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Capital Markets Project

**PRELIMINARY FINDINGS,
CONCLUSIONS AND
RECOMMENDATIONS ON THE
DEPOSITORY SYSTEMS OF UKRAINE**

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CONSULTANT BACKGROUND

Harry Cartner is a Securities Operations Executive with over thirty year's extensive experience in Clearing, Settlement and Depository operations and systems.

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BACKGROUND

Currently, under Ukrainian law, there are two depositories, the National Depository of Ukraine (NDU) and Interregional Securities Union (MFS), an open joint stock company. Under a Memorandum of Understanding (MOU) between the Government of Ukraine, the Government of the United States of America and the World Bank, dated January 25, 1999, MFS is currently the only functioning Depository in Ukraine.

The MOU states, in part, that: *“the NDU shall not have any commercial functions whatsoever and may incorporate only three functions (codification, standardization, and international relations) within the effective period of this Memorandum.”* The MOU is valid through January 25, 2010.

MFS does depository and clearance functions (transfer of positions) only for electronic (dematerialised) positions. They do not handle money settlements of transactions, although they have a system for Delivery vs Payment (DVP) using an account at the National Bank of Ukraine (NBU). But, they only have approximately 10 DVP transactions per year. The systems are in place for the participants to utilise DVP but very few elect to do so.

MFS is an extremely well run company and they are well respected in the business community. This Depository is based on the North American model of depositories. In fact, a flowchart of the operations of the Canadian Depository for Securities (CDS) shows them to be virtually identical to MFS except for the money settlement of transactions.

MFS has very competent staff. They have five (-5-) main divisions with approximately 35 employees. The main divisions are:

- Financial (Accounting) – 5 personnel
- Customer Relations – 5 personnel
- Information Technology (IT) – 6 personnel
- Operations -5 personnel
- Legal – 4 personnel

The balance of staff is comprised of senior management, administrative, analytics, international relations and security.

The Operations Department is, of course, the main key department of the Depository as they handle all the accounts of Custodians, Issuers and track actual positions within the Depository. They also interface with the Exchanges, Trading Platforms, Issuers, Custodians and Broker/Dealers.

The IT Department is the backbone of MFS. The active software was developed internally by the current staff, using the programming methodology developed under the USAID Depository Project, implemented by PriceWaterhouse Coopers. The majority of the staff has been with MFS since its beginning in 1996. It appears that the software meets internationally recognised standards. The Depository also has an off-site office of four (-4-) additional software developers in Dnepropetrovsk. The National Bank of Ukraine did an inspection of the software of MFS and certified it as acceptable.

According to their financial statements, MFS is now a profitable corporation. Net profit/loss for the last four (-4-) years are as follows:

2002 - Loss of 98,000 UAH
2003 - Profit of 108,000 UAH
2004 - Loss of 3,000 UAH
2005 - Profit of 38,000 UAH (First 9 months)

In 2004, MFS met with EuroClear to investigate a correspondent relationship to handle foreign transactions. EuroClear is the world's largest settlement system for equities and bonds. EuroClear had many questions, including that MFS was not deemed a Central Depository under Ukrainian law, but there was one question MFS could not answer – *“Who would guarantee transactions?”*

As MFS has not established a guarantee fund (this type of fund protects the Depository from failures of settlements by having market participants contribute to the fund) it would be expected that no international depository would enter into a correspondent relationship as the systemic risks would be too great; particularly in a developing economy like Ukraine.

The National Bank of Ukraine (NBU), in conjunction with MFS, is developing a Pledging System whereby commercial banks, that are participants of MFS, could pledge or escrow their positions as collateral for their outstanding loans with NBU. These positions would be pledged to the NBU and could only be released by the NBU.

MFS interfaces with 1 trading platform (PFTS) and 5 stock exchanges. The First Ukrainian Securities Trading System (PFTS) and the Kiev International Stock Exchange (KISE) are currently doing 95% of the transaction volume of MFS. Apparently, 96% of all securities trades are executed off organized markets. Of the remaining 4% PFTS does 86% of that volume (as of the end of November 2005), the majority being ‘blue chip’ Ukrainian securities.

According to KISE their volumes increased due to the use of electronic transfer of ownership through MFS.

The Depository now serves 2,000 Issuers of electronic positions. There are approximately 34,000 open joint stock companies in Ukraine. Therefore, approximately 32,000 open joint stock companies are paper based. Roughly 10% of these paper-based companies are ‘dead’ or ‘shell’ companies. The Securities and Stock Market State Commission of Ukraine (SSMSC) estimates that only 20,000 are ‘true’ Joint Stock Companies (JSC’s). Also, they estimate that approximately 6,000 are open JSC’s and the balance, an estimated 14,000, are closed JSC’s.

MFS currently meets all the requirements of the present securities laws of Ukraine. They also undergo regular inspections by the SSMSC. They have had one extraordinary inspection due to alleged fraud by a Registrar. The SSMSC found nothing irregular at MFS. MFS never received a report on the findings on the Registrar. To date, MFS does not know the outcome of this alleged fraud.

It has been reported that the NDU, in 2003, initiated an inspection of MFS by the Ministry of Economy and the tax authorities. It was alleged that MFS committed a violation of the technical assistance given by the USAID Project implemented by PriceWaterhouse Coopers (PWC) in 2000. The authorities found that no violations or fraud were committed by MFS.

It is also reported, that Mr. Ivchenko, Head of the National Depository of Ukraine, when he was a member of the SSMSC, initiated another inspection of MFS in regards to an alleged ISIN violation. Again, no violation or fraud was found to be have been committed by MFS.

OUTSTANDING ISSUES:

RECOMMENDATION 1:

In order to meet internationally recognized standards, the ownership issues with MFS must be resolved. The ideal solution would be complete ownership by all market participants and no State ownership (i.e. the Canadian system). If State ownership is insisted upon, the State should take a minority position with the majority being owned by market participants and a clear statement effectively saying that there will not be any State interference. As MFS is currently the only operating Depository, with software and staff in place, the Government of Ukraine should have MFS recognised as the official “Central Depository of Ukraine”.

That there be no perceived, or inherent, question of independence or conflict of interest in the management of the NDU or in the Boards of MFS and/or the NDU.

The current ownership structure of MFS is as follows: PrivatBank and Business Invest, its affiliate (25%), PFTS(10%), OschadBank (6%), UkrosotsBank((6%), First Ukraine International Bank (6%), ITT-Invest (3%), UkrsibBank(3%), BrokBusiness Bank (1%), National Bank of Ukraine (NBU) (5%), and other market participants owning less than 1% of the remaining 48%.

MFS has been involved in take-over battles by PrivatBank and an affiliated company, BusinessInvest. PrivatBank has made a number of attempts at taking over MFS. This has created a great deal of concern by market participants.

There is not one Depository in the world owned, or controlled, by one private company and its affiliates. They are normally owned by a broad section of market participants with, in some cases, state ownership. (e.g. Poland and Bulgaria). In Bulgaria's case the State owns 49% of the CDAD but takes a 'hands off' approach to the CDAD and it acts independently of State intervention. The balance of the Bulgarian CDAD is owned by investment intermediaries (broker/dealers), investment funds and commercial banks.

The Canadian Depository for Securities (CDS), on which MFS is modelled, is owned by the Toronto Stock Exchange (TSX), the Investment Dealers Association (IDA), an SRO, the broker/dealer community and the commercial banks. It's interesting to note that the IDA is also owned by the market participants. Therefore, all operational levels of the investment community; regulatory, clearance and settlement are completely owned by the market participants. In line with international best practises there is no government stake whatsoever. The TSX is a public company listed on its own exchange.

Control by one private company and its affiliates is extremely risky for a well functioning capital market. Private ownership would give rise to privacy issues, registries possibly being 'swept clean'¹, etc. This type of ownership structure also could increase the risk of money laundering.

According to MFS this ownership struggle prevents them from looking into new technologies due to management spending too much time defending the company.

¹ According to an OECD report, of a case in Russia, a UK company purchased a 20% stake in a Russian aluminum smelter. The smelters management reportedly did not want foreign meddling at the shareholders meeting so they simply struck the UK company from the share registry.

The bigger ownership issue is the National Depository of Ukraine (NDU). Under the current Presidential Decree, dated October 28, 2005, and signed on November 28, 2005 and the new draft “Law on the System of Depository Record Keeping in Ukraine” there is to be a State owned Central Depository. This could effectively cause a take-over or liquidation of MFS.

There also appears to be a question of independence vis-à-vis the SSMSC and the State owned stake of the NDU. A press release, dated December 7, 2005, states that the Ministry of Finance has turned over the management of its 86% share of NDU to the SSMSC. Therefore, you have the regulator of the NDU controlling the NDU.

There is also an independence issue with respect to the Boards of MFS and the NDU. The President of PFTS sits on the Board of NDU and MFS as well as the Working Group looking into the merger of NDU and MFS.

The SSMSC has reported that it has filed an official application to have the Memorandum of Understanding between the Government of Ukraine, the Government of the United States of America and the World Bank, dated January 25, 1999, cancelled. By the terms of the MOU, it is in effect until January 25, 2010. Unfortunately, no official record of this application could be located

RECOMMENDATION 2:

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

A real concern in the operations of MFS is in the IT area. They are fully redundant with full database backups kept on-site daily. This could be disastrous in the case of a fire, terrorism, a disgruntled employee etc. They do, however, store database backups in a bank deposit box ‘several times a month’. This is not sufficient.

RECOMMENDATION 3:

That the request for ownership registries be converted to an electronic system. It should also be mandatory that all Registrars use the electronic system and pay MFS a service fee.

There is a great deal of manual paper work handled by the Customer Relations Department in the area of the interface with Custodians and Registrars. This is related to requests by Registrars for ownership registries. This Department communicates with Custodians for their ownership records, supplied in paper format, which are then consolidated electronically by MFS and then forwarded to the Registrars, also in paper format.

This process is very time consuming and very expensive as they use the postal system for sending ownership registries to the Registrars. While some Registrars pay for this service the majority do not. MFS does not have the authority to make payment mandatory. Under SSMSC rules MFS cannot charge for this service. MFS successfully sued the SSMSC, in 2003, to have the rules changed so that all Registrars, requesting ownership registries, are required to pay for this service. To date, the SSMSC has ignored the legal ruling.

RECOMMENDATION 4 :

That MFS staff get on going international training with exposure to other International Depositories. As MFS is operationally very similar to the Canadian Depository for Securities this may be a good place to start. As the U.S. system (Depository Trust Company) is not representative of the Ukrainian market place due to its sheer size.

MFS currently uses international and national messaging standards. Some of the international messaging standards that they use are out of date but, in 2006, MFS has advised they plan to gradually convert to the new International standard ISO15022. This meets with internationally recognized practises.

Management expressed a 'lack of international training and experience' as they have only had a 1 day trip to see the operations of DTC in New York. This was at the beginning of the project for the development of MFS. This could very well hinder their ability at looking into new technologies and international standards.

RECOMMENDATION 5:

That MFS be granted the right to incorporate money settlements into the depository system. This would allow MFS to arrive at internationally recognized standards.

The majority of all money settlements for transactions are handled Custodian to Custodian. The bulk of money settlements are done ‘off shore’. This raises a concern over money laundering. It is reported that the National Bank of Ukraine has changed the currency rules 3 times in 4 months therefore, possibly leaving the market participants no choice but to settle off shore.

RECOMMENDATION 6:

That the SSMSC be given the legal authority immediately, by Presidential Decree or otherwise, to investigate all of the problems within the Registrar system and take all necessary steps to improve the system.

Another major issue within the Ukrainian market, including but not limited to MFS, is the Registrars. There are issues of ‘double ownership registries’, Registrars selling ownership registries etc.

Currently there are 15 cases of double ownership registries, all involving very large companies. “A strong registry and shares depository system ensures that accurate custody of ownership records is maintained; that shares will not be mistakenly or wrongfully lost, challenged or diluted”.²

Recommendation 7:

That MFS institute a guarantee fund, in conjunction with money settlements, to ensue that it is protected from settlement failure.

As stated earlier in this report, MFS has not established a guarantee to fund to protect the corporation from settlement failures. As MFS currently does not handle money transactions on the settlements this is not an issue. If money settlements were to be implemented, as recommended, then a guarantee fund would be a necessity. This would again bring MFS inline with international recognized practises.

Summary of Recommendations

- 1. In order to meet internationally recognized standards, the ownership issues with MFS must be resolved. The ideal solution would be complete ownership by all market participants and no State ownership (i.e. the Canadian system). If State ownership is insisted upon, the State should take a minority position with the**

² Excerpt from “Securities Exchange Essentials” by Charles M. Seeger, prepared for The World Bank, 1996.

majority being owned by market participants and a clear statement effectively saying that there will not be any State interference. As MFS is currently the only operating 'Depository', with software and staff in place, the Government of Ukraine should have MFS recognised as the official "Central Depository of Ukraine". In addition, that there be no perceived, or inherent, question of independence or conflict of interest in the management of the NDU or in the Boards of MFS and/or the NDU.

2. That MFS acquire an 'off-site' location, within Kiev, and set up a fully redundant back-up system. This redundant system would include ALL electronic data within MFS including any future developments. This would allow MFS to immediately move, electronically, to the off-site location in case of a disaster.
3. That the request for ownership registries be converted to an electronic system. It should also be mandatory that all Registrars use the electronic system and pay MFS a service fee.
4. That MFS staff get on going international training with exposure to other International Depositories. As MFS is operationally very similar to the Canadian Depository for Securities this may be a good place to start. As the U.S. system (Depository Trust Company) is not representative of the Ukrainian market place due to its sheer size.
5. That MFS be granted the right to incorporate money settlements into the depository system. This would allow MFS to arrive at internationally recognized standards.
6. That the SSMSC be given the legal authority immediately, by Presidential Decree or otherwise, to investigate all of the problems within the Registrar system and take all necessary steps to improve the system.
7. That MFS institute a guarantee fund, in conjunction with money settlements, to ensue that it is protected from settlement failure.
8. That the web site of MFS have an English version as have all other International Depositories.