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Capital Markets Project

Ukraine's Securities Depository System: Risk and Recommendations



Harry Cartner
International Securities Depository Specialist
Capital Markets Development

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Central Clearance Depository Chronology

The chronology of events in the development of the depository structure is important to understanding the political and economic environment in which Ukraine's depository system has been evolving.

- 1996—Verkhovna Rada adopts a Concept for the Development of the Capital Market in Ukraine.
- March 1997—Interregional Securities Union (MFS) is established as an open joint stock company by market participants in order to serve as a depository for Ukrainian companies and trading systems.
- December 1997—The Law “On the National Depository System” is approved. The Law provides for the establishment of the National Depository of Ukraine (NDU).
- June 22, 1999—Presidential Decree “On the General Basis for the Operations of the National Depository System of Ukraine.”
- 1999/2000—USAID provides technical assistance to MFS to strengthen its work as a fully functional depository that can support the development of a capital market in Ukraine.
- January 1999—Memorandum of Understanding among the Government of Ukraine, the International Bank for Reconstruction and Development, and the Government of the United States of America “On the Development of a Securities Industry-Owned Clearing Depository” is signed.
- May 17, 1999—The NDU is established as an open joint stock company with the State Securities and Stock Market Commission controlling 86% of its shares, the National Bank of Ukraine holding 4.4%, and the remaining shares, 9.6% owned by 21 market participants, including 1 share owned by MFS. SSSMC Commissioner Viktor Ivchenko is appointed to head the NDU.
- May 18, 1999—Cabinet of Ministers Resolution is adopted, based on the recommendation of the SSSMC, to transfer management of the State's 86% ownership in the NDU to the Ministry of Finance (43%) and NBU (43%).
- July 2001—Cabinet of Ministers adopts a resolution transferring the management of State's 86% ownership in the NDU to Ministry of Finance.
- December 7, 2005—Cabinet of Ministers adopts a resolution to transfer management of State's 86% ownership in the NDU back to the SSSMC, as provided in the 1997 Law “On National Depository System.”
- December 14 and 23, 2005—NDU holds a general meeting of shareholders that, among other issues, approves a decision to empower NDU to operate as a fully-functioning depository, including authority to clear and settle transactions on Ukrainian exchanges.
- January 18, 2006—Cabinet of Ministers passes a resolution to terminate MOU with US Government and World Bank.

Preface

This paper presents a snapshot of the current status of the development of one of Ukraine's capital market institutions, the securities depository. A depository is one of the most critical institutions required for a vibrant capital market to develop. Its importance can be seen by the continuing struggle in Ukraine for control of the Interregional Securities Union (MFS), a Ukrainian depository established by market participants in 1997.

It is hoped that this overview of the work of MFS will provide policy-makers and international donors with a roadmap to positive change in Ukraine leading to increased momentum for real reform of its economy.

I would like to acknowledge the assistance of the staff of MFS, Mykola Shvetsov, its president, and Yuriy Shapoval, his deputy, and their extraordinary candor in responding to my many questions. In addition, I would like to extend a special thank-you to Anatoliy Holovko, Deputy of the National Depository of Ukraine, who provided valuable information on the operation of this institution.

My meetings with market participants provided additional context for the information in this report in terms of the current problems and challenges they face in establishing a functioning market economy in Ukraine. I would like to thank the following Ukrainian experts for their valuable input: Mykhailo Nepran, Chief-of-Staff of the State Securities and Stock Market Commission; Ihor Seletskiy, President of Troika Dialog Ukraine; Ihor Seliverstov, First Deputy Chair of the Board of Directors of the Ukrainian Interbank Currency Exchange; Irina Zarya, President and CEO of the PFTS; Bohdan Lupiy, Executive Director of the PFTS; Serhiy Oksanych, President of Kinto; Anatoliy Fedorenko, Vice President of Kinto; Volodymyr Scherban, Chair of the Supervisory Board of the Professional Association of Registrars and Depositories (PARD); Andriy Kazakov, President of the Kyiv International Stock Exchange; Hanna Yatsiuk, Chair of the Council of Directors of the Ukrainian Stock Exchange (USE); Denis Butenko, Operations Manager of the USE; and Dmytro Tarabakin, Director of Dragon Capital.

Harry Cartner is a Securities Operations Executive with over thirty years' extensive experience in clearing, settlement and depository operations and systems. Mr. Cartner has worked internationally in such countries as Canada, Mexico, Algeria, Cote d'Ivoire, and Bulgaria.

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Executive Summary

Currently there are two depositories in Ukraine: the Interregional Securities Union (MFS) and the National Depository of Ukraine (NDU).¹ MFS was established by market participants in 1997 and is the only functioning depository. It has developed as a state-of-the-art depository with technical support from the United States Agency for International Development (USAID). Later, in May 1999 the NDU was established. NDU operations are limited under a Memorandum of Understanding, dated January 25, 1999, and valid through January 25, 2010, between the GOU, the World Bank and the US Government. Acting on behalf of the GOU, the 1999 MOU was signed by Deputy Premier Serhiy Tyhypko, SSSMC Chair Oleh Mozgoviy, and National Bank of Ukraine Governor Viktor Yushchenko.

“The NDU shall not have any commercial functions whatsoever and may incorporate only three functions (codification, standardization and international relations...)”

*MOU
January 25, 1999*

At the time the MOU was signed, it was recognized by the parties that the private sector is the engine of economic growth that has the capacity to generate the needed resources to complete market reforms in Ukraine. It was further understood that the parties would assist Ukraine’s securities industry to (1) build an industry-owned clearing depository capable of servicing all licensed securities markets, stock exchanges and trading and information systems, and (2) effect the voluntary merger of all existing or planned Ukrainian depositories into a single centralized clearing depository, predominately privately owned and operated by the securities market participants.

Recently, the Ukrainian government took three steps to consolidate its power over depository operations in Ukraine. First, on November 24, 2005, the President signed a Decree to enact the resolutions of the National Security Council of Ukraine. The first resolution, dated June 29, 2005, related to improving the investment climate in Ukraine and the second resolution, dated October 28, 2005, provides a program for improving the protection of the right to property of Ukrainian citizens. Among other things, this Decree and the related resolutions empowered the NDU with full depository functions, under the control of the State. This consolidation of power at the State level is contrary to international best practice for the development of a free market economy.

Next, this Decree was followed by a general shareholders’ meeting of the NDU in December 2005, whose agenda included expanding the operations of the NDU. At this meeting, the NDU, based on the State’s ownership of 86% of its shares, was granted permission by the GOU to engage in commercial operations as a fully-functioning depository.

The third step was a unilateral decision by the Cabinet of Ministers on January 18, 2006, to terminate the MOU between the GOU, the World Bank and the U.S. Government.

“The Cabinet of Ministers decided to terminate the MOU without consulting with international experts and without any discussion with USAID. SSSMC controlling a clearing organization would mean a dangerous conflict of interest. We are concerned that such unilateral actions of the GOU will adversely affect the market and investors, including non-State pension funds.”

*USAID Kyiv Office
January 20, 2006*

¹ The NBU has established several departments that perform depository functions for government securities and are often referred to collectively as “the NBU Depository.”

Many of the issues that the Decree addresses and proposes to resolve by empowering the NDU, such as the protection of ownership rights, the elimination of double registries and the improvement of the investment climate, are laudable goals. However, the way that these policies are being implemented gives the impression that the market reforms already achieved by Ukraine are being eroded and that Ukraine is returning to the clutches of special interest groups. The adverse effect of these actions not only prevents Ukraine from advancing but will actually reverse its status as a country with economic freedoms.

While the immediate consequence of these GOU actions appears to be the demise of MFS, when viewed in their totality, they have a serious negative impact on the transition of Ukraine to a free and competitive market economy.

1. Overview of Depository Functions

Based on international practice, the central depository is essential to a well-organized capital market. It provides secure custody of ownership records. The depository/registrars maintain a record of the owners of securities for a company. For each broker/dealer and issuer, the depository maintains a record of shares. Following successful clearance and settlement, the depository records the transfer of the security from the seller's account to the buyer's account and then the registrar reconciles the registry to insure that it is in balance. The registrar often provides other critical services such as issuing material for annual shareholder meetings and payment of dividends, calculating the votes at annual shareholders meetings, and mailing other information required by law to shareholders.

"Governments need to be careful of [state ownership] because, in some emerging markets, public cynicism about state ownership runs so high that state ownership or operation of these functions, even initially, may discourage citizen participation in share ownership and capital markets development."

Securities Exchange Essentials
The World Bank, 1996

While the ownership of the registrar can take many forms, it is essential that it be *independent*, free from abuse by market participants or government interference. When the registrar is not independent, this fosters distrust. Too often, there are reports of ownership records being struck from the registry, adversely affecting both domestic and foreign investment and good corporate governance.

The lack of independence in the depository and registrar functions has been particularly problematic in emerging economies. Frequently, the government's response to this problem has been to create a state agency to handle the process. But it is most important that the ownership structure provides the *essential creditability and trust* in the system.

International experience has shown that investors will not enter—or will quickly abandon—a securities exchange with questionable clearance and settlement, doubtful custodial protection, or uncertain liquidity. A recent example of such problems with the system occurred in Japan,² when the stock exchange had to close trading earlier than its posted hours due to its inability to handle the volume of trading. The volume caused problems in the clearance and settlement process.

There are many lessons to be learned from experiences in emerging markets that have had a negative effect on the development of the capital market because of poor clearance and settlement systems and lack of independent depositories. For example, as early as 1996, it was reported that one foreign company that had invested \$60 million in an aluminum company in the Russian Federation had its ownership wiped off the company's share registry. In another case in India, it took more than 500 days to transfer ownership to a major investor. Yet another violation of shareholder rights resulted when a company doubled its share capital by making an unauthorized issuance to friends of the management, diluting the ownership interest of existing shareholders.

Today, Ukraine is facing similar problems. Lack of a strong judiciary, coupled with a poor legal framework, has created a situation in recent years in which the actions of powerful oligarchs and political interference have been aimed at setting up dual registries of shareholders. Rightful owners have been deleted from the registries, particularly of key

² James Brooke, "Rush to Sell Shuts Down Tokyo Stock Exchange", New York Times, January 18, 2006.

energy companies in various regions of the country. This activity has created a critical problem for the country's policy-makers.

Clearance and Settlement

Stated simply, clearance and settlement is the process by which trades between two parties are reconciled. It ensures that each party to the transaction gets the benefit of the deal: securities delivered and payment made. The mechanics of this process begin once two parties contract to trade a particular security at a particular price. Following the executed trade, the parties—usually the broker-dealer intermediaries for each side—confirm the details of the trade and their respective obligations. The details of the trade are sent to the depository or clearinghouse, which compares the two sides of the transaction and confirms to the broker/dealer for each party whether the trade has been successfully compared or there are open questions on the transaction that must be resolved.

“Although largely invisible to the end investor, clearing and settlement lie at the core of all securities markets. In concept, there is nothing mysterious about this process; yet in practice, it is quite complex. Matching transaction terms, confirming and settling the many millions of trades taking place every day in major markets is complicated enough in a purely domestic context. But the process has become even more complex with the rapid growth of cross-border trading, which spans many clearing and settlement systems and legal and regulatory jurisdictions.”

*The Group of Thirty*³
2003

Once a transaction is successfully matched, the settlement obligations are calculated. This can be done on a “gross” basis for each individual trade, but general practice today is that the settlement obligation is made on a “net” basis for trades between the broker/dealers in a particular security. Netting simplifies the process by reducing the number of shares and the amount of funds transferred. In primitive markets, brokers settle transactions directly with one another bilaterally.

In more developed markets, the clearing process allows for the netting of the liabilities of one broker to another broker, multilaterally. For example, if a broker has sold \$1,000 of stock to other brokers and bought \$500 of stock from other brokers, the clearing process would require a net payment of \$500. This netting process is essential when there is an active stock exchange and a high volume of trading on a particular day or in a particular security.

Final settlement occurs when the obligation of the buyer and the seller are met: the securities are transferred to the purchaser and the seller receives payment for the securities. If the transfer of securities and funds occurs **sequentially**, it leads to substantial risk for the market and the parties to the transaction. Only one party is satisfied initially, while the other party faces many risks. For example, if the purchaser has the securities, they can sell these to a third party, although there is a question of legal title to the securities since they have not been paid for. On the seller's side of the transaction, the securities have been released but not paid for. Or the seller might refuse to deliver the shares because the market price increased significantly before final settlement. Thus, there is systemic risk in the transaction and a loss of confidence in the market.

In developed markets, and in recognition of the globalization of securities markets, such risks are mitigated by a delivery-versus-payment (DVP) system. Under a DVP system, the delivery of securities occurs **simultaneously** with the transfer of funds.

³ Global Clearing and Settlement, A Plan of Action, Group of Thirty (G30), Washington, D. C. 2003.

One of the important functions that a clearinghouse performs in a developed economy is to act as a guarantor of the broker/dealers in the market. It establishes a guarantee fund from among the broker/dealers using its services, based on the amount and volume of transactions conducted on the exchange. The existence of a guarantee fund, no matter how it is structured, avoids the process of constantly checking the creditworthiness of traders in the system. On an active securities exchange, it is impossible for each member to know the other party to a particular transaction. This guarantee function protects the integrity of the market and promotes investor trust in it.

There are several ways of structuring this guarantee function:

- First, the clearinghouse can require that all parties provide the securities and payment in advance of settling the trade. For example, the broker/dealer sets up a cash account at the clearinghouse before being permitted to trade and can only execute a trade if there are funds or securities in this account at the clearinghouse.
- Second, the clearinghouse can restrict participation to only those firms that meet certain minimum capital requirements. A broker/dealer who cannot meet these minimum capital requirements must transact business through one of the creditworthy intermediaries.
- Third, the clearinghouse can mandate a mutual guarantee system, where all firms agree to stand behind the performance of the other members in the system.

In summary, the goal of clearance and settlement is to have “seamless trade.” The guarantee system is designed to eliminate, to the extent possible, any systemic risk by establishing the necessary guarantees at the clearing and settlement stage. The guarantee acts as a substitute for each party to the transaction having to know the other party to the transaction and allows each party to have confidence that the other party will fulfill its obligation.

2. Background on Ukraine's Depositories

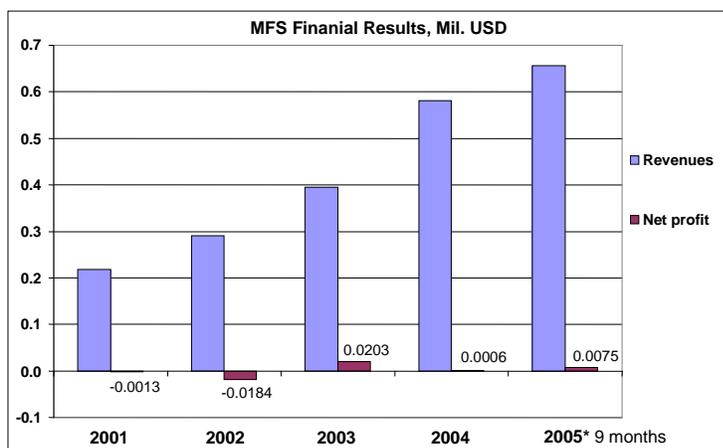
Currently, there are two depositories in Ukraine, the National Depository of Ukraine (NDU) and Interregional Securities Union (MFS). MFS is the only functioning depository for the Ukrainian securities market.

2.1 The Interregional Securities Union (MFS)

In 1997, market participants established MFS. The international donor community, with technical assistance provided by USAID, supported the further development of this market initiative, which resulted in a state-of-art depository. MFS was established as an open joint stock company under Ukrainian law. Of its 352 shares currently outstanding, nearly 50% are owned by eight participants who hold 4% to 10%: Ukrsofsbank (21 shares); First Ukrainian International Bank (PUMB) (22 shares); Oschadny Bank, the state savings bank (22 shares); Privatbank (21 shares); Business Invest (22 shares); Sea Transport (20 shares); Slavutysh Capital (14 shares); and PFTS (35 shares). These major shareholders are reported to be among the initial founders of MFS. Over 142 market participants, including other Ukrainian stock exchanges, broker-dealers, and foreign and domestic banks, own the remaining shares. In summary, the ownership structure is: 220 shares (62.5%) to banks, 91 shares (25.9%) to broker/dealers, 38 shares (10.8%) to exchanges, and 3 (0.8%) to others. This structure matches international practice, where banks play a key role as custodians and act on behalf of their clients as broker/dealers.

MFS currently has a 10-member board of directors which includes representatives of several market participants: Ukrsofsbank, Oschadny Bank, PFTS, Business Invest, Privatbank, First Ukrainian International Bank, Komeks Brokerage, the Ukrainian Interbank Currency Exchange, PromInvestbank, and Tekt Investment. The Board of Directors holds regular meetings and sets the policy for the operation of the company. The president of MFS is Mykola Shvetsov and he has one Deputy, Yuriy Shapoval. Together, they are responsible for the daily operations of the depository and report directly to the Board of Directors.

MFS has a staff of 35 who handle the daily work of the depository. The major departments are: financial (accounting) – 5, customer relations – 5, information technology (IT) – 6, operations – 5, and legal – 4.



As an open joint stock company, MFS files its annual report with the SSSMC and makes it available to the public. Because cost of transaction execution is a critical factor for all market participants—investors, broker/dealers, banks and custodians—, based on the policy of the MFS Board of Directors, the fees charged and operating costs are kept at a minimum. While MFS revenues have substantially increased over the past five years, it has reported

minimum profits and for two years it even reported a small loss as a result of this policy.

It services the accounts of over 1,100 market participants including issuers, banks and custodians who hold securities, equity and debt, in electronic format (dematerialized form) rather than certificate form.

MFS performs depository and clearance and settlement functions (transfer of securities positions) only for electronic (dematerialized) securities. In compliance with international norms, MFS has established a Delivery vs. Payment (DVP) system using an account at the National Bank of Ukraine (NBU). However, there are apparently less than 20 DVP transactions a year. The major reason for the limited use of the DVP system is the lack of political will on the part of the Government and certain market players to follow international norms.

In addition, it is reported that, due to currency transaction restrictions, most major transactions are settled offshore in euros or US dollars. Adding to this problem is the fact that existing regulations do not require that all transaction be conducted on the regulated market and existing regulations do not require that transactions be settled at the depository. These problems are among the reasons that the regulated market in Ukraine is one of the smallest in the region.

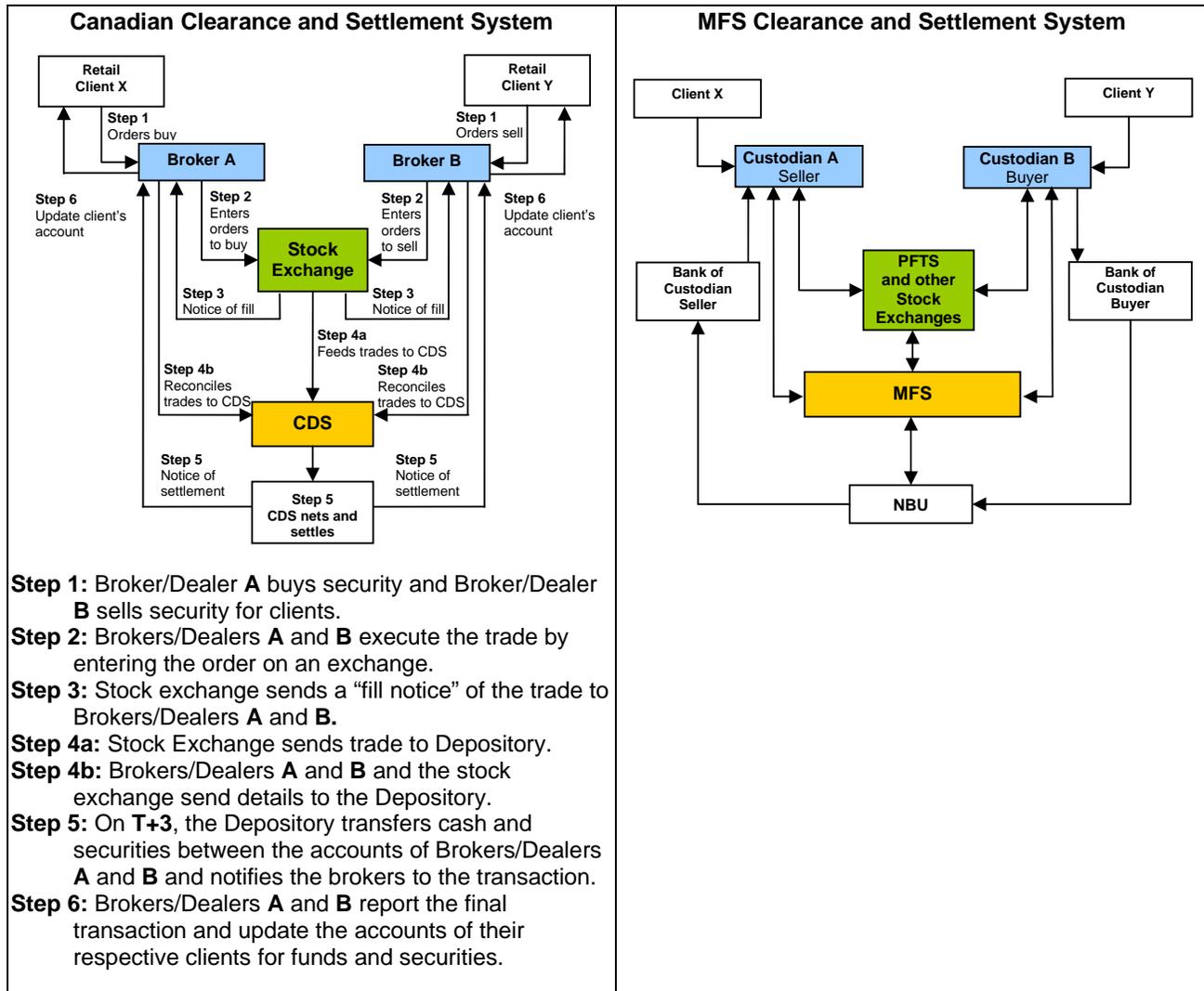
MFS staff display an excellent knowledge of the intricacies of a clearing depository process. A review of the activities of the operations department showed that transactions are handled promptly and effectively in accordance with international norms. MFS enjoys an excellent reputation among key market participants for its honesty, competency and transparency of operations. It appears that this has been difficult to achieve and maintain, given pressures from Ukrainian industrial groups coupled with reports of direct and indirect attempts by certain elements in the government to influence its activities.

MFS's Operations Department is, of course, the main department of the Depository. This Department handles the accounts of custodian/broker-dealers and issuers who have elected to establish electronic registries and place a global certificate with MFS representing shares held in the electronic registries. MFS's clearance and settlement system is handled through an electronic interface with Ukrainian exchanges and electronic trading systems.

MFS's operations are based on the North American model of depositories. An analysis of the flowchart of the operations of the MFS depository shows that it mirrors the Canadian Depository for Securities (CDS) described further, except that MFS does not have market demand to handle the money settlement portion of transactions. The current process for clearance and settlement through MFS is substantially in compliance with international standards. MFS has a special account at the NBU for clearance and settlement (MFS Special Depository Account). Transactions on the exchange or individually negotiated transactions are noticed to MFS by the exchange or the individual parties.

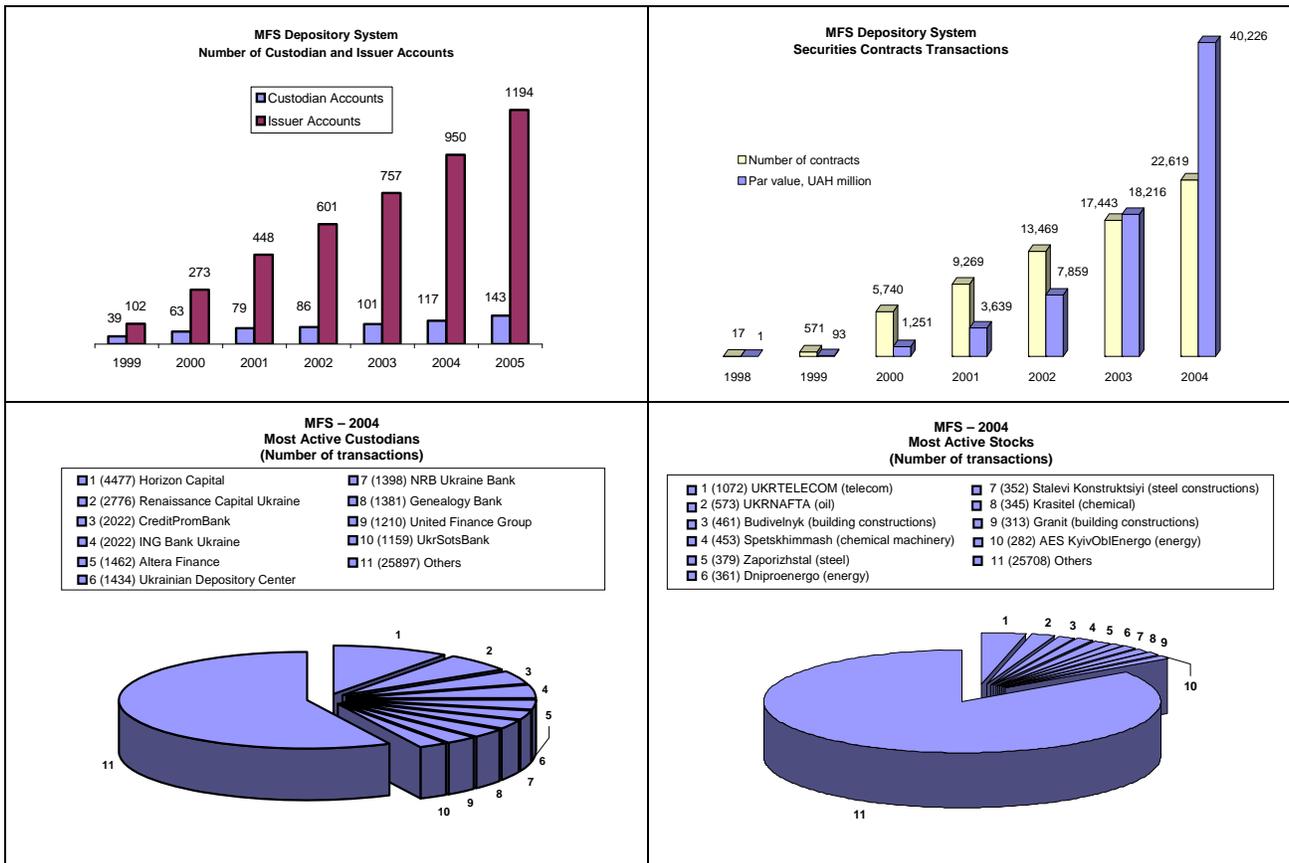
MFS then immobilizes the securities in its nominee account for the custodian/broker-dealer. Once the custodian/broker-dealer representing the buyer electronically wires the funds to the MFS Special Depository Account, MFS matches the order and the funds. It then transfers the securities to the custodian/brokers account for the purchaser and electronically transfers funds to the custodian /brokers account for the seller from the MFS Special Depository Account. If the custodian is a bank the funds are wired to its account at the NBU. If it is not a bank, then the funds are wired to the broker/dealers account at its bank.

Process of Clearance and Settlement



MFS interfaces with one trading platform (PFTS) and five Ukrainian stock exchanges. The First Securities Trading System (PFTS) and Kyiv International Stock Exchange (KISE) are currently conducting more than 95% of MFS transaction volume. It appears that about 90% of all securities trades in Ukraine are executed off organized markets. Of the remaining 10%, PFTS does 86% of that volume, the majority being ‘blue chip’ Ukrainian issuers. According to KISE, their volumes increased due to the use of electronic transfer of ownership through MFS.

MFS’s volume of transactions has steadily increased. Since January 1999, the number of accounts opened for custodian/broker dealers has increased from 39 to 143 in 2005. The number of accounts opened for issuers has increased from 102 in 1999 to 1,194 in 2005.



MFS now serves issuers who deposit global certificates with the depository representing their electronic registries. The SSSMC estimates that there are some 34,000 joint stock companies, of which 20,000 are actually operating entities while the others are mostly dormant. About 6,000 of these are open joint stock companies whose shares are permitted to freely trade and the remaining 14,000 are closed joint stock companies that, under Ukrainian law, may only transfer their shares among existing shareholders.

The IT Department is the backbone of the depository and clearance and settlement operations performed by MFS. The current staff, which has been with the Depository since its founding, developed the core software based on programming methodology provided by USAID-supported technical assistance. The software appears to be effective and operates in compliance with internationally-recognized standards. The Depository also has an off-site IT office, in Dnipropetrovsk, that has four additional software developers. As required by the laws of Ukraine, the National Bank of Ukraine has certified the MFS software as acceptable.

To facilitate foreign investment and transactions in foreign securities for Ukrainian investors, particularly non-state pension funds, MFS representatives met with representatives of EuroClear to investigate a correspondent relationship to handle clearance and settlement of foreign transactions. EuroClear is the world's largest settlement system for equities and bonds. EuroClear raised several issues regarding establishment of a correspondent relationship with MFS. First, although MFS is the only institution in Ukraine providing depository and clearing and settlement operations, EuroClear was concerned that MFS did not have an official designation as a central depository. Second, EuroClear expressed concern with the lack of a guarantee fund at MFS to insure effective delivery versus payment for foreign transactions.

As MFS has not established a guarantee fund—this type of fund protects a depository from failures of settlements by having market participants contribute to a fund that guarantees performance—, 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 international donor community is strongly encouraged to provide the necessary technical assistance to MFS to establish a “guarantee” system that will meet the current needs of the Ukrainian market and allow this system to grow with the demands of the market.

The Group of Thirty (G30), in conjunction with the International Securities Services Association (ISSA), put forward nine recommendations for clearance and settlement systems in the global securities markets. MFS is well on the way to meeting these recommendations. MFS currently meets six of the nine recommendations. Because Ukrainian legislation is currently not in compliance with certain international standards, MFS cannot meet the other three.

Nine Standards for Clearance and Settlement	MFS Scorecard
<ul style="list-style-type: none"> • T+1 trade confirmation and affirmation 	✓
<ul style="list-style-type: none"> • Confirmations extended to clients, especially large institutions 	✓
<ul style="list-style-type: none"> • Multilateral netting 	x
<ul style="list-style-type: none"> • Central stock depository 	x
<ul style="list-style-type: none"> • Delivery vs. payment 	✓
<ul style="list-style-type: none"> • Irrevocable payment 	✓
<ul style="list-style-type: none"> • T+ 3 settlement 	✓
<ul style="list-style-type: none"> • Stock borrowing and lending procedures 	x
<ul style="list-style-type: none"> • Coding Standards 	✓
<i>The Group of 30 (G30)</i>	

MFS meets all the requirements of existing securities legislation in Ukraine. It is also regularly inspected by the SSSMC. They have had one unplanned inspection, due to alleged fraud by a Registrar, but the SSSMC found nothing irregular at MFS. Moreover, MFS never received a report on the findings on the Registrar in question. To date, MFS does not know the outcome of this alleged fraud. MFS says that, in 2003, the Ministry of Economy and the tax authorities conducted a special inspection of the depository, based on allegations that Ukrainian law was violated in the transfer of assets to MFS as a result of the technical assistance provided by USAID in 2000. In the end, the authorities found that MFS was in compliance with the law.

MFS has been the subject of takeover attempts by Privatbank and one of its affiliates, Business Invest, an investment company. This has concerned the GOU, market participants and representatives of the international donor community.

In April 2004, MFS called a stockholders’ meeting to increase its statutory capital, to allow for about 40 custodians who were not stockholders to participate. Attempts to address the issue failed due to the actions of one group of stockholders, Privatbank and its affiliates, to

take control of the depository. Existing shareholders agreed to purchase all of the issue. However, the new share issue was not approved at the shareholders' meeting. Court orders restricted both the Ukrainian Interbank Currency Exchange (UICE) and PFTS from participating in the meeting, with the result that 20% of MFS shares could not be voted. Following the meeting, the press reported that Privatbank had started a campaign to "lease" shares at substantial monthly fees and to purchase some shares from willing sellers at a price of UAH 100,000.

Another MFS shareholders' meeting was scheduled for June 2004 at the initiation of Privatbank and Business Invest. The meeting was to approve the subscriptions of the April 2004 meeting and to consider another share issue. Due to court decrees obtained by Privatbank and its affiliates, MFS was prohibited from taking any action to prevent the meeting, while guards surrounded the meeting place and restricted access to the meeting. The result was that the meeting failed to gain a quorum. Subsequently, several attempts were made by the Association of Ukrainian Banks to mediate and attempt to resolve the problem. One of the recommended solutions was to place a mandatory limit of 5% on ownership in the statutory capital of MFS and sell excess amounts to minority shareholders. Following these efforts, the parties maintained the status quo and there was no increase in the statutory capital of MFS.

"In my opinion, the current problems flow out of the success of this project. In other words, MFS faces the risk of falling prey to its own success. The procedures have now been worked out, the depository has gained the respect of market participants, and technical problems have been resolved... Such conflicts will make the whole market suffer. I think that by supporting this project, the GOU and market participants wanted to get straight and transparent rules of play."

*Christopher Crowley
USAID Mission Director
Summer 2004⁴*

It is clear that the control of MFS by one or more market participant groups will have a serious adverse affect on current and future development of an honest and well-regulated market in compliance with international standards.

2.2 The National Depository of Ukraine (NDU)

In May 1999, after MFS was established, the SSSMC took steps to set up the NDU. It was established as an open joint stock company with the State owning 86% managed by the SSSMC, the NBU owning 4.4% and the remaining shares owned by market participants, including one share owned by MFS. At that time, then-SSSMC Commissioner, Viktor Ivchenko, served as Chair of the Supervisory Board of the NDU.

In accordance with the provisions of the January 1999 MOU, the NDU has conducted limited operations, with most of its activities concentrated on assigning numbers or codifying securities, for which it charges a fee. The NDU's lack of transparency means there is no information on its operations, the size of its staff or its financial condition, including its revenues and expenses.

In December 2004, the Government under acting premier Mykola Azarov approved the State Program for the Development of the National Depository System. Under that document, NDU was to be assigned all possible powers. In addition, the Program:

- requires UAH 900 million from the State Budget, and UAH 1.1 billion from the market over 2005-2010, without any explanation of possible expenditures;

⁴ Christopher Crowley: "I would not like to see MFS fall victim to its own success..." Dzerkalo tyzhnia, Summer 2004.

- intends to resolve such market infrastructure problems that derive, primarily, from existing legislation on securities issuance and circulation, taxation, currency regulation, foreign investment and so on. These are problems whose resolution requires proper and effective State regulation, not additional public funds;
- intends to start from scratch and set up a system of ownership records that is not coordinated in any way with the other infrastructure components of the market;
- intends to set up a great number of high-cost elements (a separate national information network, a separate data transfer system, a separate safekeeping vault, and so on), which is likely to increase the cost of transactions in the market and, accordingly, lowering its competitiveness;
- assigns functions to the depository system that are alien to the system, e.g., the development of a real estate market and risk-hedging in commodity markets, none of which is in line with international practice;
- includes no criteria for proper implementation, which means that there is no effective means of monitoring the program;
- does not anticipate any involvement by market participants in its implementation.

According to its website, the NDU development program anticipates this kind of funding:

NDU Five-Year Development Plan Budget, in millions

Year	State Budget (UAH)	Other Sources (UAH)	Total (UAH)	Total (USD)
2005	140	0	140	28
2006	205	250	455	90
2007	250	250	500	99
2008-2010	300	600	900	178
Total	895	1,100	1,995	395

Because of the considerable funding requirements from the private sector for the NDU activities, market participants voiced strong objections to this program. Following the passage on December 23, 2004 of the State Budget for 2005, 66 market participants, including 26 domestic and international banks and 40 broker/dealers and other market participants, signed an open letter dated February 9, 2005 to the Cabinet of Ministers and the Verkhovna Rada of Ukraine opposing the significant State Budget support to the NDU.

The letter expressed the signatories' objection to the use of public funds to address problems that they stated were either non-existent or that have been resolved and funded by market participants. The letter also expressed concern that the State's national depository program would very likely result in substantial increases in the cost of securities transactions and that Ukrainian securities might move to alternative record-keeping systems abroad. Finally, the letter noted that the State's program for a government-owned depository system would make it impossible to continue developing the system under the principles of market needs and self-regulation.

Meanwhile, State Budget line items indicate that the NDU was actually allocated \$6.4 million for 2005 and again for 2006.

2.3 The 1999 Memorandum of Understanding Regarding the NDU

Prior to the establishment of the NDU, a Memorandum of Understanding "On the Development of Securities Owned Clearing Depository" was signed among the Government of Ukraine, the International Bank for Reconstruction and Development, and

the US Government (1999 MOU). Acting on behalf of the GOU, the MOU was signed by Deputy Premier Serhiy Tyhypko, SSSMC Chair Oleh Mozgoviy, and National Bank of Ukraine Governor Viktor Yushchenko. The MOU, signed on January 25, 1999, is valid through January 25, 2010.

The stated objective was to cooperate in developing an open, competitive, well-regulated, private sector-based market for securities in Ukraine. It was further agreed that the signatories would assist Ukraine's securities industry in:

- *building a securities industry-owned Clearing Depository capable of serving all licensed securities markets (stock exchanges, trading and information systems) and serving all appropriate market participants (issuers, registrars, custodians, broker-dealers and licensed securities markets);*
- *effecting the voluntary merging, in the shortest period of time, of all existing or planned Ukrainian depositories into a single, centralized clearing depository, predominantly privately owned and operated by securities market participants;*
- *developing a strategic development plan for Ukraine's securities market infrastructure that will rationalize and optimize its scarce resources.*

The MOU further provided that, although the Parties did not object to the establishment of a National Depository by the GOU, it was agreed that any such entity *would have no commercial functions whatsoever and would engage in only three functions: codification, standardization and international relations* within the effective period of the MOU.

Under the Presidential Decree "On the General Operating Principles of the National Depository of Ukraine," dated June 22, 1999, the NDU could not perform any clearance and settlement operations until the state's stake in its statutory capital was reduced to 25%. To date, the NDU has not engaged in commercial activities as a fully operational depository and has carried out only the three functions provide in the MOU.

Sometime in 2001, the Ministry of Finance was given the power to manage the state's share in the NDU. However, by the time of the December 2005 general meeting of NDU shareholders, control over the State's 86% stake had been returned to the SSSMC.

2.4 The NDU Annual Meeting in December 2005

On December 13 and 23, 2005, the NDU held its annual shareholders' meeting to consider several major issues, including: (1) the election of management, (2) the revision of the charter and by-laws, (3) an increase of share capital, (4) the establishment of a central vault for keeping documentary securities, and (5) the approval of its main activities for 2006. At the meeting, Viktor Ivchenko was re-elected chair of the Supervisory Board and the First Deputy Director of the NDU, Volodymyr Uliyanov, was elected president.

In addition, the shareholders approved a proposal to convert the NDU from a state agency into a joint stock company and revised its charter and by-laws, granting it authority to perform all of the functions of a depository. Shareholders also approved an increase in the statutory capital of the NDU, subject to the availability of GOU financing to maintain the State's 86%

"The [share increase] will not come into force until a separate line item is added to the State Budget for 2006 specifying the amount of funds earmarked for the acquisition of the additional NDU shares."

*Mykhailo Nepran
SSSMC Chief-of-Staff
December 26, 2005*

interest. Statutory capital was to be increased six-fold, to EUR 5 million. Apparently, the State will have to allocate at least USD \$4.25 million to maintain its ownership at 86%.

According to press reports, the central vault, to be located in Crimea, is to be used as a depository for documentary securities, and that other top-secret State objects capable of withstanding a direct nuclear hit were transferred to the balance sheet of the NDU during the year. Market participants expressed astonishment at the remote location of this vault because of the untenable cost of such service, including the transportation of documents to Crimea.⁵

At the meeting, shareholders voted to approve the NDU's action plan for 2006, which was based on the Presidential Decree on the development of the NDU signed on November 24, 2005. With regard to the NDU, the Presidential Decree provided for "*... [E]stablishing, on the basis of the National Depository of Ukraine, a Central Depository of securities, controlled by the State and independent of the influence of financial and industrial groups and professional participants of the stock market.*"

⁵ "NDU Needs UAH 20mn More, Delo, a newspaper, December 26, 2005.

3. GOU Program for Developing the NDU

While the MOU did not establish limitations on the ownership structure of the depository, there is existing and draft legislation that addresses this issue. In December 1997, the Rada approved the Law “On the National Depository System.” This Law stated that the share of any one participant in the statutory capital of the depository could not be more than 25%. Meanwhile, pending with the Cabinet of Ministers is a bill, dated December 1, 2005, “On the System of Depository Record-Keeping in Ukraine.” This draft law requires that the authorized capital of the Central Depository be *not less than UAH 25 million*. This Bill further states that the GOU’s stake in the statutory capital not be *less than 25%* and that no other shareholder can own, directly or indirectly, more than 5%.

Attempts by some market participants to take over MFS, reportedly to corrupt its operations, compounded by questionable court decisions and a weak regulator, have rightfully raised concerns at the highest levels of the Ukrainian Government. On November 24, 2005, the President signed a Decree (November 2005 Decree) on two resolutions of the National Security Council “On Measures to Improve the Investment Environment in Ukraine” dated June 29, 2005, and “On Measures to Ensure Guarantees and to Improve the Effectiveness of the Protection of Property Rights in Ukraine” dated October 28, 2005.

The November 2005 Decree provides a broad and sweeping package of government actions and programs. The Decree addresses the needs for judicial and regulatory reform, the speedy establishment of the State Agency of Ukraine for Investments and Innovations as a central executive body with special status, the establishment and empowerment of the National Depository of Ukraine, the implementation of a detailed action plan for improving the investment climate in Ukraine, and guidelines for stock market development.

Under this Decree, the National Depository of Ukraine will maintain the central register of owners of registered securities. Later on a Central Depository for securities, based on the National Depository of Ukraine, would be set up as well, *“to be controlled by the State and independent of the influence of financial and industrial groups and professional participants of the stock market.”* The Decree further requires that the operations of the NDU be brought into line with the Law “On the National Depository System of Ukraine and the Specifics of Securities Circulation in Ukraine.” This Decree also directs the Cabinet of Ministers to cancel the Presidential Decree of June 22, 1999, which supported the implementation of the MOU.

Unfortunately, closer inspection and analysis of the provisions of this Decree makes it safe to assume that, while it may not be the intended purpose of the Decree, the effect of its provisions as to the empowerment of the National Depository will be to return Ukraine to a planned economy—to the detriment of its economic reforms and its citizens. The Government has a conflict of interest in being both the owner and regulator of the Depository. In addition, Government ownership and control of the Depository is contrary to international best practices and promotes inappropriate Government interference in a free market economy.

In support of the Presidential Decree, on January 18, 2006, the Cabinet of Ministers decided to terminate the MOU between the GOU, the IBRD, and the U.S. Government concerning the establishment of a Central Depository owned by the securities industry. Market participants, on February 2, 2006, signed a letter to the President of Ukraine, the Cabinet of Ministers and the SSSMC requesting that the GOU to reconsider the cancellation of the MOU and to rescind its decision to create a central depository based on

the NDU. The Ukrainian Banking Association, the Ukrainian Association of Investment Businesses, the Professional Association of Registrars and Depositories, PFTS and 38 other market participants signed this letter. News reports indicate that market participants are concerned over the possible outflow of foreign investors, political influence and inappropriate interference by powerful vested business interests, the so-called oligarchs. Market participants clearly identified the problems with state ownership: loss of confidential information, loss of foreign investor trust, and a downturn in the investment processes achieved to date.

The international donor community supported the concerns of these market participants. USAID issued a press release stating that it was very disappointed with the GOU decision to unilaterally terminate the Memorandum of Understanding regarding the NDU. The statement expressed concern over the Cabinet of Ministers' decision to terminate the MOU without consulting with international experts and without any discussion with USAID. USAID stated that it was concerned that such unilateral actions on the part of the GOU would adversely affect the market and investors, including non-state pension funds.⁶

On February 1, 2006, The World Bank sent a letter to the Premier of Ukraine expressing its concern with the recent steps on the part of the GOU to develop a state-owned depository. The letter stated that this action "seems inconsistent with the pronounced intentions of the Government of Ukraine to improve the investment climate and consolidate financial and capital markets in the direction of a conducive and transparent environment for investments." The letter went on to state that the establishment of a central depository should result in enhanced corporate governance and dominant private ownership of the depository, in line with current international practice where, at most, the state might own a blocking share of a unified depository.

In short, the Government of Ukraine's actions are contrary to international best practice and are not in keeping with the GOU's stated intention to seek EU membership and integration with the global financial markets. It is clearly opposed by market participants, who correctly fear the GOU's latest steps.

⁶ "Cabmin to Set Up Depository," Kommersant-Ukraine, January 20, 2006.

4. Conclusion and Recommendations

It is important that the international donor community engage in constructive dialog with the Government of Ukraine and market participants to resolve the issues surrounding the establishment of a depository system with an effective clearance and settlement system that will facilitate and support a free market economy in Ukraine. Any action plan should insure that the resulting institution can operate free of inappropriate interference from both government and industrial groups and have the trust of both domestic and foreign investors.

The GOU's reversal of the positive reforms established in the 1999 MOU can only result in continued lack of development of Ukraine's economy.

The recently published Heritage Foundation 2006 Index of Economic Freedom shows that Ukraine has made no progress over the last five years. When looking at the various factors rated in the Index, such as Foreign Investment, Property Rights and Regulation, Ukraine's ratings are at the low end of the scale and show no improvement since 2001. The outlook is the same for 2006.

A close look at the results of the positive reform agenda followed by many of its neighbors could provide guidance to Ukraine's policy-makers. For example, the 2006 Index of Economic Freedom ranks Ukraine as 100, in the group of "mostly unfree" countries, out of 157 countries ranked. Meanwhile, many of its regional neighbors ranked in the "mostly free" group: Czech Republic (21), Lithuania (23), Armenia (27), Slovenia (38), Latvia (39), Hungary (40), and Poland (41).⁷ The reported reasons for this significant difference is that countries that liberalize rapidly and thoroughly achieve remarkable success, while gradualism leads to stagnation and even reversals. Following a strategy of gradualism results in the electorate not experiencing the benefits of reform. Therefore, the electorate does not support the reform initiatives.⁸ The program for movement from the group of "mostly unfree" countries to the group of "mostly free" countries offers an important lesson for GOU policy-makers.

The negative impact on the economy resulting from the failure to establish a positive reform program can be seen in both the short-term and the long-term—loss of investor confidence, lack of increase in foreign investment and possible failure to be granted market economy status. It may be best for the GOU to reconsider its actions and follow success rather than implementing policies that have lead to problems in other countries.

⁷ "Mostly free" countries had an average per capita GDP of \$13,530 compared to average per capita GDP of \$4,239 for "mostly unfree" countries.

⁸ Mary Anastasia O'Grady, *Hail, Estonia!*, The Wall Street Journal Europe, January 4, 2006.

4.1 Recommendations

These recommendations present a program for the GOU to continue on its declared plan to meet EU standards and establish capital market institutions that support these goals.

Recommendation 1: Establish a Predominately Privately Owned Ukrainian Depository.

In order to meet existing internationally-recognized norms, the depository should be created with predominantly private ownership. ***The ideal solution would be complete ownership by all market participants with no state ownership, i.e. the Canadian system.*** If state ownership is insisted upon, the State should have a passive minority position in which its ownership is controlled by the National Bank of Ukraine. Ownership should be widely distributed among market participants, with no one market participant owning, directly or indirectly, more than 5% of the outstanding voting shares of the depository. This would avoid inappropriate interference by one group in the activities of the depository.

Because MFS has been operating effectively as the Ukrainian Depository since 1997 and enjoys the trust and respect of the marketplace, ***it is highly recommended that any central depository be established on the basis of this entity.*** First, MFS operations are substantially in compliance with international norms and strengthening this institution even further would not disrupt the operations of the market or require additional funding from an already overextended State Budget. Equally important, this institution has both the necessary software and human capital trained and effectively implementing the critical depository function for Ukraine.

An informal review of the ownership of depositories in 48 countries, both developed and emerging markets, shows that only in five countries was the depository controlled or partially owned by a government body. These five countries, all former members of the Eastern bloc, have depositories with some or a portion of ownership held by the Ministry of Finance: Bulgaria, Croatia, the Czech Republic, Poland and Slovakia. The other countries have various ownership structures that involve primarily stock exchanges, banks, broker-dealers, investment funds, and other market participants, with some ownership by the central bank of the particular country.

Based on increased experience in developing a market economy, eliminating the need for state funding of these activities, and increased understanding that the private sector is the engine of economic growth that has the capacity to generate the needed resources for directing meaningful economic reform, movement towards market-owned and operated stock exchanges and national depositories continues to be on the agenda of many countries, particularly in Eastern Europe. For example, Poland has appointed an international team of experts to privatize the Warsaw Stock Exchange, currently owned by the Polish Treasury. Similarly, Poland has commenced planning the privatization of the national depository for securities.

To this end, it is recommended that the international donor community, with the support of the GOU, establish a transparent and all-inclusive working group of both international and local experts to develop a plan for Ukraine's Central Depository. While the ultimate plan for developing the depository system should factor in many variables, there are several key elements that should be considered in establishing the action plan:

SUGGESTED ELEMENTS OF AN ACTION PLAN TO ESTABLISH UKRAINE'S CENTRAL DEPOSITORY

1. Conduct an internationally compliant audit of both existing depositories and make it available to the public.
2. Hold public debate on alternative methods of establishing a Central Depository (management, ownership and operations) with GOU representatives, regulators and market participants.
3. Finalize a program on the legal and financial mechanism for establishing a Central Depository, including the composition of the supervisory board, and make this program available for public discussion.
4. Approve the selected mechanism with the GOU and MFS shareholders.
5. Engage an internationally recognized law firm, familiar with Ukrainian legislation, to prepare a legal and financial plan to establish the Central Depository.
6. Approve the legal and financial plan with the GOU and MFS shareholders and make it public.
7. Make changes to Ukrainian legislation (National Depository System Law, SSSMC regulations and NBU regulations) necessary to institute and operate the Central Depository.
8. Implement the plan and launch the operation of the Central Depository.

Recommendation 2: Strengthen the Operations of MFS

While MFS operates in accordance with international best practice, there are several key areas where its operations could be improved to meet both the current and anticipated needs of non-state pension funds and the projected Pension Accumulation Fund. These include:

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

Currently, MFS is fully redundant with full database backups kept **only** on-site daily. This on-site back-up could lead to serious problems in case of a fire, terrorism, or a disgruntled employee, etc. It should be noted that MFS does store database backups in a bank deposit box 'several times a month.' This is not sufficient.

- ***That requests for ownership registries be converted to an electronic system. It should also be mandatory that all registrars use this electronic system upon payment of a service fee established by market participants.***

At the present time, there is a large volume of manual paperwork handled by the Customer Relations Department in interfacing with custodians and registrars, 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 staff use the postal system to send 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 current SSSMC regulations.

- ***That MFS be granted the right to incorporate all types of money settlements into the depository system. This would allow MFS to institute internationally recognized standards.***

The majority of all money settlements for transactions are handled custodian-to-custodian, with the vast majority of these transactions conducted off-shore, in hard currencies. In this connection, the international clearance and settlement practices provide for settlement in local currency, euros or US dollars. Offshore settlement reportedly grew after the National Bank of Ukraine changed its currency rules three times in less than four months, possibly leaving market participants with little choice but to settle outside Ukraine.

- ***That MFS institute a guarantee fund for money settlements, to ensure that it is protected from settlement failures.***

Currently, MFS does not handle significant money settlement transactions, but it needs to establish a guarantee fund to protect the market from settlement failures. If money settlements were to be implemented as recommended, then a guarantee fund would be a necessity, bringing MFS in line with internationally- recognized best practice.

- ***That MFS staff establish a program, initially with international donor support, for ongoing international training with exposure to international depositories. As MFS is operationally very similar to the Canadian Depository for Securities this may be a good place to start or else to visit depository operations in EU countries.***

MFS currently uses international and national messaging standards. However, some of the international messaging standards are out-of-date. MFS has advised that they plan to gradually convert to the new International standard ISO15022 during 2006.

Management also expressed concern that things are changing rapidly in clearance and settlement, particularly in EU countries, such as the establishment of the EuroClear system, which MFS needs to understand in order to handle foreign clearance and settlement operations.

- ***That the MFS website provide an English version, as do all other international depositories, to promote transparency and attract foreign transactions.***

In order to conform to international standards, the MFS website should be translated into English. This would make it compliant with other international depositories and promote increased foreign investment.

Recommendation 3: Strengthen the Regulatory Oversight of SSSMC

- ***That the SSSMC be immediately given the legal authority, by Presidential Decree or otherwise, to investigate all of the problems within the Registrar system and take all necessary steps to improve the system in accordance with international best practice.***

Another major issue with the Ukrainian market is attempts to manipulate ownership records among the various registrars. The first step in this process would be to eliminate “pocket registrars,” address inappropriate “telephone justice” leading to double registries, and impose heavy penalties, including the withdrawal of licenses of registrars who illegally sell registries.

The SSSMC should improve its oversight by strengthening effective SROs with the necessary powers to eliminate these machinations for the security and soundness of the system.

In addition, the SSSMC should establish effective oversight of the central depository based on IOSCO principles of international best practice, free of political and other interference. Regulations should require that all transactions in securities be reported over the organized market and that all transactions in securities be cleared and settled at the MFS Depository.

Summary of the 1999 Memorandum of Understanding On Development of a Central Depository

In 1999, a Memorandum of Understanding was signed among the Government of Ukraine, the International Bank for Reconstruction and Development, and the Government of the United States of America, "On the Development of Securities Owned Clearing Depository" (1999 MOU). Acting on behalf of the GOU, it was signed by Deputy Premier Serhiy Tyhypko, SSSMC Chair Oleh Mozgoviy, and National Bank of Ukraine Governor Viktor Yushchenko. Signed on January 25, 1999, it is valid through January 25, 2010. The stated objective was to cooperate in developing an open, competitive, well-regulated, private sector-based market for securities in Ukraine. It was further agreed that the signatories would assist Ukraine's securities industry in:

- *building a securities industry-owned Clearing Depository (CD) capable of serving all licensed securities markets (stock exchanges, trading and information systems) and serving all appropriate market participants (issuers, registrars, custodians, broker-dealers and licensed securities markets);*
- *effecting the voluntary merging, in the shortest period of time, of all existing or planned Ukrainian depositories into a single, centralized clearing depository, predominantly privately owned and operated by securities market participants;*
- *developing a strategic development plan for Ukraine's securities market infrastructure that will rationalize and optimize its scarce resources.*

The MOU further provided that, although the parties did not object to the establishment of a National Depository by the GOU, it was agreed that any such entity *would have no commercial functions whatsoever and would engage in only three functions: codification, standardization and international relations* within the effective period.

It was also understood that the cost of the economic restructuring and development of a securities market was beyond the individual financial and operational capabilities of the GOU, the donor institutions, or market participants. Thus, the donor institutions undertook to augment the resources of the private institutions to build a world-class depository system. The parties agreed to combine their resources to further develop the securities market in Ukraine and to accelerate the development of a market structure for securities in Ukraine.

To this end the parties to the MOU undertook the several obligations:

- *The GOU undertook to* (1) refrain from creating unequal conditions for market participants and institutions, (2) reject government ownership positions, especially controlling or blocking positions, in commercially-viable capital market institutions, (3) protect and promote the full rights of the private owners of capital market institutions to exercise their corporate rights. This, in particular, includes protection against imposing any structure set up by the Government or Rada, such as a National Depository with more than the three functions, upon private market participants, (4) refrain from (a) merging or amalgamating private-sector depositories with the National Depository or any other state-owned institution; (b) changing the legal and operational status of private sector depositories unless such depositories have their shareholders' consent for such action, (5) rectify certain legislative and regulatory impediments to developing and implementing a functional CD in Ukraine, such as the lack of legal recognition of electronic documents and electronic signatures, requirements for dematerialized securities to be placed only in the depository, high taxes on capital gains and dividends, and so on.
- *The NBU undertook to* provide technical assistance to the CD specialists.
- *The SSSMC undertook to* develop the regulation of depository, clearance and settlement functions that support the objective of the MOU and in full cooperation with market participants and other parties to the MOU. It also undertook to implement provisions (3), (4) and (5) noted here.
- *USAID undertook to* (1) provide legal and technical expertise to facilitate the Market Structure Strategy Working Group and the establishment of the CD, (2) provide legal and technical training for all parties involved in setting up the CD including the GOU, NBU, SSSMC, and the securities industry, as well as limited ongoing support to the Ukrainian Broker-Dealer Association and Trading System (PFTS), (3) provide financial assistance and equipment to establish the CD, (4) help the SSSMC, in cooperation with the securities industry, to develop regulations and methodological standards on depository, clearance and settlement activities.
- *The World Bank undertook to* provide access to world best practice and know-how in areas relevant to the CD project and to seek additional commercial and donor sources for financing and technical assistance to the CD.