards for SRO Bylaws, including both affirmative requirements for inclusion (e.g., membership admission and termination procedures, an ethics code, procedures for member dispute resolution and discipline) and prohibition (e.g., non-discrimination in members' rights or the rights of their clients, inappropriate limitations upon competition among members). Article V also requires SRO Bylaws to provide for sanctions for violation of the Bylaws, citing warnings, temporary suspension, and termination of membership among the permissible sanctions. Presumably, the authority to levy fines for misconduct is included within this wide range of explicitly recognized penalties.

Article VI reiterates the obligation of SROs to accept member applicants who have met the requirements set forth in previous Articles, and Article VII details the procedural requirements which the Commission has adopted for review and determination upon SRO initial applications for certification and subsequent amendments to the SRO's Charter or Bylaws. Article VII also includes grounds for refusal to grant a certificate or approve amendments, including inconsistency with the enabling legislation and violation of SRO member rights.

The remainder of the regulation largely sets forth procedural requirements for various actions of the Commission. The primary exception is Article XII, which defines the Commission's authority to regulate and control SRO activities. These include, among others, Commission rights to participate in SRO Board and general membership meetings, inspect and audit SRO operations, offer candidates for managerial positions at SRO governing bodies, consider complaints of stock market participants about refusal to admit or sanctions imposed, and to warn or sanction the SRO for violations of the legislation or the SRO's Charter or Bylaws.

While the finalization of the SSMSC's Regulation for SROs of PSMPs represents a step forward, for the reasons explained in the 2007 SRO Report, the SSMSC's regulatory oversight framework is not fully compliant with international best practices set forth in Principle 7 of the IOSCO Objectives and Principles of Securities Regulation. The regulation does not provide for an SRO being able to apply its rules, including disciplinary procedures, to associated persons of the SRO's members. Also, the regulation does not authorize SROs to levy monetary penalties on associated persons of their members. Alternative recommendations for solving these two problems were discussed extensively in the 2007 SRO Report and need not be repeated in this report.

IV. Sole Membership SROs for PSMPs

A. UAIB

In the 2007 SRO Report, it was indicated that of the three principal PSPM SROs, UAIB appeared to have the resources and capacity that came closest to matching the SRO authority that an institutional asset manager SRO might be expected to undertake. UAIB appears to have utilized its resources effectively and has made progress in the development and exercise of its SRO capabilities. While we did not conduct any independent assessment of UAIB's performance as part of our

engagement, we met with UAIB's General Manager and discussed their progress over the last two years as well as his view of prospects for the future. The following summarizes the information provided to us by UAIB.

UAIB has a planned annual budget of approximately \$900,000, and a staff of 17. They exercise SRO responsibilities over 1250 funds and 400 asset managers. UAIB's website indicates that, as of year-end 2008, their asset manager members had UAH 4.168 billion of non-venture fund assets under management, with 72% of that amount managed by the top seven member managers. UAIB indicated that prior to their certification as the sole asset manager SRO, they would have been prepared to move beyond pre-certification activities and accept regulatory responsibilities for licensing and certification of members and certified professionals. However, the recent influx of new members as a result of Resolution 2411 causes them to believe that they are not yet prepared to take on these additional SRO responsibilities, although it remains their intent to do so in the future. We believe this would be a logical extension of UAIB's functions.

In our discussions with UAIB, they also indicated that they had been exercising a number of the anticipated responsibilities of an SRO. They recently had excluded eight funds from membership because these funds were unable or unwilling to file required information with UAIB. These determinations were made by the UAIB Disciplinary Committee, and approved by the eleven-member Board, in accordance with their internal governance procedures. UAIB also noted that its Disciplinary Committee serves as its Arbitration Committee. UAIB also appears to be making progress in recognizing appropriate measures of investment performance. They demonstrated familiarity with issues related to performance and noted that they are seeking membership in the European Federation of Asset Managers Association (EFAMA) and are implementing the AIMR's Global Investment Performance Standards (GIPS).

The self-regulatory responsibilities we would expect UAIB to continue and/or to undertake, subject to delegation from SSMSC or exercise of contractual authority under membership agreements are:

- Pre-qualification and certification requirements for member firms applicants and associated persons;
- Qualification, examination, training and continuing education of associated persons of licensed member firms;
- Ethical principles and codes of conduct, that apply to member firms and their associated persons, including provisions regarding sales practices, advertising and dealings with public investors;
- Establishing portfolio performance measurement standards;⁴
- Prudential rules applicable to member firms that may exceed but are not inconsistent with regulatory requirements;

⁴ As pointed out in the 2007 Report, there may be some tension in this area between standards that are appropriate for asset managers of portfolios of publicly traded securities vs. asset managers for real estate and venture capital funds, which are also included in UAIB's membership.

- Arbitration or similar dispute resolution mechanisms for disputes between member firms, and between member firms or associated persons and member firm customers;
- Administration of a disciplinary process applicable to member firms and associated persons.

In summary, UAIB appears to have a membership base and sufficient funding to serve as a viable SRO for asset managers, and as it digests the influx of new members, should have the capabilities to accept a legislative or regulatory expansion of its SRO jurisdiction to pension fund managers. Since it is logical to expect most asset managers of investment funds also to be asset managers for non-state pension funds, and to have common self-regulatory interests, it is logical that UAIB also should serve as the SRO for asset managers of pension funds. See discussion in Section VI below.

Our schedule did not permit us to meet with UAIB to see what changes, if any, UAIB has made in its governing instruments in response to the comments on those instruments that were included in the 2007 SRO Report. This should be done at the outset of any additional assistance to UAIB. UAIB did indicate that in lieu of prior plans to establish its own tertiary court, it intends to rely on PARD's tertiary court.

B. PARD

In the 2007 SRO Report, PARD's organization, fee structure and budget (then \$160,000) were discussed. It was indicated that PARD had 15 employees and several regional affiliates. At present, PARD has 360 registrar members and 260 custodian members.

It was also indicated in the 2007 SRO Report that even if there were a consolidation of registrars under PARD as the sole depository SRO, and PARD were able to raise its fees somewhat, PARD would still have a very limited budget to support SRO functions. Now that PARD has been granted sole SRO status, thereby eliminating a "rogue" SRO that served as a haven for registrars not interested in self-regulation, PARD is in a better position structurally to perform SRO functions. However, given the limited profitability of registrars, PARD's budget will not grow substantially to enable it to take on extensive self-regulatory functions. Indeed, for the reasons discussed in Section V below, the number of Ukrainian registrars is likely to decline with adverse effects on PARD's budget.

Subject to the above limitations, and subject to delegation from SSMSC or exercise of contractual authority under membership agreements, PARD should have the capacity to exercise the following SRO functions:

- Prequalification and certification, training and continuing education of members and associated persons;
- Promoting uniform securities registration procedures and forms;
- Implementing an ethics code that requires, among other thing, adherence by members and associated persons to such uniform procedures; and
- Administering a disciplinary function whereby members and associated persons may be sanctioned for violations of the ethics code.

Our schedule did not permit us to meet with PARD to see what changes, if any, PARD has made in its governing instruments in response to the comments on those instruments that were included in the 2007 SRO Report. This should be done at the outset of any additional assistance to UAIB. As noted in the 2007 SRO Report, PARD should have a code of ethics covering securities transactions for its staff.

In the 2007 SRO report, it was stated at page 37:

[I]t should be noted that despite evidence of problems in the registrar industry, including the maintenance of double registries and elimination of names from some registries, neither PARD nor APSM have ever referred such violations to the SSMSC for enforcement action. This is an issue that needs to be explored more broadly, including whether current legislation is sufficient to provide remedies for registrar violations.

Now that PARD has achieved sole SRO status and the risk that enforcement of registrar requirements would result in registrar defections to APSM has been eliminated, it would seem incumbent on PARD to demonstrate that PARD is capable of and willing to address the above registrar industry problems. This also should be a starting point in considering ongoing assistance.

C. A UST

Our discussion and recommendations for assistance to AUST are set forth below in Section VII.B

V. Effect of Law on Joint Stock Companies' Securities Dematerialization and Depository Requirements on Registrar Industry and PARD

As discussed elsewhere in this report, we recommend that USAID and the CMP support PARD's activities. Note, however, that PARD's membership, which currently includes 350 registrars, is likely to be affected in the future by the Law on Joint Stock Companies requirements that all securities be dematerialized in a securities depository by October 2010. Under Ukrainian law, registrars are authorized to provide services only with respect to securities in physical certificate form. Therefore, unless the law is changed, Ukrainian registrars will become unnecessary. The loss of registrar members could have significant adverse effects on PARD's budget, which is modest even under current membership conditions.

Even without the changes related to dematerialization, the President of PARD expects that the number of registrars in the market will decline to about 150-200 due to consolidation. He is optimistic that some of the registrars may be able to convert to providing custodianship services. Our view is that an increase in the number of firms providing custodianship services is not a development that requires USAID or CMP support. Indeed, a more logical progression as a market develops would be a consolidation of custodianship (and securities trader) services among a smaller number of larger, financially sound firms. Nevertheless, it is appropriate to let natural market forces determine the number of registrars and custodians in the market, subject, of course to their ability to comply with sound regulatory standards.

VI. Pension-related SROs and Proposed FSR Licensing of Pension Fund Asset Managers

At the CMPs request, we met with representatives of a second pension administrators SRO that has been approved by FSR. In 2007, Mr. Strahota met with representatives of UA APF, the first pension SRO, which includes pension funds and administrators. As noted in the 2007 SRO Report, membership in pension SROs is voluntary and the Law on Financial Services and State Regulation of Financial Services Markets (Financial Services Law) does not prescribe any standards for designation or regulatory oversight of SROs.

We must point out that we are securities law experts, not pension reform specialists. Nevertheless, after being briefed on the structure of private pension funds in the Ukraine, including the functions of administrators, considering the voluntary nature of these two alleged SROs, and the absence of any self-regulatory standards in the Financial Services Law, we do not see any necessity for an SRO for pension fund administrators or pension funds, or any reason for the CMP or USAID to support these organizations financially on the premise that they perform self-regulatory functions. While the work of pension administrators requires certain technical competencies, this is true of many vocations that do not have membership SROs. The work of pension administrators is also largely ministerial and appears to involve very little discretion, interaction among administrators, or dealings with the public that would necessitate invoking the type of self-regulatory principles that are expected of capital markets SROs.

We recognize that there may be some value in having a voluntary professional association of pension fund administrators with a code of ethics and, perhaps, a set of common professional standards to the extent that these are not already prescribed by Ukrainian pension regulations. However, this activity by itself, without any realistic government oversight being performed by the FSR, does not warrant characterizing such an association as an SRO with self-regulatory responsibilities. Whether USAID and the CMP should support such a professional association is obviously their call. Our recommendation is not to do so and to leave it up to the administrators to form their own association with their own funding. When one looks at the significant fees administrators are receiving for their services and the paltry amounts they are willing to contribute to their own “alleged” SROs, this hardly makes a convincing case for use of scarce USAID resources to support a professional association.⁵

We also hope that the FSR does not proceed with its plans to require a separate license for pension fund asset managers. Frankly, there is nothing involved in

⁵ Although we are not pension reform specialists, we both have experience with general principles of asset management in the United States and other countries, and Mr. Urban serves as Vice Chairman of the Board of Investment Trustees of a public employees’ pension fund which manages \$1 billion of assets. We point out that the fee of up to 6% of contributions per year that pension fund administrators are entitled to receive seems extraordinarily high. When added to the fees of pension fund asset managers and custodians, it raises a serious question whether a pension fund system that normally would be expected to invest conservatively in assets allocated appropriately to match anticipated fund liabilities (generally comprised substantially of fixed income investments), is capable of producing positive returns for pension beneficiaries given the fee burden. Normally, we would expect a fee for the type of services that an administrator provides to be less than 1% of contributions per year.

pension fund asset management that significantly differentiates it from investment fund management or other portfolio management. Note, for example, that the EU UCITS Directive, as amended, recognizes as a derogation from the requirement that management companies of UCITS should not be involved in other businesses that:

“Member States may authorise management companies to provide, in addition to the management of unit trusts/common funds and of investment companies, the following services:

(a) management of portfolios of investments, including those owned by pension funds, in accordance with mandates given by investors on a discretionary, client-by-client basis, where such portfolios include one or more of the instruments listed in Section B of the Annex to the ISD,---”.⁶

Although we did not have an opportunity to discuss this new licensing proposal directly with FSR, we were advised that the concern is that pension fund performed poorly during the recent economic downturn. We respectfully suggest that a separate licensing requirement will do nothing to address this problem. Asset managers around the world performed poorly during the recent economic downturn. What the FSR’s proposal is likely to do is simply exacerbate what is already a very burdensome cost structure for operation of Ukrainian pension funds. We recommend that USAID and the CMP oppose separate licensing. Moreover, even if separate licensing is adopted, we believe that pension fund asset managers belong in the UAIB sole SRO for asset managers. Accordingly, we recommend against providing any support for a separate pension asset manager SRO.

VII. Recommended Next Steps

A. Overall Strategy

Going forward, we recommend that USAID and the CMP focus the SRO-related part of their capital markets strategy on development of a sound securities trader SRO. A key part of this strategy should be the encouragement and support of initiatives designed to reduce the number of licensed securities traders (to less than 500) and the number of licensed stock exchanges and trade organizers so that the Ukrainian capital market consolidates into a market where transactions take place on a limited number (e.g. 2-3) exchanges and are cleared and settled through a single, non-government owned, central securities depository operating on an internationally accepted settlement cycle (e.g. DVP at no later than T+3).⁷ Unless these goals remain foremost in the capital markets strategy, very little of the other capital markets initiatives being undertaken will produce significant benefits to investors and market participants.

⁶ Consolidated version of Council Directive 85/611/EEC (20, December 1985), Article 5.3.

⁷ We recognize, of course, that foreign exchange, currency controls, tax issues and to some extent, government corruption, continue to frustrate achievement of these goals. After nearly 15 years of Ukrainian capital markets, these problems remain unresolved. We do not address them in more detail because they are beyond our SOW.

B. AUST Securities Trader SRO- Next Steps

AUST is the “new kid on the block.” Many persons were surprised that it has succeeded in gaining representation of more than 50% of the licensed securities traders (currently 530 members out of 798 licensed traders on the SSMSC register).⁸ This is a noteworthy milestone in Ukrainian capital market development. As explained in the 2007 SRO Report, a securities trader SRO is the most important of the three PSMP member SROs because of the greater degree of interaction that takes place among securities traders compared to other PSMPs and the greater degree of interaction between securities traders and public investors.⁹ Therefore, USAID and CMP efforts should be focused on nurturing the development of this SRO.

We are encouraged by a number of elements of the AUST strategy explained by its President, Mr. Antonov. For example, AUST is the only one of the three PSMP SROs that has recognized the importance of an SRO exercising self regulation of associated persons of member firms as well as the member firms themselves.¹⁰ AUST also recognizes the importance of encouraging electronic communications among members and between members and the SRO and SSMSC.¹¹ Finally, AUST appears willing to take over licensing and registration and register maintenance of securities traders and associated persons if the SSMSC will permit it to do so.

Before any of these or other AUST initiatives are supported by USAID and the CMP, it is essential to review AUST’s governing instruments and governance structure to ensure that they ensure a fair representation of AUST membership on the AUST board of directors and committees, and that conflicts of interest are not present within permanent staff of AUST due, for example, to outside business interests. For example, a number of comments regarding charter provisions and governance were raised by members at AUST’s July 2nd special general meeting.¹² Among these comments, it was suggested that separate persons should serve as President and Chairman of the Board, that a board of directors of seven persons was too small to be representative of different types of members, and that a classified board with one-

⁸ In the 2007 SRO Report, it was indicated that PFTS appeared to be the only logical candidate to become the sole securities trader SRO. In our meeting with PFTS President Irina Zarya during this assignment, Ms. Zarya indicated that although PFTS security trader members now number over 300, the PFTS Board decided not to seek the approximately 100 additional members that would be required to represent more than 50% of licensed securities traders because it did not appear in the PFTS Exchange’s interests to do so. One advantage of AUST becoming the sole securities trader SRO is that it obviates the need to address a number of difficult governance issues that would have been present if PFTS had become the sole trader SRO while still owning the PFTS Exchange.

⁹ The United States and many other developed and developing markets do not have asset manager SROs or registrar and custodian SROs.

¹⁰ The importance of this point is discussed at length in the 2007 SRO Report, including the means of achievement through delegation of authority from the SSMSC or contractual agreement with member firms. The SSMSC did not accept the CMP’s recommendations to include authority over associated persons in its final SRO regulation (Resolution 2411) probably due to the belief that the SSMSC lacked authority to do so. However, in our June 30 meeting with Commissioner Petrenko, he suggested that there have been recent legislative changes that broaden the SSMSC’s authority regarding individuals employed by PSMPs.

¹¹ While this strategy, as outlined by Mr. Antonov, relates to securities trader reporting, if it is accepted in principle by the members of AUST and the SSMSC, we believe it should follow logically that the AUST membership should be supportive of the electronic disclosure system developed by the SSMSC, which is currently stalled before the SSMSC.

¹² As of the date of this report, we have not learned the outcome of the meeting.

third of the members elected annually for three-year terms might be preferable to electing all directors once every two years.

Although not raised by members, at least during the part of the AUST meeting we attended, we have concerns about who will be the permanent staff of AUST, including the role of President, and whether these persons will be prohibited from having any other employment or business. This should be the best practice standard with respect to the permanent staff of any SRO. On the other hand, the board of directors of AUST should be expected to be comprised of securities traders. Any potential conflicts between individual directors' business interests and their role as directors may be resolved by their recusal from participation in these matters. If a transaction is proposed between AUST and a director or a party in which a director has an interest, the transaction should be approved by a disinterested majority of AUST's board or by the members.

Unfortunately, AUST did not seek CMP assistance regarding review of its proposed governing instruments or governance structure. Also, it appears that this information was not made available to AUST members sufficiently in advance of the July 2 special general meeting for them to raise objections in advance of the meeting. Regardless of what was ultimately agreed at the July 2 meeting, we recommend as a first step and precondition to assistance for AUST that an agreement be reached with AUST that the CMP should review its governing instruments and governance structure for consistency with international best practices in SRO governance, and that CMP issue a report that would be made available to AUST members recommending any necessary changes in this area.

Once these governance and potential conflict of interest concerns are resolved, assistance might be provided to AUST with respect to AUST performing the following self-regulatory functions, subject to delegation of authority from the SSMSC or through the contractual provisions of membership agreements:

- Pre-qualification and certification requirements for member firms applicants and associated persons;
- Qualification, examination, training and continuing education of associated persons of licensed member firms;
- Ethical principles and codes of conduct, that apply to member firms and their associated persons, including provisions regarding sales practices, advertising and dealing with public investors;
- Prudential rules applicable to member firms that may exceed but are not inconsistent with regulatory requirements;
- Arbitration or similar dispute resolution mechanisms for disputes between member firms, and between member firms or associated persons and member firm customers;
- Administration of a disciplinary process applicable to member firms and associated persons.

C. Assistance and evaluation of PFTS Exchange

The 2006 Law and regulations of the SSMSC establish largely parallel regulatory functions and responsibilities for both stock exchanges and the sole securities trader

SRO. Notwithstanding these parallel functions and responsibilities, stock exchanges are not recognized under the 2006 Law and regulations as SROs, and the lack of such recognition creates uncertainty as to the responsibility of the exchanges to regulate both direct trading on their floors or through their trading systems and the parties which engage in such trading or who have the client relationships with parties initiating such trades. This lack of clarity may at times impede cooperation or appropriate allocation of investigatory or disciplinary responsibility between SROs and exchanges. The formal designation of exchanges as SROs or, alternatively, legislative or regulatory action to clarify such exchange responsibilities would strengthen the regulatory capabilities of both exchanges and SROs in this area.

The role of stock traders (broker-dealers) is central to the securities markets in the Ukraine, with activities of stock traders relating directly to clients, asset managers, custodians and depositories, in addition to their participation in trading on stock exchanges. Consistent with the discussion above, these activities currently place the greatest regulatory responsibilities upon PFTS as the predominant, established stock exchange at the hub of trading. With the emergence of AUST as the sole stock trader SRO, more of those responsibilities will fall upon AUST or have to be shared with PFTS by AUST. Given the importance of stock traders who are members of PFTS to the further development of Ukrainian capital markets,¹³ we believe it is important to assess the performance of PFTS to date, particularly in the areas of governance structure; management's performance in exercising its regulatory responsibilities; and the exchange's exercise of its market surveillance, trading practices, investigatory, enforcement and disciplinary responsibilities.¹⁴ As AUST emerges as a stock trader SRO, a similar assessment of its capabilities would be appropriate, particularly in the coordination of its SRO responsibilities with PFTS.

D. Assistance to Central Securities Depository

The progress that has been made since 2007 with respect to the establishment of a privately owned, central securities depository is noteworthy. Even though Ukrainian securities law does not recognize the depository as an SRO, as a practical matter, the depository will have to enforce depository clearing and settlement and other rules applicable to securities traders, banks and others who use the depository's services. This should be done subject to SSMSC oversight, and central bank oversight with respect to money clearance issues. USAID and the CMP should establish assistance with depository rules and the related member-participant aspects that follow from these rules as an important third priority after AUST and PFTS assistance.

¹³ PFTS' stock trader members number over 300 and account for at least 85% of all trading activity. This statistic supports our recommendation in Sections VII.A and VII.E.1 of this report that the number of licensed securities traders should be reduced. Whatever the remaining licensed stock traders may be doing, they do not appear to have a significant capital market role, yet their presence as licensed entities, largely un-vetted and unsupervised, presents serious regulator challenges for the SSMSC and AUST, and provides opportunities for market manipulation, money laundering and other illicit activities.

¹⁴ We see no need to extend this assistance and evaluation to other Ukrainian exchanges unless and until it is established that one or more of these exchanges accounts for significant trading volume. In our view, none of the other exchanges do so at present.

E. Other Legal and Structural Recommendations

1. Ukraine needs to re-qualify its licensed stock traders and eliminate several hundred marginal traders that should not remain licensed. We reiterate this recommendation expressed in the 2007 SRO Report and in at least two reports by the World Bank. We refer to the 2007 SRO Report for a detailed discussion why the SSMSC (and now also AUST) need to address this problem. We point out only the World Bank staff reports regarding how shortcomings in the SSMSC's licensing procedures for PSMPs adversely affect Ukraine's capital market development and the SSMSC's ability to meet its obligations as an IOSCO member.

“The regulatory and supervisory framework for securities markets and Non-Bank Financial Institutions (NBFIs) suffers from serious deficiencies.”

“SCSSM [the SSMSC] does not have the legal authority to trace the ultimate beneficial owners of the entities that it supervises, nor to carry out background check on these owners. SCSSM has no internal procedures in place to trace ultimate beneficial owners through the chain of controlling companies, and no arrangements in place with other institutions to carry out background checks on these owners. Therefore, no entity currently licensed by SCSSM to operate on the securities market has been subject to a fit and proper test of its ultimate beneficial owners.”¹⁵

Similarly, a 2008 World Bank Staff Working Paper, addressing capital markets changes required to take advantage of an EU-Ukraine Free Trade Agreement, recommends that Ukraine:

“Re-validate the licenses of all professional securities market participants and NBFIs, specifically enforcing the reputation test for the ultimate controllers of regulated entities and the reputation and professional experience tests for persons who direct the business of regulated entities, in accordance with the relevant EU Directives;”¹⁶

If the SSMSC has no way of knowing who are the beneficial owners of the licensed securities traders, the integrity of the licensing process has been seriously undermined. As an IOSCO member, the SSMSC is required to use its best efforts to become a signatory to the IOSCO Multilateral MOU for information sharing by 2010. The regulator's ability to obtain beneficial ownership information regarding licensed intermediaries, customer accounts and issuers is a core requirement of the Multilateral MOU.

We are encouraged that Commissioner Petrenko indicated that legislation is proposed that would increase the capital requirements for securities traders. This would be a constructive step to help eliminate marginal firms.

¹⁵ World Bank Concept Note, “Developing Capital Market Conditions for the Introduction and Development of Second Pillar Pensions (revised draft March 8, 2007), p.6. A “fit and proper” evaluation is one of the requirements for implementation of Principle 21 of the IOSCO Principles relating licensing of securities intermediaries

¹⁶ “Challenges and Opportunities of EU-Ukraine Free Trade Agreement for the Development of Securities Markets and Non-Bank Financial Institutions in Ukraine”, (October 2008), p. 10.

2. Greater Use of Electronic Means. Through our meetings with SRO's, exchanges and participant in the self-regulation training seminar, we observed a common thread of concern with respect to the need to modernize reporting systems and required information flows to exchanges, SROs and the SSMSC. We observed that PSMPs (as well as SROs and exchanges) are adversely impacted by the undue reliance upon hard copy reporting systems when electronic submission systems offer opportunities for significantly greater timeliness and efficiency of reporting, as well as ongoing cost savings. An assessment of opportunities for implementation of such systems and their perceived regulatory and cost benefits would appear to be another area of potential benefit to the capital markets program in Ukraine.

VIII. Conclusion

Our recommendations regarding SRO-related assistance discussed above may be prioritized as follows:

1. Assistance related to AUST and PFTS
2. Assistance to the central securities depository
3. Assistance to UAIB
4. Assistance to PARD

In all cases, the priority of onshore market consolidation, outlined in Section VII.A above, should remain the principal focus of SRO-related assistance. Assistance should not be provided under circumstances whereby SROs may seek to perpetuate unnecessary functions or retain as members marginal PSMPs that frustrate market consolidation.

The two, so-called pension SROs are not bona fide SROs. We would not provide any assistance to these SROs and we recommend no longer referring to them as SROs. Other pension reform assistance that USAID and the CMP may provide is beyond our SOW.

Appendices

- A. List of persons interviewed and documents reviewed
- B. Robert D. Strahota Curriculum Vitae
- C. Theodore W. Urban Curriculum Vitae

APPENDIX A

LIST OF PERSONS INTERVIEWED AND DOCUMENTS REVIEWED

Persons Interviewed

Serhiy Antonov, President, Chairman of the Board, Association of Ukrainian Stock Traders (AUST)
Natalia Baryshnikoya, Adviser of International Relations, Professional Association of Registrars and Depositories (PARD)
Mykola O. Burmaka, Commissioner, SSMSC
Oleksiy Kiy, President, PARD
Igor Kogut, Director, AUST
Ella Libanova, New Pension Administrators SRO
Bohdan Lupiy, Executive Director, PFTS Stock Exchange
Anatoly Nikolov, Associate Director, New Pension Administrators SRO
Vladimir Petrenko, Commissioner, SSMSC
Andrei Rybalchenko, General Director, Ukrainian Association of Investment Businesses (UAIB)
Victor Stetsenko, Capital Markets Project, Kiev
Ann Wallace, Chief of Party, Capital Markets Project, Kiev
Irina Zarya, President, PFTS Stock Exchange

Documents Reviewed

Law of Ukraine on the National Depository System and Specificities of the Computerized Securities Circulation System of Ukraine (2006)
Law of Ukraine on Securities and the Stock Market (2006)
Law of Ukraine on Joint Stock Companies (2008)
SSMSC Resolution 2411 dated December 27, 2007 on Regulation of Stock Market Professional Participants

APPENDIX B

ROBERT D. STRAHOTA CURRICULUM VITAE

Mr. Strahota is the sole principal of Strahota Capital Markets LLC, which provides securities and corporate governance consulting services for emerging capital markets.

Mr. Strahota served from 1993 until his retirement in July 2005 as Assistant Director in the US Securities and Exchange Commission's Office of International Affairs. His principal responsibilities included management of the SEC's technical assistance programs for emerging securities markets, including US and overseas training programs, on-site assessment missions, and analysis and commentary on emerging market countries' capital markets laws and regulations. Mr. Strahota has provided capital markets training and assistance in over 40 emerging market countries.

Mr. Strahota began his career in 1964 in the SEC's Division of Corporation Finance, where he served as a financial analyst and branch chief. In 1972, he joined the Kirkland & Ellis law firm, becoming a partner in 1977. His practice specialized in securities, corporate and partnership law. Mr. Strahota returned to the SEC in 1991 and served as Attorney-Fellow and Senior Adviser in the Office of General Counsel. During 1992-93, he served as SEC Senior Adviser to the Polish Securities Commission, before joining the Office of International Affairs.

Mr. Strahota received a B.A. in Economics and an M.B.A. with concentrations in accounting and finance from Cornell University and a J.D. from the Catholic University of America School of Law. He is a member of the District of Columbia Bar.

Mr. Strahota is the author of several articles on US securities regulation and numerous continuing professional education and international technical assistance outlines. During 1996-2002, he was an Adjunct Professor at the Georgetown University Law Center where he taught a course on Global Securities Markets. He has also lectured at Warsaw University and the Government Law College in Mumbai, India. Mr. Strahota is the recipient of an Officer's Cross for meritorious service to the Republic of Poland and the Financial Services Volunteer Corps annual Outstanding Volunteer award. Upon his retirement in 2005, he received a Certificate of Appreciation from USAID for 14 years of organizing critical technical assistance for emerging securities markets.

THEODORE W. URBAN CURRICULUM VITAE

H: [REDACTED]
C: [REDACTED]

Employment History:**Independent Consultant (2007-present)**

Since re tiring fro m Ferris, Baker Watts, Inc., I have been an inde pendent securities industry regulatory consultant and expert witness. I am active as a FINRA disciplinary panelist and arbitrator, serving as an extended hearing panelist in a multi-party FINRA disciplinary proceeding in 2008. I also serve as Vice Chairman of the Board of Investment Trustees for the Montgomery County Public Schools' Employees Pension and Re tirement Sy stem, which ov ersees the management of a \$1 billion pension fund.

Ferris, Baker Watts, Inc. (1984 – 2007)

I s erved a s Exe cutive Vic e President and General Co unsel of FBW, a major regional broker dealer, i nvestment bank a nd investment advis or, un til retiring i n March, 2007. I was a key member of the ex ecutive management team, serving as a member of the Board of Direc tors and the Bo ard's Execu tive, Co mpensation an d Investment Screening Committees. My primary responsibilities included direction of FBW's c ompliance w ith all bro ker dealer and investment a dvisor regulatory requirements.

U.S. Commodity Futures Trading Commission 1979 – 1984

Deputy Director, Division of Trading and Markets
CFTC NFA Liaison

U. S. Securities and Exchange Commission 1974 – 1979

Staff Attorney, Division of Market Regulation (1974-77)
Branch Chief, Exchange Regulation (1977-78)
Assistant Director, SRO Regulation (1978-79)

Other Business and Professional Service

- NASD National Adjudicatory Council, Member (2001-02)
- District of Columbia Securities Advisory Committee, Member (2003-05)
- NASD District Committee for District 9; Chairman (1997), Member (1995-98)
- Maryland Chamber of Commerce; Board Member (1998- 2007)
- Other securities industry committees: Chairman, NASD Member Admission Review C ommittee; Member, NASD National Arbi tration C ommittee;

Member, SIA Committee on Federal Regulation; Arbitrator for the NASD, NYSE and NFA

- Adjunct Professor, Washington College of Law at American University; taught course on Regulation of Futures Markets
- Speaker - numerous seminars regarding a variety of securities, commodity futures, and corporate law matters
- Maryland Civil Justice: pro bono representation of mortgage foreclosure clients

Education

Cornell University, B.S., major in Electrical Engineering, 1971

Columbus School of Law at the Catholic University of America, J.D. 1974

Associate Editor, Law Review