Capital Markets Project

Ukraine's Securities Depository System:

Risk and Recommendations

Follow-up Report

Harry W. Cartner
International Securities Depository Specialist
Capital Markets Development

March 2008

PREFACE

This paper is a follow-up to my report: *Ukraine's Securities Depository System: Risks and Recommendations* dated May 19, 2006.

I would like to acknowledge the assistance of Mykola Shvetsov, Management Board Chairman of The Interregional Securities Union (MFS), and Yuriy Shapoval, his Deputy, and their continued candor in responding to my many questions.

EXECUTIVE SUMMARY

Not a lot has changed in the area of the Ukrainian Securities Depository Systems since my last report of May 2006.

As in my last report, the controversy created by the Government of Ukraine's (GOU) decision to abrogate a 1999 Memorandum of Understanding among the GOU, the United States, and the World Bank on the development of a market owned central depository is on-going.

Market participants have been unanimous in voicing strong objections to the National Depository development plans of the Yushchenko government, including warnings of a loss of confidence in the depository function, a loss of confidence in the worth of shareholder rights, and a loss of confidence in Ukraine's securities markets by investors.

The paper concludes with a review of the recommendations made in my previous report. Those recommendations covered the ownership of a central depository, actions required to strengthen the MFS, and enhanced regulatory oversight by the Securities and Stock Market State Commission of the registry and depository systems.

Also included are two new recommendations.

CURRENT SITUATION

The Persha Fonddova Torhova Systema (First Ukrainian Securities Trading System or PFTS) has two markets:

1. The Quotation Market - this market trades non-guaranteed transactions that **should** settle on T+3.

2. The Order Driven Market – this market trades locked-in transactions that are 100% settled on T+0.

Currently some 200-500 transactions from the Quotation Market are cancelled, on a daily basis. In fact, almost **all** transactions from this market are cancelled. These transactions are then settled free of payment (FoP). The public, the regulators and the press are beginning to be aware of this situation.

PFTS has stated that their software is outdated. They feel that if the software were updated it would solve the majority of its current technological problems.

The World Bank and USAID have issued a joint concept paper recommending among other things:

1. Trade Concentration Rule – all trades must trade on the exchange where they are listed.

2. All trades must be Delivery versus Payment (DvP). This legislation should state a deadline to move to a DvP environment.

3. Over The Counter (OTC) Reporting Rule. All firms must report **all** OTC trades to an exchange within one minute of execution.

4. Mandatory Trade Reporting Rule (all OTC and Listed transactions). The Exchanges must implement a system that reports all trades to the SSMSC. This would give the exchanges a minute-by-minute regulatory regime and the SSMSC would have daily reporting.

Ukraine is moving toward some of the concepts in the European Union Markets in Financial Instruments Directive (MiFID). MiFID requires pre and post trade transparency. The aim of MiFID is to make sure that investors are fully informed regarding the true level of potential or actual transactions in shares.

MiFID requires a consistent transparency regime across all trading venues to make sure that the price discovery mechanism works. Firms trading OTC would be subject to post trade transparency.

Under MiFID, investment firms trading shares OTC would have to make public the same information about transactions in shares admitted to trading on an exchange as they would if they used the exchange and traded under the rules of the exchange. All of these transactions must be as close to real time as technically possible.

MFS has stated that their systems are capable of handling 10 times their current business. And, if all these recommendations were put in place they would have no problems handling the additional volume. However, MFS may need some additional staff.

The Group of Thirty (G30), in conjunction with the International Securities Services Association (ISSA), recommends nine standards to assess and evaluate clearance and settlement systems in global securities markets. Currently, MFS meets all but three of the nine requirements. They are:

- Multilateral netting
- Central Depository
- Stock borrowing and lending procedures

Due to the size of the Ukrainian market multilateral netting and stock borrowing and lending are not an issue at this point. There are many clearing and settlement organizations around the world that do not meet these requirements due to market size.

The bigger issue here of course, is the matter of MFS not being recognized as the Central Depository. This is a very important issue that needs to be addressed by the GOU. And, until is it addressed, MFS will continue to encounter on-going problems (i.e. signing agreements with foreign counter-parties for cross-border clearing and settlement).

CROSS-BORDER CLEARING AND SETTLEMENT

> *There are many issues to examine in a foreign link-up – a couple of the main issues being legal and technical. This document, by no means, covers all the benefits, risks and issues.*

Due to the globalization of the world's capital markets, more and more Clearing and Settlement Depositories (CSD's) are finding the need to link up internationally with a foreign counterpart.

These link-ups allow participants in the domestic country (i.e. Ukraine) to trade in securities in a foreign country but allow them to clear and settle in their home country. For example, a Ukrainian participant could trade Polish securities but clear and settle the transactions through their domestic depository in Ukraine. As links will be reciprocal, Polish participants would also have access to the Ukrainian markets.

Poland is a good example as their rules allow a non-European Union CSD, which is not subject to supervision by European Union member countries, to become a participant in the National Depository for Securities (KDPW).

Another example is in Canada, the Canadian Depository for Securities Inc. (CDS) has links with the Depository Trust Company (DTC) and the National Securities Clearing Corporation (NSCC) in New York. As well, in August 2007, CDS launched Euroclear UK Direct for Canadian participants to have access to European markets.

RECOMMENDATION:

That Ukraine explores the legal and technical aspects of a link-up with a foreign counterpart.

Mr. Shvetsov, Management Board Chairman of the MFS, pointed out that there has been considerable interest from exchanges in Poland, Russia and some of the Baltic States to engage in Cross-Border Clearing and Settlement. Early in December of 2007, MFS executives also met with the Hungarian Stock Exchange and Deutche Bank on this same subject.

Effective January, 2008 MFS achieved full connectivity with SWIFT that enables them to send SWIFT messages for Cross-Border Clearing and Settlement transactions. SWIFT is the message system used in international practice.

There are some serious obstacles with Cross-Border Clearing and Settlement in Ukraine. Most notably:

i) The Government of Ukraine has appointed the National Depository of Ukraine (NDU) as the only Ukrainian depository allowed to do business with international entities

ii) The lack of a Guarantee Fund within MFS

In order to address these obstacles, and others, a Cross-Border Clearing and Settlement Working Group (Working Group) has been set up. The Working Group consists of representatives from the Ukraine Securities Commission (SSMSC), the National Depository of Ukraine, MFS, the National Bank of Ukraine (NBU) and the USAID Capital Markets Project. The Working Group is chaired my Mr. Vladimir Petrenko, Commissioner of the SSMSC.

Appendix A shows a step-by-step process of a Cross-Border transaction and a Power Point Presentation of each step.

Recommendations:

That the Working Group continues to explore the legal and technical aspects of a link-up with a foreign counterpart. The Working Group, and the SSMSC, should also look at how to overcome all the obstacles that prevent depositories other than the NDU from entering into an agreement with a foreign counterpart.

MFS should continue their dialogue with all foreign counterparts while the work of the Working Group is on-going.

GUARANTEE FUND

As mentioned previously, the lack of a Guarantee Fund has become a hindrance for MFS and its ambitions for Cross-Border Clearing and Settlement. There are some very real risks involved with this type of settlement. One of the biggest risks would be the potential of a failure of a participant on either side of the transaction.

A Guarantee Fund is essentially an insurance policy to protect the Depository in the event of a failure by one of its participants. All the funds are collected and held by the Depository. The funds can be all cash, or a combination of cash and government securities. In the unlikely event that a Depository goes out of business then all the funds would be distributed back to the participants.

All participants of the Depository would be required to contribute to the Guarantee Fund. Each participant's contribution could be a flat rate (i.e. the Bulgarian system) or based on trading volume (i.e. the participants doing the largest trading volumes pay more).

Having looked at the Polish and the Canadian Guarantee Funds they are much too complicated for a market the size of Ukraine. The Polish algorithm is attached.

The Bulgarian Central Depository (CDAD) charges their members a flat rate of 200 Leva (approximately USD$150). They have never had to use the Guarantee Fund. They have rules in place that allow CDAD to call upon their participants for additional funds if a requirement arises.

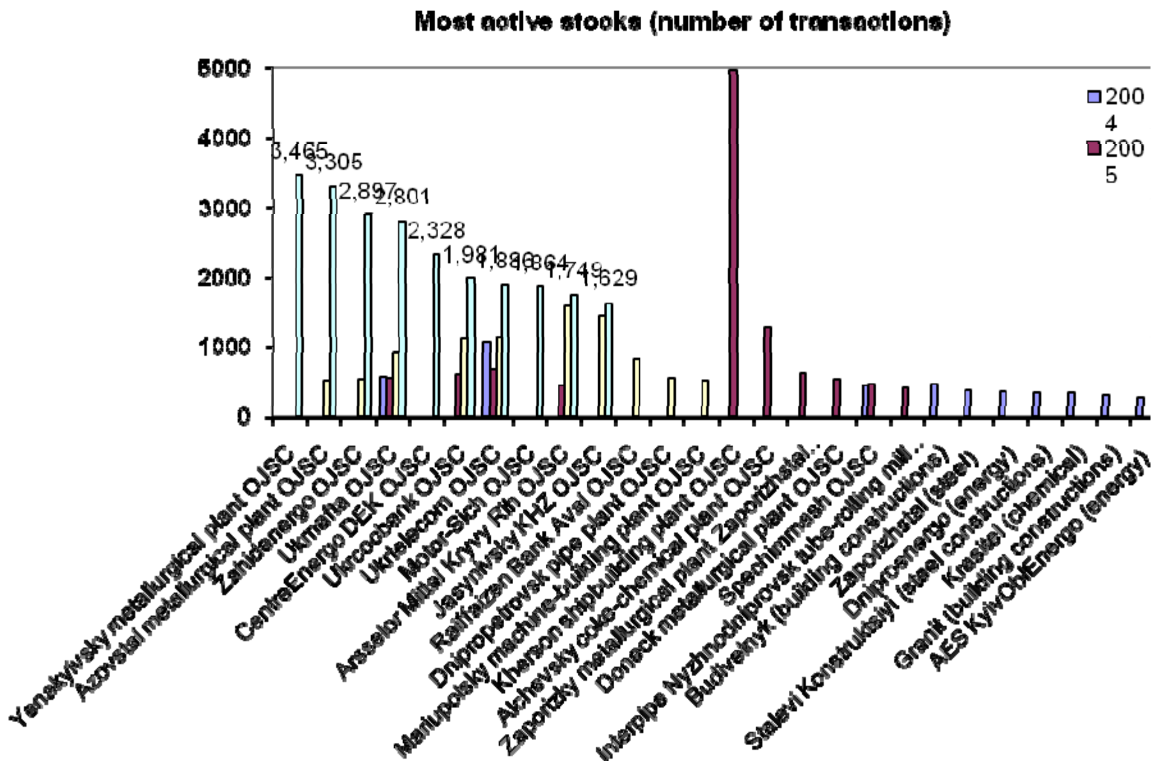
Currently, MFS has very little risk within the Ukrainian market place. The Order Driven Market settles on T+0, therefore there is little/negligible risk. The Quotation Driven Market is supposed to settle on T+3. But, as stated earlier, the majority of these transactions are cancelled and settled free of payment. Again, there is very little risk to MFS. Once a DvP rule is put in place then the risk to MFS would grow accordingly.

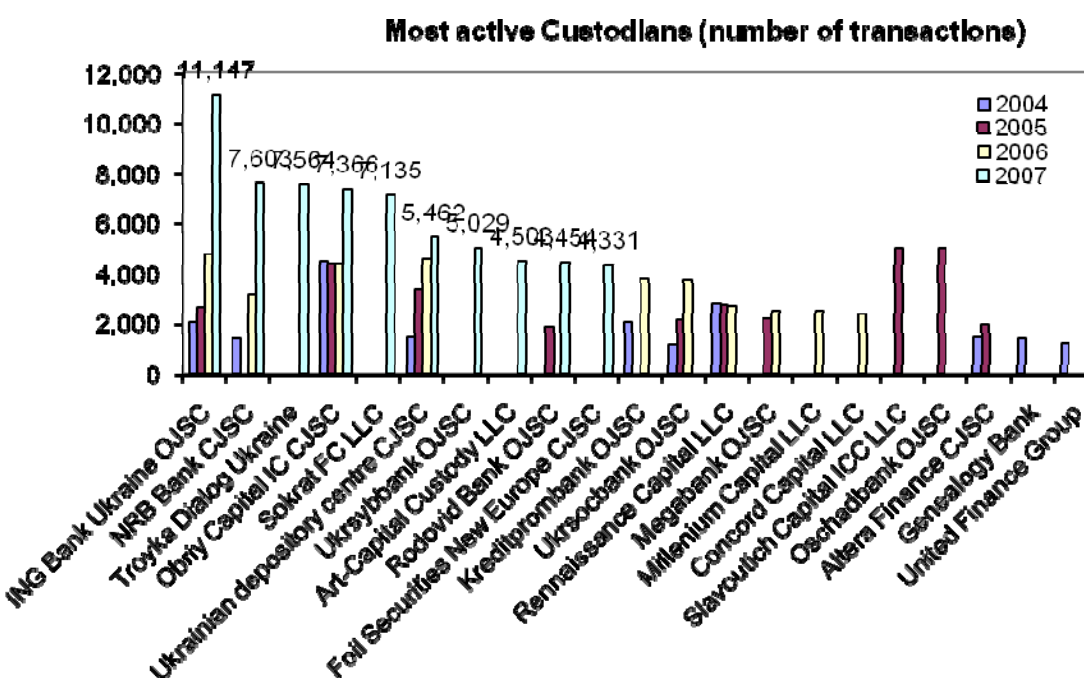
With Cross-Border Clearing and Settlement there is a much larger risk factor. As an example, if a Ukrainian participant executes a transaction on the Polish market and the Ukrainian participant goes bankrupt then the Polish Clearing House will look to MFS to guarantee the transactions. Therefore, it is mandatory that a Guarantee Fund be put in place if MFS is to transact cross-border transactions on a DvP basis.

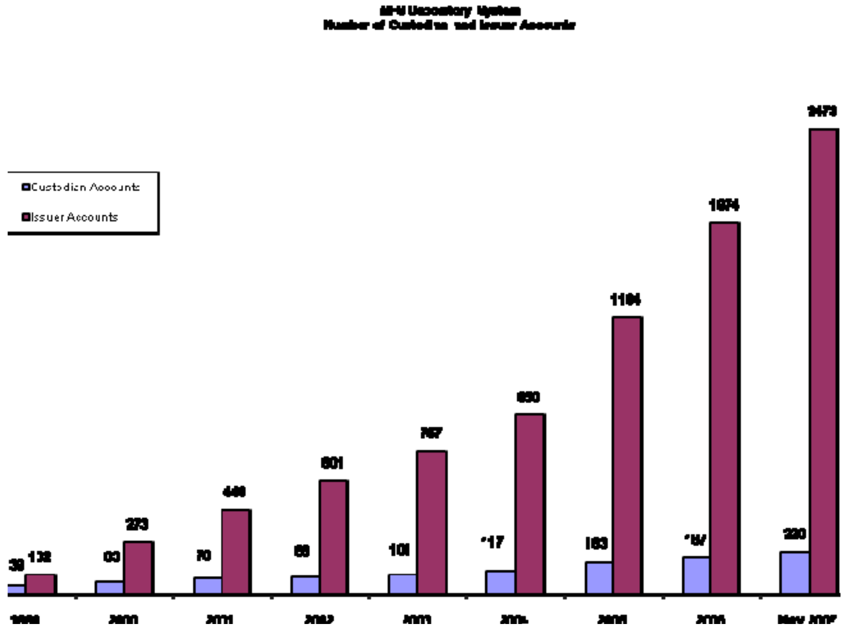
Recommendation:

That MFS set-up a Guarantee Fund in the manner of the Bulgarian market. It is recommended that MFS start off with a mandatory deposit, from ALL participants, in the amount of UAH2,500 (approximately USD$500). Due to the uncertainty of the Ukrainian bond markets the Guarantee Fund should be funded with cash only. These funds should be maintained by MFS and deposited into an interest bearing account and the interest used for the day-to-day operations of MFS. MFS should also put rules in place that would allow them to go back to all participants in the case of a failure of a participant. All participants business should be monitored so that MFS does not incur any risk by the failure of a participant.

UPDATE OF CHARTS FROM PREVIOUS REPORT







Custodian Accounts
Issuer Accounts
273
601
70
101
220

REVIEW OF PREVIOUS RECOMMENDATIONS

Of all the recommendations made in my May 2006 report (see below) only one has been implemented. MFS now has a fully redundant offsite back-up facility. All the other recommendations are still outstanding. Although MFS, with USAID support, has stated that it is in the process of providing an English version of their web site.

Further additional recommendations are also listed below.

PREVIOUS RECOMMENDATIONS:

Recommendation 1: Establish a Predominately Privately Owned Ukrainian Central Depository

In order to assure independence and to meet internationally-recognized standards, 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.

Since MFS has been operating commercially as the Ukrainian Depository since 1997, and because it has earned the trust and respect of the marketplace, ***it is recommended that any central depository be established on the basis of this entity.*** MFS operations are substantially in compliance with international norms, and strengthening this institution 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. However, Poland has appointed an international team of experts to privatize the Warsaw Stock Exchange, currently owned by the Polish Treasury, and has also commenced planning the privatization of the national depository for securities. 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.

Recommendation 2: Strengthen the Operations of MFS

Although MFS operations are generally in accordance with international best practice, there are several key areas where its operations could be improved. 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 database backups kept ***only*** on-site. The fully redundant backups should also be kept off-site as well to permit MFS to maintain full operations.

  This recommendation has subsequently been put in place.

- ***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 uses 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 SSMSC 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 institution might be an appropriate "partner" for training.***

- ***That 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 SSMSC

- **That the SSMSC 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.**

New Recommendation 1: Authorize MFS as the central registrar

Legislation should be adopted to appoint MFS as the only registrar in Ukraine. This would eliminate the ongoing ownership issues in the registry system.

Most Depositories around the world also maintain ownership registries. There is registry software that is commercially available such as "*Regard, Registry Software*" that has been developed by Percival Software Inc.

Attempts to manipulate ownership records among the various registrars continue in Ukraine. Necessary steps to reform 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 SSMSC should improve its oversight by strengthening the self-regulatory organization in this area with the necessary powers to eliminate these machinations for the safety and soundness of the system.

In addition, the SSMSC should establish effective oversight of the central depository based on IOSCO principles of international best practice. 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.

As mentioned earlier in this report, the SSMSC should work diligently to clear all the obstacles that prevent MFS from entering into an agreement with a foreign counter-party.

New recommendation 2: Adopt recommendations of the World Bank and USAID.

- **Trade Concentration Rule- all trades must occur on the exchange where they are listed.**

- **All trades must be Delivery versus Payment (DvP). This requirement should also include a deadline to move to a DvP environment.**

- **Over the Counter (OTC) Reporting Rule. All OTC trades must be reported to an exchange within one minute of execution.**

- **Mandatory Trade Reporting Rule (all OTC and listed transactions). The exchanges must implement a system that reports all trades to the SSMSC. This would give the exchanges a minute-by-minute regulatory regime and the SSMSC would have daily reporting.**

APPENDIX A

CROSS-BORDER CLEARING AND SETTLEMENT BETWEEN UKRAINE AND FOREIGN DEPOSITORIES

STEP-BY-STEP PROCESS OF A TRANSACTION FROM UKRAINE TO A FOREIGN EXCHANGE

1. Ukrainian clearing/settlement depository opens accounts with a foreign counterparty

2. A Ukrainian client instructs their broker to execute a trade on the foreign stock market

3. The Ukrainian broker sends the trade details to a foreign broker

4. The foreign broker executes the trade on their market

5. The foreign stock exchange confirms the trade back to the foreign broker and the foreign depository

6. The foreign participant confirms the transaction with its Ukrainian counterpart as well as with the foreign depository via an interface

7. The Ukrainian participant inputs the transaction details with the UA custodian and the depository

8. The UA depository confirms the transaction with the UA participant

9. The UA depository confirms the transaction with its foreign counterpart via interface
   - transaction is now 'locked-in' or irrevocable

10. On T+3 settlement is completed with the exchange of funds through both domestic and foreign national banks

On settlement date positions are moved from the foreign custodian to the account of the UA custodian/depository

RISKS AND ISSUES:

There are many risks and issues to take into account. Some are covered below:

- Are there any legal impediments, can a UA clearing/settlement/depository open accounts with a foreign counterpart? (i.e. parliamentary laws, securities laws, depository rules/regulations)

- Can you Ukrainian citizens hold foreign securities?

- Will any kind of special licensing be required for transactions in foreign markets?

- Other legal risks could include disputes, court system etc.

- Are there any tax implications for Ukrainian citizens (i.e. withholding taxes)

- Brokers in either the domestic or the foreign market could fail. Are there procedures in place to protect the investing public (i.e. guarantee funds in both the domestic and the foreign markets)?

- System/technical risks, are there procedures in place to cover system crashes, power failures etc.? Could there be capacity issues or upgrades required at the UA clearing/settlement/depository?

- Operational issues, will additional staff be required at the clearing/settlement/depository. Are training procedures in place? Is the use of international messaging standards in place?

- Settlements, can brokers in UA hold foreign currency accounts? Are there any laws that prohibit this.

Cross-Border Clearing and Settlement

Between Ukraine and a Foreign Depository

Benefits:

- Brings Ukraine up to international standards and code of conducts for clearing and settlements - i.e. European Union directives, IOSCO, Committee of European Securities Regulators (CESR), Federation of European Securities Exchanges (FESE) European Central Depositories Association (ECSDA)

- A reciprocal link could potentially bring foreign business to the Ukrainian markets

- Allows Ukrainian retail clients and institutional clients to clear and settle foreign securities in Ukraine

Risks:

- Failure of a participant in Ukraine or the foreign market
- Foreign exchange risks
- Custody risks
- Legal risks (i.e. disputes, court system)
- System risks (i.e. system crash, power failure etc)

Issues:

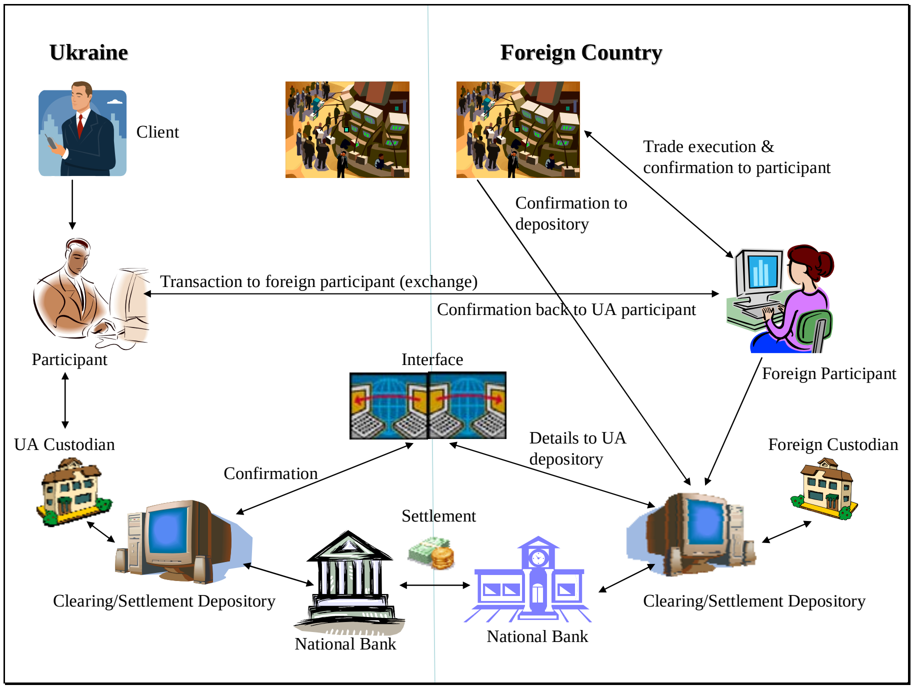
- Parliamentary law
- Securities laws in both domestic and foreign markets
- Depository rules and regulations – both domestic and foreign

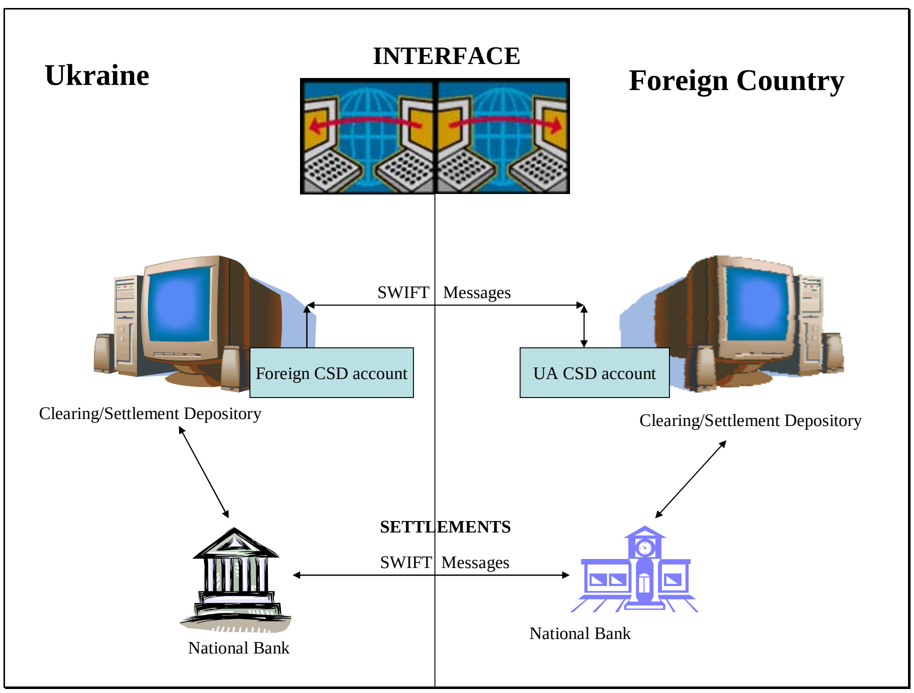
Issues (continued):

- Technical issues (i.e. computer systems, capacity etc.)
- Operational issues (i.e. staffing)
- Guarantee Funds
- All transactions must be ‘locked-in’ or irrevocable
- License for foreign transactions

Issues (continued):

- Banking (money settlements through the National Bank of Ukraine)
- Bank accounts in foreign currencies


Ukraine
Foreign Country
Client
Trade execution &
confirmation to participant
Confirmation to
depository
Transaction to foreign participant (exchange)
Confirmation back to UA participant
Participant
Interface
Foreign Participant
UA Custodian
Details to UA
depository
Foreign Custodian
Confirmation
Settlement
Clearing/Settlement Depository
Clearing/Settlement Depository
National Bank
National Bank


INTERFACE
Ukraine
Foreign Country
SWIFT Messages
Foreign CSD account
UA CSD account
Clearing/Settlement Depository
Clearing/Settlement Depository
SETTLEMENTS
SWIFT Messages
National Bank
National Bank