

# STRATEGIC RECOMMENDATIONS FOR FURTHER DEVELOPMENT OF UKRAINE'S CAPITAL MARKETS

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## I. Executive Summary

A superficial review of the capital markets in Ukraine would indicate an infrastructure that is essentially well developed. There are a number of stock exchanges, and at present, two securities depositories with operating licenses issued by the securities market regulator. Ukraine has numerous independent and apparently competitive registrars, maintaining share ownership records and otherwise serving the legitimate needs of joint stock companies across the country. Government and corporate bond markets are in operation, and there are early but positive signs that other types of fixed income securities will be introduced in the near future. There is also awareness within government and the private sector that demand is growing for new forms of investment products.

On the surface, it would appear that Ukraine is moving at an orderly pace toward the development of a market driven economic system. However, a more comprehensive analysis of the capital market casts doubts on the efficiency of its central institutions. It also discloses potentially serious deficiencies in the legal and regulatory framework that is intended to protect the interests of both domestic and foreign investors. Taken together, these deficiencies have created an environment that is neither transparent nor efficient. This tends to discourage both retail and institutional investment, and certainly contributes to the general uncertainty that impedes further financial market development.

The CMP team has reviewed the regulatory and operating environment of Ukraine's capital market, and has discussed potential deficiencies and/or weaknesses with senior governmental and private sector officials. Our specific findings and recommendations are presented in detail later in this paper. In summary however, we have found that:

- 1) The securities market and pension regulators are well managed, but need on-going assistance to reinforce the secondary legislation that defines the operating practices of market participants.
- 2) The overwhelming majority of securities trading is conducted informally between the parties, in a manner that is both non-transparent and prone to manipulation.
- 3) Two depository organizations are licensed in Ukraine, but neither has implemented operating procedures and technology that fully conform to international standards for clearing & settlement.
- 4) Government auctions of enterprises continue through nine licensed stock exchanges, but no serious commitment has been made to list a portion of these shares on the exchanges in order to improve liquidity in the markets.

- 5) Restrictive foreign currency rules have resulted in a flight of investment capital that discourages institutional investment, and further reduces domestic market liquidity.
- 6) The current supply of investment products on Ukraine's markets is not adequate to meet the increased demand arising from implementation of the Pillar II private pension system.

This paper contains a description of stock exchange and central depository operations in international markets, and will recommend measures to improve the technical capabilities of the local institutions. It will propose measures to strengthen the authority of the market regulators, including a recommendation that each commission be given authority to develop traditional sources for independent funding of regulatory activity. We will urge legal modifications to consolidate "off-exchange" trading onto the regulated markets, and propose the adoption of standard clearing & settlement practices by a properly constituted central depository organization. Finally, the paper emphasizes the need for increasing the supply of investment instruments to meet the surge in demand expected from implementation of a private pension system in Ukraine.

Taken together, the analysis and recommendations outlined in this paper are intended to provide an integrated strategy for further development of the capital markets. We discuss the most significant impediments to this development, and conclude with a brief discussion of the potential benefits to be derived from a determined implementation of these strategic recommendations.

## **II. Capital Market Structures & Institutions**

An exhaustive analysis of international market structures is beyond the scope of this paper. As a practical matter, numerous international institutions and experts have prepared a substantial body of capital market analyses and recommendations, and much of this material is readily available to interested researchers. This paper presents only the author's summary of typical standards and operations as a guide for the evaluation of Ukraine's institutional and regulatory structure. Variations and alternatives do exist, and we acknowledge that structures and methods have been developed in other countries to meet unique local conditions. Our assessment is offered as a focus for discussions on cooperative efforts to improve Ukraine's capital markets. These improvements are essential for creation of a fair and transparent environment for all investors.

### **Securities Trading:**

All capital markets have one or more stock exchanges that serve as a venue for buyers and sellers of securities. With recent advances in computer technology, many exchanges have converted from traditional "floor-based" trading to remote electronic platforms. In floor-based systems like the New York Stock Exchange, member brokers maintain representatives at the stock exchange floor. They execute buy and sell orders through exchange specialists who conduct continuous "open-outcry" trading for specific security positions.

In remote trading environments like the London Stock Exchange (LSE), in-house systems enable brokers to communicate with the exchange from their offices, using proprietary networks for execution of in-house (own account) and customer trades. Indeed, new Internet technologies enable individual clients to enter orders directly into their broker trade entry systems, using unique software developed for this purpose by their brokers. We note that this latter enhancement presents new challenges for both the exchanges and securities market regulatory commissions.

Trading systems come in many varieties, but three versions have some relevance for Ukraine. In many emerging markets, simplistic “*blind auction*” systems have been installed to discourage negotiation and manipulation. Orders are pre-entered in the system, and trading is conducted using specially developed algorithms that determine the optimum price at which the largest number of available shares can be sold. In some cases, specialized auctions are held for privatization, and negotiation of large “block trades” between brokers is often permitted. Trades negotiated off-exchange are entered into the system in a special trading session, and in some markets, these orders are held open for a brief period to allow for entry of competing orders. When executed, these negotiated trades are cleared and settled in the course of normal post-trade processing.

As markets evolve, these systems may be replaced with more advanced trading platforms that are designed to enhance market efficiency, improve transparency, and/or expand the scope of broker-dealer activity. These systems are characterized as either “quote-driven” or “order-driven” depending on the organization of the local market. However, the definitions are problematical because many systems are actually hybrids. They can contain both order and quote-driven characteristics, depending on local trading volume, market liquidity, and regulatory requirements.

Many active markets use *order-driven systems* that allow *continuous trading* in all security positions. These systems are considered more transparent because all customer buy and sell orders are usually displayed to the markets. Since trades are automatically executed against the exchange’s central (often anonymous) “order book”, order-driven systems work well in high volume trading environments where speed of execution is critical. However, this technology may not allow brokers to negotiate trades, and executions are not guaranteed.

*Quote driven systems* (like the LSE and NASDAQ) are dealer-based because they rely on competition between dealers to derive the best buy and sell prices. The dealers are required to guaranty execution within specific pricing ranges (or bands), but transparency may be sacrificed because these systems usually do not display customer buy/sell orders to the market. There is substantial on-going debate about the two trading methods, and market realities appear to be moving both variations toward hybrid systems that increase transparency without sacrificing competition for orders by markets makers and dealers.

In Ukraine, the PFTS Stock Exchange is clearly the most experienced and sophisticated exchange. Its trading system appears to fit into the quote-driven category (similar to the earlier Russian RTS system), but it has elements that may derive from the blind auction

model discussed above. We believe the PFTS should acquire or develop a new system that retains the highest level of transparency, while improving both trade execution and processing capabilities. Specifically, there are continuous order-driven systems available that will accommodate off-exchange negotiation, without sacrificing speed of execution or market transparency.

While trading technology evolves constantly, it is important to note that stock exchanges continue to occupy the central position in the capital markets. The exchange sets the standards for broker membership, and it determines the operating rules and limitations that members must accept as a condition of participation. In the vast majority of cases internationally, stock exchanges are privately owned institutions, both operated and managed by their member brokers. In effect, the exchange members set common rules for all, in order to protect their individual business and financial interests.

Improved technology has not diminished the need for sound operating rules, and it has certainly not eliminated the requirement for timely and comprehensive monitoring of trading activity. On the contrary, more sophisticated systems have led to increased investment by exchanges and regulators in market surveillance software. These systems give the regulator real-time access to all trading activity across the markets, and they often contain sophisticated analytical and operating capabilities. Flexible “parameter-driven” systems monitor trading activity, and employ pre-set limits that trigger instant alerts for violations of trading rules and procedures.

### **Clearing & Settlement Operations:**

Clearing & settlement is a post-trade function that is either accomplished at a specialized clearing organization or through a central securities depository (CSD). Stated simply, it is the process by which the obligations of the parties to a trade (buyer and seller) are calculated, verified, and properly discharged. This post-trade operational process usually takes from 1-3 days, depending on the market and its technical processing capabilities. Special circumstances (usually involving negotiated trades) can take longer by mutual agreement of the parties. However, clearing & settlement always begins on the day the trade is executed, which is commonly referred to as “T+0.” The intent is to establish the buyer’s contractual obligation to pay for the securities, and the seller’s equal obligation to deliver the securities against payment at an agreed time and place. A seemingly simple operation, clearing & settlement is actually a complicated process that, from time to time, causes substantial problems in many markets.

Stock exchanges often produce the trade contract documentation that initiates the clearing & settlement process. Information on executed trades is sent electronically to the CSD, and the clearing & settlement system automatically compares and matches each seller’s security position with the buyer’s purchase documentation. A legally binding trade “confirmation” is then produced and distributed to each of the parties to the trade. Where a large institutional customer is involved, the CSD system should allow the customer to “affirm” the details of the trade. The transaction is then cleared for settlement, and added to each brokers’ total settlement obligations (for all clients) for the day in question.

To protect the integrity of the global markets, international standards for clearing & settlement were developed by the international Group of Thirty (G-30). Established in 1978, twenty G-30 recommendations on clearing & settlement have become the standard for international securities clearance and depository operations. Within this paper, the most relevant of these standards for Ukraine are condensed and loosely reproduced below:

1. Comparison of trades should be completed by T+0, and matched trades should be linked to the settlement system.
2. Indirect participants (institutional investors or non-member brokers) should participate in trade comparison, and produce a positive “affirmation” of trade details by T+0.
3. Delivery versus Payment (DVP) should be employed for settling all securities transactions. DVP is defined as a *simultaneous, final, irrevocable and immediately available exchange of securities and cash* on a continuous basis throughout the day.
4. A rolling settlement system should be adopted by all markets, and final settlement should occur no later than 3 days after trade execution (T+3).

Apart from “finality”, the most important of the G-30 recommendations relates to DVP settlement. DVP means the seller delivers securities and the buyer simultaneously effects payment for those securities, usually on the third business day after trade execution. To reduce settlement and foreign exchange risks, markets have always sought to shorten their settlement cycles. With new technology, some markets are moving toward (or have already adopted) T+0 settlement, but shorter processing cycles require fundamental changes in operating procedures and substantial investment in new systems technology.

Finally, the G-30 standards prescribe that indirect participants (like pension and mutual fund managers) should be members of a trade comparison system that allows them to positively “affirm” the details of trades made on their behalf by direct CSD participants. A member broker or custodian must give the indirect participant access to the trade comparison system for purposes of affirming trade details on trade date (T+0).

### **Central Depository Operations:**

The following technical description is provided because certain aspects of the Ukrainian market are similar to the structure used in the U.S and Canada. This paper will later make recommendations for consolidation of all trading activity, as a means to improve both transparency and market efficiency. The recommended changes will result in greater transaction volume at the CSD, and this volume can also increase the risk of settlement failures. Appropriate procedures will be required to reduce the possibility of such disruptions in the market.

For settlement to work efficiently, brokers are required (theoretically) to control their clients' securities and cash. In reality, they often cannot guaranty delivery, and this can result in "failed" trades. Fails are a chronic problem in many markets because they can only be fully prevented by systems that "lock in" both the securities and cash positions prior to trade execution. The CSD must either have physical control of securities and cash, or it must adopt procedures that mitigate the risks arising from incomplete control of "both sides" of all trades.

The risks associated with failed trades can be profound, and they can affect individual clients, their brokers, and ultimately, the entire securities market. While there are many forms of risk, the most relevant to this report are 1) settlement risk (if DVP fails), and 2) systemic risk, which derives from failed trades that set off a sequence of downstream failures. If a trade fails at T+3, and the seller has previously committed the expected funds to other purchases, further fails are almost certain. This sequential failure can have repercussions that threaten the stability of the entire market.

CSD organizations may develop solutions to these problems based on conditions in their markets, but they all seek to conform to G-30 standards. Cash positions can readily be secured by pre-delivery of client funds to the broker, or directly to specially created settlement bank accounts. However, the CSD must have physical control of securities in order to guaranty delivery at settlement, and this is not always possible in active markets. As a practical matter, pre-verification of ownership is only achievable where a *central registrar organization* maintains complete records of all beneficial owners of securities. This alternative will be further discussed in the following section. In the absence of a central registrar, other less direct means are employed to limit the risks of a failure to deliver securities at settlement.

In the US markets, stock ownership is normally evidenced by physical share certificates issued to the owner by the issuing company's "registrar". Prior to the automation of post-trading operations, a buyer of shares would receive the seller's certificates, and these would be sent to the registrar for re-issue in the new owner's name. If that owner later sold those shares, the process would be repeated. Unfortunately, re-registration can take several weeks, and problems can occur if the shares are actively traded. In the above example, the shares in question could have been re-sold several times before the first re-registration was completed.

To eliminate this problem, the use of "nominee" ownership was introduced and became common practice in the U.S. markets. All brokerage houses create a unique nominee name for their firm, and routinely encourage their clients to leave their securities on deposit in the broker's custodian (bank) account. The broker re-registers the securities in its nominee name. When they are sold again, the broker delivers the shares to the buying broker, who then repeats the re-registration process for its own nominee name. While this improves the broker's ability to make good delivery of securities, it does not substantially reduce the need for re-registration into nominee names. Once again, dramatic increases in transaction volume eventually created further problems.

To cope with growing trading volumes, the US markets eventually created Depository Trust Co. (DTC) as the central clearing & settlement organization. DTC was established and funded by the market participants as a means to “immobilize” physical certificates. Stated simply, brokerage firms deposit their client securities at DTC, which immediately re-registers those shares into its own nominee name. It maintains a separate internal account for every member-broker, and simply “moves” shares from the inventory records of one broker to another through a process known as “book-entry” accounting. In this way, DTC has effectively immobilized more than 95 % of the shares traded in the U.S. markets, and this has vastly reduced the need for re-registration of physical certificates. For all practical purposes, DTC is the registered owner of most of the securities in circulation in the U.S., as reflected in the records of independent registrar organizations.

It is important to note the distinction between immobilization and the growing concept of “dematerialization”. *Immobilization* is the process by which physical share certificates are essentially removed from circulation in the securities markets. The actual shares still exist, though most are represented by a “master” certificate held in the name of the central depository. Any individual client can arrange for issuance of a physical share certificate, and this is often the case when, for example, shares are given as gifts to family members. In a *dematerialized* environment, no physical certificates exist. Ownership is represented by documentary evidence taken from the official records of the issuing company’s registrar.

### **Independent Registrars:**

U.S. companies have, for many years, used independent registrars to maintain their official record of share ownership. The system works because electronic links between DTC and its members enables periodic reconciliation and audit of ownership records. Over the past 30 years, DTC has expanded its role to meet industry demands for ancillary services, like cash and stock dividend collection and disbursement, and distribution of annual reports and related materials to the actual (beneficial) owners of securities. Because it is the largest “owner of record” of many share issues, the registrars routinely cooperate with DTC in the distribution of shareholder information.

For comparison purposes, some newer markets have adopted the concept of a central registrar organization. As indicated earlier, it replaces independent registrars completely, and in doing so, is able to make the records of individual share ownership available directly to the market institutions. The stock exchange and/or CSD can access these records prior to commencement of trading. If a seller’s shares are verified in the registrar records, a hold can be placed on the shares and delivery guaranteed prior to trade execution. As with the other market institutions described herein, the central registrar is usually created as a non-profit entity, owned jointly by the market participants. Its primary purpose is to act as a repository of ownership information that can be used to eliminate trade failure under the DVP processing environment.

Opinions vary on the relative advantages of independent vs. central registrars. The U.S. system of independent registrars evolved over many decades, and probably traces its roots to the American emphasis on competition and private enterprise. While these can produce important advantages, the use of independent registrars has created problems for market participants. The time-consuming registration process was, in fact, a primary cause for development of immobilization procedures. The central registrar concept offers important efficiencies in trade processing because one central institution maintains all ownership records. It has the ability to ensure that both cash and securities are available for settlement, thereby eliminating the primary causes of failed trades. This enhanced efficiency makes “same day settlement” (T+0) practical and efficient. However, there is continuing concern that a central institution can be subjected to political and/or other pressures that may cast doubts on the accuracy and reliability of shares ownership records.

### **III. Current Situation in Ukraine**

The basic institutional structure of Ukraine’s capital markets is, in many respects, similar to the organization of the North American markets. The local market has multiple stock exchanges, two depositories, and a large number of independent registrars. There is a securities regulator (the SSMSC), managed by Commissioners appointed for 7-year terms by the President and approved by the Ukrainian Parliament. There is also a Financial Services Regulator (FSR) with responsibility for monitoring other components of the capital market, including most notably, the various participants in the developing private pension system. Finally, and perhaps due to recommendations of the donor community, various self-regulatory organizations (SROs) have been created to help the formal regulatory bodies monitor the activities of market participants.

The following briefly summarizes the activities and condition of the primary institutions that comprise the local securities market:

1. **PFTS Stock Exchange** – The PFTS was created with USAID assistance more than 10 years ago. It operates as an SRO, and conducts trading activities using a quote-driven system originally designed by the US-based National Association of Securities Dealers (NASD). We point out that this system was implemented in Ukraine in the mid-1990s as a start-up solution for the new stock market. Other versions of the system were installed to support the fledgling RTS system in Russia, and the RASDAQ, OTC-oriented system in Romania. Both of those systems have been independently improved or replaced by more sophisticated and powerful trading systems.

By all reports, the PFTS now accounts for approximately 90% of exchange-based trading activity in Ukraine. It is under increasing pressure from its members and certain government sources to upgrade its trading system to a more flexible, order-driven environment. The PFTS membership has indicated a strong interest in acquiring “market-maker” capabilities that are similar to the trading practices common in more developed financial markets. This development would require

careful review and regulatory involvement by the SSMSC, particularly in terms of monitoring and enforcement of market making rules and regulations.

Against this background, numerous market assessments have indicated that an estimated 90% of *total securities market trading activity* is actually done off-exchange. Our current investigations have essentially confirmed this information, and it implies that less than 10% of overall trading activity is executed through the PFTS Stock Exchange. All other trades are negotiated away from the organized markets, and certainly outside the scrutiny of the PFTS' self-regulatory authority. The terms and conditions of these transactions appear to be opaque at best, and clearing & settlement is accomplished between the parties. The SSMSC requires (and apparently receives) reports on this activity 5 days after the trades are completed, via paper or computer diskette. This reporting is not adequate for effective monitoring and not in compliance with international standards for securities commissions.

2. **Other Exchanges** - There are currently eight other stock exchanges licensed by the SSMSC, which in the aggregate account for the other 10% of exchange-based trading. The majority of these exchanges apparently derive their revenue from the sale by auction of shares in state-owned enterprises. These exchanges are controversial, and beset by allegations of favoritism and lack of transparency. It appears that most have no credible experience or capacity to conduct normal trading operations.

The only exception to the above may be the Ukrainian Stock Exchange (USE) which reportedly has an older version of a trading system acquired from French sources. Assuming this remains accurate, we believe the USE must also implement a program to upgrade or acquire trading software that conforms to present-day international standards of transparency, flexibility, and trade reporting. For any of Ukraine's other stock exchanges to gain credibility in the markets, their core trading systems must meet the participant's requirements. They must also have the processing and data transmission capabilities needed for delivery of information to the securities market regulators. In the absence of a commitment to upgrade systems capabilities by these organizations, we consider the PFTS to be the primary securities trading platform in Ukraine's capital market.

These organizations are listed below:

- **Ukrainian Stock Exchange**
- **Perspectiva TIS**
- **Kiev International Stock Exchange**
- **Ukrainian International Stock Exchange**
- **Donetsk Stock Exchange "Innex"**
- **Pridneprovsk Stock Exchange**
- **Ukrainian Interbank Currency Exchange**

- **South Ukrainian TIS**

- 3. Interregional Securities Union (MFS)** – Somewhat like the PFTS, the MFS depository is the oldest and only experienced securities depository in Ukraine. It too was created with technical assistance from USAID, and it operates on an automated system that essentially serves the needs of the existing securities market. The MFS system is tested and reliable but does not provide automated DVP processing capabilities, and thus does not conform to the G-30 clearing & settlement requirements described earlier. Further, MFS has not established a Guaranty Fund to protect against the hazards of failed trades.

It should be emphasized that the MFS was reportedly only required (by market participants) to settle some 30 trades via DVP during 2006. This suggests it justifiably defends its operating shortcomings by citing the lack of demand for such services. It is also clear that DVP settlement is not used because most trading is done off-exchange. Actual settlement occurs informally between the parties, further suggesting that adherence to the G-30 standard for “finality” may also be problematical. This situation exists because the operative laws in Ukraine do not prohibit this activity.

- 4. National Depository of Ukraine (NDU)** – The other licensed depository in Ukraine, NDU is a (86%) majority-owned state entity funded by allocations from national budget sources. The NDU received its license in 2007, though by all reports, it has no direct operating experience as a securities depository. It apparently functions on the basis of codification services it provides to securities issuers. The NDU is at the center of a long-standing debate over the proposed formation of a central depository that would consolidate the operations of the MFS and NDU. That idea was not implemented after considerable pressure from the donor community and market participants in 2006.

Current plans for a national depository are described in a Letter issued by the SSMSC to the Cabinet of Ministers that has been discussed with all major interested parties. The Letter calls for a merger of the two depositories, with the state holding a 25% plus 1 share stake in the new entity. Because partial state ownership of a central depository is not uncommon in developing markets, this report finds no fault with the current plan that includes a partial government stake in the CSD. Indeed, it should be viewed as a positive effort to stabilize the central depository operation, and separate it from political considerations that have created uncertainties in Ukraine’s capital markets.

- 5. Independent Registrars** – There are approximately 350 licensed registrars in Ukraine, most of which are members of, and represented by the PARD association. Neither the operating or managerial capacity of PARD nor its membership is assessed in this paper. However, we are aware of continuing allegations that many of its members are, in fact, “pocket registrars” whose operations are effectively controlled by the companies for which they maintain

share ownership records. We note that international experience (in Russia and elsewhere) has indicated such operations are frequently the object of protests and legal action arising from questionable registry practices. Scandals surrounding allegations of fraudulent attempts to disguise or eliminate ownership records have occurred in Ukraine, and reform through passage of legislation to prohibit these practices should be a major priority for the Government of Ukraine.

6. **Securities and Stock Market State Commission (SSMSC)** – The SSMSC has been in existence since 1995, with regulatory authority to monitor the operations of all securities market participants. The present commission has indicated a willingness to address certain difficult issues that have effectively been ignored in previous years. It has cooperated fully with USAID’s Capital Markets Project (CMP) in the development and introduction of a new electronic disclosure system (EDS) that will require full periodic reporting of financial and operating information by all listed companies in Ukraine. Based firmly on international financial reporting standards, the EDS system represents a substantial step toward the adoption of rules and procedures that will increase information flow and transparency to the capital markets.

Unfortunately, the SSMSC lacks the necessary legal authority and independence to regulate market activities by the standards defined, for example, by the International Organization of Securities Commissions (IOSCO). The SSMSC is funded from the State budget, and in the present circumstances, must submit a separate draft law to the Verkhovna Rada to obtain authority to consolidate trading at the regulated stock exchanges.

There are also concerns related to the Commission’s authority to undertake effective disciplinary action, and the CMP advisory team has agreed to provide technical assistance to improve its ability to supervise the markets based on international practice. We believe the SSMSC’s independence from government pressure is an important component of effective supervision. Priority effort should be initiated to allow the SSMSC to levy fees on market participants, and to retain that fee income for internal operating expenses. This will reduce its dependence on government budget allocations, and naturally strengthen its regulatory authority over market participants.

7. **Financial Services Regulator (FSR)** – As indicated earlier, the FSR has been designated the primary regulator for non-bank financial (other than securities market) and pension related activities in Ukraine. It has formally agreed to cooperate fully with the CMP in the planned adaptation of the EDS system for use in reporting and disclosure by pension market participants. Given the potential societal impact of any future fraudulent activity by pension fund managers, a strong and efficient regulator must be a national priority for Ukraine.

Like the SSMSC, the FSR is a state funded agency, and it too lacks full authority to effectively carry out its regulatory obligations. Among other things, the FSR

does not have authority to verify the credentials of applicants seeking licenses to manage the investment of contributions into the private pension system. Pension reform and regulation should be among the highest priorities for the Government of Ukraine, and we urge all parties to firmly establish the FSR as an independent regulatory agency. It too should collect fee income on the basis of accepted international norms, and gradually eliminate its reliance on government funding.

8. **State Property Fund of Ukraine (SPF)** – The SPF is the designated government agent responsible for sale of state-owned enterprises. Historically, these sales are either negotiated directly with investor groups (foreign or domestic), or sold via state-operated auctions through one of Ukraine’s licensed stock exchanges. Based on recent discussions with SPF management, the Fund is in process of a substantial sales program designed to ease the government’s current budget deficit.

Unfortunately, the SPF has no experience with privatization sales by Initial Public Offerings (IPOs) through any organized stock exchange in Ukraine. Indeed, SPF management has recently indicated a pressing need for assistance in preparing for partial public offerings (via IPO) of shares in state-owned enterprises. These sales of minor blocks of enterprise shares can significantly improve overall returns to the government, by establishing a market-driven share price prior to negotiation with direct investor groups. The CMP team has tentatively agreed to provide technical assistance to the SPF in this regard.

9. **Private Pension Fund Managers** – There are currently approximately 70 private pension funds in Ukraine, managing voluntary pension contributions estimated to total approximately \$30 million. At this writing, the Pillar II (Mandatory Accumulation) Law is under consideration by the Verkhovna Rada. Assuming passage of the Law in 2007, Pillar II contributions are expected to begin in 2009, and first year contributions (at 2%) are projected at some \$500 million. More importantly, contribution flows of some \$200 million per month (or \$2.3 billion per year) are expected at the maximum 7% contribution rate.

Considering the vast sums of money entering the system over the next ten years, it is essential that strict controls be introduced to monitor the activities and reporting practices of pension fund managers. Both the World Bank and CMP are engaged in technical assistance to all parties concerned, and it is reasonable to expect at this writing that a proper operating and regulatory structure will be in place prior to commencement of the Pillar II system. However, we have an equal concern with respect to the securities market’s ability to provide a robust and transparent trading environment for pension fund investors. It is therefore critically important that new and varied investment products are introduced in Ukraine.

We believe this process should begin with expansion of the fixed income markets to include secondary trading in medium and longer-term Government and municipal bonds. To achieve long-term pension funding objectives, it is equally

important that the equity markets expand to meet the expected demand for growth-oriented instruments. The Pillar II Law requires pension funds to invest only through regulate markets, and this graphically illustrates the need for increased listings of shares in major state-owned enterprises. We note that mandatory pension programs in neighboring countries (like Russia and Kazakhstan) have encountered serious problems due to the unrealistic limitations placed on pension investments.

#### **IV. Primary Impediments**

This paper has attempted to identify and focus attention on the most critical impediments to development of a transparent and fair capital market in Ukraine. It is hoped this will lead to further discussion, and eventually to agreement on priorities for removal of these impediments. The most important impediments are indicated below:

*1) There is a widespread perception, domestically and internationally, that Ukraine's investment climate is marred by government intervention, lack of transparency, and widespread corruption.*

The above concerns have frequently been reported by various researchers and non-governmental organizations. The World Economic Forum's "Global Competitiveness Index" for 2006-2007 notes deterioration during the year, with Ukraine dropping from 68<sup>th</sup> to 78<sup>th</sup> position. The Index of Economic Freedom's 2007 assessment considers Ukraine to be 53.3% free, ranking it the world's 125<sup>th</sup> freest economy. It also indicates that Ukraine ranks 40th out of 41 countries in the European region. Most importantly, investment freedom is rated at 30%, freedom from corruption at 26%, and property rights at 30%.

These results point to serious barriers to investment, and most appear to be based on inadequate or arbitrary laws and regulations. Because substantial independent research is available, we have not attempted an independent assessment for this paper. However, we believe it appropriate to suggest that the Government of Ukraine has the ability to address these issues. Property rights must be reinforced and legal and bureaucratic restrictions on investment must be removed entirely. Perhaps most importantly, initiatives to strengthen the independence and integrity of the judiciary are required before foreign investment can be expected to increase in a meaningful fashion.

*2) The existing Company Law does not provide adequate protection for shareholders, and is not sufficiently specific in setting standards for corporate governance and financial disclosure.*

A modern JSC Law is an essential part of Ukraine's financial market development. Every investor, both foreign and domestic, will examine Ukraine's legal structure before committing investment capital to local enterprises. Because much has been written in previous papers, we note only the most important elements of the JSC Law:

- International standards for protection of minority shareholders
- Specific and reliable procedures for annual meetings and shareholder voting
- Clear rules defining the rights and responsibilities of Directors
- Firm requirements for information disclosure and reporting
- Specific regulations to prevent insider trading, unlawful dilution, asset stripping, and related-party transactions

The new Joint Stock Company (JSC) Law is presently under consideration by the Verkhovna Rada, and we urge all interested parties to actively support its passage without substantial modifications. The Law is urgently needed to eliminate the uncertainties and abuses that have inhibited investment and undermined the legitimacy of the market.

*3) Current banking laws impose restrictions on currency flows that are unrealistic, and which have reportedly led to the settlement of securities transactions outside the borders of Ukraine.*

The easing of currency restrictions is not discussed here in detail because monetary policy is determined on the basis of national priorities and political considerations. For the most part, these policies are not formed on the basis of capital market reform initiatives. Nevertheless, we note our firm belief that restrictions on export/import of currency are a primary impediment to the free flow of capital required for development of a vibrant and sustainable economic system. This capital is an inexpensive alternative to more traditional bank lending, which often involves high interest rates and unnecessarily short repayment terms.

The capital market is the nation's engine for growth because it is the venue wherein local enterprises compete for the capital required to fund technological development and expansion. This competition is based on investor perception of sound management and efficient and profitable operating practices. In effect, the capital market rewards well-managed and transparent business practices. The resulting expansion can create new markets that attract investment and foreign currency, and new labor opportunities that will eventually increase the nation's tax revenues. Clearly, increased tax revenues enable the government to improve infrastructure and deliver better social services to its citizens.

*4) Privatization of state-owned enterprises is conducted through non-transparent auctions or direct sales to strategic investors.*

Privatization sales are presently carried out in a manner that can lead to mistrust of both government activities and capital market operations. These transactions are done by direct sale or auction, making it difficult to establish prices that reflect the true value of the enterprises. Since these sales may not result in secondary market trading on the regulated markets, investors lose the opportunity to acquire shares in well-known local enterprises.

Moreover, these transactions lead to mistrust of market pricing methods, making it difficult (or impossible) for foreign and domestic institutional investors to purchase

shares in the secondary market. We believe this is a substantial disadvantage for pension fund managers who are required by law to invest through the regulated markets.

5) *The current Securities and Stock Market Law permits off-exchange trading in a manner that discourages the introduction of institutional investors to Ukraine's markets.*

Off-exchange trading is a major concern of this paper because it directly impacts the functioning and further development of the capital markets. As currently practiced in Ukraine, off-exchange trading fragments the market, and more importantly, discourages the uniform adoption of international practices for price discovery, best execution, and transparency in disclosure of market activity. Moreover, due to gaps in the regulatory structure, it undermines the ability of the central institutions to implement international standards for market operations and practices.

We emphasize that off-exchange trading is not inherently destructive, and this paper does not assert that the practice should be prohibited by law. On the contrary, there is ample evidence of similar operations in other markets. An over-the-counter (OTC) market has existed and operated successfully in the US for decades. It serves a valid and critical function by providing a market for lightly traded and (usually) smaller companies whose capital structure does not meet the listing requirements of the organized exchanges.

The OTC market allows brokers to negotiate trades in “small cap” issues, based on their experience and knowledge of pricing methodologies and current market conditions. The pricing “spreads” (between bid and asked quotes) in this market are often much wider than for listed and actively traded issues, and both brokers and their clients understand the risks involved. In essence, the off-exchange market matches smaller companies with investors willing to assume the risks associated with speculative opportunities. However, these transactions are nevertheless promptly reported and/or settled through transparent market organizations.

The absence of timely and transparent reporting is an inhibiting element in Ukraine's market. It is a direct impediment to foreign investment through the exchanges, because it reduces liquidity, encourages price manipulation, and casts serious doubt on the feasibility of orderly “exit strategies” for portfolio managers. It virtually eliminates the possibility for institutional investment by foreign mutual and pension funds, since both are usually required to trade through organized and regulated market institutions.

Fortunately, this practice can be readily modified and brought into compliance with international practices. The solution requires a financial commitment by various market participants for new systems, along with a coordinated commitment by governmental authorities to modify the existing legal and regulatory structure. Presuming commitments are forthcoming, our proposed recommendations and strategy are offered below.

## **V. Strategic Recommendations**

The following recommendations are based on the presumption that fundamental changes are required to bring Ukraine's securities markets in line with international standards. As indicated above, certain reform efforts are either under way at this writing, or simply not within the scope of this paper.

1. *The Board of the PFTS Stock Exchange should commit to the timely development or acquisition of a more sophisticated and powerful trading system.* We recommend a focus on purchase of a new system, and USAID and the CMP advisory team are prepared to provide assistance in the selection and implementation of such a system. Based on experience in other markets, we believe in-house development will be problematical and inordinately time-consuming. Adequate systems are available, and the selection process should focus on a solution that will support a continuous order-driven environment.

We suggest the PFTS should acquire this system because it presently accounts for 90% of exchange-based trading in Ukraine. For all practical purposes, it is the only exchange with a proven ability to operate and maintain an orderly and transparent market. Assuming future consolidation of trading (or trade reporting) through PFTS, an efficient and sophisticated system will be a prerequisite for maintaining an orderly market. The system alternatives should be evaluated on their ability to provide enhanced surveillance and monitoring capabilities that can strengthen PFTS' self-regulatory activities.

As indicated earlier, these recommendations can and should be extended to other Ukrainian stock exchanges, provided they can demonstrate an ability and willingness to compete effectively with the PFTS. This is likely to require a capital commitment to upgrade operating systems, along with an operating plan that demonstrates their intention to maintain a commercially viable trading venue for market participants. Moreover, this is likely to involve a further investment in professional staff with the training and experience in trading, listings, and SRO-related compliance procedures.

2. *The MFS should acquire and implement a new central depository, clearing & settlement system.* The MFS is recommended purely on the basis of its lengthy depository experience, which gives it a unique ability (within Ukraine) to accommodate and adapt to new systems and operating procedures. The new system must have flexible clearing & settlement characteristics, and the capacity to interface electronically with all related market institutions and participants. Moreover, the system must offer the ability to clear and settle a reasonable array of equity and fixed income securities.

The eventual consolidation of trading through the PFTS will have a profound impact on the MFS' clearing & settlement operations. We strongly urge both institutions to cooperate in the implementation of the G-30 recommendations discussed above. *DVP processing should be mandated*, and the contractual obligations of the parties clarified and documented to assure finality of settlement. *A properly configured Guaranty Fund should be established*, based on clearly defined procedures for

calculating broker contribution obligations. Given the DVP environment, non-participating brokers should be required to settle their trades through a participating member specifically authorized to function as a clearing broker. Perhaps most importantly, *the market institutions should implement a trade comparison system that enables all institutional investors to positively affirm trades executed on their behalf.* This is of crucial importance for ensuring proper trade execution and settlement for pension fund portfolios.

To eliminate errors and manipulation of ownership records, *independent registrars should receive re-registration instructions directly from the MFS.* These should be transmitted automatically if possible, and the trade documentation generated by brokers, PFTS, and MFS *should be established in law as the legal evidence of share ownership in Ukraine.* Considering the substantial aggregate investment in establishment of independent registrars, we do not recommend creation of a central registrar entity in Ukraine. While a central registrar may represent a more efficient and reliable alternative, the independent registrar environment has been in existence for more than 10 years. We believe regulatory changes can be implemented to improve both the efficiency of the present system, and the security of the ownership data maintained by the registrars.

We stress that this recommendation is not intended to preempt or subvert the merger process outlined in the SSMSC's Letter described earlier in this paper. Indeed, we consider this Letter should be binding on the parties, and would recommend that government funding be provided for acquisition of the new processing system. This would be entirely consistent with the government's determination to acquire an ownership position in the central depository. This paper refers to the MFS for reasons indicated earlier, and urges any (post merger) successor organization to undertake the reforms discussed above.

3. *The SSMSC and FSR should lead a coordinated government initiative to create the legal framework required to move off-exchange trading to the regulated markets.* This must include modifications to the existing securities laws (or passage of new laws) that mandate the gradual implementation of electronic reporting by brokers of all trades through the PFTS system. This reporting can be made directly to the MFS, but the procedures involved may strain broker systems capabilities, and unnecessarily complicate the systems selection and implementation process. An alternative strategy for consideration by the PFTS would be the creation of a new "OTC Board" that displays all off-exchange trades for information purposes.

Regardless of method, we urge the regulatory authorities to require all trades in listed securities to be immediately reported and disclosed to market participants. To facilitate this transition, *both regulatory commissions should select and implement modern regulatory surveillance systems,* as described earlier in this paper. Again, USAID and the CMP project are prepared to provide all possible assistance to the commissions in the selection and implementation of appropriate software.

We also recommend that both *regulators be granted full authority to levy and collect licensing and other fees* normally associated with the activities of securities market regulatory commissions. This will alleviate pressure on the government budget by gradually shifting the commissions' funding requirements to the professional participants in their respective markets. It will strengthen the Regulators' authority by emphasizing their independence from government funding sources. These practices are well established in the developed markets, and indeed, are considered essential by foreign institutional investors.

4. *The SPF should make a commitment to sell stakes in important state-owned enterprises through initial public offerings on the organized markets.* Since many state-owned entities are substantial and profitable enterprises, the listing of some portion of their shares at the PFTS would have a significant and positive effect on securities market development in Ukraine. They would strengthen the "blue chip" base of the equity markets, and provide an essential pricing benchmark for other, lesser-known equity issues. Moreover, listing of these shares via IPO would demonstrate the government's commitment to market reform, legal due diligence, and financial reporting based on international accounting standards.

The IPOs should be preceded by public tenders for selection of auditors, legal representatives, and most importantly, the investment banking teams that will organize, manage, and bring the offerings to market. As indicated above, the CMP team can also provide training and technical guidance to the SPF and, if appropriate, to the management teams of the companies slated for public offerings.

## **VI. Potential Benefits**

1. The consolidation of trading information through the PFTS will substantially improve the transparency and reliability of the market information used by investors. All trading data will be available for normal pricing operations, and the acquisition of major blocks of shares in listed companies will be published and reviewed by all investors.
2. Market regulators will gain immediate access to all trading data, and their upgraded monitoring systems will provide timely notification of unusual or prohibited market activity. This will substantially improve their ability to discern and prevent market manipulation and insider trading techniques.
3. Significant barriers to foreign and institutional investment will be eliminated, setting the stage for investment growth in Ukraine. Increased investment through the stock exchange will substantially improve market liquidity, and serve to reduce investment managers concerns over the present inability to develop sound exit strategies.
4. Foreign and domestic pension funds will have increased confidence in the reliability and transparency of the markets. With the introduction of new investment products,

pension managers will have realistic alternatives for portfolio diversification and long-term growth of pension investments.

5. Domestic investors will have viable investment alternatives, thereby reducing pressure and pricing on the real estate and banking markets. Furthermore, the growing competition between these sectors will inevitably produce better investment returns and alternatives for all investors.