Capital Markets Project

# *Ukraine Capital Markets Project*

# *FINAL REPORT*

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ABSTRACT: This Final Report summarizes the responsibilities and achievements of the USAID Ukraine Capital Markets Project (CMP). Implemented by Financial Markets International, Inc. (FMI) from 2005 to 2010, CMP was a five-year, $14.2 million project that addressed three broad objectives within the Ukrainian economy: (i) capacity building and institutional strengthening, (ii) financial sector development and financial instruments, and (iii) pension system reform. CMP made considerable progress in each of these areas, despite operating in a complex and challenging political environment. USAID's sustained support for capital markets development in Ukraine has facilitated GDP growth, increased investment, and resulted in greater economic opportunity and social welfare. CMP furthered these ends by strengthening Ukraine's capital markets and financial sector, and by promoting economic transparency and accountability.

**Submitted by:**
**Financial Markets International, Inc. (FMI)**
**USAID Contractor**

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This Final Report was prepared by Financial Markets International, Inc. The author's views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.

FMI relied on the USAID Capital Markets Project Quarterly Reports drafted by FMI and CMP staff since 2005. Additionally, this report was reviewed by Ann Wallace, CMP Chief of Party from 2005 to 2006 and 2009 to 2010, Victor Stetsenko, CMP Deputy Chief of Party, and Robert Bond, FMI Home Office Project Director. FMI is grateful to the many USAID/Ukraine officials who contributed to the success of CMP, particularly Sarah Wines, Paul Richardson, Mike Martin, Kevin McCown, Rick Gurley, Volodymyr Yatsenko, Andriy Mitskan, and Natalia Berezhna.

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## Table of Contents

## Executive Summary

Since its independence in 1991, successive Ukrainian governments have struggled with the transition from a centrally-planned economy to one based on free market principles. Ukraine lacked the basic building blocks for a market economy, and it had no capital markets at all: no stock exchange, no central securities depository, no market-based legal and regulatory framework, and no reliable disclosure of financial information. With the assistance of USAID and other international donors, Ukraine commenced wholesale structural reforms to rework its economic system. This included sweeping legal and regulatory changes, institutional reform, and capital markets development. These changes invigorated Ukraine's economy, and in the early 2000s, Ukraine enjoyed relatively stable economic growth.

In 2005, USAID launched the Capital Markets Project (CMP), envisioned as the capstone on its 15 years of financial markets assistance. CMP had three principal objectives: (i) strengthen the capacities of the financial market regulators to provide efficient and effective prudential regulation to the non-bank financial institution (NBFI) sector; (ii) broaden the range of financial instruments available for portfolio investments and market infrastructure development; and (iii) strengthen the capacities of pension fund providers, regulators, supervisors, and policy makers to establish an efficient and effective pension system. This five-year, $14,205,864 million project sought to assist Ukraine in creating a vibrant and effective financial sector as the basis for sustainable and more equitable economic growth and reduce the costs and risks to a sound pension system.

CMP made considerable progress in each of the three principal areas of activity. CMP strengthened Ukraine's regulatory, administrative, and operational capacities of the Securities and Stock Market State Commission (SSMSC), the Ministry of Labor and Social Policy (MLSP), and the Financial Service Regulator (FSR). The Project transformed financial reporting and disclosure in Ukraine through the development of the Electronic System for Comprehensive Information Disclosure (ESCRIN). CMP helped develop the fundamental legal and regulatory framework for financial sector development, and focused on building support for needed revisions to existing laws, regulations, and governmental policies. Finally, the Project reformed both legal and operational shortcomings in Ukraine's pension system by working with fund providers, regulators, supervisors, and policy makers.

USAID's support for capital market development has resulted in significant improvements to the legal/regulatory framework for investment, and substantially strengthened institutional capacities to regulate the market. USAID/CMP furthered all of these ends by promoting international standards for Ukraine's capital markets and financial sector, and by promoting financial information disclosure, market transparency, and accountability. Although this process remains ongoing – and indeed progress must be measured in years – CMP's many achievements paved the way for sustained and long-term economic growth in Ukraine.

# SUMMARY OF PROJECT OBJECTIVES AND ACHIEVEMENTS

***Capacity Building and Institutional Strengthening Component***

**General Objective 1:** Strengthened capacities of the financial market regulators to provide efficient and effective prudential regulation to the non-bank financial institution (NBFI) sector.

**PMP Results**[1]

- Development and implementation of risk-based supervision at FSR: Achieved through 13-stage development plan, including protocol development, field testing, and CMP oversight.

- Development and implementation of disclosure system for Pillar III Funds at FSR: Achieved through a comprehensive 19-stage development plan, which resulted in the development and implementation of an electronic system for information disclosure by non-state pension funds (NPFs) to the public on the FSR web site. The disclosure system, known as PDS, is an essential tool for both the regulators and the public to monitor NPF performance.

- Development and implementation of an electronic issuers disclosure system at SSMSC: USAID/CMP worked closely with the SSMSC and public companies to develop and test the Electronic System for Comprehensive Information Disclosure (ESCRIN), and assisted the Commission to write a regulation mandating financial disclosure by listed companies through ESCRIN. The system provides real time financial disclosure of quarterly, annual, and ad hoc information on the Commission's web site to the public. ESCRIN has been lauded as one of the ten most important developments in Ukraine's capital markets by the SSMSC.

**Other Achievements**

- Management Information Systems and IT upgrades at SSMSC and FSR: CMP conducted IT assessments at the SSMSC and FSR, in part related to the development of ESCRIN and PDS. The Project purchased hardware (two servers and over 30 computers) and software to enable the implementation of these two information disclosure systems, and transferred these commodities to the counterparts.

- International best practices reforms at Ukraine's securities exchanges and depositories: CMP worked to promote fairness and transparency in Ukraine's securities exchanges and depository sectors, involving a coordinated effort with PFTS Stock Exchange and MFS securities depository, as well as close work with the Verhovna Rada. CMP provided over 250 recommendations to Rada Committees regarding the requirements for implementing improved licensing and listing requirements, an order driven system, and a more liquid securities market.

[1] The Final CMP Performance Monitoring Plan (PMP) is attached as Appendix C.

- Legal and regulatory reform to promote Self Regulatory Organizations (SRO): CMP undertook a review of the SRO legal/regulatory framework for Ukraine and offered recommendations on how best to implement this system of market regulation in Ukraine. USAID/CMP produced new draft SRO regulations, held numerous roundtables and workshops with the regulators and market participants, and provided both regulators and the SROs with Examination and Inspection Manuals.

- Non-State Pension Provision Department of Surveillance: CMP initiated a major capacity building effort to improve NPF oversight and enforcement. CMP commented on numerous draft regulations on oversight and supervision of the operations of NPFs, and held several seminars to facilitate interaction between the regulators and the market. CMP sponsored participation of three senior level FSR NPF regulators, including the First Deputy Commissioner Eugene Grigorenko, in a high level pension management training program, "New Trends in Pension Funds Management." CMP also facilitated the FSR's joining and participating in the activities of the International Organization of Pension Systems (IOPS).

- SSMSC-SEC Training: At the request of USAID, and with financial and logistical support from CMP, the US SEC conducted three (3) Capital Market Development Training Programs in Kiev for the SSMSC staff. Each of the programs was 3-4 days in duration, and focused on securities market infrastructure, legal and regulatory issues, market manipulation and insider trading, and enforcement. By conducting the trainings in Kiev, the Project was able to expose over 90 Ukrainian regulators to US best practices in securities regulation and enforcement.

- Development and launch of ESCRIN: CMP focused on resolving existing problems in Ukraine's disclosure system, developing new solutions, and incorporating international best practices for disclosure in the Ukrainian market. This work resulted in the design, development, and implementation of ESCRIN: Electronic System for Comprehensive Information Disclosure. Modeled on international examples such as EDGAR, in the United States, SEDAR, in Canada, as well as lessons learned from the Russian experience, ESCRIN was developed by CMP to provide publicly available financial and business information on listed companies, in a real-time mode. When the issuer submits its ad hoc, quarterly, or annual report it automatically goes to the Commission's web site and is available to all. Working with the SSMSC, CMP: designed and secured approval of the reporting forms; designed and programmed the software system (including a statistical/analytical package for the Commission to analyze the reports); developed appropriate security procedures, including electronic signatures; and drafted the regulation mandating electronic reporting through ESCRIN.

- Consensus building, international best practices, and training: In order to build support for ESCRIN, CMP held numerous seminars for public companies and market professionals in 2006-2007 to acquaint them with the system and the new requirements. CMP also held several conferences on ESCRIN for SSMSC central and local staff, GoU officials, stock exchanges, investment companies, rating agencies, and journalists prior to the official launch of ESCRIN January 1, 2010

**<u>Impact</u>**

CMP strengthened institutions and increased the organizational capacity of Ukraine's financial sector regulators, enabling them to provide more efficient and effective prudential regulation. This included work with the SSMSC, FSR, securities exchanges, and securities depositories. CMP endeavored to ensure that each regulator understood its specific role and responsibility, and attempted to develop regulatory capacity, institutional and individual, so that each possessed the necessary manpower, resources, and understanding to perform the required tasks. At the conclusion of CMP, the capital market was significantly better regulated than at the start, information disclosure was significantly improved at both the SSMSC and the FSR, and market professionals were moving toward assuming a greater self-regulatory role of surveillance and inspection, based on international practices.

***Financial Instruments Component***

**<u>General Objective 2:</u>** Broadened the range of financial instruments available for portfolio investments and market infrastructure development.

**<u>PMP Results</u>**

- <u>Increased trading of equities and bonds</u>: Achieved a 73% increase in equity and bond trading over the life of the project, despite the profound effects of the 2008 global financial crisis on the Ukrainian economy.

- <u>Increased trading in regulated markets</u>: By project conclusion, 10% of all trades occurred on regulated markets, representing a 250% increase from 2005.

- <u>Increase in new companies traded</u>: By 2008, achieved a 224% increase in companies listed on regulated exchanges due in large part to the implementation of the Joint Stock Company Law, which CMP helped to draft and pass. After the SSMSC adopted new listing requirements in 2007, CMP helped 111 companies comply with the new rules.

- <u>Strengthened MFS and Facilitated MFS and AUSD Merger</u>: Achieved through a 5-step implementation plan that culminated with the MFS and AUSD Merger.

- <u>Strengthened PFTS</u>: Achieved through a 5-step institutional strengthening plan based on the adoption of international best practices.

**<u>Other Achievements</u>**

- <u>MFS (Interregional Securities Union) Guidance and Support</u>: CMP supported the MFS in its efforts to create a single central securities depository for Ukraine, first by providing expert advice on the possible merger of the MFS and the state-owned National

Depository Union (NDU). CMP drafted an "Action Plan for Merger" and also prepared a "Roadmap" for this process.

- Formation of the AUSD: After it became clear that a MFS/NDU merger was not feasible, CMP supported MFS in its merger with the All-Ukrainian Securities Depository (AUSD). CMP provided MFS an investment adviser to assist it in strategic discussions with the AUSD, and to advise it on the process of an international valuation of the MFS as a going concern. This assistance was vital to the eventual creation of the new, merged depository, which was majority-owned by market participants with a 23% stake for the National Bank of Ukraine (NBU).

- Legal and regulatory reform: CMP was very active in support of reform of the legal/regulatory regime for the capital market. This included: New Law on Securities and Stock Market, Joint Stock Company Law and Regulations, Depository Law, Derivatives Law, Law on Accounting, Trade Reporting Regulation, Regulation on Cross Border Transactions, and Pension Law.

- Risk Based Supervision (RBS) and financial instrument market oversight: CMP implemented a review of existing capacity of financial sector regulators to conduct risk-based supervision, enabling Ukraine to focus its limited resources on specific issues/categories of risk in a particular industry or company.

- Regulation reform of non-bank financial institutions (NBFI): CMP initiated a joint effort with the FSR to translate all relevant NBFI regulations into English and review them against international norms.

- Collaboration with the World Bank on joint Capital Markets Strategy: Working closely with the USAID Mission, and in coordination with the World Bank, the CMP team developed the joint USAID/World Bank Programmatic Technical Assistance Partnership (PTAP). CMP took the lead in drafting the analytic document that formed the basis for PTAP, and also served as the basic assessment of Ukraine's capital market development for both institutions. The PTAP was an unprecedented effort at collaboration between USAID and the World Bank, the two institutions collaborating on implementing the strategy.

**Impact**

CMP improved the enabling environment for new financial instruments by working to develop establish an independent central depository, and by developing a pro-investment legal and regulatory framework. These efforts resulted in increased and more transparent trading on regulated markets, fairer treatment of securities holders, improved audit and accounting standards, and better laws and regulations that encouraged investment, while deterring unfair and abusive practices. The formation of the AUSD allowed for improved registration and clearing of securities, without undue governmental interference. As shown on the PMP in Appendix C, the 2008 global financial crisis undercut some of CMP's initial progress, and forced a sharpening of project goals. Nonetheless, CMP still achieved considerable progress in broadening and deepening Ukraine's financial markets.

***Pension Reform Component***

**General Objective 3:** Strengthened the capacities of pension fund providers, regulators, supervisors, and policy makers to establish an efficient and effective pension system.

**PMP Results**

- Increase in Pillar III assets: At the end of the project, the FSR reported $123 million in total Pillar III (private pension funds or NPFs) assets, representing a 1000% increase from project inception.

- Diversification of Pillar III portfolio: At project conclusion, 55% of all Pillar III assets were held in equities, bonds, and foreign securities (increased from 2005 baseline level of less than 1%).

- Increased population coverage: Pillary III pension coverage increased from 88,000 to 500,100 over the life of the project.

- Improved legal framework for Pillar II implementation: CMP achieved 28 points out of a possible 39 points on the projects Pillar II legal and regulatory scorecard. The target score of 39 was not reached due to political factors outside CMP's control, as the Government of Ukraine postponed the Pillar II draft law until after the completion of CMP.

- Strengthened PFU: CMP helped strengthen the PFU from from 2005 to 2007. However, USAID elected to stop work with the PFU in 2008 due to a lack of PFU cooperation on this task.

**Other Achievements**

- Pillar II support and development: It was anticipated in the CMP project design that the Pillar II Mandatory Accumulation System (MAS), passed into law in 2004, would be implemented during the life of the project. However, the GoU chose not to do this, even though the objective conditions for implementation were met. Nevertheless, CMP provided significant Pillar II assistance, including legal and regulatory drafting for the Ministry of Labor and for a Rada working group. CMP also prepared and distributed to government officials, parliamentarians, and industry professionals a monthly newsletter on international developments in MAS.

- Drafting and support of Pillar III Amendments: CMP played a key role in the drafting and revision of proposed amendments to the Law "On Non-State Pension Provision" (NPFs). CMP drafted numerous amendments to Pillar III, including critical amendments on the valuation of individual accumulation accounts and on establishing marking-to-market in valuing individual accounts.

- Legal/Regulatory drafting: CMP supported numerous efforts to revise and update the laws and regulations, including draft laws on: Implementation of the Accumulation System; Mandatory State Pension Insurance Privileged Pensions; Implementing Mandatory Occupational Pension System; Amending the Law of Ukraine On Non-State Pension Provisions; Amending Article 26 of the Law of Ukraine.

- Occupational Pension reform: CMP experts redrafted the Occupation Pensions Law, which removed privileged pensions from Pillar I, placing them on a fully funded footing as part of Pillar III.

- Comprehensive Pension Survey: CMP developed and conducted a national opinion and knowledge survey of pension awareness in Ukraine, which polled approximately 2000 Ukrainians age 18 and over, from across all regions of the country. The survey highlighted the challenge to GoU authorities in implementing pension reform (lack of trust in pension institutions, lack of support for pension reform generally, lack of awareness of Pillar II). The survey formed the basis of an important seminar on the MAS system, and was widely distributed to key pension reform individuals and institutions.

- Training and outreach; Policy papers and reform Initiatives: CMP supported pension system reforms through a broad spectrum of training and outreach programs.

**Impact**

CMP addressed pension reform from several different perspectives in order to address both current and future issues in pension development, while emphasizing the interconnectedness of financial sector reform. This effort included working with counterparts to insure the essential elements of a well-functioning pension system are in place; encouraging the continued emergence of Pillar II and Pillar III; coordinating closely with the multi-donor initiatives taking place. CMP developed eligibility standards and improved asset valuation procedures, while working to improve FSR regulation of market intermediaries.

# I. Introduction

From September 19, 2005 to October 19, 2010, FMI implemented the USAID Capital Markets Project (CMP) in Ukraine. CMP sought to assist Ukraine in creating a vibrant and effective financial sector that will sustain economic growth and reduce the costs and risks to a sound pension system. This project had three general objectives:

- Objective 1: Strengthened capacities of the financial market regulators to provide efficient and effective prudential regulation to the non-bank financial institution (NBFI) sector;
- Objective 2: Broadened the range of financial instruments available for portfolio investments and market infrastructure development; and
- Objective 3: Strengthened the capacities of pension fund providers, regulators, supervisors, and policy makers to establish an efficient and effective pension system.

CMP activities were closely linked to USAID's Access to Credit Initiative project, which introduced a series of financial instruments to Ukraine's markets, such as municipal, corporate, mortgage and government bonds. CMP focused its efforts on improving financial information disclosure that facilitated investment on the local Ukrainian stock market and shaping the legal and regulatory reform directed towards the continued development of the financial sector.

Under USAID's leadership, CMP made considerable progress in each of the three target areas.[2] The CMP produced significant accomplishments for the Ukrainian financial sector. The project guided and supported the work of a range of local partners, including the SSMSC, MLSP, FSR, the NBU, and private sector entities such as the PFTS stock exchange, the central depository MFS-AUSD, the Ukrainian Association of Investment Businesses (UAIB), and other key capital markets actors. Importantly, CMP demonstrated a commitment to gender equality, as over half of all training and education services were provided to women. The USAID Capital Markets Project achieved a series of pro-market, investor-friendly, reforms, such as the development of ESCRIN, the formation of the AUSD, and numerous legal and regulatory improvements. These long-term initiatives strengthened Ukraine's financial institutions and promoted sustainable economic growth.

# II. Background and Country Context

FMI has worked in the Ukrainian financial sector since 1996, with CMP representing FMI's fourth multi-year USAID project. Accordingly, FMI understands the unique economic and political challenges of achieving capital markets reform in Ukraine. When Ukraine asserted its independence in 1991, and began the transition from a centrally planned economy to one more reliant on market forces, Ukraine had no stock exchange, no central securities depository, no market-based legal and regulatory framework, and no reliable disclosure of financial information. Thus, for mass-scale privatization to succeed – and indeed for Ukraine to transition

[2] An index of project deliverables, a complete listing of contract benchmarks, and the final CMP Performance Monitoring Plan (PMP) are included in Appendixes A through C.

successfully to a stable sovereign nation – Ukraine needed to establish and develop well-regulated capital markets.

USAID responded to this challenge by promoting, and continuing to support, the development of three critical building blocks of effective capital markets in Ukraine: (i) reliable central securities depository; (ii) transparent and fair securities exchanges; and (iii) an efficient system of information disclosure about publicly listed companies. The USAID CMP project directed its activities to these objectives.

USAID's previous efforts to develop Ukrainian capital markets underscored the importance of linkages between various economic sectors and actors. The lessons were clear: capital markets activities are highly linked and require simultaneous development. Securities markets only succeed in gaining investor confidence if all of the following are in place: reliable clearing and settlement systems; an honest private-sector owned central securities depository; corporate governance procedures that protect shareholder rights; accurate accounting practices; and prudential government agencies and regulatory bodies. Also linked are the government's tax, fiscal, and monetary policies. Additionally, prior USAID lessons demonstrated the importance of proper legal foundations, such as a modern civil code and laws on shareholder and creditor rights; judicial enforcement of contracts; and protection of property rights. By design, the USAID/CMP project proceeded with all of these inter-connected activities, in order to facilitate and promote a "rule of law" environment that fosters confident expectations about performance of contractual obligations in the capital markets, in order to create economic growth.

The experience in Ukraine demonstrates the difficulty of achieving economic reform in a country where politics, government control, and private business are greatly intertwined. It must be noted that Ukraine operated for seventy years under central government control. That political control over businesses has proven hard to relinquish, with opportunities and temptations for corruption still considerable. Ukraine has made progress, publicly promoting the "rule of law," but nonetheless still has a somewhat opaque political and economic rewards system. The USAID/CMP project operated cognizant of potential undue influence, whether government or private, and yet worked diligently to advocate the alternative benefits of open market activities.

## III. Project Launch, Staffing, and Organization

CMP commenced in October 2005, with a focus on quickly establishing a presence with GoU counterparts and communicating critical aspects of the project to Government and private sector counterparts. This required the following:

- Numerous high level meetings with key Ukrainian institutions to explain the project's strategic objectives, and obtain insights into current priority issues. These sessions included meetings with the Chairman of the SSMSC; Chairman of the FSR; the Minister of MLSP; the Chairman of the PFTS Ukraine Stock Exchange; and Interregional Securities Union (MFS); Ukrainian Association of Investment Business; Cabinet of Ministers; the AmCham; and extensive sessions with partner USAID projects.

- Staffing of the CMP project across all components, including incorporating staff from the existing USAID/Pension Reform Initiative; developing an overall staffing plan to match project activities with resources. After appropriate interviews and vetting, the core staff of attorneys, financial sector experts, IT specialists, translators, accountants, and administrative support staff was hired.

- Development of the Project Work Plans in an interactive process with key international advisers, Ukrainian experts and institutions, and USAID. The Work Plan served not only as a planning tool, but also reflected of practical on-the-ground concerns in the Ukrainian market. FMI's open process, which solicited inputs from all sectors, helped CMP to build an initial consensus for key priorities; identify critical assumptions which could impact technical assistance; and select those practical issue areas which required early attention.

Additionally, FMI prepared over 20 reports and initial analyses during the project start-up phase. These included a review of existing information systems at the SSMSC; analyses of the existing Depository System and Stock Exchange System in Ukraine; and an analysis on the legal and political issues surrounding the issuing of exchange licenses.

## IV. <u>CMP Tasks, Activities, and Accomplishments</u>

The CMP activities described below are divided into three categories that reflect the project's three General Objectives: (i) capacity building and institutional strengthening, (ii) financial instruments, and (iii) pension system reform.

### A. General Objective 1: Capacity Building and Institutional Strengthening

For Ukraine to achieve the benefits of dynamic and transparent financial markets, it needed to reform and develop its regulatory, administrative, and operational institutions. CMP strengthened these institutions and increased the organizational capacity of Ukraine's financial sector regulators, enabling them to provide more efficient and effective prudential regulation. This included work with the SSMSC, FSR, NBU, securities exchanges, and securities depositories. Specific achievements included the following:

**Protocols on Cooperation*:*** In the early stages of project implementation, CMP entered into a series of ancillary Protocols on Cooperation with the MLSP; the Pension Fund of Ukraine (PFU); the State Property Fund of Ukraine (SPF); PFTS Stock Exchange; Professional Association of Registrars and Depositories (PARD); Ukrainian Association of Investment Business (UAIB); and the MFS securities depository.

***CAPACITY BUILDING AND INSTITUTIONAL STRENGTHENING: KEY ACCOMPLISHMENTS***

- Number of senior financial sector regulatory staff trained in off-site surveillance with USAID assistance: 230
- Number of financial sector regulatory staff trained with USAID assistance: 420
- Number of financial sector private professionals trained on international standards with USAID assistance: 1425 (including 51% women)
- Number of material improvements in the infrastructure institutions that reduce market risks: 55
- Estimated total attendees at CMP sponsored conferences, seminars, training programs, etc.: 2300
- Public outreach: 2.5 million

**Management Information Systems and IT*:*** CMP focused on the technological capacity at the SSMSC and FSR, particularly in the Project's early stages. The comprehensive MIS and IT overhaul facilitated resource sharing, and improved compatibility across the regulators. It also allowed the Project to better develop the specifications for the ESCRIN system and the PDS, as described below.

**SMIDA Reform**: Following the SSMSC's decision to address major problems in the Stock Market Information Development Agency (SMIDA), and change that organization's management, the outgoing SMIDA leadership precipitated a crash of the SMIDA website, effectively eliminating a key source of financial information in Ukraine. CMP worked extensively with the SSMSC during this period to repair this damage to the system, and successfully re-launch the SMIDA website in early 2006, under new leadership. These repairs and reforms by USAID/CMP insured that the SSMSC database of disclosure information functioned properly, could be easily maintained, and was freely available to the public.

**Exchanges and Depositories:** CMP worked to promote fairness and transparency in Ukraine's securities exchanges and depository sectors. This involved a coordinated effort with PFTS Stock Exchange and MFS securities depository, as well as close work with the Verhovna Rada. CMP provided over 250 recommendations to Rada Committees regarding the requirements for implementing improved licensing and listing requirements, an order driven system, and a more liquid securities market.

The project also focused on international best practices, and worked to build linkages between Ukrainian exchanges and their international counterparts. For example, CMP assisted two of Ukraine's leading securities exchanges in securing agreements with leading international partners. The Ukraine Inter-Currency Exchange (UICE) signed Memorandum of Intent to bring the NASDAQ/OMX trading platform Xtreme to Ukraine. The All-Ukrainian Securities Depository (AUSD, the successor of the MFS) and the NBU entered an agreement with NASDAQ/OMX to provide guidance to create an international trading hub with correspondent relationships globally. These efforts also paved the way toward a merger of the MFS and the AUSD, positioning AUSD to become Ukraine's single Central Securities Depository. In a related development, CMP helped the PFTS Exchange form a strategic alliance with the Moscow

Interbank Currency Exchange (MICEX) to adopt a proven, acceptable, version of the NASDAQ/OMX trading platform.

The CMP project organized and supported over 130 activities designed to expand the technical understanding of Ukraine's securities exchanges. CMP sponsored a study tour to Slovenia to evaluate both trading and central depository systems. As part of this tour, the Ljubljana Stock Exchange (LJSE), and the KDD Central Depository, offered their software and systems to the PFTS and MFS. CMP organized 42 high-level roundtables on key issues in the depository sector, in conjunction with the Ukrainian Association of Investment Business (UAIB). Participants included representatives of the SSMSC, NDU, MFS, PFTS and all leading market players (broker/dealers, investment advisers, asset managers, venture capital funds, etc.).

In order to assist the USAID and the State Department with their ongoing efforts to promote a broad financial sector reform agenda for Ukraine, the CMP project also accomplished 58 briefing sessions, and papers, on the importance of a well functioning depository system. These significant Briefing Papers were used to facilitate discussions between the U.S. Ambassador, USAID Mission Director, the Prime Minister and Deputy Prime Minister, and other highest level GoU decision makers on the need to guarantee an independent depository system if Ukraine were to continue toward global integration, and attract more domestic and foreign investments.

**Self Regulatory Organizations (SRO) Establishment:** In order to encourage the establishment of true SROs with necessary authority from the GoU, CMP undertook a review of the legal/regulatory framework, conducted numerous meetings with the seven leading financial sector SROs, interviewed market participants on self-regulation in Ukraine, and offered regulatory drafts and position papers to the key regulators (SSMSC and FSR). CMP's efforts focused on regulatory and disciplinary requirements in conformance with international best practices for SROs. CMP created an SRO framework for business ethics that was widely adopted. CMP experts prepared detailed commentary on the SSMSC's SRO regulation, and served as keynote speakers at over 40 SRO conferences.

**Non-State Pension Provision (NPFs) Department of Surveillance:** CMP initiated a major capacity building effort to improve NPF oversight and enforcement. CMP sponsored participation of three senior level FSR NPF regulators, including the First Deputy Commissioner Eugene Grigorenko, in a high level pension management training program, "New Trends in Pension Funds Management." This program was designed and implemented by Oxford Financial Training and taught in Moscow. CMP supplemented this training via CMP Expert, Robert Kyle, for FSR and NPF line staff in the financial reporting unit.

**SSMSC-SEC Training:** With the support of CMP, the US SEC conducted three Capital Market Development Training Programs for the SSMSC staff, which was organized as a series of training courses in Kiev and a training/mentoring program for the Ukrainian securities regulator. Each of the programs was 3-4 days in duration, and focused on securities market infrastructure, legal and regulatory issues, market manipulation and insider trading, and enforcement. By conducting the trainings in Kiev, the Project was able to expose over 90 Ukrainian regulators to US best practices in securities regulation and enforcement. In addition to SSMSC staff, participants also included delegations from the securities regulators of Armenia, Georgia, Kyrgyzstan, and Moldova, allowing the Ukrainian regulators to network with their regional counterparts. CMP also provided support and funding for eight top level SSMSC officials and one representative from the Cabinet of Ministers in the annual International Institute for Securities Market Development at the US SEC headquarters in Washington D.C. In coordination with World Bank/PTAP (discussed below), CMP greatly expanded this securities market educational effort. The Agenda from the June 23-27, 2008 SSMSC-SEC training program is attached as Annex D of this report.

**ESCRIN Development:** CMP supported Ukraine's adoption of international standards and best practices of disclosure established by International Organization of Securities Commissions (IOSCO), the Organization for Economic Cooperation and Development (OECD), and EU Directives. These requirements have furthered a more uniform approach for the form and content of disclosure documents, similar to that implemented by regulators and issuers in well regulated markets. This standardization, with minor modifications, resulted in disclosure documents that are substantially similar, no matter the market or country, in which the issuer conducts its business or trades its securities.

The USAID/CMP project focused on resolving existing problems in Ukraine's disclosure system, developing new solutions, and incorporating international best practices for disclosure in the Ukrainian market. This work followed from the Protocol of Cooperation between the SSMSC and USAID/CMP. It focused on the design, development, and implementation of a new Electronic Disclosure System (EDS) named ***ESCRIN: Electronic System for Comprehensive Information Disclosure***. Modeled on international examples such as EDGAR, in the United States, SEDAR, in Canada, as well as lessons learned from the Russian experience, ESCRIN was developed by CMP as an easy to use, state-of-the-art system to service the Ukrainian market. The ESCRIN implementation process consisted of four major components:

1. The mandate that issuers electronically file annual reports, quarterly reports and special information (ad hoc) reports, which provide information in compliance with international standards as to both form and content on their business and financial condition. The CMP was the major drafter of this regulation for the SSMSC.

2. The electronic collection and dissemination by the SSMSC of the reports in a real-time mode, free of charge to the public.

3. Enhancement of the SSMSC web site to insure easy and free access to this information at all times.

4. Training programs for SSMSC staff, companies, market participants, and the public to promote compliance with ESCRIN and encourage its use.

CMP launched a pilot project in 2007 for ESCRIN users, taking the presentation to 11 cities, and using 27 of Ukraine's largest publicly traded companies for the pilot. These issuers (businesses across the sectors of manufacturing, energy, and banking) submitted their financial information, including quarterly, annual, and special reports, in order to test ESCRIN's effectiveness in gathering, processing, and verifying companies' financial data. The pilot ESCRIN worked. The ESCRIN pilot companies were later cited as the "best" in transparency by the international rating agency Standard & Poors (S&P) and the Financial Initiative Agency (FIA).

During the subsequent "roll-out phase," the CMP staff continued development of additional disclosure reporting forms which provided for the electronic delivery of all required reporting forms (issuers' annual reports, quarterly information for each of the first three quarters of the year, and an expanded list of special information) to provide a continuous update of business and financial information on companies. CMP technical staff provided considerable training to reporting company personnel, and SSMSC central and regional staff, as part of this process. Each company participant received individualized support and consultation on both the substantive requirements and the electronic requirements of the ESCRIN system. Procedures were developed to address practical aspects of implementing electronic signatures for reporting companies. Simultaneously, the CMP prepared a manual on the substantive disclosure requirements, and a manual that addresses the technical aspects of ESCRIN.


In October 2009, the SSMSC approved the ESCRIN system and officially signed a resolution mandating that all publicly traded companies in Ukraine must submit their financial information electronically through ESCRIN. ESCRIN usage increased, and from zero, today 139 firms use ESCRIN for reporting.

**ESCRIN Information Systems Development:** The Project's IT group designed, developed, and tested the necessary software for ESCRIN. This included: installation and evaluation of the reporting system used by the Russian Federal Markets Service; evaluation of current approaches for the use of open source Digital Signatures for possible application to ESCRIN; adoption of current practices in the local banking sector; and development of the ESCRIN server.

**ESCRIN Forms and Procedures:** The CMP technical staff drafted model forms and documents for Annual Reporting, Quarterly Reporting, and Ad Hoc Reporting. CMP also identified the key regulatory revisions which were required to advance ESCRIN implementation, and drafted relevant regulations which served as an integral part of ESCRIN (including those related to numbering, reporting, and identifying issues in the system).

This CMP work was implemented in close coordination with key counterparts, with a particular effort made to involve leaders in regional SSMSC offices who acted as champions for implementation of the system. It was critical that the SSMSC "bought-in" to ESCRIN and took "ownership" of its implementation. In order to facilitate this process, CMP held numerous training sessions on the essentials of disclosure with companies and the SSMSC staff to enable them to more effectively interact with the public as this effort accelerated. CMP also developed with the SSMSC Commissioners a strategic plan to sustain ESCRIN. CMP drafted an easy-to-use ESCRIN toolkit for use by the SSMSC leadership and participating firms. An ESCRIN Factsheet (one of the many training documents produced by CMP) is attached as Appendix E of this report.

**Consensus Building and International Best Practices:** In order to support ESCRIN's launch, CMP held an ESCRIN conference for 80 SSMSC central and local staff, GoU officials, PFTS Stock Exchange, investment companies, rating agencies, and pilot companies. This conference accelerated the process of improving awareness concerning the new system and building consensus with key public and private sector stakeholders at the central and oblast level. The SSMSC and PFTS committed to improving the quality of the information provided to investors. Additionally, CMP organized a "train-the-trainer" EDS seminar for 60 SSMSC central and local staff in order to train important SSMSC line staff on ESCRIN implementation.

***SUCCESS STORY: ESCRIN TRANSFERRED TO UKRAINE SECURITIES COMMISSION***

On Friday, July 23, 2010, USAID Capital Markets Project and the Securities and Stock Markets State Commission finalized the transfer of ESCRIN ownership to the SSMSC. Commissioner Mykola Burmaka, USAID Financial Sector Program Manager Natalia Berezhna, and CMP's Chief of Party, Ann Wallace, signed the Act of Acceptance of the ESCRIN system. Signing the Act of Acceptance was a final stage in formalizing all the necessary documents under which the SSMSC has become a legitimate owner of the ESCRIN system.

The final transfer followed an earlier official ceremony, at which ESCRIN was presented to the capital markets industry. The importance of this event was reflected by the attendees: Vice Premier Minister Serhiy Tigipko, U.S. Ambassador John F. Tefft, SSMSC Chairman Tevelyev, USAID Mission Director Janina Jaruzelski, Deputy Minister of Finance Tetyana Yefimenko, First Deputy Minister of Economy Anatoliy Maksyuta, SSMSC Commissioner Mykola Burmaka, people's deputies Ihor Prasolov and Vladislav Lukianenko, NBU Governor Roman Shpek, Chief of Party of the USAID Capital Markets Project Ann Wallace, heads of Ukrainian stock exchanges, and 40 Ukrainian print and broadcast media from across the country.

Following the transfer to the SSMSC, all listed companies issuing equities or corporate bonds were required to communicate quarterly and annual filings according to the new disclosure system, pursuant to the SSMSC's new regulation "On Information Disclosure by Issuers of Shares and Bonds Listed on a Stock Exchange." The ESCRIN system brought unprecedented financial accountability and corporate responsibility to Ukraine's capital markets

## B. General Objective 2: Financial Instruments

> ***FINANCIAL INSTRUMENTS: KEY PERFORMANCE INDICATORS***
>
> - Increased trading of equities and bonds: $4.3 billion (73% increase over the life of the project)
> - Increased trading in regulated markets: 150% increase from project inception
> - Increase in new companies traded: 111 companies registered under the new SSMSC listing requirements

CMP worked to improve the enabling environment for new financial instruments by supporting an independent central depository, and by developing a pro-investment legal and regulatory environment. These efforts resulted in increased and more transparent trading on regulated markets, fairer treatment of securities holders, improved audit and accounting standards, and better laws and regulations that encouraged investment, while deterring unfair and abusive practices. As shown on the PMP in Appendix C, the 2008 global financial crisis undercut some of CMP's initial progress, and forced a sharpening of project goals. Nonetheless, CMP still achieved considerable progress in broadening and deepening Ukraine's financial markets.

The CMP activities under this objective are divided into two broad categories: (i) depository and accounting reforms (ii) legal and regulatory reform.

### 1. Depository and Accounting Reforms

**MFS/AUSD and NDU Merger Discussions:** CMP initially worked with SSMSC to support the merger between the MFS and the state-owned NDU. CMP drafted an "Action Plan for Merger" in 2006 that provided a "Roadmap" for this process. The plan was based on the following elements:

- Conduct an independent, internationally recognized, assessment of the technical and human capacity of the two depositories, to be available to the public.
- Conduct an internationally compliant audit of both depositories, to be available to the public.
- Hold public discussions on methods of establishing one Central Securities Depository (management, ownership, and operations) among all participants.
- Finalize the legal and financial mechanisms for the establishment of one Central Securities Depository, including the composition of its Supervisory Board.
- Approve the legal and financial plan with the MFS and NDU shareholders, and make it public.
- Adopt necessary changes to Ukrainian legislation (National Depository System Law, SSMSC, and NBU regulations) necessary for implementation and operation of the Central Securities Depository.

- Implement the plan and commence operations of the newly created Central Securities Depository.

Ultimately, the depository merger discussions were complicated by several steps of misdirection, including a court filing by the NDU seeking to obtain a license from the SSMSC; an attempted effort by the NDU to dilute MFS shareholder's stake; and efforts by MFS shareholder PrivatBank to gain control of MFS.

**AUSD Formation:** After the NDU resisted the merger with MFS, in June 2007, CMP began to work with MFS on a series of reforms and a reorganization of the MFS as the All-Ukrainian Securities Depository (AUSD) (see timeline on page 22). This development was a direct result of USAID and World Bank joint efforts seeking to resolve the on-going conflicts between the NDU and MFS, because those two entities had failed to work out a model for their merger. Formation of the AUSD served many of the same functions as would have the NDU-MFS merger, namely by moving Ukraine closer to a single Central Securities Depositary, as advocated by the Ukrainian private sector, and as supported by USAID and the World Bank. Prior to the AUSD restructuring, USAID/CMP provided substantial technical assistance to the MSF in order to modernize and standardize operating systems. CMP also worked to overcome numerous political, legal, and procedural obstacles to the transition, and assisted international law and accounting firms that assisted in this process.

From 2008 through 2009, CMP supported numerous activities designed to facilitate the formation of the AUSD and its merger with the MFS. This included: a series of operational and legal forums with MFS management, focusing on MFS' corporate structure and ownership; strategic rationale for the merger; the business plan; and valuation considerations. CMP supported a third party audit and valuation performed by PricewaterhouseCoopers; legal and regulatory due diligence; additional technical assistance by USAID/CMP on the re-evaluation of the merger consideration to allow greater participation by broker/dealers in the new legal entity.

USAID/CMP also organized and sponsored the AUSD/MFS conference on "The Merger." Over 70 leading market participants including banks, broker/dealers, and exchanges attended the USAID/CMP conference. The SSMSC, NBU, USAID, and WB representatives expressed their strong support for the merger. Media reports on the conference received national attention: National Channel 1, Ukraine's Sate TV channel (95% coverage) in its daily business news program "Business World" featured interviews with depository representatives and CMP experts. In addition, the International Courier newspaper outlined the key issues of the Ukrainian depository system and its role for the country's economic development based upon the USAID/CMP experts positions in the "White Paper On Depositories."

In mid-2009, the National Security Council prepared a draft resolution on the depository issue that required the merger be cancelled and that Prosecutors investigate any activities that conflicted with the resolution to establish a State Owned Depository. MFS/AUSD requested USAID/CMP assistance to fight this action. Additionally, MFS/AUSD requested that CMP seek assistance from the international donor community. USAID/CMP undertook significant tasks in response, including gaining coordinated donor support from the World Bank and IMF; preparing White Papers on the issue for the US Embassy and World Bank; drafting Position Papers for various parties; and supporting the USAID and the World Bank memorandum to the Prime Minister of Ukraine. On June 25, 2009, the USAID and the World Bank sent a joint communications to the Prime Minister on this matter, which received major coverage in the Ukrainian press. These combined efforts resulted in the remarkable decision of "No Action" being taken by the National Security Council on the depository issue.

***SUCCESS STORY: AUSD FORMATION TIMELINE***

The successful formation of the AUSD resulted from the dedicated efforts of USAID, CMP, and key Ukrainian stakeholders, who worked to develop the AUSD amidst a continually changing political and economic climate.

- March 16, 2006: USAID and SSMSC hold a Task Force meeting to discuss the merger of the MFS and NDU, and to formulate an action plan for the establishment of a Ukrainian central depository.
- June 21, 2007: After months of tension and inability to resolve shareholding structure issues, NDU withdraws from the negotiations with the MFS on establishing a single depository in Ukraine.
- December 2007: After the failed negotiations between the NDU and MFS, the National Bank of Ukraine, in collaboration with several banks and stock exchanges, approved a decision to create the All-Ukrainian Securities Depository (AUSD). This entity resulted from a merged MFS. USAID and CMP advised and supported this process.
- April 18, 2008: The foundation meeting of the creators of the "All-Ukrainian Securities Depository" (AUSD) took place. The meeting unanimously approved a decision to establish the AUSD, and set forth MFS shareholders new ownership.
- February 27, 2009: MFS shareholders agreed to an arrangement of the merger of the MFS with the AUSD through the procedure of purchase and sale of the MFS single property complex in favor of AUSD.
- May 2009: The NDU lobbied the National Securities and Defense Council to make the NDU the Central Depository of Ukraine and to eliminate the AUSD. NBU Governor Stelmakh denounces the NDU position. USAID and World Bank also oppose the NDU.
- June 2009: SSMSC granted the AUSD with the depository and clearance & settlement licenses.
- September 10, 2009: The shareholders of AUSD voted to approve the new issue of shares (to MFS shareholders) to complete the merger and elected a new supervisory board.
- October 2009: AUSD becomes operational. Lawsuits filed by the NDU to stop the AUSD.
- February 2010: NDU abandons court claim challenging AUSD depository license.

USAID/CMP and the World Bank continued to work with AUSD, and internationally respected entities such as the NASDAQ/OMX, to promote international relationships for AUSD with OMX and Euroclear. Although the NASDAQ/OMX relationship with AUSD failed to materialize, CMP laid the groundwork for potential international partnerships in the future. CMP continued to support increased knowledge in this area, to ensure that AUSD developed the capacity to handle foreign securities transactions, thus taking a major step in building the depository's operations in accordance with international standards and best practices.

AUSD requested CMP's assistance to develop a strategic plan to achieve one Central Securities Depository for Ukraine, and to establish a central counterparty system to handle trades on the international market. The system was designed to insure that there would be no "failed trades," where either the buyer or the seller failed to perform their obligation. CMP continued to work closely with AUSD on developing its operations, and monitoring actions of the new GoU with respect to its ownership stake. It was intended that the establishment of AUSD, with 25% ownership held by the NBU, would eliminate any inappropriate political interference in the operations and ownership of AUSD.

**Accounting Reform:** CMP implemented a major initiative to reform accounting practices in Ukraine. These reforms supplemented and enhanced CMP's larger financial sector goals, and included:

- CMP secured assistance from The Ukrainian Chamber of Auditors to support the development of the Electronic Disclosure System (ESCRIN, discussed below); containing financial statements based on either Ukrainian Accounting Standards or International Accounting Standards, with a required signed opinion of the auditors.

- CMP supported the Ukrainian Chamber of Auditors pro-active role in moving Ukraine to International Accounting Standards, and sponsored and organized three prominent international conferences.

- CMP coordinated the Ministry of Finance Protocol of Cooperation with the USAID project on technical assistance to implement International Accounting Standards.

- CMP drafted a definitive paper on the differences between Ukrainian Accounting Standards and International Accounting Standards as they apply to Pillar III, Non-State Pension Funds. This paper served as an essential training vehicle for the FSR.

- CMP supported and assisted the Standard & Poor's Study on Transparency and Disclosure by Ukrainian Banks for 2009 and 2010, as a promotion of the ESCRIN system, and implemented an independent survey of practices of banks in identifying "real owners" of bank loans.

- The CMP staff reviewed and commented on the draft regulation of the SSMSC on IFRS-based disclosure by public companies.

### 2. Financial Sector Legal and Regulatory Reform

CMP efforts in upgrading the fundamental legal framework for financial sector development focused on building support for needed revisions in the Law on Securities and

Stock Exchange, and identifying gaps in the Law which should be addressed to insure the continued success of USAID's financial sector development program. This work included both capital markets and pension law components, with CMP experts working across Ukraine's public and private sector to both draft and advocate for legislation/regulations. In particular, an active partnership with the Ministry of Labor yielded progress on key issues for Pillar II implementation (described further in the Pension section below). Specific legal and regulatory reforms included:

**New Law on Securities and Stock Market:** CMP, at the Rada's request, worked extensively toward passage of the new Law on Securities and Stock Market. Emphasis was placed on insuring that the Law was approved by the Rada without significant changes that might diminish its positive impact on the market. While the Law was awaiting Rada consideration, CMP implemented a coordinated outreach program to insure that Ukrainian advocates were well informed and prepared. CMP specialists worked closely with members of the SSMSC (designated by the GoU to shepherd the Law through the Rada) and key Verkhovna Rada Committees to insure that support for passage of the Securities Law remained solid, and provided answers to any questions raised. This process successfully ensured that key provisions maintained intact. The new Securities Law passed by an overwhelming margin. Subsequently the Law was forwarded by the Rada to the President, and signed into force.

The Securities Law provided much needed modernization of Ukraine's securities markets. It included two central provisions:

- Requiring the use of international disclosure standards in Ukraine and providing for direct reporting from issuers to the SSMSC. Direct reporting to the public on a real-time basis, without any opportunity for manipulation or withholding of the information. The previous law called for the use of a third party provider in processing reports, a loophole which facilitated the establishment of SMIDA, and permitted profiteering on the sale of information disclosure. The new Securities Law eliminated this loophole, and supports free and transparent information disclosure.

- Eliminating the requirement that only an organization with the legal status of a Joint Stock Company can serve as an exchange, a loophole which was being used to the potential detriment of PFTS. In addition, the new Securities Law improved licensing standards for exchanges and market participants, moving Ukraine further into compliance with international best practices.

**Joint Stock Company Law and Regulations:** CMP actively supported the progress of the Joint Stock Company law, as a key element in efforts to build sustainable financial markets. In 2008, the Verkhovna Rada adopted this important legislation, which brought Ukraine into compliance with international best practices for Company Law. Once passed and signed, CMP was asked to draft numerous regulations for and with the SSMSC that were required for proper implementation. Certain of the draft regulations related to accounting issues that would best be handled by adoption of international accounting standards, not ad hoc regulations of the regulator. CMP, and the USAID sponsored Commercial Law Center (CLC), worked jointly with the SSMSC on drafting these regulations.

CMP was asked to become a member of the SSMSC Working Group on implementing regulations under the Joint Stock Company Law, which after substantial drafting effort, became effective in April 2009. CMP staff participated in the review and comment on the key matters that were presented to the Working Group, which included:

(1) Draft regulation on procedures for replacement of certificates due to change of issuer's name;

(2) Revised draft regulation on procedures for securities issuance for the establishment of a joint stock company, which incorporated changes discussed earlier by the Working Group;

(3) Draft regulation on procedures for increase (or decrease) of the statutory capital of a joint stock company;

(4) Draft SSMSC explanations on selection of board members by the joint stock company;

(5) Draft procedures for joint stock company methods of informing shareholders of the company as to certain activities;

(6) Draft procedures for the disclosure of the competency of both the board of directors and the management board of the enterprise;

(7) Research on the issue of valuation and purchase of shares of minority shareholders. This research served to support the White Paper prepared by CMP experts on implementing these provisions of the new Joint Stock Company Law. CMP endeavored to ensure that the SSMSC would implement regulations that protected the rights of minority shareholders in buyout transactions.

**Depository Law:** CMP and the World Bank provided joint comments on the draft of the new Depository Law. These comments advocated that the law would create a Central Securities Depository without mention of the NDU, and clear the way for the new entity created by the acquisition of the MFS by the AUSD to become the one Central Securities Depository. This draft law was approved by the Governmental Committee on Economic Policy Development of the Cabinet of Ministers, which forwarded the law to the Rada for consideration. CMP was also invited to join the SSMSC Working Group responsible for the new draft Depository Law and regulations under the existing (or new) law.

**Derivatives Law:** A draft law was approved by the Governmental Committee on Economic Policy Development of the Cabinet of Ministers, and sent to the Rada for consideration. CMP was asked to comment, and prepared a White Paper on the basic types and uses of derivatives, the advantages and risks associated with these financial instruments, and on the appropriateness of derivatives for the Ukrainian market. This White Paper was distributed to the appropriate parties as the basis for discussions for the re-drafting of the proposed law for the Ukrainian markets.

***SUCCESS STORY: LAWS AND REGULATIONS DRAFTED AND/OR REVISED BY CMP***

1. Law on Securities and Stock Market
2. Joint Stock Company Law (and accompanying regulations)
3. Depository Law
4. Derivatives Law
5. On Amendments to the Tax Code of Ukraine and Certain Legislative Acts
6. Law on Accounting
7. Trade Reporting Regulations
8. Regulations on Cross Border Transactions
9. Pension Law

**Law on Accounting:** At the request of the Ministry of Finance, CMP prepared comments on the draft amendments to the Law on Accounting. These comments expanded the categories of financial sector enterprises and participants required to file financial reports in accordance with international accounting standards. The comments also clarified existing requirements to ensure that audits and opinions of the auditors conformed to international accounting standards.

**Trade Reporting Regulation:** In an effort to have "real time" reporting of all trades, CMP drafted for the SSMSC consideration a proposed regulation requiring all listed companies to report all trades to the exchange on which they are listed, and all non-listed companies to report trades to an exchange where the trading broker is a member within three (3) minutes of the time of the trade. All non-listed company trades traded by brokers not a member of an exchange would be reported within five (5) minutes through a member broker to an exchange where the reporting broker is a member.

**Regulation on Cross Border Transactions:** CMP provided comments to the SSMSC draft regulation on cross border correspondent accounts for investment grade securities. This was an important step because CMP had developed AUSD so it could integrate with other nation's systems and expand Ukrainian investment opportunities, vital to Pillar III and II. This draft was considered by the full Commission, which due to changes in developments on the National Depository System required additional CMP drafting for the SSMSC.

**Pension Law:** As discussed below, CMP worked on numerous aspects of Ukraine's pension laws. This included work with the FSR on proposed changes to the "Draft Law on Amending the Law of Ukraine on Non-State Pension Provisions." CMP prepared comments on this draft law for the Rada Committee on Finance and Banking, the FSR, and the MLSP. CMP provided key policy advice on the Mandatory Accumulation Fund.

**Risk Based Supervision (RBS) for Ukraine:** In order to improve the regulatory capabilities of key GoU institutions responsible for oversight of the financial sector (e.g. SSMSC, FSR and NBU), CMP conducted a review of existing capacity to conduct risk-based supervision. RBS is part of an increasing body of international best practices for NBFI regulation. This approach will enable Ukraine to focus its limited resources on specific issues/categories of risk in a particular industry or company, thereby maximizing the impact of the oversight. CMP experts concluded that it was possible to introduce risk-based supervision provided that the regulatory authorities have the appropriate status, independence, and powers; and provided that the introduction of risk-based supervision builds on the procedures already in place. Selected recommendations included:

- Risk-based supervision can and should be applied to Ukraine, but only if the GoU is committed to its implementation and takes certain steps to address gaps in the legal framework, overlaps between the relevant regulatory institutions, and human resources problems. This would require intensive training for front-line staff.

- Risk-based supervision for Ukraine must be built on the procedures already used by the professional staff of the FSR and SSMSC. NBU personnel who have previously received training in applying risk-based supervision should take part as trainers in the program.

- Moves towards risk-based supervision can be achieved by reviewing the current information requirements; enabling staff to interpret and analyze the reports in terms of the risks posed; enable on-site and off-site staff to communicate; identifying the risks during an on-site visit and assessing the quality of risk-management and enforcement actions.

- Regulatory guidelines should be used at the early stage of development to set limits and internal controls. Developing risk-based supervision will be a valuable tool, especially for NBU's supervisory staff due to the high staff turnover.

**NBFI Regulation:** In order to facilitate efforts to update key laws and regulations in the non-state pension sector, CMP initiated a joint effort with the FSR to translate all relevant regulations into English and review them against international norms. This effort formed the basis for an Action Plan for the FSR to update key regulations, and improve market regulation. This plan was incorporated into the draft Protocol on Cooperation with the FSR. Based on the Protocol of Cooperation, CMP provided substantial NFBI assistance to the FSR, including:

- On-going consultation during the Cabinet of Ministers' consideration of the draft Pillar II pension law prior to its submission to the Rada. This included provision-by-provision comparison of the MLSP and CabMin drafts of the law.

- Review of the FSR's reporting forms for NPFs in terms of international standards, and conducted an on-site review of the electronic filing system for NPF financial reporting.

- Drafting of regulations requiring "mark-to-market" valuation of individual accumulation accounts by investment managers. This international standard identifies and records “unrealized” gains and losses on securities positions, thus preventing fraudulent sale and repurchase of shares by managers between period-ending valuation dates. CMP also drafted a regulation on NPF advertising practices, and prepared comments on various proposed amendments to the FSR Law.

- CMP advisors facilitated a study tour to Slovakia and Lithuania for staff from MLSP, FSR, SSMSC, MoF, and the Cabinet of Ministers. CMP advisors prepared briefing materials, and developed a Report of Findings for later reference. The study tour was to examine the regulatory practices employed in these two host countries that have developed a reputation for advanced effective supervision of NBFIs.

**SRO Development:** CMP enhanced viable and functional self-regulatory organizations in Ukraine. CMP completed a comprehensive review of the existing legal/regulatory framework that applies to SROs. The review focussed on practical ways to improve the sector in Ukraine, compliance with international best practices, and identification of training and technical assistance initiatives to be launched by CMP.

Following this review, CMP drafted and disseminated key regulations, model charters, SRO documentation, and proposed legislative amendments. CMP conducted a series of workshops on these issues that focused on the status of implementation, identifying and resolving key issues in the legal/regulatory framework, and establishing a process for completing the necessary legal/regulatory changes. Participants included SSMSC, FSR and seven SROs representatives, including PFTS, PARD, UAAPF and UAIB. Based on the workshop results, CMP staff prepared final revisions to previously drafted regulations for improving the existing legal framework for SROs in conjunction with key staff and policymakers at the SSMSC.

CMP experts also participated in numerous education and outreach efforts, including the Traders of Ukraine Forum organized by the Association of Ukrainian Stock Traders (AUFT, a newly created association of broker/dealers that registered with the SSMSC to receive the status of a SRO). CMP experts shared information on international experiences with self-regulatory organizations and their interaction with market regulators and their membership. Topics covered included importance of ethical standards, oversight of members, arbitration proceedings, and disciplinary actions. CMP specialists also discussed preventive measures to avoid and eliminate potential conflicts of interest among SRO members and their clients.

**USAID/World Bank Capital Markets Strategy:** Working closely with the USAID Mission, and in coordination with the World Bank, the CMP team developed the joint USAID/World Bank Programmatic Technical Assistance Partnership (PTAP). The PTAP was an unprecedented effort at collaboration between USAID and the World Bank. CMP drafted the analysis of Ukraine’s capital markets that was the basis for the PTAP. As part of PTAP, CMP senior staff developed recommendations necessary for legislation that was appropriate for EU Directives. PTAP identified five pieces of legislation that it believed were critical to the efforts in combating the financial crisis and reforming Ukraine’s capital markets. CMP worked closely with PTAP on these issues:

1. Draft Law on Amendment of Selected Laws of Ukraine as to Regulation of Financial Services Markets (Amending Laws of Ukraine “On Financial Services and State Regulation of Financial Service Markets" and "On State Regulation of the Securities Market of Ukraine”.) This draft established the definitions of affiliated, related, and associated persons and required disclosure of ultimate controllers of financial institutions. It would require the Cabinet of Ministers to set requirements for the origin and source of funds of founders of financial institutions.

2. Draft Law on Procedural Rules and Evaluation Criteria for Prudent Assessment of Acquisitions and Increase in Holdings in Financial Institutions. This draft law required the prudential assessment of acquisitions and increases in holdings in financial institutions, approximating EU Directive 2007/44/EC on Prudential Assessment of Acquisitions and Increase in Holdings in the Financial Sector.

3. Draft Law on Amendment of Law of Ukraine on Financial Services and State Regulation of Financial Service Markets (as to supervision on consolidated basis). This draft required consolidated supervision of financial institutions and compliance with EU Directive 83/349/EEC on Consolidated Accounts and Council Directive 86/635/EEC on Annual Accounts and Consolidated Accounts of Banks and Other Financial Institutions.

4. Draft Law On Amending Selected Laws of Ukraine on Accounting. This draft required international accounting standards for preparation of financial reports by banks, insurance companies, and issuers of securities on an organized exchange. CMP amendments also added exchanges, investment funds, NPFs, broker-dealers that hold client assets, custodians, and asset managers.

5. Draft Law On Supplementary Supervision of Financial Conglomerates. This draft law regulated supplementary supervision of financial conglomerates and provided compliance with EU Directive 2002/87/EC on Supplementary Supervision of Financial Conglomerates.

CMP also provided the World Bank and the PTAP team with an analysis of the Constitutional Court decision declaring unconstitutional the sections of the 2006 Law on Securities and the Stock Market and Presidential Decree No. 142/97 that provided for the appointment by the President of the Commissioners of the SSMSC. This action reverted the power of appointment of the Chair of the SSMSC to the Cabinet of Ministers as provided in the Constitution of Ukraine, but left open the question of who appoints the other Commissioners of the SSMSC.

Also under the PTAP program, CMP successfully worked with the World Bank and IMF to include into IMF Conditionalities three pieces of legislation: (1) a definition and disclosure of “ultimate control persons” of banks, drafted by CMP for the NBU (2009 loan conditionality); (2) requirements for consolidated supervision; and (3) supplemental supervision of financial conglomerates (which became 2010 IMF loan Conditionalities).

The September 2008 PTAP evaluation is attached as Appendix E.

**USAID/World Bank PTAP Twinning Program:** CMP and PTAP (World Bank) jointly developed a twinning program for the SSMSC, which linked the SSMSC with the Polish Financial Sector Authority (FSA) and the US SEC. CMP took the lead in drafting the analytic document that formed the basis for the program. The SEC's support included an institutional assessment, training modules delivered by SEC experts, and the hosting of a large SSMSC staff delegation at the SEC Institute in Washington, DC. SEC experts prepared a White Paper analyzing the status of existing securities market regulation and formulating proposals for improvements needed to support the development of securities markets. While it initially appeared that the Twinning Program might create lasting partnerships for the SSMSC, the initiative stalled due to a lack of funding from the World Bank.

## C. General Objective 3: Pension System Reform

CMP sought to address pension reform from several different perspectives in order to address both current and future issues in pension development, while emphasizing the interconnectedness of financial sector reform. This effort included working with counterparts to insure the essential elements of a well-functioning pension system are in place; encouraging the continued emergence of Pillar II and Pillar III; coordinating closely with the multi-donor initiatives taking place. CMP enhanced the operational capabilities and understanding of key issues for pension fund providers, regulators, supervisors, and policy makers. Specific pension system activities included:

**Pillar II Implementation:** It was anticipated in the CMP project design that the Pillar II Mandatory Accumulation System (MAS), passed into law in 2004, would be implemented during the life of the project. However, the GoU chose not to do this, even though the objective conditions for implementation were met. Nevertheless, CMP provided significant Pillar II assistance. CMP's Pillar II activities began by supporting the GoU Pillar II Pilot Program and developing an analytic model for testing Pillar II assumptions. In order to assist the GoU in the process of moving forward with launch of the mandatory accumulation system, the project engaged in a series of discussions with the MLSP, and the Pension Fund of Ukraine (PFU), concerning assistance with their proposed pilot test of the Pillar II system. This effort included a complete software simulation of the receipt and payments process; analysis of the system of individualized accounts; and an overall assessment of the budget requirements. CMP sent an IT team to Lviv to participate in the pilot, including review of the process and development of recommendations for improvement. CMP technical specialists also worked closely with colleagues in the GoU and World Bank's Pension Advisory Group to finalize and test the analytical model for testing Pillar II assumptions. This model included actuarial, demographic, and macro-economic components to guide the next phase of implementation.

CMP worked with the political leadership to establish a Task Force to consider broad-based changes to the existing pension system. CMP prepared briefing notes on prototype pension systems in Eastern Europe and the CIS; use of banks and insurance companies as managers of Pillar II Pension Funds; alternative approaches to Pillar I benefit computation (e.g., unfunded, individual accounts); and treatment of pensions for civil service and other special groups. The Task Force evaluated various options for Pillar II, including the possibility of immediate placement of Pillar II administration in the private sector through existing non-state pension funds.

In late 2008, the MLSP circulated a new proposal for implementing Pillar II, which made substantial changes in policy, including: (i) covering only workers under age 25, rather than those under age 40, (ii) beginning collection of contributions on January 1, 2011, and (iii) having NPFs receive all Pillar II contributions from the first day of their collection.

CMP prepared initial comments on these changes at the request of MLSP, and for the regulators that were uncomfortable with the immediate use of NPFs to manage recordkeeping and assets. CMP was selected to draft a detailed commentary focusing on the additional requirements that needed to be added to the proposed draft in order to protect workers' contributions against fraud and incompetence.

CMP was also asked by the MLSP to draft and direct training sessions for journalists on methods of protecting Pillar II assets from corruption and fraud, and ensuring that international standards and best practices are adhered to in all areas of administration, collections, record keeping, and accounting.

CMP experts worked closely with the Rada's Pillar II Working Group, as it considered different legislative versions and proposed amendments. Much of this work dealt with measuring rates of return on pension portfolios, valuing individual accumulation accounts, and "mark-to-market" practices. These were crucial issues for private pension reform because no proper mark-to-market calculations had been currently employed in calculating net asset value (NAV) of portfolios. Unrealized gains and losses (on portfolio assets) were not credited to individual accounts, and this would result in incorrect valuations and benefit distributions. Importantly, the Working Group adopted CMP recommendations on these issues.

***PENSION SYSTEM REFORM: KEY PERFORMANCE INDICATORS***

- Increase in Pillar III assets: $123 million ($10.4 million at project inception)
- Diversification of Pillar III portfolio: 55% of assets in capital markets (less than 1% at project inception)
- Increased population coverage: 500,010 (88,000 at project inception)

The global financial crisis of 2008-2009 ended the Pillar II reform program by the GoU. As securities prices began to plummet, financial market participants (especially asset managers) lobbied for immediate enactment of Pillar II under the new concept. They claimed that Pillar II, with heavy NPF involvement, would inject much needed liquidity into capital markets and jump start a new cycle of rapid economic growth. By contrast, CMP staff argued that this proposal would be detrimental to pensioners and to pension reform generally. Flooding sagging securities markets with pension monies would only artificially inflate asset values and create windfall profits for asset managers. CMP argued that no real value would be created for workers, and Pillar II would be regarded as an instrument for profiteers, rather than a vehicle to improve workers' pensions. The CMP perspective prevailed.

**Pillar III Amendment Process:** CMP played a key role in the drafting and revision of proposed amendments to the Law "On Non-State Pension Provision" (NPFs). CMP drafted numerous amendments to Pillar III, with the most critical being amendments on the valuation of individual accumulation accounts, and establishing marking-to-market in valuing individual accounts. The Rada created a Working Group to finalize changes to the CMP drafted amendments, and asked CMP to work closely with FSR to develop final provisions on valuating individual participant accounts. These CMP changes provided the correct, transparent accounting required for financially sound Pillar II and III pensions. Ultimately, the Working Group incorporated draft amendments to the Pillar III law that would:

1. Correct serious deficiencies in valuing individual pension fund accounts by bringing the law in line with international practice;

2. Grant SRO status to only one association of pension fund administrators, whose members constitute 50 percent of all fund administrators;

3. Clarify provisions that limit insurance company participation, and;

4. Broaden Pillar III investment options.

Although the Working Group reached decisions on all outstanding issues, provisions for valuing individual participant accounts remained controversial. Asset managers and NPF administrators opposed adopting international practices that included strong provisions against manipulation of account values. This opposition to the valuation methodology delayed Pillar III progress. In response, CMP increased its efforts, and focused on educating market participants to garner support for best international practice. This included a report for the National Association of NPFs and NPF Administrators, and a workshop on "Innovations in NPF Reporting and Personified Record-Keeping: Problem Issues and Opportunities".

CMP pension experts stressed that neighboring Central and Eastern Europe countries (Bulgaria, Croatia, Latvia, Lithuania, Poland, Romania, Slovenia, and Kazakhstan) *already* mandate exclusive use of the CMP recommended method for valuing individual accumulation accounts.

CMP co-sponsored the FSR Round Table on NPF Financial Issues, and over 100 NPF representatives (asset managers, administrators, members of boards) attended. CMP senior pension experts detailed the problems of asset diversification during a severe recession; plans for the FSR pension disclosure system; and needed draft regulations. Largely as a result of these efforts, resistance to the Pillar III reforms dissipated, and the NPF amendments were enacted.

**Legal/Regulatory Drafting:** CMP supported numerous efforts to revise and update the legal/regulatory framework for pension reform, including:

- Collaboration with the MLSP on the draft law on "Implementation of the Accumulation System."

- Submission of comments and proposed revisions to the draft law on “Mandatory State Pension Insurance” to the Cabinet of Ministers, Verhovna Rada, the MLSP, and the FSR.

- Submission of comments and proposed revisions to the draft law on “Mandatory State Pension Provisions for Privileged Pensions.”

- Development of the Draft Law of Ukraine “On Implementing Mandatory Occupational Pension System” (with proposals on amending other laws).

- Submission of Comments on the draft law “On Amending the Law of Ukraine On Non-State Pension Provisions,” which were sent to the Rada Committee on Finance and Banking, the FSR, and the MLSP.

- Finalization of the Draft Law of Ukraine “On Amending Article 26 of the Law of Ukraine "On Mandatory State Pension Insurance” (regarding the retirement age increase).

**Occupational Pension Reform:** CMP experts redrafted the Occupation Pensions Law, which removed privileged pensions from Pillar I, placing them on a fully funded footing as part of Pillar III. Privileged pensions apply to nearly 2.5 million workers. The MLSP circulated the draft for comments from all relevant stakeholders, with CMP assisting MLSP by amending the draft where appropriate and presenting analysis/supporting information to stakeholders. All parties agreed that NPFs should take the lead role in managing these mandatory accumulation accounts immediately upon implementation. At the request of the MLSP, CMP translated the draft law into English and began in-depth analysis to bring the draft law in line with international standards.

***SUCCESS STORY: CMP REFORMS INCREASE PENSION CAPITAL***

*Growth in Pension Capital: Actual (2009-2010) and Projected (2011-2014)*

| Year | Pillar II Contribution Rate | Mandatory Pillar II Contributions (bl $) | Cumulative Contributions (bl $) | Percent of Real GDP |
|---|---|---|---|---|
| 2009 | 2% | 0.7 | 0.7 | 0.5% |
| 2010 | 3% | 1.3 | 2.0 | 1.4% |
| 2011 | 4% | 2.0 | 4.0 | 2.8% |
| 2012 | 5% | 2.7 | 6.6 | 4.7% |
| 2013 | 6% | 3.3 | 9.9 | 7.0% |
| 2014 | 7% | 4.0 | 13.9 | 9.9% |

**Training and Outreach:** CMP supported pension system reforms through a broad spectrum of training and outreach programs. These included:

- Institute of Demography and Social Studies seminar on the financial model for implementation of Pillar II reform and Prospects for Implementation of the Accumulation Pension System.

- MLSP seminar on conformity of social security legislation in Ukraine with EU and international standards, with the participation of the Council of Europe and International Labor Organization.

- Supported the visit of the Deputy Minister of Labor to Zhydachiv and Sokalsk regions of Lviv oblast and prepared a review and analysis of the “Lviv Experiment” on establishment of personalized accounts and creating an automated system for the Accumulation Fund of mandatory state pension insurance.

- Edited, designed and printed 1000 copies of the Ministry of Labor statistical booklet on “Mandatory State Social Insurance and Pensions: Figures and Facts” for distribution to policy makers and members of the new Government of Ukraine.

- Established and maintained a pension web site providing current information on pension reform in Ukraine and provided written responses to questions presented to “ASK A PENSION EXPERT.”

- Prepared and published a booklet entitled: “Private Pension and Proposed Model of Mandatory Accumulation System.” The manuscript focused on international best practices and how the model should operate in Ukraine.

- A national public relations campaign targeting employers providing non-state pension funds (NPF) for employees.

- A brochure on private pension funds, and printed the first tranche of 100,000 copies for distribution.

- Modernization of the www.pension.kiev.ua website.

- Providing materials to journalists on expected demographic developments in Ukraine relating to the Pillar II pension system.

- CMP reviewed the operations and performance of the project’s Pension Hot-Line operators (pictured at right), and developed a training program to increase their capacity to respond to questions from the public about Pillar II and III private pension developments.

- Development of multiple television spots on the benefits of saving for retirement and the merits of employer-sponsored supplemental pension programs.

- Drafted and published numerous articles and/or op-eds on pension reform issues.

- Distribution of the Pension Investment Glossary explaining the main concepts and their implications targeted at young people who will be impacted by pension reform.

**Pension Disclosure System (PDS):** Disclosure was a fundamental CMP goal for joint stock companies and other business entities. NPFs are non-profit entities whose accounting differs substantially from for-profit business entities. Moreover, disclosure for pension schemes is much more straightforward. CMP worked in close cooperation with FSR in developing an electronic pension disclosure system (PDS) by procuring the services of Atlas, a local software development company, to design the data extraction function. This function allowed for information to be taken from the NPF reports and displayed on PDS. In April 2009, CMP delivered the PDS system to FSR for a 30-day testing period during which CMP would be available to answer questions and make modifications as necessary. After FRS approval, CMP reviewed the final screens for the PDS to ensure that financial terms and data were presented in accordance with OECD principles. CMP instituted reporting requirements and methodology for Pillar III investments that can serve as a model for Pillar II investment reporting.

***SUCCESS STORY: NATIONWIDE PENSION SURVEY***

CMP organized a national opinion and knowledge survey of pension awareness in Ukraine. The survey, conducted by public opinion and polling firm GfK in June 2010, polled approximately 5000 Ukrainians age 18 and over, from across all regions of Ukraine and Kyiv. Questions were asked in face-to-face interviews to solicit attitudes and knowledge of pension and retirement related issues. The survey also included a sub-sample of approximately 1000 18- to 36-year-olds, who were in the age group targeted by the second pillar of the pension reform. The survey revealed that most Ukrainians (70%) do not believe that they will have sufficient income to finance their “golden years.” They also believe that providing for a secure retirement is the joint responsibility of the government and the individual (slightly more than 50%), and yet a majority of respondents (75%) plan to rely on a state pension in the future.

Other key findings included:

- Public awareness of the pension reforms introduced in 2004 is very low.
- The majority of the population opposes increasing the retirement age (86 percent).
- Sixty-six (66) percent of respondents consider the best solution to deal with the deficit in the pension system is to cut state expenditures in other areas of the budget.
- Forty-two (42) percent of the population makes its cash savings in UAH and 11 percent in foreign currency.
- Only 7 percent of Ukrainians currently have deposits at banks; 8 percent of those surveyed plan to open bank deposits in the near future.
- Only 20 percent of Ukrainians consider bank deposits attractive, while 37 percent think investment in real estate is attractive.
- The level of attractiveness in investing into securities (shares, corporate bonds and government bonds) is less than 1 percent.
- Ukrainians trust government financial institutions more than private ones. The most trusted financial institution is the Pension Fund of Ukraine, followed by state-owned banks.

The survey data provided USAID, CMP, and the Ukrainian Government with important information to push forward an effective pension reform.

**Policy Papers and Reform Initiatives:** Throughout the project CMP performed, at the request of the GoU and leading private sector officials, repeated influential analyses, policy briefs, and "white papers" regarding key pension issues. These included:

- Paper for the MLSP which provided a detailed timetable and action plan for addressing open issues which must be resolved in order for MAS to launch.
- Policy brief on deferring payment of pensions past the normal retirement age, until actual retirement, with recommendations focused on the U.S. model wherein deferred pensions are paid at age 70.
- Paper on "Role of The Investment Advisor," addressing the need for MAS to have qualified advisors, not just asset managers.
- Policy brief on social insurance contributions for prisoners.
- Paper on investments and investment returns in Russia and Poland, including comparisons of pension system structures, investment products, and legal/regulatory issues.
- Policy paper on Civil Service Pensions in selected countries.
- Policy paper and recommendations on how unified social insurance contributions should operate in Ukraine for maximum impact and effectiveness.
- Policy brief on trustees and their fiduciary obligations as part of the operational board's of MAS funds.

- Policy paper on how SROs operate and whether they should be the sponsors of pension funds for civil servants and other categories of pensioners in Ukraine.
- Policy Paper on Annuities for MAS and an accompanying roundtable, which involved key policymakers in an interactive discussion on key issues for reform. Roundtable participants included the MLSP, PFU, FSR, Trade Unions, President's Secretariat, Cabinet of Ministers, Ukrainian pension consultants, and other market participants.
- Detailed commentary on the proposed MAS and existing Non-State Pension Law with an emphasis on annuities issues and recommendations for revisions as necessary.

- Provided analysis for the FSR on annuities for non-state pension funds and how they should work, including delivery of a paper for use by the regulator in developing its own policy in this area.

- Summary paper on who should be allowed to provide annuity products in the market and who should regulate it, especially important in Ukraine considering the underdeveloped insurance industry. Key recommendations included establishing a strong state model, with an independent state agency empowered to provide effective regulatory oversight.

## V. Other Project Considerations

### A. Subcontractors

FMI implemented CMP in collaboration with one subcontractor: PADCO (Planning and Development Collaborative International), now a part of AECOM. PADCO had previously implemented the Ukraine Pension Reform Implementation Project, and used this experience to contribute technical expertise and personnel to FMI's implementation of General Objective 3 (pension reform). As FMI's only subcontractor, PADCO was also involved in the implementation of General Objectives 1 and 2. PADCO was a major and significant contributor to CMP efforts from 2006 to 2009. On March 13, 2009, FMI and PADCO mutually agreed to end PADCO's involvement in CMP.

### B. Gender Equality

FMI considered gender bias and gender equality in structuring all CMP tasks. Many CMP activities involved reform of high-level institutions (e.g. legal reform, regulator strengthening, etc.), where FMI concluded that a direct gender component was inapplicable or inapposite to project goals. However, during these tasks, FMI ensured that the effects of any CMP reforms would impact men and women equally, and would not unduly burden any vulnerable subsets of the population.

CMP's most significant contributions to gender equality occurred though the project's pension outreach and training activities. Because women, on average, live longer than men, they are more likely to face poverty and hardship later in life. Moreover, CMP estimated that the value of women's pensions in Ukraine is only two-thirds that of men. This leaves elderly women in a particularly vulnerable position. CMP sought to address this vulnerability by ensuring that half of all training and education recipients were women. Project staff, including operators of the Pension Hotline, received specialized training on dealing with gender specific issues and enhancing female involvement. As a result, 49% of 412,100 new Pillar III pensioners were women.

Over the life of the project, FMI monitored CMP's training and outreach activities to ensure that they did not discourage persons of either gender from participating. This included examining the actual gender patterns of participation in selected programs, and seeking to understand the causes of differential participation by gender. In instances where gender underweighting occurred, post-task analysis was conducted to understand the reasons behind it.

## C. Microenterprise

The CMP Statement of Work did not include any direct microenterprise activity. However, FMI ensured that CMP supported the USAID Access to Credit Initiative in its efforts to develop SME sustainability and expand SME access to finance. Additionally, CMP's investor and pension training programs worked to increase SME participation.

## D. Environmental Compliance

FMI is aware that, pursuant to The Foreign Assistance Act of 1961 (as amended), the environmental impact of USAID's activities must be considered. The nature of the work under CMP involved personal services activities. CMP had no adverse environmental impact, and complied with all applicable USAID regulations and Ukrainian environmental and public health laws.

## E. Financial Information

CMP's initial contractual period of performance was September 19, 2005 to September 20, 2010, with a total obligated amount of $14,205,864.00 (Contract No. 121-C-00-05-00707-00). On August 10, 2010, USAID/Ukraine issued a no-cost modification (Amendment No. 06), which extended the original contract through October 19, 2010.

The following Amendments were issued under CMP:

- Amendment No. 01 (July 28, 2006) provided incremental funding in the amount of $791,990 for a new obligated amount of $5,231,990.

- Amendment No. 02 (August 2, 2007) provided the following:
  - Added incremental funding of $2,500,000 (total obligated amount, $7,731,990);
  - Modified the terms under Part I – The Schedule, F.4. (b) Quarterly Performance Monitoring Reports;
  - Added Section H. 15 Branding and Marking to the contract.

- Amendment No. 03 (July 21, 2008) included the following:
  - Added $1,000,000 in additional funds, increasing the total obligated amount to $8,731,990;
  - Added Section H.16 (Voluntary Population Planning Activities);
  - Incorporated FMI's approved Branding Implementation and Marking Plans.

- Amendment No. 04 (September 18, 2009) provided incremental funding in the amount of $2,000,000 thereby increasing the amount obligated to $10,731,990.

- Amendment No. 05 (September 25, 2009) increased the total obligated amount to $13,928,731 (increase of $3,796,741).

- Amendment No. 06 (August 10, 2010) provided incremental funding in the amount of $277,133, thereby fully funding the award ($14,205,864). This amendment also extended the project 30 days from September 20, 2010 to October 19, 2010, and revised Section H.10 Third Country Training.

### F. Project Close-Out and Transition to FINREP

In close coordination with USAID personnel, FMI oversaw the phase-out of CMP staff and managed an inventory and disposition plan for CMP property. CMP closed on Tuesday, October 19, 2010. FMI submitted its final CMP Expense Invoice (No. 62) to USAID/Ukraine on December 27, 2010.

By the time CMP ended in October 2010, the USAID Financial Sector Rehabilitation Program (FINREP), implemented by the consortium of Booz Allen Hamilton and FMI, had been operational for eleven months. CMP and FINREP were implemented jointly during this period, with FINREP relying almost exclusively on CMP personnel, operating out of CMP's offices in Kiev, and using CMP facilities and equipment. This served three primary purposes: first, the joint implementation ensured a fluid and efficient transition from CMP to FINREP; second, the use of CMP personnel ensured that FINREP would build upon CMP's successes, relationships, and experiences in Ukraine; and third, the operational and technical linkages between the two projects produced cost-saving efficiencies for USAID.

## VI. Conclusion and Lessons Learned

The USAID Capital Markets Project represented a vigorous and transformative effort to strengthen Ukraine's financial markets, improve regulatory oversight, and reform the pension system. The project achieved successes on all objectives. CMP enhanced the institutional capacity and understanding of Ukraine's key regulators and drafted scores of financial sector laws and regulations. It supported the development of SROs capable of monitoring their own members, and discipline bad-actors to protect the industry sector as a whole. CMP made a major contribution to financial information disclosure by enabling public companies to report reliable financial information through ESCRIN on a real time basis.

However the success of a USAID capital markets development project cannot be measured like a stock portfolio, or company earnings, on a quarterly basis. Years, not months, of sustained efforts are required for the achievement of success. Time, plus a commitment by the local citizens and government to reform their commercial laws, regulations, and financial institutions' operational practices, are essential for success in capital markets development.

Accordingly, CMP's many successes must be understood within the larger context of Ukraine's post-socialist economic development. The CMP experience teaches that economic reform in Ukraine requires willing governmental and regulatory partners, coupled with a knowledgeable and engaged private sector. USAID's commitment to assist Ukrainian economic development via the Capital Markets Project represents an important step in a sustained and continuing process.

## Appendix A: Index of Major Reports and Deliverables

**<u>Reports and Studies</u>**

- "Preliminary Findings, Conclusions And Recommendations On The Depository Systems Of Ukraine," by Harry Cartner, December 16, 2005.

- "Ukraine: 2005 Macroeconomic And Financial Sector Developments," by CMP Staff, April 2006.

- "The Prospects For Risk-based Supervision In Ukraine," by Oonagh McDonald, June 2006.

- "Capital Market Assessment," by W. R. McGillivray, September, 23, 2006.

- "New Equity Investment Instruments: The Challenge for Ukraine's Pension Reform," by Charles Seeger, Victor Stetsenko, and Ann Wallace, December 2006.

- "Diversified Investment Alternatives and New Financial Instruments: The Challenge for Ukraine's Pension Reform," by CMP Staff, May 2007.

- "Development of Risk-Based Prudential Supervision of the Capital Markets in Ukraine" by Oonagh McDonald January 2008.

- "Ukrainian Capital Market Regulatory Assessment," by Ester Saverson, Jr. and Katherine K. Martin, June 2, 2008.

- "A Year in Review & Priorities for the Year Ahead: Report on the PTAP Implementation," by CMP Staff, September 2008.

- "On the Use of Derivatives in Ukraine," by John P Crowley, October 2, 2009.

- "Financial Instruments Development To Support Ukraine's Pension Reform" by John Crowley, May 14, 2009.

- "Implementing Risk-based Supervision For Non-state Pension Funds And Insurance Companies," by Oonagh McDonald, December 2009.

- "Comparison Of Ukrainian Accounting With International Accounting," by Benjamin Hill, March 26, 2010.

- "USAID and Capital Markets Development in Ukraine 1995 – 2010," by Charles M. Seeger, March 2011.

- “2010 Pension Reform Public Survey Results: Comparison with 2005 Survey,” by CMP Staff, Fall 2010

**Assessments and Recommendations**

- “The Ukraine Stock Exchange Environment: Challenges And Recommendations,” by Robert L. Smith, January 17, 2006

- “Ukraine’s Securities Depository System: Risk and Recommendations,” by Harry Cartner, February 10, 2006.

- “Program for Development of Electronic Disclosure System (EDS) for Ukrainian Issuers for Securities and Stock Market State Commission,” by CMP Staff, April 25, 2006.

- “Corporate Board Evaluation and Action Plan,” by Bertram Lewis, July 26, 2006.

- “Assessment of PFTS Stock Exchange: First Tier Listing Standards,” by Bertram Lewis, July 2006.

- “Report And Recommendations For Development, Operation And Regulatory Oversight Of Self-regulatory Organizations In The Ukrainian Capital Market,” by Robert D. Strahota, October 27, 2006 (updated June 15, 2007).

- “A Strategy For Further Development Of Ukraine’s Capital Markets,” by Nils E. Ekberg, March 21, 2007.

- “Strategic Recommendations For Further Development Of Ukraine’s Capital Markets,” by CMP Staff, April 24, 2007.

- “The Ukraine Stock Exchange Environment: Challenges And Recommendations,” 2007 Update. by Robert L. Smith, August 20, 2007.

- “Developing Securities Markets And Non-bank Financial Institutions In Ukraine: Key Impediments And Policy Reform Priorities,” by CMP Staff, September 21, 2007.

- “Ukraine’s Securities Depository System: Risk and Recommendations – Follow-up Report,” by Harry W. Cartner, March 2008.

- “Strategy for Stock Exchange Development in Ukraine and Expected Technical Assistance,” by CMP Staff, September 3, 2009.

- "Analysis And Comments Regarding Dematerialization Initiatives Under Ukraine's Joint Stock Company And National Depository System Legislation." By Robert D. Strahota, November 20, 2009.

- "Privileged Retirement Provision for Certain Categories of Employees," by Greg McTaggart, November 2009.

- "Analysis And Recommendations Regarding Dematerialization Initiatives Under Ukraine's Law On Joint Stock Companies And Law On The National Depository System And Specificities Of The Computerised Securities Circulation System Of Ukraine," by Robert D. Strahota, July 27, 2010.

**Legal Opinions and Comments**

- "The 2006 Ukrainian Law Of Securities And Stock Market: Is It Adequate For Disclosure And Electronic Filing Purposes?," by Robert D. Strahota, July 18, 2006.

- "Comments the draft bill 'On Implementation of Accumulation System of the Mandatory State Pension Insurance,'" by CMP Staff, July 24, 2006.

- "Comments on Draft Law on Public-Private Partnership in Ukraine," by Robert D. Strahota, Legal Adviser, August 20, 2007.

- "General Comments to the New Language of the Draft Law of Ukraine on Implementing Accumulation System of Mandatory State Pension Insurance," by CMP Staff September 25, 2008.

- "Proposals on Amending the Law of Ukraine On Non-State Pension Provision," by Natalia Goriuk, October 27, 2009.

- "Legal Opinion on UAAPF Case," by Yulia Vitka, November 8, 2009.

- "Comments on the Draft Law of Ukraine on "Introduction of Accumulation System of Mandatory State Pension Insurance," by CMP Staff, February 11, 2010.

- "Comments On The Concept For The Implementation Of Prudential Supervision Of Non-bank Financial Institutions By The State Commission For The Regulation Of The Financial Service Markets Of Ukraine, by Oonagh McDonald, May 2010.

- "Non-State Pension Fund Reform: Draft Legislative and Regulatory Proposals," by Theodore W. Urban, May 10, 2010.

- "Comments on the Draft Law of Ukraine 'On Amendments to the law of Ukraine 'On Advertising' with regard to advertisements on the securities market.'" CMP Staff, June 15, 2010

**Training Materials, Guidelines, and Outreach**

- "Some Questions And Answers About Securities Self-regulatory Organizations," by Robert D. Strahota, October 14, 2006.

- "Procedure for Actuarial Calculations in the Accumulation Component of the State System of Pension Insurance," by CMP Staff, Fall 2006.

- "ESCRIN: Legal Aspects of Information Disclosure," by CMP Staff, March 13, 2007.

- "Prospectus Resource Document For Nonfinancial Disclosure," by Robert D. Strahota, October 10, 2007.

- "Valuing Accumulation Accounts Using Units And Unit Value International Experience," by CMP Staff, September 2008.

- "Capacity Of Ukrainian Capital Markets SROs To Exercise Self-regulatory Functions Subject To Regulatory Oversight," by Robert D. Strahota and Theodore W. Urban, July 3, 2009.

- "Protecting Participants In The Pillar II Pension Accumulation In Ukraine," by Richard L. Symonds, November 2, 2009.

- "Definition and Disclosure of Real Owners (formerly ultimate controllers)," by CMP Staff, November 30, 2009

- "Pension Reform In Ukraine: What To Do About The Mandatory Accumulation System?," by CMP Staff, April 28, 2010.

- "Key Indicators for Regulators of Non-State Pension Funds," by Benjamin Hill, June 29, 2010.

- "Transactions And Practices That May Avoid Public Joint Company Status: A White Paper Including Issues and Recommendations, by Robert D. Strahota, July 14, 2010

- "International Pension Newsletter," by CMP Staff, Published Monthly from 2005-2010.

- Various Local Newspaper and Periodical Publications and Interviews Re: Pension Issues.

- Pension Reform Web-Site, updated by CMP staff throughout project.

- "Pension Investment Glossary," by CMP Staff, Annually updated.

## Appendix B: Expected Outcomes (i.e., "What Success Looks Like")

| Expected Outcome | Status | Results/Comments |
|---|---|---|
| ***General Objective 1: Strengthened capacities of the financial market regulators to provide efficient and effective prudential regulation to the non-bank financial institution (NBFI) sector*** | | |
| A. The Regulators and Regulatory Process | | |
| The responsibilities of the regulators should be clear and objectively understood. | ✓ | Numerous laws and regulations; training |
| The regulators should be operationally independent and accountable in the exercise of its functions and power | ✓ | Regulatory training |
| The regulators should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers. | ✓ | Numerous laws and regulations; training |
| The regulators should adopt clear and consistent regulatory processes. | ✓ | Regulatory training |
| The staff of the regulator should maintain the highest professional standards including appropriate standards of confidentiality. | ✓ | Regulatory training |
| The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets. | ✓ | SRO Reports; SRO best practices training |
| SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities. | ✓ | SRO Reports; SRO best practices training |
| B. The Enforcement of Regulations | | |
| The regulator should have comprehensive inspection, investigation and surveillance powers. | ✓ | ESCRIN disclosure; training |
| The regulator should have comprehensive enforcement powers. | ✓ | Numerous laws and regulations; training |
| The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program. | ✓ | ESCRIN disclosure; training |
| ***General Objective 2: Broadened the range of financial instruments available for portfolio investments and market infrastructure development*** | | |
| A. New Financial Instruments and Issuers | | |
| Productive, diversified investment should be developed for retirement savings (pension funds, insurance companies, others) that offer institutional investors portfolio diversification, and risk management options. | X | Task delayed at the request of USAID (shifted to Access to Credit Initiative) |
| There should be full, timely and accurate disclosure of financial results and other information that is material to investors decisions. | ✓ | ESCRIN; Numerous commercial laws and regulations; RBS development |
| Holders of securities in a company should be treated in a fair and equitable manner. | ✓ | Numerous commercial laws and regulations |
| Accounting and auditing standards should be of a high and internationally acceptable quality. | ✓ | IFRS and IAS reform; Accounting reform; Law on Accounting |
| B. The Securities and Exchange Commission and Securities Trades | | |

| | | |
|---|---|---|
| The regulatory system should ensure full, timely and accurate disclosure of financial results and other information that is material to investors' decisions. | ✓ | ESCRIN; Numerous laws and regulations |
| There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants. | ✓ | Numerous laws and regulations; regulatory training; RBS development |
| Regulation should promote transparency of trading. | ✓ | AUSD Formation, ESCRIN, Commercial laws and regulations |
| Regulation should be designed to detect and deter manipulation and other unfair trading practices. | ✓ | Regulatory reform |
| Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient, and that they reduce systemic risk. | ✓ | AUSD Formation; RBS development |
| ***General Objective 3: Strengthened the capacities of pension fund providers, regulators, supervisors, and policy makers to establish an efficient and effective pension system*** | | |
| A. Collective Investment Schemes | | |
| The regulatory system shall set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme. | ✓ | Pension laws and regulatory reforms/ amendments |
| The regulatory system shall provide for rules governing the legal form and structure of collective investment scheme and the segregation and protection of client assets. | ✓ | Pension laws and regulations; regulatory training |
| Regulation shall require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme. | ✓ | PDS development; Pension laws and regulations |
| Regulation shall ensure that there is a proper and disclosed bias for asset valuation and the pricing and the redemption of units in a collective investment scheme | ✓ | Pension regulatory reform |
| B. Pension Schemes | | |
| Policies and procedures for the mandatory contribution pension system developed and adopted, present regulatory provisions amended in 2006 - 2008 to reflect the current situation. | ✓ | Pension laws and regulatory reforms/ amendments (remains ongoing) |
| Strengthening the organizational and functional capacity of the financial services regulator. | ✓ | Regulatory training (primarily 2005-2008; PFU did not participate from 2008-2010) |
| All pension funds provide investors full and complete disclosure in a written offering circular or prospectus | X | GoU postponed CMP proposed reforms; part of ongoing pension reform efforts |
| Fee structures developed and there is an adequate disclosure of fees on a comparable basis across funds. | ✓ | Policy papers and training |
| Standards for asset allocation developed. | ✓ | Policy papers and training |

| | | |
|---|---|---|
| Portfolio management guidelines developed. | ✓ | Policy papers and training |
| Capital adequacy and reserve requirements developed. | ✓ | Regulatory training |
| Efficient management of pension assets. | ✓ | Policy papers and training |
| Reporting requirements developed and adopted. | ✓ | PDS development and implementation |
| Audit procedures developed and adopted. | ✓ | International best practices training. |
| An informed public capable of making decision about the new pension system. | ✓ | Pension survey; training and outreach; pension hotline |
| C. FSR and Market Intermediaries | | |
| Regulation shall provide for minimum entry standards for market intermediaries. | ✓ | Regulatory reform |
| There shall be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake. | ✓ | Policy papers and regulatory reform |
| Market intermediaries shall be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters. | ✓ | International best practices training |
| There shall be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk. | ✓ | Policy papers; regulatory reform; training |

## Appendix C: Final Performance Monitoring Plan (PMP)

**Performance Monitoring Plan**
**Capital Markets Project**

The following Performance Monitoring Plan (PMP) was approved on February 10, 2006 and updated on September 17, 2010. This version represents the final PMP, including all final CMP data and results. Checkmarks have been added to indicate an achievement of a project target or deliverable.

| Expected Result | Indicator | Data Source | Responsibility for data collection & method | Frequency of collection | Baseline | Year of Baseline | Target-2006 | Actual-2006 | Target-2007 | Actual-2007 | Target-2008 | Actual-2008 | Target-2009 | Actual-2009 | Sep 2010 End-of-Project target | Sep 2010 End-of-Project actual |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| SO 1: Improved Investment Climate | | | | | | | | | | | | | | | | |
| IR 1.1: Business Legal Environment Improved | | | | | | | | | | | | | | | | |
| Project Objective 1: Strengthened capacities of the financial markets regulators to provide efficient and effective prudential regulation to the NBFI sector | | | | | | | | | | | | | | | | |
| F S R | | | | | | | | | | | | | | | | |
| 1. Development and implementation of disclosure system for Pillar III Funds at FSR | Stage level of development and implementation of disclosure system at FSR (See Attachment 1) (Total number of stages - 19) | FSR | Report by FSR with spot-checking by CMP as appropriate; report of CMP activities | Annually | Stage 0 | 2005 | Stage 3 | Stage 2 | Stage 4 | Stage 4 | Stage 10 | Stage 11 | Stage 19 | Stage 19 | Stage 19 | Stage 19 ✓ |
| 2. Development and implementation of risk-based supervision at FSR | Stage level of implementation of risk-based supervision at FSR (See Attachment 2) (Total number of stages – 13) | FSR | Report by FSR with spot-checking by CMP as appropriate; report of CMP activities | Annually | Stage 0 | 2005 | Stage 5 | Stage 1 | Stage 9 | Stage 4 | Stage 8 | Stage 5[3] ✓ | n/a (task suspended by USAID) | n/a (task suspended by USAID)) | n/a (task suspended by USAID)) | n/a (task suspended by USAID) |
| 3. Practical implementation of risk-based supervision program | # of deficiencies identified by FSR involving substantive issues | FSR | Report by FSR | Annually starting in 2007 (after pilots have been established) | 0 | 2005 | 0 | 0 | 10 | 0 | 0 | 0[4] | n/a (task suspended by USAID) | n/a (task suspended by USAID) | n/a (task suspended by USAID) | n/a (task suspended by USAID) |
| S S M S C | | | | | | | | | | | | | | | | |
| Development and implementation of issuers disclosure system at SSMSC | Stage level of development and implementation of disclosure system at SSMSC (Attachment 1) (Total number of stages – 19) | SSMSC | Report by SSMSC with periodic review by CMP as appropriate; report of CMP activities | Annually | Stage 0 | 2005 | Stage 5 | Stage 5 | Stage 12 | Stage 12 | Stage 16 | Stage 16 | Stage 19 | Stage 19 | Stage 19 | Stage 19 ✓ |

[3] The stages specified at the beginning of the project assumed more advanced regulation at FSR than was the case. Accordingly, considerable capacity building was required to prepare for risk based supervision. The FSR was not prepared in 2008 to assume this task, so the task was stopped, as advised by USAID.
[4] Deficiencies cannot begin to be identified until stage 10 of item 2. "Development and implementation of risk-based supervision is completed." This task was suspended at USAID's request.

| Expected Result | Indicator | Data Source | Responsibility for data collection & method | Frequency of collection | Baseline | Year of Baseline | Target-2006 | Actual-2006 | Target-2007 | Actual-2007 | Target-2008 | Actual-2008 | Target-2009 | Actual-2009 | Sep 2010 End-of-Project target | Sep 2010 End-of-Project actual |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| IR 1.3: Financial Mobilization Increased[5] | | | | | | | | | | | | | | | | |
| Project Objective 2: Broaden the Range of Financial Instruments Available for Portfolio Investment | | | | | | | | | | | | | | | | |
| 1. Increased trading of equities and bonds | Dollar value of trades Desegregated by equities bonds | SSMSC and PFTS | Report by SSMSC and PFTS | Annually | Total: USD $2.6 billion<br><br>Equity: $0.6 billion<br><br>Bonds: $2.0 billion | 2005 | 10% increase in equities<br><br>and<br><br>15% increase in bonds | Total: $5.47 billion (110% ↑)<br><br>Equity: $1.18 billion (97% ↑)<br><br>Bonds: $3.74 billion (87% ↑) | 10% increase in equities<br><br>and<br><br>15% increase in bonds | Total: $6.3 billion (15% ↑)<br><br>Equity: $2.01 billion (70% ↑)<br><br>Bonds: $5.39 billion (44% ↑) | 10% increase in equities<br><br>and<br><br>15% increase in bonds | Total: $7.14 billion (13% ↑)<br><br>Equity: $2.23 billion (11% ↑)<br><br>Bonds: $4.84 billion (10%↓) | n/a[6] Due to develop-ments in Ukraine and world securities markets | n/a Due to develop-ments in Ukraine and world securities markets | Total: USD $10 billion<br><br>Equity: $3 billion<br><br>Bonds: $7 billion | Total $4.5 billion (73% ↑ from 2005)[7]<br><br>✓ |
| 2. Increased trading in regulated markets | Percentage of trades on regulated markets | SSMSC and, PFTS | Report by SSMSC and PFTS | Annually | 4.1% | 2005 | 10% increase in 2005 | 5.8% (41% ↑) | 10% increase in 2006 | 4.66% (20% ↓) | 10% increase in 2007 | 5.01% (7.4% ↑) | n/a Due to develop-ments in Ukraine and world securities markets | n/a Due to develop-ments in Ukraine and world securities markets | 30%[8] | 10%<br><br>✓ |
| 3. Increase in new companies traded | # of companies in 1st and 2nd tier | PFTS | Report by PFTS | Annually | 222 | 2005 | 10% increase in 2005 | 296 (33% ↑) | 10% increase in 2006 | 86 (71% ↓) | 10% increase in 2007 | 193 (224% ↑) | n/a Due to develop-ments in Ukraine and world securities markets | n/a Due to develop-ments in Ukraine and world securities markets | 180 | 111[9]<br><br>✓ |

5 CMP tracked non-sovereign debt as percentage of GDP, NBFI assets as a percentage of GDP, and real GDP as contextual indicators.

6 The data from 2009 is not a relevant indicator of market performance in equities and bond trading in Ukraine, as the global financial crisis skewed these figures. Accordingly, data is not present for 2009.

7 The 73% increase in equity and bond trading should be viewed as a major CMP success (despite falling short of the original 500% increase goal), considering the profound effects of the global financial crisis on the Ukrainian economy. In 2008, prior to the crisis, CMP was on track to meet the 500% goal.

8 30% was a highly optimistic goal in 2005 for on-exchange trading in Ukraine. CMP did not achieve this goal; however, reaching 10% is viewed as a major success because it represents a 250% increase from 2005.

9 The net decrease in number of companies listed was due to new SSMSC listing requirements, which were implemented in 2007. CMP lowered its end goal to 180 because compliance with these requirements was difficult for many companies. The 224% increase in companies listed in 2008 was due in large part to the implementation of the Joint Stock Company Law, which CMP helped draft and pass.

| Expected Result | Indicator | Data Source | Responsibility for data collection & method | Frequency of collection | Baseline | Year of Baseline | Target-2006 | Actual-2006 | Target-2007 | Actual-2007 | Target-2008 | Actual-2008 | Target-2009 | Actual-2009 | Sep 2010 End-of-Project target | Sep 2010 End-of-Project actual |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 4. Strengthened MFS and Facilitated MFS and AUSD Merger | Scorecard of MFS accomplishments (Attachment 3) (Total possible points – 10) | MFS | Discussion with MFS; CMP observation of operations | Annually | 0 points | 2005 | 3 points | 4 points | 5 points | 5 points | 7 points | 7 points | 7 points | 7 points | 10 points | 7 points[10] ✓ |
| 5. Strengthened PFTS | Scorecard of PFTS accomplishments (Attachment 4) (Total possible points – 10) | PFTS | Discussion with PFTS; CMP observation of operations | Annually | 0 points | 2005 | 2 points | 4 points | 4 points | 4 points | 6 points | 6 points | 8 points | 8 points | 10 points | 10 points ✓ |
| O 5: Improved Social Conditions and Health Status | | | | | | | | | | | | | | | | |
| IR 5.2: Improved social protection system | | | | | | | | | | | | | | | | |
| 1. Increase in Pillar III assets | USD value of Pillar III assets | FSR | Report by FSR | Annually | US $10.4M | 2005 | 10% increase in 2005 | $27 million (161% ↑) | 15% increase in 2006 | $56 million (117% ↑) | 30% increase in 2007 | $115 million (102% ↑) | n/a Due to develop-ments in Ukraine and world securities markets | n/a Due to develop-ments in Ukraine and world securities markets | Over $200 million | $123 million[11] ✓ |
| 2. Diversification of Pillar III portfolio | Percentage of Pillar III assets in capital markets products<br><br>Desegregated by:<br><br>-Equities<br>-Bonds<br>-Foreign Securities | FSR | Report by FSR | Annually | Less than 1% | 2005 | 5% increase in 2005 | 5300% ↑ to 53% of assets<br><br>Eq: 13%<br>Bon: 41%<br>FS: 0% | 5% increase in 2006 | 0% - stayed at 53% of assets<br><br>Eq: 13%<br>Bon: 41%<br>FS: 0% | 5% increase in 2007 | 68% ↓ to 36.4% of assets<br><br>Eq: 9%<br>Bon: 27%<br>FS: 0% | n/a Due to develop-ments in Ukraine and world securities markets | n/a Due to develop-ments in Ukraine and world securities markets | 70%<br><br>Eq: 30%<br>Bon: 30%<br>FS: 10% | 55% ✓ |
| 3. Increased population coverage | Number of people covered under Pillar III<br><br>Desegregated by gender | FSR | Report by FSR | Annually | 88,000 Gender N/A | 2005 | 10% increase in 2005 | 119% ↑ to 193,000 (women = 49.6%) | 15% increase in 2006 | 44% ↑ to 279,000 (women = 49%) | 15% increase in 2007 | 73% ↑ to 482,500 (Women = 47%) | 450,000 | 2% ↑ to 492,000 (women = 48%) | Over 500,000 | 500,100 ✓ |
| 4. Improved legal framework for Pillar II implementation | Scorecard of legal and regulatory actions (Attachment 5) (Total possible points - 39) | PFU | Discussion with PFU; CMP activities | Annually | 0 points | 2005 | 9 points | 9 points | 24 points | 24points | 30 points | 27 points | 28 points | 28 points | 39 points | 28 points[12] ✓ |

[10] The Guarantee Fund was not instituted due to the MFS / AUSD Merger. Thus, CMP could not capture the additional 3 points. Nevertheless, the MFS / AUSD Merger is viewed as a major CMP success.
[11] CMP helped increase Pillar III assets by 1000% over the lifetime of the Project. However the Project did not achieve $200 million due to: 1) the global financial crisis; and 2) the subsequent movement of assets to bank deposits, which were seen as a safer investment.
[12] The final score of 39 for this task was not reached due to political factors outside CMP's control. The Government of Ukraine postponed the draft law until after the completion of CMP. Activity moved to FINREP.

| Expected Result | Indicator | Data Source | Responsibility for data collection & method | Frequency of collection | Baseline | Year of Baseline | Target-2006 | Actual-2006 | Target-2007 | Actual-2007 | Target-2008 | Actual-2008 | Target-2009 | Actual-2009 | Sep 2010 End-of-Project target | Sep 2010 End-of-Project actual |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 5. Strengthened PFU | Scorecard of PFU accomplishments (Attachment 6) (Total possible points – 10) | PFU | Discussion with PFU; CMP observations of operations | Annually | 0 points | 2005 | 3 points | 1 points | 5 points | 3.5 points | No target: PFU is not part of CMP work plan | n/a | n/a | n/a | No target: PFU is not part of CMP work plan | n/a[13] |

[13] This task was stopped at USAID's request. From 2008 to 2010 PFU did not cooperate with USAID, and did not request technical assistance. Thus, CMP did not work with the PFU. Assitance to PFU was renewed after the end of CMP.

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# Capital Markets Project

**PERFORMANCE MONITORING PLAN**
**UKRAINE CAPITAL MARKETS PROJECT**
**February 10, 2006**

| **Attachment 1: Stage level of development and implementation of disclosure system for regulators** | **Attachment 2: Stage level of development of risk-based supervision f FSR** |
|---|---|
| Stage 1: Discussion with regulator regarding system<br>Stage 2: Agreement with regulator to develop disclosure system<br>Stage 3: Preliminary rules and regulations being drafted<br>Stage 4: Disclosure forms and number of forms being drafted<br>Stage 5: Implementation of disclosure system under pilot program<br>Stage 6: Manual on substantive disclosure requirements for reports prepared<br>Stage 7: Manual on electronic transfer of information prepared<br>Stage 8: Training of regulator in headquarters and regional offices on EDS<br>Stage 9: Training of public companies in EDS<br>Stage 10: Implementation of disclosure system under pilot program<br>Stage 11: Assessment of EDS (PDS) under pilot program<br>Stage 12: Adjustment to disclosure system to adjust for deficiencies identified in assessment<br>Stage 13: Adoption of final forms and regulations<br>Stage 14: Implementation of EDS (PDS) with biggest companies (based on capital)<br>Stage 15: CMP review of reports from sampled companies<br>Stage 16: CMP actions to correct deficiencies found in review of reports of companies (training, modified rules, regulations, etc.)<br>Stage 17: Phase in of companies based on statutory capital<br>Stage 18: CMP review of reports from sampled companies (phased in)<br>Stage 19: CMP actions to correct deficiencies found in review of reports of sample companies (phased in) | Stage 1: Assessment of current status of risk-based supervision at FSR completed<br>Stage 2: First draft of methodology developed<br>Stage 3: Preliminary rules and regulations drafted.<br>Stage 4: Preliminary rules and regulations reviewed and commented on by Commission.<br>Stage 5: Program accepted by Commission.<br>Stage 6: Draft inspection manuals for implementation of program drafted.<br>Stage 7: Staff trained on how to effectively implement on and off-site risk-based supervision.<br>Stage 8: Program field-tested by FSR with pilot of three companies (insurance and pension funds)<br>Stage 9: Manual refined based upon experiences of pilot program<br>Stage 10: Establishment with Commission of risk-based supervision progra – selection of companies, timing of program, public announcements, letters of deficiency, etc.<br>Stage 11: Implementation of program<br>Stage 12: CMP assessment of program<br>Stage 13: CMP recommendations for improvement of program based on assessment |

| Attachment 3: Scorecard of MFS Accomplishments | | Attachment 4: Scorecard of PFTS Accomplishments | |
|---|---|---|---|
| 1. Development of emergency plan, including program for back-up of data | 3 points | 1. Establishment of internationally recognized listing standards (Tier 1) | 2 points |
| 2. Ownership requests are in electronic form | 1 point | 2. Real time settlement of transactions implemented | 2 points |
| 3. Money settlements are included in depository | 2 points | 3. Market order system in place and operating | 2 points |
| 4. On-going training program on international clearance and settlements procedures developed and implemented | 1 point | 4. Auction procedures are in accordance with international norms | 2 points |
| 5. Guarantee fund instituted | 3 points | 5. Rules to prevent trade manipulation adopted and implemented | 2 points |
| TOTAL POSSIBLE POINTS | 10 points | TOTAL POSSIBLE POINTS | 10 points |

## Attachment 5: Scorecard for Improved Legal and Regulatory Environment

Stages
1. Draft amendments, new laws, or regulations developed by key stakeholders.
2. Drafts of amendments, new laws, or regulations have been completed and sent to the Ministries and state bodies.
3. Comments from Ministries and state bodies received and draft revised to incorporate comments (final draft).
4. Draft law sent to the Ministries and state bodies for approval
5. Draft law approved by Ministries and state bodies and passed to Cabinet of Ministers.
6. Draft law has been reviewed and commented on by appropriate committee(s) of Cabinet of Ministers.
7. Draft law has been submitted to and considered by entire Cabinet of Ministers
8. Draft law has been signed by the Prime Minister and passed to the Verkhovna Rada
9. Draft law has been reviewed and commented on by the appropriate Verkhovna Rada committee(s).
10. Comments have been implemented in the draft law.
11. Draft law has been presented in readings (1 – 2) of Verkhovna Rada
12. Verkhovna Rada votes and approves the law.
13. Final law signed by President

| Stages in legislation / regulation | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Laws/Regulation for Implementation of Pillar II** | | | | | | | | | | | | | | |
| 1. Sustainability of Pillar I / Progression to Pillar II (Pension Law) | B | | | 2006 | | | | 2010 | | | | | | |
| 2. Law on Implementation of Pillar II (Accumulation Fund) | B | | | | 2006 | | | | | | | 2010 | | |
| 3. Law on Occupational Pension System | B | | 2006 | | | | | | | 2010 | | | | |

Codes: B - baseline; 2006 - target for 12/31/06 ; 2007 - target for 12/31/07

Scoring
1. A checkmark will be placed in the column representing the status of each law/regulation (based on scorecard).
2. The total of all checkmarks in each column will be multiplied by number of the stage represented in the column to obtain a column total.
3. All column totals will be added to obtain a total score.
4. Total possible score for three initiatives listed above = 39 (3 laws x 13 stages)

## Attachment 6: Scorecard of PFU Accomplishments for Pillar II implementatio

1. Establishment of regulations and systems to ensure that employer contributions to the Accumulation Fund can be personified and accurately transferred to an individual's account — 3 poir
2. Establishment of IT systems to collect, allocate, and monitor individualized Accounts — 1 po
3. Establishment of regulations and procedures to effectively coordinate with the solidarity fund — 2 poir
4. Establishment of tendering rules for criteria to become a qualified/authorized Pillar II asset management firm — 2 poir
5. Establishment of regulations and monitoring procedures for Pillar II Fund Operations — 2 poir

TOTAL POSSIBLE POINTS 10 poir

**Appendix D: SEC-SSMSC Capital Market Training Program Agenda**

# CAPITAL MARKET DEVELOPMENT

**Sponsored By**

## UNITED STATES SECURITIES AND EXCHANGE COMMISSION

## SECURITIES & STOCK MARKET STATE COMMISSION

## U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

## AGENDA

Commentary will be provided by all speakers throughout the program.
Questions and Answers will occur throughout the program.

**Monday, June 23, 2008**

| | |
|---|---|
| **9:00** | **Opening Remarks** |
| **9:20** | **Challenges of Securities Regulation and Capital Market Development in Emerging Markets**<br>**Speaker: Dr. Robert M. Fisher** |
| **10:40** | **Break** |
| **11:00** | **The Offering Process**<br>**Speaker: Katherine K. Martin** |
| **12:00** | **Lunch** |
| **1:00** | **Market Manipulation**<br>**Speaker: Dr. Robert M. Fisher** |
| **2:15** | **Break** |
| **2:30** | **Self-Regulatory Organizations**<br>**Speaker: Bill Jannace** |

**Tuesday, June 24, 2008**

| | |
|---|---|
| **9:00** | **Broker-Dealer Enforcement**<br>**Speaker: Dr. Robert M. Fisher** |
| **10:15** | **Break** |
| **10:30** | **A Financial Reporting Regime for Public Issuers**<br>**Speaker: Katherine K. Martin** |

**12:00** **Lunch**

**1:00** **<u>Broker Dealer Compliance and Supervision</u>**
**Speakers: Bill Jannace and Ester Saverson, Jr.**

**2:15** **Break**

**2:30** **<u>Broker-Dealer Compliance and Supervision</u> (Continued)**
**Speakers: Bill Jannace and Ester Saverson, Jr.**

**<u>Wednesday, June 25, 2008</u>**

**9:00** **<u>Insider Trading</u>**
**Speaker: Dr. Robert M. Fisher**

**10:15** **Break**

**10:30** **<u>Disclosure Requirements for Beneficial Ownership, Takeover Bids, Mergers, Acquisitions and Other Potential Change in Control Transactions</u>**
**Speaker: Katherine K. Martin**

**12:00** **Lunch**

**1:00** **<u>Broker Dealer Compliance and Supervision</u> (Continued)**
**Speakers: Bill Jannace and Ester Saverson, Jr.**

**2:15** **Break**

**2:30** **<u>Capital Adequacy and Financial Responsibility</u>**
**Speaker: Ester Saverson, Jr.**

**<u>Thursday, June 26, 2008</u>**

**9:00** **<u>Anatomy of a Broker-Dealer Examination</u>**
**Speaker: Bill Jannace**

**10:15** **Break**

**10:30** **<u>Clearance and Settlement</u>**
**Speaker: Ester Saverson**

**12:00** **Lunch**

**1:00** **<u>Financial Reporting Fraud</u>**
**Speaker: Dr. Robert M. Fisher**

**2:15** **Break**

**2:30** **<u>Corporate Governance</u>**
**Speaker: Katherine Martin**

**<u>Friday, June 27, 2008</u>**

| | |
|---|---|
| **9:00** | **<u>Regulatory Scheme Regarding Investment Advisors and Collective Investment Schemes</u>**<br>**Speakers: Bill Jannace and Ester Saverson, Jr.** |
| **10:15** | **Break** |
| **10:30** | **<u>Inspection of Investment Advisers and Investment Companies</u>**<br>**Speaker: Bill Jannace and Ester Saverson, Jr.** |
| **12:00** | **<u>Question and Answer Session</u>** |
| **12:30** | **<u>Closing Ceremony – Presentation of Program Certificates</u>** |

# Appendix E: ESCRIN Factsheet

## ESCRIN Compliance with International Disclosure Standards

An analysis of disclosure systems implemented by securities market regulators in the United States, European Union, Canada and Russia shows that today most regulators mandate that information be filed in electronic format to provide a routine and orderly flow of data to the capital market. While the systems vary widely, electronic submission facilitates information to investors, the key element in a vibrant capital market.

The advancement in technology permits regulators to tailor disclosure mandates to the needs of their markets. This allows the regulator to require publicly listed companies to meet international norms of financial, and other relevant business information disclosure. Thus, in the course of the development of ESCRIN one of the primary considerations was to design a disclosure system that facilitated the understanding of the business and financial information ("substantive information") required by a well-regulated capital market.

COMPLIANCE STANDARDS

The ESCRIN system, as designed, addresses the following international norms:

- OECD Principles of Corporate Governance 1999, as amended 2004
- International Organization of Securities Commissions (IOSCO)
  - Principles for Ongoing Disclosure and Material Developments Reporting by Listed Entities, approved by the IOSCO Technical Committee in October 2002.
  - General Principles Regarding Disclosure of Management's Discussion and Analysis of Financial Conditions and Results of Operations, published by the IOSCO Technical Committee in February 2003.
- European Union Directives
  - Directive on harmonization of transparency requirements in relation to information on issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC.

In addition, ESCRIN reflects the requirements of the Law of Ukraine "On Securities and Stock Market," effective on May 13, 2006, and the "Joint Stock Company Law" effective on April 30, 2009. The system also implements the electronic document flow with an electronic digital signature, as provided by the Presidential Decree of October 20, 2005, No. 1497/2005 "On Top Priority Actions Regarding the Implementation of Innovative Information Technologies." The Presidential Decree required the Cabinet of Ministers to implement in government agencies the electronic data flow including electronic signatures by 2010.

*The development of ESCRIN was a collaborative effort between the Securities and Stock Market State Commission and the USAID Capital Markets Project. ESCRIN is one of the key areas where the SSMSC and the USAID Capital Markets Project cooperate in support of capital market integrity and transparency in Ukraine.*

USAID | Capital Markets Project

SECURITIES AND STOCK MARKET STATE COMMISSION

# ESCRIN

Electronic System for Comprehensive Information Disclosure

http://eds.ssmsc.gov.ua

## ESCRIN for Timely and Accurate Disclosure

**The foundation of a well-regulated capital market is timely and accurate information disclosure by publicly listed and traded companies. This disclosure regime also forms the basis for the regulators' program to protect investors and take enforcement actions for violations of the law.**

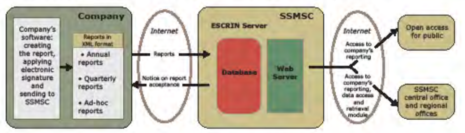
**Under the SSMSC's new regulation *On Information Disclosure by Issuers of Shares and Bonds Listed on a Stock Exchange*, all listed companies issuing equities or corporate bonds are required to file statements through ESCRIN. The ESCRIN system will bring unprecedented financial accountability and corporate responsibility to Ukraine's capital markets. Additionally, the system will greatly improve the SSMSC's ability to provide prudent and effective regulation of the market.**

## The ESCRIN System Was Designed Based on the Following Core Principles:

- Compliance with European Standards of disclosure and international best practices of information flow.
- Conformity with Ukrainian legislation.
- Ease of preparation of reports by public companies in compliance with international standards.
- Easy and free access for investors to reports filed by issuing companies in a real time mode through the ESCRIN website.
- Use of modern information technologies:
  - User friendly software enables issuing companies to create reports by completing electronic templates that allow companies to insert narrative texts and tables, and post electronic documents to ESCRIN through Internet.
  - ESCRIN electronic documents are generated and stored using XML technology that makes it possible to structure, select and analyze information and transfer it to other systems as needed.
  - Web-based technologies are used for public display of the reports of issuing companies, as well as for access by SSMSC central and regional offices, shareholders, investors, and the general public: the company's reports are posted to the ESCRIN server and simultaneously disclosed on the ESCRIN website in a real time mode.
  - Information security actions have been taken, including using electronic digital signatures, to verify the integrity of an electronic document and to authenticate its sender.

## ESCRIN System Architecture and Data Flow

The chart below shows the ESCRIN structure, its components and data flow in the system.




**The Issuer's software** generates, edits, and stores reports (annual, quarterly and ad-hoc) as electronic documents in XML format. The issuer/company can prepare reports in a free narrative form. ESCRIN also provides for the use of electronic digital signatures, which the company's officers must affix to the document. The auditor's report should also have the auditor's electronic digital signature. The company sends the electronic document with the electronic digital signature(s) to the ESCRIN server through the Internet.

**The ESCRIN server**, to ensure data integrity and authenticity of the report, verifies open keys of the company's officers who signed the document. If verification is positive, the report is posted to the ESCRIN database and becomes immediately available on the ESCRIN web-site. If any one of the electronic digital signatures does not match the verification data in the server, it rejects the report. In both cases, an automatic message is generated by the system and e-mailed to the company. Thus, the company's reports posted to ESCRIN become available to shareholders, investors, and the general public, in addition to the staff of the SSMSC's central offices and 27 regional offices, in a real-time mode.

**The ESCRIN website** (http://eds.ssmsc.gov.ua) provides easy public access to the reports filed with SSMSC by issuers of stocks and corporate bonds listed on an exchange in Ukraine. The ESCRIN website permits a search of companies and their reports by name of company, type of report, date of posting, industry group, location of company by region, etc. The website also performs an issuer support function: companies register with the website for the purpose of using ESCRIN by downloading software from the website and guidelines for its installation and use.

After entering their name and password, SSMSC staff can access the web-based data access and retrieval module that offers a wide range of possibilities to select, review, and analyze reports stored in the ESCRIN database. This module can be used solely by SSMSC for the exercise of its regulatory powers. Using this module, statistical information can be grouped to prepare reports and to analyze the data as part of the staff's routine oversight of the disclosure and the financial condition of public issuers, prepare reports for official use by the regulator and for dissemination by the regulator to the public.

**THE WORLD BANK**
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*for Reconstruction and Development*

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**Appendix F: PTAP Evaluation and Report**

# Programmatic Technical Assistance Partnership (PTAP)
# Capital Market Development and Pension Reform

## "A Year in Review & Priorities for the Year Ahead"
## Report on the PTAP Implementation

**World Bank/USAID**
**September 2008**
**Kyiv, Ukraine**

## ACRONYMS AND ABBREVIATIONS

| | |
|---|---|
| AA | Association Agreement |
| AFSP | World Bank Access to Financial Services Project |
| AKK | The Hungarian Debt Management Agency |
| ATCI | USAID Access To Credit Initiative |
| AUSD | All-Ukrainian Securities Depository |
| CLC | Commercial Law Center |
| CMP | USAID Capital Markets Project |
| CPI | Consumer Price Index |
| DPL | Development Policy Loan |
| DVP | Delivery vs Payment |
| ECSHD | World Bank Europe and Central Asia Human Development Sector Unit |
| ECSPE | World Bank Europe and Central Asia Poverty Reduction and Economic Management Sector Unit |
| ECSPF | World Bank Europe and Central Asia Finance and Private Sector Development Sector Unit |
| EU | European Union |
| FIRST | World Bank Financial Sector Reform and Strengthening Program |
| FOP | Free of Payment |
| FSAP | Financial Sector Assessment Program (FSAP) |
| FTA | Free Trade Agreement |
| FX | Foreign Exchange |
| G-30 | The Group of Thirty |
| GDP | Gross Domestic Product |
| IAIS | International Association of Insurance Supervisors |
| IFRS | International Financial Reporting Standards |
| IMF | International Monetary Fund |
| IOPS | The International Organization of Pension Supervisors |
| IORP | Institutions for Occupational Retirement Provision |
| IOSCO | International Organization of Securities Commissions |
| IPO | Initial Public Offering |
| JII | Joint Investment Institutions (similar to mutual funds) |
| JSC | Joint Stock Company |
| LTV | Loan-to-value |
| MFS | The Interregional Depository and Clearing/Settlement Organization, Mizhregionalny Fondovy Sojuz |
| MiFID | Markets in Financial Instruments Directives |
| MLSP | Ministry of Labor and Social Policy |
| MOF | Ministry of Finance |
| MOU | Memorandum of Understanding |
| NBFI | Non-Bank Financial Institutions |
| NBU | The National Bank of Ukraine |
| NDU | National Depository of Ukraine |

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|---|---|
| NSPF | Non-state pension funds |
| OTC | Over-the-Counter |
| PAYGO | pay-as-you-go pension system |
| PFTS | PFTS Stock Exchange, Persha Fondova Torgova Systema (First Securities Trading System) |
| PFU | Pension Fund of Ukraine |
| PTAP | Programmatic Technical Assistance Partnership |
| Repo | Repurchase Agreement |
| SCRFSM | State Commission for Regulation of Financial Services Market |
| SCSSM | State Commission  for Securities and Stock Market |
| SDMD | the Financial Policy and Debt Management Department of the Ministry of Finance |
| SMI | State Mortgage Institution |
| SNG | Sub-National Government |
| SSC | Single Social Contribution |
| STA | Single Treasury Account |
| TRS | Trade Reporting System |
| UAH | Ukrainian Currency – Hryvnia |
| UC | Ultimate Controllers |
| UCITS III | Undertakings of Collective Investment in Transferable Securities Directives |
| UICE | Ukraine Inter-Currency Exchange |
| UIT | Unit Investment Trusts |
| USAID | U.S. Agency for International Development |

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**TABLE OF CONTENTS:**

## EXECUTIVE SUMMARY

1. This Report reviews the results of the Joint USAID/World Bank Programmatic Technical Assistance Partnership (PTAP) from its beginning in June 2007 up to date, and presents the priorities of the Partnership for the year ahead. The objective of the Partnership is to help the Government, the NBU, market regulatory agencies and market participants to develop Ukrainian capital markets in the perspective of their future integration in the EU single market in financial services, and in particular to create conditions for the successful introduction and development of second pillar pensions.

2. Part I presents the rationale and background for the Partnership. Part II provides an overview of key findings and challenges in each of the four Partnership components. Part III presents an action plan for the year ahead.

3. A separate Report entitled "Challenges and Opportunities of EU-Ukraine FTA for the Development of Securities Markets and NBFIs in Ukraine" (PTAP FTA Report, September 2008) has been prepared by the PTAP team and circulated separately.

4. In June 2007, the World Bank and USAID agreed to join forces in a Programmatic Technical Assistance Partnership (PTAP) to support the Government in implementing this reform agenda. On the Bank side, the Partnership brings together experts from the Human Development Sector Unit (ECSHD), the Poverty Reduction and Economic Management Sector Unit (ECSPE) and the Finance and Private Sector Development Sector Unit (ECSPF) of the Europe and Central Asia Region. On the USAID side, the Partnership brings together experts from the USAID/Ukraine Office, the USAID Capital Market Project (CMP), and the USAID Access to Credit Initiative (ATCI).

5. Over the past year, the PTAP has delivered advice and support to the Government and regulatory agencies to develop security markets and NBFIs, in particular in preparation for introduction of second pillar pensions. The work of the Partnership has focused on four main components: (i) Pension reform; (ii) Strengthening of the legal, regulatory and supervisory framework for securities markets and NBFIs; (iii) Strengthening securities market infrastructure; and (iv) Developing the supply of domestic securities, focusing on the government bond market.

6. Going forward, the capital market policy reform agenda will be shaped by the Free Trade Agreement (FTA) currently being negotiated between the Ukrainian Government and the European Commission. Specifically, Ukraine will face three fundamental challenges in integrating its securities market and NBFIs in the EU single market in financial services: (i) Approximation of Ukrainian legislation with EU securities market and NBFI Directives (Level 1) and Implementing Measures (Level 2); (ii) Mutual recognition between Ukrainian securities market and NBFI regulatory agencies and their counterparts in EU Member States; and (iii) Adaptation of Ukrainian securities market professional participants, NBFIs, and securities issuers to the EU single market in financial services.

7. The USAID and the World Bank stand ready to support the Government to design and implement the proposed policy reform agenda and action plan through a broad range of instruments, including Development Policy Loans, the PTAP, the AFSP (including TA component to SCRFSM and SCSSM), and ongoing USAID projects (CMP, ATCI and CLC Projects), working

in close collaboration with the European Commission and the European Commission Delegation in Kyiv.

**MAIN TEXT**

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## I. RATIONALE AND BACKGROUND

### A. I.1 Rationale for the Partnership

1. Due to adverse demographic trends and budgetary constraints, Ukraine's current Solidarity Pension System (Pillar I) is becoming increasingly unsustainable. To address this urgent problem, in February 2007, the Cabinet of Ministers adopted a draft law "On implementation of the Mandatory State Pension Insurance Accumulation System." In April 2007, the Ukrainian Parliament (Verkhovna Rada) passed the draft law in its first reading. Further review of the draft law has been delayed following recent political developments. The successful implementation of the Pillar II system is critical to the social protection of Ukraine's work force. Equally critical is the adequacy of Ukraine's capital markets to accommodate productive investment of the substantial assets Pillar II will generate. However, the capital markets are unprepared and will require far-reaching legal, regulatory, supervisory and infrastructure reforms to ensure the successful launch of the mandatory accumulation system.

2. More broadly, the development of a well-regulated, broad, deep and transparent securities market and sound NBFI sector is critical for Ukraine to sustain rapid growth and to ensure its successful integration into the EU single market in financial services, as envisaged under the Free Trade Agreement (FTA) currently being negotiated between the European Commission and the Government. In this perspective, Ukraine faces three fundamental challenges: (i) Approximation of Ukrainian legislation with EU securities market and NBFI Directives (Level 1) and Implementing Measures (Level 2); (ii) Mutual recognition between Ukrainian securities market and NBFI regulatory agencies and their counterparts in EU Member States; and (iii) Adaptation of Ukrainian securities market professional participants, NBFIs and securities issuers to the EU single market in financial services. These challenges are examined in detail in a separate Report prepared by the PTAP Team entitled: "Opportunities and Challenges of the EU-Ukraine FTA for the Development of Securities Markets and NBFIs in Ukraine" (PTAP FTA Report, September 2008).

3. The rationale for the Partnership was formulated in a June 2007 World Bank Concept Note on the financial conditions that are required to ensure the successful introduction and development of second pillar pensions, in a Technical Note on Capital Market Development prepared as part of the joint IMF/World Bank FSAP Update in June-July 2007, and in the CMP/USAID's Strategy on Capital Markets Development. The objectives and findings of these Reports were further articulated in a joint USAID/World Bank Position Paper entitled "Developing Securities Markets and Non-Bank Financial Institutions in Ukraine: Key Impediments and Policy Reform Priorities Ahead", presented in September 2007 at the 10th International Forum of Capital Market Participants.

4. The original World Bank *Concept Note* identified the conditions that are critical to successful introduction and development of second pillar reforms. These conditions pertain to four main areas:

- (i) Macro-financial stability and a balanced strategy for financing the transition cost to the second pillar system;
- (ii) A strong legal, regulatory and supervisory framework for securities markets, non-state pension funds (NSPFs) and insurance companies offering retirement products;

- (iii) An efficient financial market infrastructure including payment and securities settlement system, securities trading platform, custodian and depository institutions, and proper accounting, auditing and valuation systems; and

- (iv) A diversified supply of domestic securities in which pension funds will be able to invest, including government securities, municipal bonds and corporate bonds, asset-backed securities and equities.

5. The *joint USAID/World Bank Position Paper* presented a ten-point action plan to remove impediments to securities market and NBFI development, in particular to create the conditions for the introduction of second pillar pensions:

- *(i) First*, the authorities should strengthen the market regulatory and supervisory framework by (i) empowering the regulators to trace the ultimate controllers of financial market entities and carry out economic, fiscal and criminal background checks; (ii) transforming the current regulatory agencies into specialized agencies with the same status as the National Bank of Ukraine (NBU), or integrating them into NBU; and (iii) establishing multi-year twinning programs with counterpart regulatory agencies in European Union (EU) countries using donor support.

- *(ii) Second*, the authorities should implement a well-crafted action plan to strengthen government debt management and develop a government debt market. Donors could support implementation.

- *(iii) Third*, the authorities should undertake a comprehensive reform of the legal and regulatory framework for the sub-national debt market, focusing on (i) increasing sub-national government (SNG) fiscal autonomy, (ii) improving the framework for SNG borrowing, (iii) removing distortions in market incentives, (iv) improving market transparency, (v) establishing a bankruptcy framework for SNGs, and (vi) strictly monitoring connected party lending between banks and SNGs.

- *(iv) Fourth*, the authorities should support development of the equities market through the adoption of the Joint Stock Company (JSC) Law and associated regulations that ensure effective business and financial disclosure of listed companies and their controllers, protection of minority shareholders, and accountability of supervisory and management boards.

- *(v) Fifth*, the authorities should support the development of the market for asset-backed securities through reviewing NBU regulations for risk management of foreign currency and high loan-to-value (LTV) mortgages by banks, adopting a revised legal and regulatory framework for mortgage bonds, privatizing the State Mortgage Institution (SMI), pricing State guarantees of SMI bonds at market, and adopting a Law on Securitization.

- *(vi) Sixth*, the authorities should strengthen securities market infrastructure by (i) tightening information disclosure requirements for first-tier securities; (ii) requiring stock exchanges to establish independent compliance departments reporting to their supervisory boards, (iii) re-licensing all stock exchanges that do not meet minimum activity requirements and (iv) requiring that all off-exchange trades be reported electronically to stock exchanges. Further, the authorities should strengthen clearing and settlement by (i) adopting legislation on multilateral netting, central securities  depository, and stock lending and borrowing procedures, (ii) adopting regulations to prohibit acquiring (directly or indirectly) more than 5% of shares in any securities depository and clearing and settlement company, and to allow MFS Depository to open correspondent accounts with depositories abroad. The authorities should streamline the registrar and custodian system, strengthen the accounting and auditing framework, issue regulations for the valuation of infrequently traded stocks, and simplify NBU and Government controls on foreign currency transactions for securities market participants.

- *(vii) Seventh,* the authorities should support development of investment funds through (i) revising the Law on Joint Investment Institutions (JIIs) to allow the establishment of investment funds with compartments and funds-of-funds and the participation of retail investors in Unit Investment Trusts (UITs), (ii) ensuring the political independence and financial autonomy of SSMSC  (iii) re-licensing investment funds focusing on tracing and checking their ultimate controllers; (iv) developing risk-based supervision of JIIs, and (vi) exercising oversight over the corporate governance of JIIs.

- *(viii) Eight,* the authorities should support development of voluntary non-state pension funds (NSPFs) by (i) ensuring the political independence of the regulators; (ii) re-licensing NSPFs focusing on tracing and checking ultimate controllers; (iii) developing risk-based supervision of NSPFs, and (iv) exercising oversight over the corporate governance of NSPFs.

- *(ix) Ninth,* the authorities should create the essential capital market conditions for the successful introduction of second pillar pensions, including (i) conducting a detailed assessment of the benefits, costs and risks of alternative financing strategies of the cost of transition to the second pillar; (ii) strengthening the governance framework for the second pillar to ensure that technical criteria prevail in the selection of asset managers and the definition of investment policies, under the supervision of the regulator; (iii) implementing the reforms required to ensure the political independence of the regulators; (iv) implementing the reforms required to strengthen market infrastructure; (v) establishing clear limitations on use of pension fund assets and establishing incentives to attract international asset managers; and (vi) implementing a comprehensive strategy and action plan to develop the government debt market.

- *(x) Tenth,* the authorities should support development of the insurance sector through laws and regulation meeting international standards, re-licensing insurance companies focusing on ultimate controllers; reforming applicable tax laws, and implementing a re-insurance policy based on prudential rules, corporate governance requirements and supervision.

## B. I.2 Joining Forces and Creating Synergies

6. In June 2007, the World Bank and USAID agreed to join forces in a Programmatic Technical Assistance Partnership (PTAP) to support the Government in implementing this policy reform agenda. On the Bank side, the Partnership brings together experts from the Human Development Sector Unit (ECSHD), the Poverty Reduction and Economic Management Sector Unit (ECSPE) and the Finance and Private Sector Development Unit (ECSPF) of the Europe and Central Asia Region. On the USAID side, the Partnership brings together experts from the USAID/Ukraine

Office and its projects: (i) Capital Markets Project (CMP), (ii) Access to Credit Initiative (ATCI); and (iii) some involvement from the Commercial Law Center (CLC) supported by USAID.

7. The PTAP launch visit that took place in September 2007 agreed with the Government to implement an action plan structured around four components, i.e.:

- (i) Supporting pension policy reform, in particular strengthening the fiscal framework for implementation of second pillar and designing a balanced financing strategy for the cost of transition to second pillar;

- (ii) Strengthening the legal, regulatory and supervisory framework for securities markets and NBFIs;

- (iii) Strengthening securities market infrastructure, in particular improvement in transparency and efficiency of stock exchanges and strengthening of the depository system; and

- (iv) Developing the supply of domestic securities, focusing on government bonds.

## C. I.3 Follow-Up Visits and Objectives

8. Over the past year, PTAP follow-up visits were organized every three months with two fundamental objectives. *First*, to carry out in-depth discussions with the Government, NBU, market regulators and market participants on the progress achieved in each area of the PTAP action plan. *Second*, to agree with the Government and market regulators on a detailed action plan in the area of capital markets and pension reforms going forward, and on support to be provided by the Partnership for the implementation of this action plan, in close coordination with the European Commission Delegation in Kyiv.

9. The implementation of PTAP is anchored by specific policy reforms in the legal and regulatory environment of capital markets and pension reform, that are included in the Development Policy Loan (DPL II) as future benchmarks. Specifically, DPL-II contains four future benchmarks that are of critical importance for the implementation of PTAP:

- (i) Amendments to the Law on Financial Services and the Law on Banking submitted to the Verkhovna Rada to enable consolidated supervision in the financial sector;

- (ii) Amendments to the Law on Financial Services submitted to the Verkhovna Rada empowering SCSSM and SCRFSM to trace the ultimate controllers of securities market participants and NBFIs and to carry out economic, fiscal and criminal background checks of these ultimate controllers;

- (iii) Government strategy adopted to strengthen the political and financial independence of the SCSSM and SCRFSM, in accordance with international standards; and

- (iv) SCSSM to issue regulation prohibiting any entity (legal or physical) from acquiring (directly or indirectly) more than 5% of shares of any clearing and settlement company.

## II. OBSERVATIONS OF THE TEAM: KEY HIGHLIGHTS

10. The PTAP operates in a dynamic political and economic environment. National elections in late 2007 changed the political landscape. In particular,, major progress was achieved in drafting key provisions for the Amendments to the Law on Financial Services, the Depository Law and the Joint Stock Company Law. However, the legislative process in Verkhovna Rada has remained slow. Several laws and amendments expected to be considered before the summer break have not moved forward and while they remain on the Agenda, may face further delays.

11. During the first year, USAID and the World Bank held four joint follow-up visits. This Section presents key findings, achievements and challenges in each of the four PTAP components: (i) Pension reform; (ii) Strengthening the legal, regulatory and supervisory framework for securities markets and NBFIs; (iii) Strengthening securities market infrastructure; and (iv) Developing the supply of domestic securities, focusing on the government bond market.

### A. II.1 Pension reform

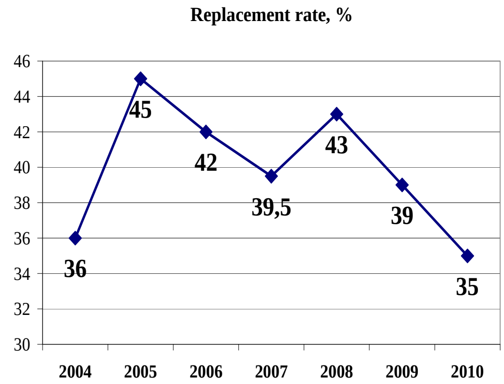
12. The Team organized a series of Roundtables with Government, NBU, market regulatory agencies and market participants to discuss key findings and policy recommendations on pension reform.

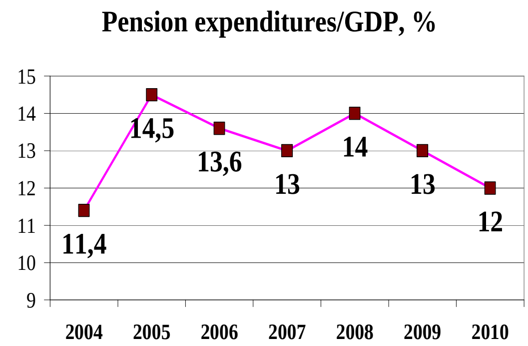
13. Key Analysis and Findings Presented at Roundtables: Under current law, the 2008 parametric changes in the PAYGO system will cause an imbalance in system through mid-2009. Although balance will be restored in the short-term, instability in PAYGO costs will persist. Introducing clear, transparent, and stable indexation rules is a priority to stop the continued swings in replacement rates experienced in the PAYGO system since 2004. At the same time, parametric changes to create savings and restore fiscal soundness to this system are urgently needed.

14. The implementation of the second pillar should be conditional upon achieving long-run fiscal sustainability of the first pillar, establishing the operational systems required for the administration of the second pillar, and establishing a transparent capital market regulated broadly in accordance with international standards. Sustainable Pillar I (PAYGO) finance is one of the most important factors determining the timing, size and tempo of mandatory funded pension pillar development. Furthermore, a balanced PAYGO budget is one of the legal requirements for its introduction. Simulations of PAYGO financial flows should provide answers to policymakers as to whether the setting is right or more has to be done to sustain the multi-pillar pension reform. Based on the results of the fiscal analysis carried out by the Team and on the extent of the capital market reforms required, the implementation of the second pillar will not be feasible by 2009 as planned in the Draft Second Pillar Law, and will need to be postponed to 2010 at the earliest.

15. The PTAP team presented the results based on the pension model, developed and maintained by the local consultants. Results indicate that implementation of the suggested changes would result in a PAYGO deficit of 2% in 2008, replacement rates raising to 45%, and pensions as a share of GDP increasing above 15%.

16. Since 2004, the parameters of the pension system in Ukraine have been changed constantly, resulting in strong swings in the ratio of pensions to GDP and in replacement rates. Following the hikes in pension benefits, balance has been restored or improved mainly by indexing benefits at a rate below inflation so that the real value of pensions fall.




17. The 2008 parametric changes make the pensioners better-off in comparison to 2007. However, pensioners will be worse-off in 2010 as well as and in the longer run. A sharp decline in replacement rates after 2008 may provoke another round of changes to pension parameters, perpetuating the destabilizing cycle of increasing and decreasing real pensions.

18. Introducing clear and transparent indexation rules would stop perpetual swings in PAYGO system parameters. The introduction of full price indexation of pensions in 2009 would preserve the purchasing power of benefits and provide a slower decline in replacement rates. Indexing would yield less fiscal savings than the status-quo option, but could in theory allow for second pillar introduction assuming that the necessary administrative systems are in place and that a transparent capital market regulated broadly in accordance with international standards is firmly established. Fixing the indexation pattern would ensure stability for a second pillar contribution rate that would increase from 2% in the first year to 7% in the fifth year after introduction, as envisaged by the draft legislation awaiting adoption in Verkhovna Rada.

19. Nevertheless, the Government should strengthen the fiscal framework for introduction of the second pillar by implementing parametric changes to the PAYGO system that not only to ensure a manageable transition but also to assure long run sustainability of the first pillar. Moreover, additional savings measures would be needed if the Government decides to launch a stronger second pillar with contribution rate above 2% in the first year. A list of suggested measures is presented below.

20. The Team discussed with the authorities the status and next steps of policy dialogue and analytical work on macro-fiscal-financial scenarios for pension reform. The Team will also continue analyzing pension system developments in the context of the draft second pillar legislation in Verkhovna Rada and provide comments to the counterparts. The Team will help the Government design a new system of early and privileged pensions in the context of the new multi-pillar pension system.

21. The pension system policy implemented in 2008 temporarily closed the door for second pillar introduction. Recommended policy actions to restore the fiscal space required for the second pillar include:

(i) In 2009 introduce full price indexation of pension benefits;

(ii) In 2009 implement additional parametric changes that generate savings in the PAYGO system. The list of measures include: (i) Gradual increase of retirement age for women to 60 years, starting in 2009; (ii) delaying pension benefit for working pensioners until the pensioner quits working; (iii) elimination of 1% increase of pension benefit for service above 20/25 years for women/men; (iv) revision of pension benefits under special regimes (early retirement, privileged and military).

22. Applying additional policy measures that generate savings in the PAYGO would allow introduction of the second pillar with an initial contribution rate above the currently envisaged 2%. If all proposed measures were implemented, the Pillar II contribution rate could be set at 7% immediately in the first year of implementation. Immediate launch of a stronger second pillar, instead of gradual increase of its contribution rate, would eliminate the political risk underlying raising the second pillar contribution rate and the potential issue of insufficient multi-pillar replacement rates for the oldest second pillar participants.

23. A pension policy should not yield strong swings in replacement rates and pension system parameters should not be revised every two years. Introduction of second pillar absolutely requires as a first step that the indexation rules be fixed to prevent ad hoc politically motivated pension hikes. The team presented an alternative policy based on setting a firm indexation pattern which gives less in the short run but more in the medium run, while preserving the fiscal opportunity for second pillar introduction in 2009. The new indexation rule allows keeping the replacement rate in 2008 at the level of 2007 and results in a slower decline in replacement rates in the long run. While providing more meaningful replacement rates in the future, it allows for second pillar introduction in 2009, depending on technical and administrative readiness.

24. As with Pillar I, Pillar III reforms are also needed. There are indications of problems in all segments of NSPF's operations, including individual accounting and disclosure, asset valuation and unit accounting, custody, portfolio structure, eligible investment, and reporting and supervision practice. There is a general lack of data on the industry performance and practices. For the purpose of PTAP, the team will hire external consultants to screen the current state of the voluntary pension funds industry, identify and analyze the problems, and propose recommendations for improvement.

25. The system seems to be particularly weak along the whole value chain of transparency. There are difficulties in valuation of assets. The role of custodians is very passive. Accounting practices are uneven and there are still doubts as to whether profits and losses should be distributed to the accounts of members and at what frequency (which translates into the problem of how often should pension unit value be calculated and by what measures). Public disclosure is also very weak.

26. A major weakness is related to prevention of conflicts of interest. Ukrainian pension funds are legal hybrids between common law and civil law models where founders play an important role in initiating a fund and in appointing its Board. Pension funds can invest in securities issued by persons affiliated to founders. Information about relationships between persons surrounding the fund (founders, board members, asset managers, administrators, custodians, their affiliated entities and their ultimate controllers) are not transparent. Regulators' abilities to prevent conflicts of interest are limited and should be substantially extended immediately.

27. Another major weakness is the ability of a large pool of persons (spouse, siblings, parents, etc…) in addition to the participant and the employer to contribute to the participant's account and

the lack of a limit on the amount that may be contributed, which caneven exceed the amount of age compensation

28. Even if the whole array of aforementioned problems could be resolved immediately, the limited development of the Ukrainian capital market would still represent a serious obstacle to future growth of pillar III pensions. The lack of transparency of issuers in general; the small number of share issues listed in the 1st and the 2nd tiers, the absence of a government bond market, the large number of illiquid corporate bonds which constitute almost half of pillar III funds' portfolios, and a de facto ban on investment in high quality foreign securities represent major problems.

29. Without rapid improvement of Ukrainian capital markets, it will not be possible to grow the value of assets under management and reach standards of valuation and transparency required under international standards of regulation and supervision for pension funds. In particular, the development of a market for government debt is required not only to develop a meaningful yield curve that can be used as a benchmark for pricing of non-government debt instruments, but also to provide a safe haven investment to be used by pension funds. This is particularly worrisome in an environment where investment abroad is practically non-existent. The absence of foreign investment and government bond investment forces pension funds towards exposures that they would not otherwise prefer.

30. The development of equity markets through promoting IPOs and SPOs is required as well. In addition, regulators should focus on decreasing operational risks by promoting the establishment of a Central Depositary for securities' clearing and settlement of securities.

31. Highlights of Key Meetings: The following are pension reform highlights by pillar:

*(i) First pillar*. The team discussed with the Ministry of Labor and Social Policy (MLSP) introduction of a fixed CPI indexation rule and further parametric PAYGO reforms in 2009 to stabilize pension finance, prevent random pension hikes, and support the introduction of the second pillar in the future. The team was informed that the options for the PAYGO parametric changes that will accompany the indexation rule are still being considered and evaluated by the modeling team in the Institute for Demography and Social Studies. The PTAP team will continue to work with the modeling team on simulating alternative scenarios.

*(ii) Second pillar*. The team also discussed with MLSP the introduction of a second pension pillar and a single social contribution as a vehicle for the establishment of the needed administrative framework for second pillar operations. The Law on Single Social Contribution (SSC) has been submitted to the second reading in September 2007, and has not been discussed since. Among other aspects that the SSC Law regulates, it sets the PFU's responsibility for collection of contribution reports, individual record keeping and establishment of centralized databases, all being the prerequisites for establishment of centralized clearing and individual accounts system in the PFU, as stipulated in the legislation. The Law on Second Pension Pillar has been pending second reading in Verkhovna Rada. The key three parameters the Law should set, i.e. the implementation date, the cutoff age and the contribution rate, have been discussed at the Rada's working group established for this purpose. The team was informed that a postponement of the second pillar implementation date to January 2010 has been considered for fiscal and administrative preparedness reasons. The team agrees that postponement of the second pillar implementation by one calendar year is needed. Indeed, even if the SSC law was passed expediently, we estimate it would need at least one

calendar year to be implemented.[14] Regarding second pillar key parameters, the current draft envisages a cutoff age of 40 and a contribution rate of 2% steadily growing to 7% in five years. The team believes there is a public choice to be made between a larger contribution rate for a smaller number of participants and a smaller initial contribution rate for a larger number of participants in the second pillar. There are pro and cons with both and a rich international experience and the team will continue discussing them with the working group and MLSP, with the objective to inform Ukrainian decision makers.

*(iii) Third pillar*. The team participated in a round table on voluntary pension system, organized by the SCRFSM, with participation of the financial industry, the Government, and donors, to discuss open issues in voluntary pension system, proposed changes in the Non-State Pension Funds law and the supervision practice to improve its implementation. The key document referenced at the round table was the Report on Voluntary Pension Funds, produced by the team and presented to the counterparts in December 2007. During the workshop, the team reiterated the key conclusions from the report, including the need to clearly define unit valuation procedures, improve system transparency and strengthen supplementary regulations and supervision procedures. The team also stated that USAID and the Bank will continue to provide support to the SCRFSM and the Government in that respect.

## B. II.2 Reform of legal, regulatory and supervisory framework for securities markets and NBFIs

32. Over the past year, several factors significantly improved the overall policy and institutional environment for capital market reforms. *First*, the proposed inclusion of financial services under a deep Free Trade Agreement (FTA+) between Ukraine and the European Union would create major opportunities and challenges for the development of the Ukrainian capital market over the medium to long-term: (i) approximation with EU capital market Directives, (ii) mutual recognition of Ukrainian financial sector regulators with their EU counterparts; and (iii) adaptation of market participants to the new competitive environment.

33. *Second*, the inter-agency Task Force organized by the Office of the President to develop a Presidential Decree on Emergency Measures for Securities Market Development produced a comprehensive set of policy and institutional reform proposals implementation of which would have a major impact on developing modern transparent securities markets and setting the course for integration with the EU single market over the medium-term.

34. At the request of the Office of the President, the Team reviewed the Draft Decree and provided detailed comments. This paper has attempted to identify and focus attention on the most critical impediments to development of a transparent and fair capital market in Ukraine. It is hoped this will lead to further discussion, and eventually to agreement on priorities for removal of these impediments. However, it is not clear at this point whether such a Decree will be issued.

35. The authorities are pursuing the reform of the legal, regulatory and supervisory framework for securities markets and NBFIs under the overall umbrella of the Association Agreement (AA)

[14] Anticipating the passage of the SSC Law, the PFU has taken steps to shorten the time for its implementation, such as starting the work to create a system of electronic signatures infrastructure, needed for electronic submission of reports. PFU's view is that the administrative system in the PFU to support second pension pillar could be within 6 months of enactment of the SSC Law.

and of the deep Free Trade Agreement (FTA+) currently being negotiated between the Government and the European Commission. Specifically, the FTA+ will require approximation of Ukrainian legislation with EU securities market and NBFI Directives (Level 1) and Implementing Measures (Level 2) (See PTAP FTA Report, September 2008)).

36. The European Delegation in Kyiv is supporting a legal gap analysis of Ukrainian legislation vs. EU Capital Market Directives under the EUROPEAID/119860/C/SV/multi Grant. This analysis is structured around two studies. The first study consists of a legal gap analysis vs. all EU securities market Directives with the exception of MiFID. The study has just started and will be completed by early 2009. The second study will consist of a legal gap analysis vs. the MiFID Directive. It will start in the second half of 2008 and is scheduled to be completed in mid-2009.

37. As for the progress achieved in specific policy reforms, the PTAP team extensively commented on the following:

(i) *Amendments to the Law on Financial Services* to empower financial sector regulators to trace the ultimate controllers (UCs) of regulated entities and to carry out economic, fiscal and criminal background checks of UCs. SCRFSM explained that a revised Draft Law has been prepared integrating comments received from NBU as well as several comments received from the Bank. However, the revised Draft Law maintains the threshold for sufficient participation at 10%. The team's solid position is that the threshold for sufficient participation should be set at 5% in accordance with the best international practice.

(ii) *Preparation of strategies to increase political independence and financial autonomy of SCRFSM and SCSSM*. SCRFSM is currently preparing a strategy paper to increase political independence and financial autonomy of SCRFSM and that the strategy paper was planned to be produced by July 2008. SCSSM explained that the recent decision of the Constitutional Court nullifying the Presidential Decree on SCSSM places it in a position of legal uncertainty, and therefore that it does not plan to prepare a similar strategy paper at this stage. Both SCRFSM and SCSSM recognized that the requirement for political independence of regulators, including financial sector regulators in the Association Agreement between Ukraine and the European Commission will require the authorities to bring Ukrainian legislation in conformity with the requirements of the AA and specifically to prepare new Laws for SCRFSM and SCSSM that establish the political independence of the two regulators. Both SCRFSM and SCSSM management requested that the Bank support the preparation of these two Laws in accordance with international standards under the TA component of the IBRD Access to Financial Services Project (AFSP). The team indicated that such request would need to be submitted to MOF for review and approval.

(iii) *Preparation of a new Law on Depositories, including limitation of maximum direct or indirect ownership share by a physical or legal entity in any depository to a maximum of 5%.* SCSSM indicated that the Draft Law has been circulated among relevant Government ministries and agencies for comments and that it will prepare a revised draft Law integrating comments received by mid-July 2008. The Economic Policy Committee of the Cabinet of Ministers approved a draft Depository Law. . A depository law that establishes a Central Depository will allow the AUSD with assistance from NASDAQ/OMX, to assume the role of the sole central clearing and settlement depository. This will be a groundbreaking event for Ukraine's Capital Markets.

38. SCSSM Senior Management indicated that the Commission issued a regulation requiring that all on-exchange trades be settled by the depository using DVP settlement starting November

24, 2007 (See SCSSM Decision #1001 of 10/17/2006 registered with Ministry of Justice on 11/13/06 and effective as of 11/23/07). SCSSM further indicated that they intend to conduct inspections of stock exchanges, trading systems and depositories to verify their compliance with the regulation, and intend to impose sanctions, including revocation of licenses in case of non-compliance with the regulation. The Team took good note of this positive development and encouraged SCSSM to enforce the new regulation vigorously.

39. The team further recommended that SCSSM adopt three additional regulations to improve market efficiency and transparency: the trade concentration rule, OTC trade processing and reporting regulation, and mandatory trade reporting regulation.

*(i) Trade concentration rule*. This regulation would require all trades in securities of listed corporations to be executed through the exchange where they are listed. CMP Senior Staff have drafted this amendment for the proposed Joint Stock Company Law currently in the Verkhovna Rada. The SCSSM requested the CMP prepare recommendations for amendments to Regulation #1449 on Rules for Traders. The proposed amendments were drafted to require traders to report trades of listed companies to the exchange on which they are traded (concentration rule) and off-exchange (Over-The-Counter or OTC) trades to a licensed exchange furthering the objectives of PTAP. Given the slowness with which the Rada is passing legislation, the team believes that additional efforts should be focused on the implementing regulations which can be modernized more efficiently to accomplish the necessary change in the legal/regulatory framework. The concentration rule does appear in proposed amendments to the Joint Stock Company law draft which was sent by the SCSSM to the Economic Policy Committee of the Verkhovna Rada and considered on Wednesday, June 4, 2008. The Committee unanimously approved the draft and sent it to the Rada for the second reading. Unfortunately, political events in the Rada prevented the law from being considered by the full Rada in the summer prior to Rada's vacation. Passage of this law would bring Ukraine closer to international standards on such issues as transparency, disclosure, corporate governance, shareholder rights and improving liquidity of Ukraine stock exchanges. It remains a priority issue for the PTAP team, but the team will also work to achieve important goals embodied in the legislation via regulations, decrees and other methods as possible.

*(ii) OTC trade processing and reporting regulation*. This regulation would require that (i) all brokers adopt the Transaction Reporting System (TRS) in operation in the EU within one year of regulation issuance. Failure to meet this deadline would lead to sanctions, including suspension of license; (ii) all OTC securities trades be executed through a TRS-enabled broker; and (iii) brokers report all OTC trades to a TRS-enabled exchange at T+3 minutes (see (iii) below). CMP Senior Staff have drafted amendments to the Law on Securities and the Stock Market to accomplish these goals and submitted them to the SCSSM for consideration and recommendation to the Cabinet of Ministers.

*(iii) Mandatory trade reporting regulation*. This regulation would require that (i) all exchanges adopt TRS within one year of regulation issuance. Failure to meet this deadline would lead to sanctions including suspension of license; and (ii) all exchanges report on-exchange and OTC trades to SCSSM through TRS on-line. SCSSM Senior Management indicated that they would welcome the support of the PTAP Team to prepare regulations to require trade reporting through TRS and to implement TRS at SCSSM in the framework of the planned twinning program. The Team indicated the full readiness of the PTAP Team to do so. In this context, SCSSM management indicated to the team that a proposed Law requiring that trades of shares of large "strategic" corporations take place on exchanges was submitted by SCSSM to the Cabinet of Ministers (COM),

adopted by COM and sent to the Verkhovna Rada in 2007. However, the proposed Law did not pass the first reading before the elections and will be resubmitted to the Verkhovna Rada.

*40. Opening of correspondent accounts with foreign depositories.* SCSSM has established a working group on the opening of correspondent accounts with foreign depositories. The working group consists of SCSSM, NBU, NDU, MFS and CMP. The working group was preparing a model contract and a list of amendments to the laws and regulations that impede the establishment and operations of correspondent accounts. The working group was also preparing new regulations that may be necessary. In parallel, at the request of its members, MFS is in discussions with several foreign depositories that have expressed interest in establishing correspondent relationship with MFS.

*41. Development and implementation of guarantee fund*. MFS has explored options for the development of a guarantee fund with the support of the USAID CMP. The objective of the guarantee fund is to provide for the payment of an indemnity against default with respect to payment for, or delivery of securities by participants and of obligations of participants towards the depository. A CMP Consultant worked in Kyiv to analyze design options and make recommendations on guarantee fund development and implementation in early 2008.

*42. DVP capability*. MFS indicated that it has achieved full DVP capability, and is ready to serve the move to DVP by all exchanges. PFTS Senior Management indicated that the order-driven system is ready to process trades on a DVP basis, but that all trades are still processed through the quote-driven system and settled FOP.

43. The following remains key priorities for regulatory and supervisory reform of securities markets and NBFIs:

***(i) Approximation of Ukrainian securities market and NBFI legislation and regulations with EU Directives.*** In light of the requirements of the planned deep Free Trade Agreement (FTA+) with the European Union, SCSSM and SCRFSM will need to approximate Ukrainian securities market and NBFI legislation with EU Directives. This includes approximation of Ukrainian securities markets and NBFI Laws with EU Level 1 Directives, as well as approximation of Ukrainian securities markets and NBFI regulations with EU Level 2 Directives. (See PTAP FTA Report September 2008);

***(ii) Strengthening of licensing procedures.*** Following the adoption of the revised Law on Financial Services, SCSSM and SCRFSM will need to strengthen their licensing procedures, specifically to trace the ultimate controllers of securities market professional participants and NBFIs and to carry out economic, fiscal and criminal background checks on these controllers. As stipulated in the revised Law on Financial Services, all existing professional market participants and NBFIs will be required to disclose their ultimate controllers to SCSSM and SCRFSM within a specific deadline following the adoption of the Law. As a result, the regulatory agencies will need to build their capacity to investigate the ultimate controllers of licensed entities in anticipation of the coming into force of the new legislation, both domestically and abroad, and be equipped to enforce sanctions, including fines, suspension of licenses, and/or revocation of licenses to entities that do not fully and accurately disclose their ultimate controllers, or whose ultimate controllers do not pass the economic, fiscal and/or criminal background checks.

a. SCSSM and SCRFSM will need to prepare enhanced licensing procedures for professional market participants and NBFIs compatible with EU Level 2 Directives. These should cover enhanced governance and conduct of business procedures for financial brokerages, exchanges, depositories, custodians, registrars, investment fund and pension fund asset managers and administrators, and insurance companies. These should include in-depth regulations for the segregation of client accounts at custodians and the protection of customers accounts in case of bankruptcy of custodians, in-depth regulations for the calculation of net asset value by investment funds and pension funds and for the calculation of pension units by pension funds, methodologies for the valuation of infrequently traded assets by investment funds and pension funds, and increasing the responsibility of custodians for checking the valuation of pension fund and investment fund assets. This should be supported by a roundtable with EU regulators to share best practice in licensing procedures for professional securities market participants and NBFIs. This roundtable would cover best-practices in licensing and regulation of custodians.

b. SCSSM and SCRFSM will need to establish systems for tracing ultimate controllers of professional securities market participants and NBFIs. These systems will need to enable tracing the affiliation of founders of investment funds and pension funds, other entities related to investment funds and pension funds and affiliated persons.

c. Finally, SCSSM and SCRFSM will also need to strengthen their cooperation with domestic law enforcement and tax authorities, and to develop detailed MOUs with regulators in major OECD countries, in particular with regulators in EU and EEA Member States to share economic, fiscal and criminal information about ultimate controllers of professional securities market participants and NBFIs residing abroad.

***(iii) Strengthening supervision procedures.*** SCSSM and SCRFSM will need to strengthen on-site and off-site supervision procedures of professional securities market participants and NBFIs by the regulators. This will require building their capacity to exercise effective risk-based supervision of professional securities market participants and NBFIs based on the EU Capital Requirement Directive.

a. Regulations will need to be developed to enhance the intervention powers of the regulators in case of liquidation and/or mergers of pension funds. Specific regulations will need to define the extreme conditions under which the regulators can step in place of the Board of the pension fund and/or administrator in order to protect members' interests, based on best international practice.

b. SCSSM and SCRFSM will also need to enhance their tax due diligence capacity for securities market professional participants and NBFIs, in particular for pension funds and insurance companies that are suspected of being used as vehicles for tax evasion. They will need to review existing regulations to ensure that the regulators have enhanced powers to detect and prosecute cases of tax evasion by these entities, in collaboration with tax authorities and law enforcement agencies. This applies to pension funds during the accumulation and pay-out phase.

c. The regulators will need to revise NSPF regulations on segregation of funds reserved for finance-defined term withdrawals and funds held on individual account during the accumulation phase.

d. Finally, the regulators will need to revise NSPF regulations on the distribution of gains and losses on invested assets to provide for daily distribution of the full value of pension fund assets.

***(iv) Strengthening market surveillance.*** SCSSM will need to strengthen its market surveillance capacity. As a matter of priority, SCSSM will need to acquire a Trade Reporting System (TRS) compatible with TRS systems used by EU market regulators and analytical software to detect suspicious transactions. Commission staff will need to be trained in the detection and investigation of suspicious transactions using this analytical software.

***(v) Strengthening enforcement.*** The regulators will need to strengthen their capacity for enforcement, including investigation, prosecution of cases with law enforcement agencies and in the courts, and application of sanctions.

a. SCSSM and SCRFSM will require significant support to strengthen their institutional capacity in order to implement these priority reforms. Twinning programs between the two regulators and an EU regulator would contribute significantly to achieving this objective; as such programs would help raise the capacity of the two regulators closer to their EU counterparts over time.

b. The World Bank stands ready to finance twinning programs between SCSSM and SCRFSM and EU regulators in the framework of the technical assistance component of the IBRD Access to Financial Services Project (AFSP). The objective of the twinning programs will be to support the two Commissions' convergence with IOSCO, IAIS and IOPS international standards of regulation and supervision and thereby making progress toward eventual mutual recognition with EU regulatory agencies. The twinning programs will include support to SCSSM and SCRFSM to approximate Ukrainian securities market and NBFI legislation with EU Capital Market Directives, based on the results of the legal gap analysis being supported by the EC Delegation. The twinning programs will also support the strengthening of SCSSM and SCRFSM across all their functions, including licensing, risk-based supervision, market surveillance, and enforcement . The PTAP team together with SCSSM and SCRFSM has finalized the TORs for potential twinning partners and submitted the draft ToR for review to MOF. It is anticipated that this program will run three-four years and include: training programs consisting of seminars, workshops, roundtables and other events in both countries; secondment of senior SCSSM and SCRFSM staff to the staff of the twinning partner in its central regulatory office; secondment of a senior staff member from the twinning partner to work with his/her counterpart and provide day-to-day guidance and coaching; assistance by the twinning partner in evaluating, recommending and commenting on existing regulations and in preparing new regulations; and educational and study tours for the Ukrainian regulators to selected countries to participate in relevant training activities.

c. USAID has been supporting a training program for SCSSM staff by US SEC, consisting of (i) participation of SCSSM staff to US SEC Institute in Washington DC (April 2008), and (ii) delivery of specific training modules on site for SCSSM staff. As part of this program, a first group of 12 SCSSM staff participated in the US SEC Institute training course held in Washington DC in April 2008, and the US SEC provided one week of training to the SCSSM in Kyiv in June 2008. The US SEC team plans to return to Kyiv for a follow-up training at six months intervals. The training on international standards and practices covers virtually every aspect of securities markets regulation and includes speakers from both the SEC and private industry. The recently established training initiative for Ukrainian regulators in cooperation with the U.S. SEC is designed to gain critical understanding on the development, operation, and regulation of securities markets.

## C. II.3 Securities market infrastructure

44. The team discussed with the authorities and with key market participants the latest developments in the transformation of Ukrainian securities market infrastructure and the actions undertaken under PTAP in support of this effort.

*45. Technology Transfer in the Stock Exchanges and Depository*: During this year, discussions have intensified between several Ukrainian exchanges and EU/US exchanges on modernizing their technology. On June 5, 2008, the PFTS Exchange announced a strategic alliance with the Moscow Inter-Currency Stock Exchange (MICEX) to adopt a version of the NASDAQ/OMX trading platform. On June 9, 2008, the Ukraine Inter-Currency Exchange (UICE) announced a Memorandum of Intent to bring the NASDAQ/OMX trading platform to Ukraine, while the NBU announced an agreement with NASDAQ/OMX to provide guidance on the post-trading platform to create an international trading hub with correspondent relationships globally. The latter represents another step toward the anticipated merger of the MFS and the AUSD into a Central Depository which the National Bank would own 25% and current MFS shareholders approximately 60%. The merger would position the AUSD to become Ukraine's Central Depository, thus meeting key G-30 international criteria for depositories while also enabling AUSD to be recognized by other EU country depositories. The NASDAQ/OMX technology will help create a seamless flow of information to assist in efficient operations of clearing and settlement for the market. Two competing stock exchanges have now acquired technology to improve operations of their trading platforms and it is anticipated this will further increase healthy competition for shares in the Ukrainian market.

46. *Central Depository*: A long standing issue in the local Capital Market was finally settled on February 14, 2008, with the establishment of the All Ukraine Securities Depository (AUSD) by 21 private market participants and the National Bank of Ukraine. The private membership includes 2 stock exchanges (PFTS and UICE) and 19 prominent, mostly international, banks. This clears the way for an AUSD and MFS merger, forming a modern Central Depository which brings Ukraine into conformity with G-30 international standards. Approximately 60% of the statutory capital will come from current MFS owners. The Senior Management of AUSD and MFS confirmed to the team their plans to proceed with a merger of the two entities. Outstanding progress has been made in the establishment of a Central Securities Depository with the anticipated merger of MFS and the newly established AUSD. However, key to this relationship becoming cemented is the continued support of the NBU, SSMSC and the successful completion of the proposed merger.

47. NASDAQ/OMX's agreements to bring its state of the art trading platforms to Ukraine this year and the joint initiatives to establish a world class central depository, which will facilitate international trading and settlement of securities, is a major accomplishment for Ukraine.

*48. PFTS Members to Report Trades Executed Off-Exchange*: On May 26, the PFTS Exchange Board approved a decision to make it obligatory for PFTS members to file, on a continuing basis, reports on off-exchange trades (hereinafter referred to as 'reported trades') with securities listed on PFTS. PFTS members will file information on reported trades with PFTS listed securities via a PFTS trade terminal no later than on the next day following the trade execution date. This information will be posted on the official PFTS site, in the "Reporting" section. It is essential to note that these are not settled trades, simply contracts that may or may not be settled at a future date. However, the new requirement includes previously unreported contracts thus giving the regulator and market participants more information than previously available. This is an important step in promoting transparency.

49. These developments constitute potential breakthroughs for Ukrainian securities market infrastructure. For example, the adoption of the cutting edge trading and post-trading technology of NASDAQ/OMX by stock exchanges and AUSD could attract considerable liquidity from financial brokerages seeking best execution, and could contribute handsomely to the integration of the Ukrainian securities market in the EU single market and in the transatlantic securities market, thereby providing access to a massive liquidity pool for Ukrainian issuers.

50. The team supported the SCSSM in drafting of a new regulation that will enable all existing depositories to establish correspondent agreements with other international CSD organization and will help the formation of a Central Depository.

51. At the same time, these developments have direct implications for market surveillance. As the Ukrainian securities market infrastructure adopts cutting edge trading and post-trading technology, the SCSSM will need to implement a modern market surveillance technology at par with the technology implemented by EU regulators. In particular, SCSSM will need to acquire, test, and implement the Trade Reporting System (TRS) used by securities market regulators in EU Member countries, and overlay some modern market surveillance software to detect fraudulent market practices. SCSSM requested support from the IBRD Access to Financial Services Project (AFSP) for the acquisition, testing, installation and maintenance of the TRS system. The team indicated that this request would need to be submitted to MOF for review and approval.

52. The team is concerned with the status of preparation of the new regulation on trade concentration, and the status of enforcement of the regulation regarding DVP settlement of on-exchange trades. SCSSM indicated that it is proceeding with the issuance of the trade concentration rule shortly, and that it intends to enforce the DVP settlement rule forcefully on all exchanges. SCSSM shared their concern that based on the most recent examinations of all stock exchanges, none implement DVP, and only two stock exchanges have electronic signatures necessary for DVP settlement.

## D. II.4 Government bond market development

53. In March 2007, the USAID's Access to Credit Initiative (ATCI) in cooperation with the World Bank, the OECD, and the IMF, co-sponsored a debt management forum with the Ministry of Finance (MOF). This forum for senior policy makers focused on the need to develop the domestic treasury market and construction of a long - term treasury yield curve for reference pricing. The forum produced a summary note with a plan of action and recommendations for implementation.

54. Since an aspect of PTAP includes development of the domestic treasury market and long-term yield curve, ATCI and WB Treasury (Team) are cooperating to facilitate this development.

55. The Team presented the MOF with a detailed set of reforms that would enable the government to meet its objectives for improving the structure of its government debt portfolio while promoting formation of an active and liquid market in government securities. To address requisite changes in portfolio structure, reforms were directed at building institutional capacity through development of a debt management office that could design and implement a debt management strategy. To increase the appetite of institutional investors for government securities in Hryvnyas and to reduce the cost of funding in local currency, recommendations included formation of primary dealers and moving to market pricing when conducting auctions.

56. The scope of the Draft Plan was limited to the priorities set in the DMO policy note and was to be complemented by upgrading the legal framework and strengthening the internal organization of the DMO. Consolidation of primary and secondary legislation in line with EU best practices was to be done in parallel with implementation of the present Reform Plan in order to enhance the probability of successful outcomes and permanence of reform.

57. This joint effort has resulted in the Ministry preparing a Debt Management Concept Note. ATCI/WB treasury response to the Concept Note has resulted in a Reform Plan of Action that generally divides activities between debt management (WB treasury) and debt market development (ATCI).

58. In this context, the Ministry of Finance of Ukraine has publically announced its intentions to increase domestic borrowing (in UAH) to fund its budgetary needs using benchmark issues 2, 5, 7, and 10 years.

59. To begin, the Ministry is looking for ways to improve primary market conditions that would allow it to increase its access to funding at minimal cost. Although rates on treasuries set at auction have been increasing, the use of market pricing has yet to occur. However, auction volume and an issuance calendar have been announced. Once auctions are conducted at market and, based on market response, MOF plans on inviting participating banks that meet selection criteria to become primary dealers. Additionally, the MOF would like to develop the capacity to conduct repo - reverse repo transactions in order to minimize the costs associated with such issuance. Recently, the MOF has acknowledged the importance of coordinating repo – reverse repo activities with the National Bank of Ukraine.

60. The Team has discussed at length the impediments to MOF issuance at market. One stumbling block to market issuance remains the inability of the MOF to earn interest on its balances in the Single Treasury Account (STA) at the NBU to offset the perceived cost to the Ministry of Finance of issuing debt at market. (Financial flows between two public sector institutions do not have any significant effect on a country's budgetary position.) By engaging in reverse repos, the MOF would be in a position to earn interest on the money borrowed to minimize the cost of going to market pricing. However, this approach provides the Ministry of Finance with the ability to initiate secondary market transactions that directly affect bank liquidity - traditionally an activity within the purview of monetary policy and the NBU. ATCI team members along with the IMF representative, U.S. Treasury advisors and market participants have been working on developing an alternative approach that would encourage issuance of domestic government debt at market interest rates without the MOF using reverse repos. This approach does require some cooperation (fee or interest rebates) from the NBU to be effective.

61. Separately, ATCI is negotiating with AKK, the Hungarian Debt Management Agency to send a senior executive to the MOF in order to advise on building reverse - repo capacity and requirements for primary dealers. These activities are expected to last through June of 2009 after which, WB Treasury would begin technical assistance in cash management with emphasis on risk controls, risk management, and risk optimization.

62. The team learned that mandatory credit ratings and use of the Cabinet of Ministers' national scale continue to have a detrimental effect to issuers of bonds. Frequently, companies use private placements to avoid the mandatory credit rating and its associated cost. On average, it takes the domestic rating agency 60 days to rate a company, while international rating agencies do it within a

week. Market participants commented that domestic credit ratings were of little use to assess investment risk. The team recommends that the GOU makes credit ratings voluntary and market driven and eliminate the use of a national scale introduced by the Cabinet of Ministers.

## III. PRIORITIES AHEAD: A POLICY REFORM ACTION PLAN

63. Politics remain a key variable as the policy intentions and stability of the government will have an important influence on the achievement of capital markets and pension reform. The willingness of the government to continue support for essential new legislation like the new draft Joint Stock Company Law and the Pillar II (Mandatory Accumulation) Pension Law is critical. Both these laws have been submitted for next readings, but to date a lack of Rada consideration of a vote has posed challenges to economic reform and to the achievement of PTAP objectives.

64. The GOU needs to take action to eliminate present restrictive policies on currency flow and broaden the scope of its privatization program to include listing and initial public offerings (IPOs) of state-owned enterprises on the regulated securities markets. The development of a government bond yield curve is important for both financial markets and pension reform. This appears to be gaining traction but the lack of work by the Rada continues to jeopardize success.

65. Major reform challenges remain ahead on the road to the development of a transparent and well-regulated securities market. First, the political independence, financial autonomy, investigation powers, market surveillance, risk-based supervision and enforcement capacity of SCSSM and SCRFSM need to be strengthened considerably in order to bring them closer to international standards of regulation and supervision. In particular, we recommend that both regulators implement without delay comprehensive, multi-year twinning programs with an EU regulator. Second, stock exchanges should move to full DVP settlement in collaboration with MFS without further delay, and they need to further enhance strategic alliances with major international exchanges. MFS needs to be merged with AUSD to form a reliable single central clearing and settlement depository as soon as practicable. Third, the Sovereign Debt Department at the Ministry of Finance needs to implement its domestic government bond market development plan in close coordination with NBU. And fourth, the GOU should make credit ratings voluntary and market driven and eliminate the use of a national scale introduced by the Cabinet of Ministers.

66. Going forward , the capital market policy reform environment may be shaped by the planned Free Trade Agreement (FTA) between the European Union and Ukraine. The FTA would imply (i) approximation of financial sector laws and regulations with EU Directives adopted under the EU Financial Sector Action Plan (the "Lamfalussy Plan"), both during the negotiation period ahead of FTA ratification for a first set of Directives, and during a transition period following FTA ratification for a second set of Directives; and (ii) mutual recognition between Ukrainian financial sector regulatory agencies and their counterparts in the EU Member States at some stage in the FTA process. With respect to securities markets and NBFIs, the FTA will imply approximation with several EU Directives including the Market Abuse Directive, the Prospectus Directive, the Takeover Bid Directive, the Markets in Financial Instruments Directive (MiFID), the Transparency Directive, the Capital Requirement Directive, the Undertakings of Collective Investment in Transferable Securities Directives (UCITS III), the Solvency II Directive Proposal, the Institutions for Occupational Retirement Provision (IORPs Directive), the Directive on Acquisition and Increase of Holdings in the Financial Sector, the Directive on Supplementary Supervision of

Financial Conglomerates, and the Directive on Combating Money Laundering and Terrorism Financing (See PTAP FTA Paper, September 2008).

67. Addressing this policy reform agenda will require careful prioritization and sequencing of actions over the short, medium and long-term. The below action matrix below outlines PTAP support for the next year to implement the reform agenda.

68. The USAID and the World Bank stand ready to support the Government to design and implement the proposed policy reform agenda and action plan through a broad range of instruments, including Development Policy Loans, the proposed PTAP, the AFSP (incl TA component to SCRFSM), ongoing USAID projects including CMP, ATCI and CLC Projects, and possible additional TA grants through the FIRST Program managed by the World Bank. The PTAP team acknowledges the importance of coordination with the EU programs.

## E. Table I: PTAP Action Matrix for the 2nd Year of PTAP Implementation

| Reform Action (Counterparts) | June 08 | December 08 | June 09 | Partnership Support |
|---|---|---|---|---|
| **1. Support pension policy reform** | | | | |
| **Establish fiscal conditions for introduction of second pillar pensions (MLSP/MOF)** | Monitor implementation of follow-up mission policy recommendations | -Update simulations and policy recommendations<br><br>-Monitor implementation of follow-up mission policy recommendations | -Update simulations and policy recommendations<br><br>-Monitor implementation of follow-up mission policy recommendations | ECSHD/ECSPE 1/ |
| **Finalize necessary amendments to pension reform legislation** | | -Monitor developments in the Rada | -Monitor developments in the Rada | ECSHD/ECSPE 1/CMP |
| **Design financing strategy for cost of transition to second pillar (MLSP/MOF)** | | | -Prepare simulations and policy recommendations<br><br>-Organize roundtable with stakeholders | ECSHD/ECSPE 1/ |
| **2. Reform legal framework for securities markets and NBFIs** | | | | |
| **Implement ongoing securities market policy reform package (SCRFSM,SCSSM, NBU)** | -Promulgate Presidential Decree on Securities Markets<br>-Submit | Follow-up implementation of policy reform package | Follow-up implementation of policy reform package | ECSPF/CMP 1/ |

| Reform Action (Counterparts) | June 08 | December 08 | June 09 | Partnership Support |
|---|---|---|---|---|
| | amendments to Law on Financial Services to Rada<br>-Prepare strategies for increased political independence and financial autonomy of SCSSM and SCRFSM<br>-Draft new Depository Law | | | |
| **Approximate legislation with EU capital market Directives (ex MiFID) (SCSSM)** | | -Complete gap analysis,<br>-Prepare paper on "Challenges and Opportunities of EU-Ukraine FTA for the Development of Securities Markets and NBFIs in Ukraine" | -Carry-out approximation (ongoing) | ECSPF (EU grant) 1/ |
| **Approximate legislation with EU insurance Directive (SCRFSM)** | | -Complete gap analysis<br>-Prepare paper on "Challenges and Opportunities of EU-Ukraine FTA for the Development of Securities Markets and NBFIs in Ukraine" | Carry out approximation (ongoing) | ECSPF (EU grant) 1/ |
| **Approximate legislation with EU MiFID Directive (SCSSM)** | | -Prepare paper on "Challenges and Opportunities of EU-Ukraine FTA for the Development of Securities Markets and NBFIs in Ukraine" | Launch gap analysis | ECSPF (EU grant) 1/ |
| **Implement twinning program between SCSSM and SCRFSM** | Prepare Terms of References | Implement twinning program Phase I | Implement twinning program Phase II (ongoing) | ECSPF/CMP 1/ |
| **Support US SEC** | -Implement | -Implement | -Implement | CMP 1/ ECSPF |

| Reform Action (Counterparts) | June 08 | December 08 | June 09 | Partnership Support |
|---|---|---|---|---|
| **Training Program for SSMSC** | module 1 in Kyiv - Support participation in April 08 US SEC Institute | module 2 in Kyiv | module 3 in Kyiv - Support participation in April 09 US SEC Institute | |
| | | **3. Strengthen market infrastructure** | | |
| **Identify strategic alliance between Ukrainian exchange and EU/US exchange (SCSSM, Stock Exchanges)** | Facilitate market assessment by EU/US exchange | Complete market assessment by EU/US exchange | Facilitate the identification of Ukrainian target for strategic alliance with EU/US exchange | CMP1/ECSPF |
| **Explore modern Trade Reporting System (SCSSM, Stock Exchanges)** | Request made to the team | Support identification of appropriate TRS for purchasing | TRS purchased and Installation of TRS at the SSMSC and exchanges started | ECSPF/CMP/ |
| **Assist in merger of MFS into AUSD (AUSD, MFS, NBU)** | Assist in the merger (valuation and legal analysis) | Merger plan developed and approved | Merger of MFS into AUSD occurred | CMP 1/ |
| | | **4. Support development of domestic bond market** | | |
| **Implement government bond market development strategy (MOF)** | Design strategy implementation plan | Implement strategy – | Implement strategy (ongoing) | ATCI/BDM 1/ |
| **Develop and implement government debt management strategy (MOF)** | | Develop strategy- AKK advises on reverse repos and primary dealer | Design strategy implementation plan | BDM/ECSPE/ECSPF 1/ |
| **Develop SNG debt market (MOF)** | | Design reform of SNG borrowing framework | Implement reform of SNG borrowing framework (ongoing) | ECSPE/ECSPF/ATCI 1/ |

1/ Legend

ATCI: USAID Access to Credit Initiative
BDM: World Bank Banking and Debt Management Unit
CMP: USAID Capital Market Project
ECSHD: World Bank Europe and Central Asia Human Development Sector Unit
ECSPE: World Bank Europe and Central Asia Poverty Reduction and Economic Management Sector Unit

ECSPF: World Bank Europe and Central Asia Finance and Private Sector Development Sector Unit

The PTAP team looks forward to work in close collaboration with the Government in further developing and implementing this Partnership in support of the development of capital markets and pension reform in Ukraine.

## F. **Table II: The joint team of World Bank/USAID experts (current composition)**

| Team Coordinators | Position |
|---|---|
| Mr. Michel Noel | Lead Financial Specialist, Co-team Chief, TTL, ECSPF |
| Ms. Natalia Berezhna | Project Management Specialist, Co-team Chief, USAID/Ukraine |
| Mr. Pablo Saavedra | Senior Country Economist, ECSPE, Senior Advisor to the Team |
| Mr. Zoran Anusic | Senior Economist, ECSHD |
| Mr. David Lucterhand | Chief of Party, USAID Access to Credit Initiative (ATCI) |
| Mr. Barry Pitts | Chief of Party, USAID Capital Market Project (CMP) |

| Team Members | Position |
|---|---|
| Mr. Vitaliy Bigdai | Financial Sector Consultant, ECSPF-Kyiv |
| Mr. Victor Stetsenko | Senior Capital Market Advisor, USAID – CMP |
| Mr. Gary Hendricks | Senior Pension Expert, USAID – CMP |
| Ms. Natasha Lozitskaya | Communications Specialist, USAID – CMP |
| Ms. Katerina Petrina | Senior Social Protection Specialist – ECSHD |
| Mr. Ruslan Piontkivsky | Economist, ECSPE |
| Ms. Julia Smolyar | ETC Consultant, ECSHD – Kyiv |
| Ms. Larisa Piskunova | Activity Manager/Portfolio Analyst, USAID/Ukraine |
| Ms. Darya Lisyuchenko | Activity Manager, USAID/Ukraine |