Capital Markets Project

Development of Risk-Based Prudential Supervision of the Capital Markets in Ukraine

Dr. Oonagh McDonald, CBE

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16A Borysohlibska Str., 04070 Kyiv Ukraine
tel: +38 044 467-7871, 467-7879, 467-7889 fax: +38 044 467-7896 e-mail:office@capitalmarkets.kiev.ua www.capitalmarkets.kiev.ua

EXECUTIVE SUMMARY

The report first defines the context in which risk based prudential supervision is to be viewed in the Ukraine. Specifically, it refers to the 2005 Action Plan agreed to by the GOU and the EU, (which among other things requires the adoption of a Joint Stock Company law and a prudential framework for financial markets) and the EU requirement of membership in the WTO as a pre-requisite for a free trade agreement.

The report then addresses the development of a prudential department within the SSMSC and provides a proposed organizational chart. It also points out that the development of a prudential department and risk based supervision under the EU Markets in Financial Instruments Directive (MiFID) will first require compliance with the Capital Requirements Directive (CRP) and the Transparency Directive (TD). This compliance will require a review of all existing legislation.

The report divides the process of establishing risk based supervision into three stages:

Stage one consists of 7 steps:

1. incorporating the capital requirements of MiFID, CRP, TD, and other Directives such as the Market Abuse Directive into the current Ukrainian legislation;
2. incorporating “best execution” into both the legislation and practice of the market intermediaries;
3. meeting the licensing (“authorization”) requirements;
4. conforming to the Prospectus and Transparency Directives in particular to the listing requirements;
5. establishing a prudential department within the SSMSC;
6. training SSMSC staff;
7. developing a training program for market intermediaries; and
8. assessing the level of risk in each market participant

Stage two is to measure and apply capital charges to market (interest related investments) and credit risks (failure of one party to a transaction).

Stage three requires the SSMSC to set forth the rules under which each firm will access its own risk and determine whether or not it holds appropriate resources to cover these risks. It also requires a procedure for continuingly monitoring and adjusting this assessment. Among other things, firms will be required to access the market risk, credit risk, counterparty risk, and concentration risk.

Stage four is the final stage where the regulator supervises the implemented risk assessment framework

1. The Context.

The necessity of the development of the regulatory system and the capital markets should be seen against the background of agreements between the European Union, such as the 2005 Action Plan, setting out a three year programme of reforms to be undertaken by Ukraine. These include the adoption of a new Joint Stock Company law, improving the definition of the responsibilities of directors, managers and shareholders' meetings, strengthening disclosure requirements as well as upholding minority shareholders' rights.

The Action Plan also requires the Ukraine to:-

-Put in place and ensure effective implementation of a prudential regulatory framework for financial markets and supervision equivalent to that existing in the European Union.

-Ensure effective implementation of independent and well-trained supervisory authorities in accordance with internationally recognised standards.

-Put into place and ensure effective implementation of adequate company law (the draft JSC law), accounting and governance rules.

This programme was due to be completed in 2008 and it is on this basis that Ukraine's capital markets would be more closely integrated with the European Union.

In addition, the European Union has made membership of the World Trade Organisation a condition of opening up discussions with Ukraine on free trade, leading to a free trade agreement between the EU and Ukraine. That will depend on Ukraine's willingness to abandon export taxes. It is expected that these matters will be resolved and that Ukraine will become a member in 2008.

These two agreements, actual and intended, set the parameters for developments in financial regulation and its goals. They also provide the political motivation for bringing them about. There are also practical reasons for the proper regulation and the adoption of international standards for the capital markets in Ukraine; namely, the loss of business to the developed Western markets. It is already the case that some start-up Ukrainian companies have chosen to trade their shares on the AIM exchange in London and the Warsaw Stock Exchange.

2. The Current Structure of Ukraine's Capital Market.

The annual report of the SSMCS for 2006 stresses the growth in the securities market, with the source of the growth being shares, bonds and investment certificates. The figure for the volume of shares traded up to the end of 2006 was 492.8 bn UAH and the general volume of securities issues registered by the Commission was 291.08 bn UAH up to the end of 2006 with 84.07 bn UAH issued in that year alone. The report provides a breakdown of securities with certificates of property being the largest proportion at 216.0UAH, followed by municipal bonds at 83.5bn UAH, then shares at 43. 54 bn UAH as compared with 22.07 bn UAH for bonds. One area which is increasing rapidly is the registration of corporative investment funds with a further 42 being registered this year, 45% of the number registered between 2003 and 2006.

Trading of securities was conducted on 7 stock exchanges and on PFTS and Perspective. In fact, almost all on-exchange trading is conducted on PFTS, now a recognised exchange. Currently 90% of the on-exchange trading is conducted on PFTS with a total of 670 issuers and 891 securities, which included 100 issuers (50 bond issuers, 4 municipalities, 14 collective investment schemes, 32 stock companies and 570 unlisted issuers. The Commission currently lists two kinds of issuers at levels 1 and 2, as well asallowing unlisted issuers to trade on the stock exchanges.

During 2006, 393 licenses were granted during the year for various kinds of market participants, but 56 licences were cancelled, partly because the firms themselves applied for cancellation, and also because licenses were annulled due to violations. No details of the violations which led to cancellation are recorded either on the Commission's website on in its annual report.

But despite the growth of the market and the adoption of some elements of standards which are taken for granted in developed markets and elements of EU Directives, its regulation and development have a long way to go. Almost all on-exchange trades take place on PFTS as already indicated, but the Commission allowed the establishment of Perspektiva, a trade and information system, to allow for the trading of special purpose bonds to fund construction projects. Most trading (estimated at 90%) takes place off-exchange with no price discovery required or possible. In addition, 570 unlisted companies were allowed to issue securities, which means that such securities, presumably bonds would be illiquid. In 2005, it appeared that bond issuers would be allowed to bypass 'listing' requirements, resulting in the possibility of purchasing illiquid assets.

Trading is concentrated in the top ten companies which account for at least 57% of the trading and the five largest companies accounting for more than 75% of trades on PTFS. But the shares of closed joint stock companies cannot be traded. These companies, often the largest in Ukraine, with large numbers of shareholders as a result of mass privatisation are held in closed joint stock companies, which cannot be listed or publicly traded. Overall, little has been achieved by changes in regulation to improve liquidity and rebuild a weak and fragmented market.

This might be changed by the new listing requirements' effective as from January, 2008, which apply to Tier 1 (Level 1) and Tier 2 (Level 2) companies. This should open up the former to establish proper standards of corporate governance and information disclosure. The current listing requirements state that a company must have been in existence for at least 3 years for shares and corporate bonds, sets out the value of net assets, levels of profit, market capitalization, the number of shareholders, and the number of exchange agreements in the previous six months. Similar requirements are in place for issuing corporate bonds, but with the specific requirement that the there should not have been any losses in two of the last three years. These listing requirements should be reviewed to ensure compatibility with international standards, and there is clearly a need for rules for the issuance of a prospectus (which has been prepared by the EDS Group), which should be in conformity with the Prospectus Directive.

To conform with the above directive the proposed rules should lay down that the prospectus should include not only all the financial details, including the prospects of the issuer and of any guarantor and of the rights attaching to such securities, but also set out who is responsible for the information and who should be held responsible. In that Directive, the responsibility attaches to the issuer or its administrative, management or supervisory bodies, the offeror, the person asking for admission to trading on a regulated market or the guarantor and the appropriate person must be held responsible in the case of any false or misleading information being discovered. The prospectus cannot be published prior to approval and when approved must be made public both through the media and in an electronic form on both the company's website and on the website of the regulatory authority. Other issues concern the advertising, which must not be inaccurate or misleading, and again responsibility for monitoring that lies with the regulatory authority.

The Transparency Directive deals with the provision of information to the public after the issuers have been admitted to trading on a regulated market. That information should include annual reports, which should be made public at least four months after the end of each financial year and should remain publicly available for at least five years. It should contain audited financial statements, the management report, and the auditor's statement. The half-yearly financial reports should contain a condensed set of financial statements, and interim management report and a statement from the finance director or the person responsible within the issuer to the effect that the financial statements do indeed give a 'true and fair' view of the financial information, and any other information regarding any important events affecting the company in the last six months and any related party transaction. Major shareholdings must also be made public.

It also covers specific information requirements for securities and debt issuers and also sets out requirements for disclosure and retention of financial information. Access to such information should be widely available on a non-discriminatory basis. Any false or misleading information should be subject to administrative and/or civil penalties. These two Directives are essential for investor protection.

3. The Purpose of the Report.

The first issue to be addressed is the development of a department of prudential supervision for the SSMSC At the Commission's request, this will involve the application of the European Union's Markets in Financial Instruments Directive (MiFid). Conformity with MiFid for many companies involves compliance with the Capital Requirements Directive (CRD) as well as the Transparency Directive. The CRD sets the requirements for the amount of regulatory capital a firm must hold. In addition, the Commission's legal requirements, introduced in January must be tested for their conformity to the Prospectus Directive and the Transparency Directive. The current listing requirements do not conform to the Prospectus Directive and the requirements of the Transparency Directive have yet to be fulfilled in the Commission's regulations. The application of these Directives is essential for proper assessments of the financial strength of the companies regulated and proper functioning of the capital markets.

Adopting MiFid and the related Directives requires a review of the existing securities law and regulations, noting where these would have to be changed if Ukraine wishes to bring its legislation in line with these Directives. The recommended changes would, on the one hand, have to take account of the market structure in Ukraine, and on the other may involve reforms of the existing institutions. This is the second issue which will be addressed in this report.

Finally, the report will provide an outline of the steps to be taken by the Commission in order to establish a prudential department, which would be able to apply the rules to the firms it regulates effectively and to enforce them.

4. The Background to CRD and MiFid.

The Capital Requirements Directive arises from the work on banking supervision carried out during the late 1990s, aimed at revising the minimum capital requirements for banks set out in Basel I (1988).

Basel II is the name given to the revised agreement between banking supervisors regarding the stability of the international banking system. Its aim is to make the framework for banking supervision more risk sensitive and more in line with the modern banks' own risk management practices. There are four main components to the new framework:-

-It reflects improvements in firms' risk management practices, for example, by the introduction of the internal ratings approach which allows firms to rely to some extent on their own estimates of credit risk.

-It is more sensitive to the risks that firms face: the new framework includes an explicit measure for operational risk and includes more risk sensitive weightings against credit risk.

-It provides incentives for firms to improve their risk management practices with more risk sensitive risk weights as firms adopt more sophisticated approaches to risk management.

-The new framework aims to leave the overall level of capital held by banks collectively broadly unchanged.

The purpose is to increase consumer protection by reducing the probability of consumer loss or market disruption as a result of bank failures owing to lack of capital. Basel II seeks to achieve this by ensuring that the financial resources a firm has reflects the risks associated with the kind of business concerned and the control environment within the firm.

The European Union has implemented Basel II through the Capital Requirements Directive, which directly applies to banks, securities and investment firms. The new framework consists of three elements:

-Pillar I. This sets out the minimum capital requirements companies will have to meet for credit, market and operational risk.

-Pillar II. This means that firms and supervisors have to decide on whether or not a company should hold additional capital against risks not covered in Pillar I and, if so, companies have to take appropriate action, that is, hold more capital.

-Pillar III. Here the aim is to improve market discipline by requiring firms to publish information about their capital, risks and risk management.

The Markets in Financial Instruments Directive is entirely the creation of the European Union. The aim is to apply the same regulatory standards throughout the Union, applying to investment services and financial markets in Europe. It is designed to change and improve the organisation and functioning of investment firms, facilitate cross-border trading and encourage the integration of EU capital markets. It is also intended to strengthen investor protection, partly by introducing a comprehensive set of rules applying to the relationships, which investment firms have with their clients. The preamble to the Markets in Financial Instruments Directive makes it clear that three Directives (that is, MiFid, the Transparency Directive TD, and CRD, Capital Requirements Directive) are to be taken together and applied to the capital markets; for example, authorisation of an investment firm can only take place, if the firms meet the initial capital endowment set out in CRD.

The Commission has indicated that it wishes to set up a prudential department in the context of MiFid. Applying MiFid to the legal requirements set out by the SSMSC will also involve applying the EU's Transparency Directive, and indeed, it is impossible to fulfil MiFid without implementing this Directive as well. The preamble to MiFid emphasises the importance of transparency concerning transactions, whereas the Transparency Directive requires information from the issuers to be made public so that investors can form an assessment of the financial strength of the company in which they propose to invest.

Section 44 of the Preamble states that:
'With the two-fold aim of protecting investors and ensuring the smooth operation of securities markets, it is necessary to ensure that transparency of transactions is achieved and that the rules laid down for that purpose apply to investment firms when they operate on the markets. In order to enable investors or market participants to assess at any time the terms of a transaction in shares that they are considering and to verify afterwards the conditions in which it was carried out, common rules should be established for the publication of details of completed transactions in shares for the disclosure of details of current opportunities to trade in shares. These rules are needed….to promote the efficiency of the overall price formation process for equity instruments and to assist the effective operation of 'best execution' obligations.' The efficient working of the capital markets requires transparency at every level.

These requirements can no longer be efficiently applied on a paper-based system. It is vital that the Commission moves forward to an electronic system of reporting for listed securities, not only for speed of information required by the Commission but also to allow information to be made easily available to the public and available on a non-discriminatory basis.

STAGE ONE.

Step 1. Capital Requirements.

The Commission has made it plain that it wishes to adopt the Markets in Financial Instruments Directive, which in turn requires the adoption of the Capital Requirements Directive and the Transparency Directive. Other crucial Directives include the Market Abuse Directive and the Prospectus Directive, which have not yet been fully incorporated into the Securities Law of Ukraine.

The first issue to be addressed is the conformity of the current Ukrainian Law on Securities and Stock Market with the Capital Requirements Directive. The Commission issued a number of Resolutions and Decisions and amendments to the Law on Securities and the Stock Market during 2006, which increased the initial funding requirements for investment firms, bringing them in line with elements of MiFid..

The capital requirements for investment firms depend on the range of activities undertaken. A 'securities trader' has to have statutory capital (in cash) of at least 120,000 UAH (approximately E60,000); broker/dealers and asset management must have at least 300,000UAH and underwriters must have at least 600,000UAH. (Article 17, Law of Ukraine on Securities and the Stock Market, 2006). A further Decision in August, 2006, made it clear that the capital resources of a trader must not fall below the original authorised fund. (SSMSC No 346).

The Commission promulgated a further Decision (No 1227, November, 2006) in which new capital requirements for asset managers. The authorised capital for such a company must be E300,000 at its establishment and must maintain capital at the level of E200,000.
The Law on Non-State Pension Provision sets out the conditions for licensing managers of pension funds. The initial capital for an asset management company is E300,000, and the equity capital must be maintained at E200,000. If a licensed pension fund administrator manages the fund, then the initial or charter fund must be E500,000 and the administrator is required to maintain capital at E300,000. This legislation goes part of the way towards meeting the Capital Requirements Directive and MiFid. These are the start-up requirements, but with the additional

clarification that the level of these funds must be maintained throughout the life of the company. The Capital Requirements Directive does state that the funding requirements should be indexed in line with the EU-wide Consumer Price Index Similar indexing arrangements should be in place for the initial funding requirement.

The first step therefore would be to look carefully at all the firms which are currently authorised in order to identify which firms fall into specific categories for the purposes of CDR and MiFid. It appears that few firms, if any, only provide investment advice and do not hold client assets or take propriety positions. If such firms exist, then they should be subject to a simple expenses regime; that is, they are required to hold capital at least equivalent to twelve weeks as cover if the business fails for any reason, so that it can be wound down in an orderly fashion.

In terms of a risk-based approach, the distinction should be between the firms which act as agents (brokers) and those which act as principals (dealers), taking positions themselves, with the latter requiring greater levels of capital. The risks for those who take positions is that they will default on their obligations and with those firms who hold client assets or monies,, although required to keep that in separate accounts, the risk is that they will mix client assets with their own and then misuse the assets. This distinction is necessary in order to see what capital requirements apply to the various firms.

Judging from the filing requirements already in force, the Commission should already have this information available. But given the large number of firms involved, the review should begin with firms with another six months of the license to run. The purpose of the review, comprising a thorough examination of the capital requirements and the firm's activities should be to consider in each case, whether or not the license should be renewed. But the relatively new requirements ought to be set out clearly on the Commission's website so that firms already in existence whose license has a year or more to run ought to be aware of the capital requirements they will have to face, depending on the nature of their business. The capital requirements in Decision No 1227 and the Law on Non State Pension Provision, for example, are not listed on the Commission's website, indicating that there is a lack of a coherent plan for setting out the requirements for the benefit of the regulated entities, issuers and the public.

According to the Resolution No 177, investment firms have to submit four ratios to the Commission on a quarterly basis: absolute liquidity ratio; capital asset ratio; return on assets and solvency ratio (capital adequacy). The absolute liquidity ratio (R1) is the ratio of cash flows, their equivalents, current financial investment and current liabilities, designed to show the extent of a company's liabilities which can be covered immediately. The capital asset ratio (R2) is the ratio of borrowed and own equity, showing a company's dependence on borrowed equity. Section 5 of the same Resolution requires the firm to indicate with a plus sign if the ratio is higher than the maximum permissible ratio and with a minus sign if the ratio is below such a ratio. It is not clear what action the Commission takes at the moment but this would certainly be a matter for the newly formed Prudential Department.

Step 2. ' Best execution'.

The second step is to ensure that other important elements in the Markets in Financial Instruments Directive are incorporated into the Law on Securities Markets. Section XIII of the Approval of Rules (Conditions) of Exercise of Securities Trading Activities: Brokerage, Dealing, Underwriting, Securities Management Activities (Decision No 1449, December, 2006) does contain elements of the 'best execution' requirements. It does not, however, fulfil all the requirements set out in the Directive.

MiFid requires that firms carrying out orders for the purchase or sale of shares or which place orders with other companies for execution when they are providing the services of portfolio management, or which transmit orders to other entities for execution when providing the services of receiving orders and transmitting orders, must have arrangements in place to obtain the 'best possible result' for their clients. Getting the best possible result depends on taking a number of factors into account: price, costs, speed, likelihood of execution and settlement, size of the order, or any other relevant factor.

As part of these arrangements, the firm must have a policy. The firm itself should consider which of the above reasons is most important for the clients or at least a process for doing this, so that it can deliver the best results to the client. For retail clients, MiFid provides that price and costs related to execution will be the most important factors, and price may very well be a very significant factor for professional clients as well. Information about the policy should be provided to clients.

Article 21 of MiFid (Level 1) and Articles 44 and 46 (Level 2) of the Implementing Directive require firms to set out a statement of policy which includes a statement of the venues to be used. It is possible to mention only one venue but the firm would have to show that they are consistently able to achieve 'best execution' there. It is not just a matter of informing clients before executing an order but obtaining their consent before executing an order on their behalf and especially if the order is to be executed outside the regulated market. Then 'prior express consent' has to be obtained by signing a document, a click on a web page or by telephone with appropriate records.

This important requirement has been adopted to a certain extent, but there are very significant differences which must be addressed. The first point to note is that firms must prepare their policy documents on achieving 'best execution' and present the policy statement to the customer. Some of the duties of traders are to be fulfilled 'at the request of the customer' (items 1 d and 5), when the initiative should be taken by the company, which should provide information on the market value of securities to the customer and providing information to the customer about the performance status of any one off transaction. These rules apply to all types of financial instruments.

'Best execution' requires pre and post-trade reporting of transactions. Indeed, it is not possible to achieve best execution without it. Investors need a securities exchange which offers safety, speed of transactions, liquidity, lower prices for order execution and price transparency. The market is indeed highly fragmented with 7 stock exchanges, two electronic trading platforms, PFTS and Perspective, with PFTS taking the leading position once again with 96.35% of on-exchange trading volume. In 2005, it was estimated that about 90% of securities transactions take place 'over the counter' and outside the organised market.[1] The number of registrars has decreased slightly to 351 by the end of 2006 and the number of issuers maintaining their own registrars has continued to decline to 357.[2] The number of investment firms reached 814 broker-dealers and 300 asset managers.

Article 28 sets out the requirements for post-trade disclosure. It states that 'investment firms, which either on their own account or on behalf of clients, conclude transactions in shares admitted to trading on a regulated market outside a regulated market or MTF, to make public the volume and price of those transactions and the time at which they were concluded. This information shall be made public as close to real-time as possible, on a reasonable commercial basis, and in a manner which is easily acceptable to other market participants.'

[1] The Ukraine Stock Exchange Environment: Challenges and Recommendations, Robert Smith, USAID Capital Markets Project, January 2006.

Articles 44 and 45 set out further requirements for pre- and post-trade transparency. Regulated markets are obliged to make public current bid and offer prices and the depth of the trading interests at those prices which are advertised through their systems for shares admitted to trading. They are also required to make public as close to real-time as possible the price, volume and time of transactions executed in respect of shares admitted to trading. The obvious choice for such tasks is an electronic trading platform, PFTS and, given its commanding position for on-exchange trades, it should be developed to take account of all the requirements of 'best execution'. This would enable the MiFid requirements in respect of 'best execution' to be fulfilled, since securities transactions would be conducted or reported over the trading system and as near to real time as possible, or at least no later than T+3 as required by international standards. In other words, the means are available to meet the requirements of 'best execution' as set out in MiFid. The Commission needs to take the necessary steps to ensure that MiFid can be fully implemented, which, once again, requires the successful implementation of the modern, electronic, Post-Trading Information Disclosure/Surveillance System for listed securities, and, indeed, cannot be successfully implemented without it.

The 'best execution' requirement is linked to the distinction which firms are expected to draw between 'professional' and 'retail' clients. For the latter, in the absence of specific client instructions, the firm should take into consideration all the factors which will allow it to deliver the best possible result in terms of the total considerations, representing price and the costs related to execution. The emphasis on certain considerations may be more relevant for a professional client, which underlines the need for client categorisation.

The Directive makes it clear what kind of general information should be given to all its clients. This consist of the investment firm and its services; financial instruments and proposed investment strategies, including appropriate guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies. In addition, the information should include execution venues and costs and associated charges. This information should be set out in a clear and comprehensible form so that they are reasonably able to understand the nature and the risks of the investment service they are offered.

Broadly speaking, MiFid requires the categorisation of clients into retail clients or 'private' customers and professional clients. The latter is a wide-ranging group consisting of individuals

[2] Annual Report, Securities Commission, (SSMSC, 2007).

who possess the experience, knowledge and expertise to make its own investment decisions and properly assess the risks it incurs. To be a professional client, the individual or company must be one of the following:

Credit institutions

Investment firms

Other regulated financial institutions

Insurance companies

Collective investment schemes and the management companies of such schemes

Pension funds and the management companies of such funds

Other institutional investors

Large undertakings meeting the following size requirements:-

-balance sheet total: E20m

-net turnover E40m

-own funds E2m

National and regional governments; public bodies; central banks and international and supranational organisations.

Other institutional investors whose main activity to invest in financial instruments.

Some of the above may, if they wish, request the additional protection of being a retail client, but this has to be stated clearly in writing.

Step 3. Authorisation of Investment Firms.

Only some of the elements of authorisation of investment firms have been adopted by the Commission. This includes providing a register of all authorised firms with information about the services the company was authorised to provide and the activities in which it is authorised to engage.

Article 8 is especially important, since it allows the regulatory authority to withdraw authorisation from an investment firm, if a firm has been authorised, but it ‘does not make use of its authorisation within twelve months…or has provided no investment services or performed no investment activity for the preceding six months.’ The Commission should adopt this Article and apply it but in such a way that it would not be possible to conduct a single trade once every few months so that it technically avoided the threat of withdrawal of the license but were not conducting serious business. Current Ukrainian regulations allow for a license to be annulled if the licensee has not engaged in stock market activity for a year (for example, within a year of the date of the license), a much longer period than MiFid allows. (Decision No 432, August, 2006). The resources of the relatively small staff of the Commission should not be diverted by having to assess the financial returns and any other regulatory reports presented by virtually inactive companies.

The regulatory authorities should not grant licenses to investment firms unless they are satisfied that those who direct the business are 'of sufficiently good repute and sufficiently experienced as to ensure the sound and prudent management of the investment firm'. The investment firm should be required to 'notify the regulatory authority of any changes to its management, along with all the information needed to assess whether the new staff appointed to manage the firm are of sufficiently good repute and sufficiently experienced.' Authorisation can be refused if the regulatory authority considers that the proposed changes would pose a threat to its 'sound and prudent management'. (Articles 8 and 9).

Article 10 state that the authorities 'shall not authorise the performance of investment activities ..by an investment firm until they have been informed of the identities of the shareholders or members, whether direct or indirect, natural or legal persons, that have qualifying holdings and the amounts of those holdings….and if they are not satisfied as to the suitability of the shareholders or members that have qualifying holdings. Authorisation can also be withheld where close links exist between the investment firm and only if they are satisfied that those 'links do not prevent the effective exercise of the supervisory authority'. 'Any natural or legal person that proposes to acquire or sell a qualifying holding' must first notify the authorities or if they propose to increase or reduce their qualifying holding and then the same considerations apply. An annual statement must be made to regulators concerning the shareholders and members possessing qualifying holdings and the sizes of such holdings.

Some but not all of these conditions are mentioned in the Decisions of May and June, 2006. (Nos 345 and 432). Previous reports have strongly recommended that the regulators must be able to identify the beneficial owners of the company and that this information must also be publicly available. It appears that the founder of the company and his ability to pay into the statutory fund must be endorsed by the auditor and the first and second pages of the passport of the founder must be produced. However, it should be noted that in other jurisdictions, specialist firms exist which act as front men, concealing the real identity of the beneficial owners. The Commission must have and exercise the powers to enter the business premises, examine all documents and ensure that the identity of the beneficial owners is correctly established, and that thorough background checks have been carried out not only to establish the identity and suitability of the ultimate owners. In addition, the Commission then ensure that the information becomes public and that it is always publicly available. (No 345, May and July 2006 sections 3.4-3.6).

Step 4. The Prospectus Directive and the Transparency Directive.

The listing requirements which the Commission has proposed set out certain requirements for companies seeking permission to list on the Stock Exchange. However,
there are gaps in the listing requirements as set out in the Commission's listing requirements. These include a clear requirements for the person or persons who would be responsible for the information in the prospectus and hence for the publication of false or misleading information. Investors must have the right in law to take action against those responsible for the prospectus if those standards are not met. The documentation must be prepared to appropriate standard. Article 6 of the Prospectus Directive imposes an obligation on the regulatory authority to make sure that the statutory authority applies to the 'issuer or its administrative, management, supervisory bodies, the offeror, the person asking for admission to trading as a regulated market, the guarantor, as the case may be'.

Other elements of the Prospectus Directive include prior approval of the prospective by the regulatory authority and the format to which a prospectus must conform as well as the advertisement regime, which should make it clear that it is not a prospectus and should inform people how to obtain a copy. These apply whether or not the shares are offered on a regulated market.

The Transparency Directive is another vital element in investor protection and is designed to be another element in creating a single capital market through a common framework requiring:
-issuers to produce periodic financial reports
-shareholders to disclose major shareholding
-issuers to disseminate regulated information
-the provision of central mechanisms for sharing regulated information.

The Directive aims to improve the quality, quantity and timeliness of periodic financial information produced by regulated market issuers and used by investors. It sets out requirements on the content and timing of annual and half-yearly reports and introduces the concept of interim management statements for issuers of shares that do not produce quarterly reports. The new periodic reporting requirements apply according to the start of the issuer's accounting year. All of financial reports are regarded as 'regulated information' and must be available in a fast, non-discriminatory way to all member states of the EEA, and for Ukraine would have to be available to the public in the same way, until it reaches its stated objective of integration with the EU's capital markets.

Step 5. Establishing a Prudential Department.

The Commission has already taken steps towards the establishment of a prudential department and improving prudential supervision of investment firms and asset managers. The working party was set up in March 2007 with a view to identifying key features to be taken into account to ensure the stability of investment firms. These include monitoring the financial stability of investment firms; increasing the capital requirements to ensure stability; monitoring complaints against market participants; monitoring offences and increasing enforcement; proposals for improvement in the current legislation; developing risk management on the part of market participants; developing and conforming to the international standards of financial reporting; and developing a software product to identify market risks. The timescale is long, between 2007-2009 with two items left until 2010, monitoring of the market in order to identify infringements and the introduction of suitable software.

The overall aim is to establish an effective system of prudential supervision in Ukraine, making use of the experience of other countries. Properly utilised and analysed, the financial information which is already required could be used as the basis of prudential supervision. Attention should be paid to delays in submitting the required financial reports but not only to the extent of imposing a fine, regarding it merely as an administrative violation. It could well be a sign of deeper problems with the company.

Adopting the additional requirements set out in MiFid, discussed as part of Stage One, provides further means of ensuring that viable companies enter or remain in the market. A step towards establishing the beneficial ownership of firms established from the requirement that the 'founder's' identity be disclosed through the presentation of a passport, though it is not clear whether or not the founder is the beneficial owner or the ultimate controller[3]. This is unlikely to achieve the desired result since it is possible for front men to substitute themselves for the true owners, a common practice in certain jurisdictions. What is required here is further clarification regarding the 'founder' and his or her role in the business. The identity of the 'beneficial owner' or controller should be made public, when the firm is licensed. The investigations at the stage of granting a license must be very thorough and should conform to the criteria set out in MiFid, and any changes in management or ownership of the company must be reported to the Commission and be made public.

Sufficient powers must be available to enable the Commission staff to enter offices, review documents, obtain any information required in order to consider whether or not to grant or remove a license or to identify any failures in the firm either in the management of its finances or in the way in which it conducts business and treats its customers. In particular, Article 10 (1)of MiFid requires that 'where close links exist between the investment firm and other natural or legal persons, the competent authority shall grant authorisation only if those links do not prevent the effective exercise of supervisory functions'. This requirement should be fulfilled before a license is granted.

The financial strength of a firm may be affected as much by breaches of conduct of business rules as by the failure to manage the financial risks of the firm. But although the Commission may now know the identity of the founder, the identity of the beneficial owners is still not a matter of public knowledge, as it should be both for the purposes of effective regulation and to reach the standards required by the Transparency Directive for issuers'.

The establishment of the working party with staff drawn from relevant departments and divisions within the Commission in fact indicates the way forward for establishing a prudential department. That should build on the relationships, which have been built up through the working party. The Commission does not plan to employ additional staff, though it should consider the appointment of one or two well-trained staff to act as advisers and co-ordinators. The staff should be in charge of collating the information from other departments. It is vital that the prudential department is not isolated from the work of the other departments and divisions, who contributed to the working party. One individual should be selected from each department to attend a weekly meeting, taking at least half a day, a high level meeting which should be chaired by the chief of staff, reporting on

[3] This is set out in Section II of Procedure and Terms of Licensing on the realization of certain kinds of professional activity in the stock market, renewal of license, issue of duplicate and copy of license, Resolution of the Commission,

the outcome to the chairman. If a company is in serious financial difficulties and its collapse would adversely affect the stability of the capital markets, then both the chairman and the board (the Commissioners) would need to be informed and involved in the decisions made with regard to the company concerned. This approach is also summarised in the accompanying revised organisational chart.

As the accompanying organisational chart shows, the prudential department should be regarded as a central department, receiving reports from all other relevant departments, where the department considers that there are issues to be addressed. In other words, the reporting lines converge on the prudential department. The issues the departments raise, these would then be considered at the weekly meeting of the prudential department and a range of actions should be considered. The initial recommendation should be for a further monitoring visit to take place immediately with a view to examining every aspect of the business, including discussions with the senior management regarding the prudential issues and the actions which the firm proposes to take to restore its capital base. This would then be followed by a further report to the prudential department with recommendations as to further actions to be taken. That can take a range of forms, including an orderly run-down of the company with appropriate payments to be made to clients if they have lost money, for example, as a result of negligence or raiding client accounts.

In other words, the prudential department would function as a watch committee to which companies thought to be at risk on the basis of evidence from the departments responsible for receiving reports and for monitoring visits. As part of the preparation for the weekly meeting, the staff of the prudential department should liaise with the other divisions and departments and discuss possible cases for the watch list and set out the reasons for that.

It should be noted that this is an entirely different structure from many regulatory authorities. There departments are often organised along the lines of units responsible for monitoring various types of financial services companies or the markets for which each it responsible. The chart for the Commission is quite different and none of the other regulatory authorities have a separate prudential department. Prudential supervision then becomes part of the process of regulation and supervision, which takes all aspects of the conduct of the companies into account. It is possible to establish a separate prudential department along the lines set out here. It may be that the Commission will wish to consider a more far-reaching reorganisation along the lines of one of the charts attached. The two countries selected are France and Spain as these are the two leading

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members of the EU who have retained a separate securities Commission as opposed to a single regulatory authority for financial services.

Step 5 Training Commission Staff.

First of all, training for the staff of the Commission is essential. Clearly the staff will have to be able to understand and assess the financial accounts they receive and are able to check the ratios submitted. The training, however, should be much more comprehensive than that. Staff must be able to understand that nature of the business and the risks involved, in particular credit and market risk Other regulators, taking on staff who do not have experience in the industry, first require that all take an introductory examination, based on a curriculum on the key issues of each sector of the market, financial reporting and risk. It also requires a clear understanding of the conduct of business issues, ranging from separation of client accounts to information for retail clients about their investments and the risks involved in this investments, and the impact of a poorly run business on the solvency of a business.

In more detail, an introductory course should provide the student with an overview of the financial markets, including identification of the major financial markets, and the key players as well as the key features, such as the essential elements of a market economy, such as the legal structures for businesses, law of contract and legal enforcement mechanisms in the European Union. The emphasis of the course should be on the concept of risk, including corporate responsibilities for risk management, techniques of risk measurement, risk profiling, probability distributions, simulation models and scenario planning, value at risk and an understanding of the risk management process. The course should also contain an analysis of the role of the financial institutions in the markets and the purpose and theory of financial regulation.

This should be followed by the Commission taking a small initial sample of the licensed investment firms in terms of the size of the operation, measured in terms of capital, activity and profit. The monitoring visits should be confined to Kiev for the purely practical reason that it will take less time. The visit should be undertaken by two or three individuals, depending on the size of the firm, but not less than two and the staff should be drawn from different departments. The visit should focus on the financial realities behind the reports received as well as looking at the management of the company and the conduct of business. Staff should then meet and discuss the results of the sample inspections and should jointly prepare a template for inspections. This initial sample is designed to aid the development of a template which would then be used for training staff in the head office and the regional offices.

The approach to monitoring visits should follow that pattern in the future with, say, quarterly fora to discuss what had been learned from such visits and how the template could be improved. This is part of the continuing development of staff and may also provide an insight into which firms are at risk or whose conduct of business requires improvement.

Organising the prudential department in the way outlined above could lead to especially intensive training to the persons responsible for the new Prudential Department. This could take the form of attending courses arranged internally for regulatory authorities, but the issue of language skills could restrict the choices available and the utility of such a proposal. More specifically English should be a part of this curriculum since it will afford the opportunity for internet research and attendance at international conferences all of which use English. A command of English would also open up international training opportunities and afford the opportunity of gaining internationally recognized qualifications. If this does prove to be a possibility, then the person or persons involved would have to undertake to remain with the Commission for two further years and to be responsible for training other staff with financial penalties for anyone who leaves the Commission before the completion of two years. If this is not available, then one part of the twinning programme should be to provide intensive training for the potential head and deputy head of the proposed Prudential Department

It should be noted that regulatory authorities in general provide both introductory training for their staff and for staff development as the market changes and changes in regulation demand it. For example, the UK Financial Services Authority, which has played a leading role in developing the concept of risk-based supervision, has set up its own Regulatory Curriculum for its staff, many of whom come from outside the industry. They receive a five day training course in the FSA's risk-assessment framework and placements in appropriate firms as well as industry forums. It will not be possible at this stage for the Commission to replicate this approach to training, apart from the development of its own staff development courses. In the meantime, the proposed twinning arrangements will cover the initial stages of development. The emphasis on the proposed twining arrangement should be on hands-on training with the staff from the Polish Financial Supervision Commission (KNF). In other words, the staff should take the Commission staff step by step through their procedures and illustrate with examples of how one or two of the firms they supervised failed to meet the requirements and what led them to suspect that the company had failed to meet the capital requirements. It is this kind of training which will prove to be one of the most valuable elements in the twinning programme and it is strongly recommended that the twinning programme takes this on board.

Step 6 Training companies.

Many regulatory authorities arrange training for the companies they regulate. Given the number of companies currently in existence, this would be a demanding commitment for the Commission. Since many of the securities companies and asset managers are subsidiaries of banks and the National Bank of Ukraine sets out the rules and regulations for these companies, either the NBU should take responsibility for this training or the training could be undertaken jointly by the Commission and the NBU. However, setting out what is now required and will be required once, for example, the Markets in Financial Instruments Directive and the Capital Requirements Directive are fully adopted and have become part of Ukrainian securities law, will prove to be rewarding. Companies will have no excuse for lack of compliance, on one hand, and, if they are seeking to comply, then they will have a better understanding of what they are expected to do.

The training should not only involve a better understanding of financial accounting and regulation, but also an understanding of risk, risk measurement and risk management. This would prepare companies in the appropriate techniques which would be required when the next stage of risk-based supervision takes place. This will require firms to understand market and credit risk and should ensure that the Commission will be able to assess the financial stability of the firm, taking credit and market risk into account.

Step 7. Application of the rules and training to licensed companies.

The first step, once the prudential department is established, should be to take a random sample of the licensed investment firms, according to the size of the firm and the level of its activity in trades whether conducted on a recognised exchange or over the counter. Based on the regulatory and financial reports, the level of risk of insolvency should be assessed on the basis of these reports. This should then be accompanied by a monitoring visit to assess the internal controls, the quality of management, information given to customers, the way in which business is conducted and the actual level of activity. All of these elements should be considered in order to assess the financial strength of the investment firm. Once the visits have been completed, the results should be discussed with those involved in the Prudential Department so that the methodology of monitoring inspections and risk assessment can be improved through a Commission forum in which the work of monitoring teams can be discussed and lessons learned.

II. STAGE TWO.

This stage will encompass understanding and being able to measure and apply capital charges to market and credit risks. The first is the risk arising from interest rate-related instruments and equities in the trading book and the second is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to suffer financial loss. Market risk is defined as the risk of losses arising from movements in market prices. Potential losses may arise from general market price movements and from price movements specific to particular issuers. The firms involved in this business have to ensure that they have stringent risk measurement and management systems in place consistent with the size of their business and their technical resources.

III STAGE THREE.

If the Commission moves on to adopt the CRD and MiFid requirements in full, then this requires more complex calculations. This will in turn require clarity on the part of the Commission to ensure that firms understand the requirements and firms themselves will have to state clearly the nature of the business they undertake and be able to calculate their own capital requirements. The Commission will set through its rules the minimum capital requirements for firms and will have to review the firm's own assessment of its capital needs and the processes and system by which that assessment is made so that it can judge whether the capital resources requirements are appropriate. It is also the firm's responsibility to see that it fulfils these requirements at all times. At this stage, it will also be important to ensure that companies receive the necessary training.

The first step is to assess whether a firm is an 'own account dealer', or a 'matched principal broker'. This determines the minimum capital requirements for the firm. A full scope investment firm, an own account dealer has to maintain capital to match credit risk, market risk and operational risk but the firms whose range of activities is limited has to maintain credit risk, market risk and fixed overheads requirement. The basic capital resources requirement ranges from E50k to E125k from a firm which neither deals in financial instruments on their own account nor underwrites issues. A firm requiring E 125k offers one or more of the following services such as receiving and transmitting clients' orders, executing investors' orders, managing individual portfolios and holds client money.

These firms must also calculate its credit risk by taking the sum of the credit risk component, the counterparty risk component and the concentration risk component. With market risk, the capital requirement is the sum of the interest rate PRR (position risk requirement) and the equity PRR, assuming that these are the only financial instruments available. Other investment firms only have to calculate a fixed overheads requirement, including such items as salaries and staff costs, rent, insurance premiums and the rent or lease of offices and equipment. This is all part of the base capital requirements for investment firms. These capital resources must be maintained at all times. In addition, firms should be able to calculate their own internal capital adequacy standards, which requires sophisticated calculations, supervised and assessed by the regulator. This applies to firms which are engaged in dealing on their own account, or which manages investments for clients, that is, a full scope investment firm.

As part of its capital requirements, full scope investment firms must also provide capital for operational risk, always much more difficult to calculate. It applies to larger firms and is focussed on their systems and controls, including an independent risk management function for operational risk. This system must be well-document and reviewed by the firm's internal and/or external auditors. Operational risks covers both qualitative and quantitative aspects, the latter requiring calculations of the amount of capital to cover both expected and unexpected losses and be able to demonstrate that its models, using internal data, external data, scenario analysis and factors reflecting the business environment and internal control systems.

This brief sketch of the more detailed Capital Requirements Directive and Markets in Financial Instruments is designed to indicate that this stage should be postponed until the Commission considers that the market participants are ready to meet such demands. A thorough and careful use of existing ratios to determine which firms meet the most basic capital requirements and levels of activity before moving on to calculations of market and credit risk. This may lead to a reduction of the number of market participants through mergers and acquisitions or through the withdrawal or decision not to renew licenses.

STAGE IV.

Risk-based supervision is the final stage of a regulatory process outlined here in which there is an increasing emphasis on risk assessment, which includes defining different types of risk and developing models to identify the most significant features of risk and calculate the amount of capital required to mitigate any losses arising from the failure to manage risk. For the Financial Services Authority in the UK, the next step is to apply a risk assessment framework to the firms it regulates and to assess the risks to the fulfilment of its statutory objectives. The risk assessment framework has four main objectives: to identify the main risks to achieving its objectives, and then to measure the importance of those risks; to mitigate those risks whenever the size of the risk justifies it and to monitor and report on progress.

The risk model is basically quite simple: the risk to FSA'a objectives plus the impact of the problem on the markets, if, for example, a major firm collapses and an assessment of the probability of such an event occurring as low, medium or high. This means considering a wide range of risks; such as the prudential risks of a bank's loan book, credit risks or in the case of an asset manager, risks to retail customers. Generally the risks fall into four categories: business risks, controls, oversight and governance and availability of capital to mitigate the risks.

The risk assessment model is used to assess the risk the firm poses and for all firms, including an examination of management, governance and culture; control functions; capital and liquidity; customers, products and markets for retail firms. For wholesale firms, customers, products and markets and for firms holding client money, the control risk element is the issue to be addressed. In order to assess the firm and the risks it poses, the FSA requests documents covering current business plans, group structure and organisation charts; financial statements, board papers and minutes; risk management information and compliance and internal audit plans and reports. This is followed by site meetings in which the regulators may also interview key members of staff, the CEO and board members.

The purpose of this risk assessment is two-fold. First of all, a formal letter is sent to the company informing the board of directors of the outcome of the risk assessment, and the actions which the firm must take to put right any failings which have been identified. A time-table is set out for remedial action to be taken and may be accompanied by enforcement actions. A review of the risk assessment of a particular firm may take place when there are changes in the external environment affecting the firm or the firm has brought about changes in strategy or changes in the senior management of the firm.

The other reason for this approach is that the risk assessment provides the regulator with a way of determining which firms attract the most regulatory attention in the form of close monitoring or repeated visits both announced and unannounced. In some cases the regulatory authority concludes that it can rely on the senior management of the firm and on its controls to remain compliant. Meetings with senior management and the control functions until the next round of visits is due keeps the FSA informed about the validity of its assessment.

Achieving risk-based supervision in this sense can only be achieved with appropriate resources, extensive training and a clear and coherent understanding of risk and risk management. It is not recommended that the Commission seeks to introduce this type of risk-based supervision until it has applied MiFid and the Capital Requirements Directive effectively to the firms it regulates.