

# All Ukraine Clearing Depository Functional Specifications

## Overview and Operation

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October 4, 1999

Mykola Shvetsov  
Chairman, Management Board  
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Dear Mr Shvetsov

PricewaterhouseCoopers is pleased to present to you the "All Ukraine Clearing Depository Functional Specifications - Overview and Operations" (Functional Specifications) This document was written by John Ruckrich, PricewaterhouseCoopers consultant specializing in securities depository clearance and settlement

As you know, the Functional Specifications have previously been distributed in draft form to the MFS, throughout the Ukrainian securities industry, and to the regulators Training, design and development of the system and the AUCD organization has been taking place over the last nine months based on the draft and updates to same No changes have been made to the final draft version within attached document This bound copy simply represents the formal delivery of the Functional Specifications to MFS as the intended recipient of the AUCD system

Sincerely,

Susan J. Hertel  
Project Director

**All Ukraine Clearing Depository  
Functional Specifications**

**Overview and Operations**

PricewaterhouseCoopers LLP  
Ukraine Capital Markets Infrastructure Development Project  
10/19/99

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## **1 Introduction**

The overall business objectives of the All Ukraine Clearing Depository, (AUCD) for the Ukrainian Capital Market are

- 1 to simplify the process of transferring ownership of securities,
- 2 to increase public confidence in the securities market through reduction of the many risks inherent in the settlement process,
- 3 to raise the Ukrainian securities market to the standard of international capital markets

In order to achieve these goals, the AUCD will implement a number of systems designed to automate the clearing, settlement and depository functions of the capital market in Ukraine. The purpose of this document is to describe the functional specifications for the principal components of this suite of systems and to describe how these systems interact in the overall capital markets environment in Ukraine.

The purpose of these systems is to settle trades which are executed in the regulated public market places of Ukraine within processes that are designed to reduce risk to the market, the AUCD participants and investors. These systems have been designed to be fully integrated.

### **1.1 System Overview**

#### **1.1.1 Clearing System**

The purpose of the Clearing System is to prepare trades for settlement. The Clearing System supports trade reporting, trade correction and trade confirmation/affirmation functions. Trade affirmation is required when a trade is executed for an Institutional Investor. The Institutional investor receives a confirmation of the trade from his custodian named in the trade and instructs his custodian to affirm or reject the trade. Where the trade is affirmed by the custodian, the custodian assumes the settlement obligation of the broker named in the trade.

Not all brokers will have a custodian license as required by law to be a member of the AUCD. These brokers should have a correspondent relationship with a member of the AUCD who will assume the clearing and settlement obligations for the non-member broker. Should the non-member broker not establish these agreement(s) with AUCD custodians for clearing and settlement services, the non-member will be restricted to a Trade for Trade settlement.

The Clearing System will examine all trades for whether they are eligible for contractual settlement wherein the AUCD guarantees the net settlement obligation or whether the trade is to be processed as a Trade for Trade transaction whereby the AUCD assumes no settlement responsibility but does provide the accounting and control process for a Delivery versus Payment facility between the original parties to the trade.

#### **1.1.2 Settlement System**

Settlement is the exchange of securities for money. Settlement will be book-based (i.e., ownership will be transferred within the records of the AUCD). Book-based settlement will

be directly against an omnibus depository sub-account maintained and managed by a custodian or a proprietary sub-account specifically opened to contain the custodian's own security portfolio. Book-based settlement will also be directly against an omnibus or proprietary depository sub-account maintained by the custodian but managed by a broker with whom the custodian has a contractual relationship to clear and settle all trades executed by the broker against the omnibus sub-account. All funds and securities will be netted at the custodian level. The securities netting process will be multi-lateral. The system will use a two-pass process to effect settlement. The first pass creates the Settlement Statements for all custodians and deals with the obligations (securities and funds) between broker/custodians and the AUCD. The second pass of the settlement cycle deals with settling obligations (securities only) between broker/custodians and the AUCD.

The settlement cycle assumed in this document is a three business day settlement cycle (Trade Date+3 is settlement date). Both securities and money will settle on the same day (T+3) in a DVP environment. The settlement cycle can be changed to one more suitable to the Ukrainian circumstances.

Trade for Trade transactions will settle within the system's settlement cycle unless the transaction contains an override settlement date in the original trade submission from the National Market System.

### **1.1.3 Depository System**

Investors will hold positions in the AUCD by opening an account with a Custodian who is a participant in the AUCD. Investment funds and other institutional investors will do likewise. Sub-accounting for positions in the custodian omnibus accounts is carried out in the internal accounting systems of the custodian. The Depository System supports the functions of account management (opening depository accounts and sub-accounts, closing depository accounts and sub-accounts, depository account and sub-account maintenance), deposits, transfers, withdrawals and corporate actions (cash dividends, stock splits, etc.).

## **1.2 Account Structure**

The Depository System maintains five types of accounts:

- 1 Custodian account – consisting of two sub-accounts, proprietary and omnibus. The proprietary sub-account will reflect the personal holdings of the custodian and the omnibus account will reflect the co-mingled holdings of the clients of the custodian (for securities). Additional proprietary and omnibus sub-accounts may be opened for each broker who has signed an agreement with the custodian to settle the trades of the broker.
- 2 Custodian clearing accounts which include the following sub-accounts: a) technical sub-account for share and money obligations, b) clearing free shares for settlement, c) settlement money.
- 3 Issuer proprietary accounts (shares)
- 4 AUCD Buy In accounts (money and securities)
- 5 AUCD Sell Out accounts (money and securities)

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Custodian omnibus accounts represent the aggregate security holdings for the custodian's clients. Security positions of the custodian's clients are co-mingled in the omnibus account. The individual security positions that make up the omnibus account are maintained in the custodian's internal accounting system and are not known to the AUCD.

Clearing accounts are maintained for each custodian account. A custodian may have one depository account. He will have one clearing account to support his depository account. Clearing accounts are used for settling money and securities. Clearing accounts represent the "other side" of the accounting transactions generated by the system during the settlement cycle.

Issuers do not have Clearing accounts because they are not engaged in the trading activity.

Buy-in accounts are also maintained in the system for use by the AUCD. A Buy In account is a special purpose account used when a custodian's clearing account contains a short position at the end of the daily settlement cycle. When a clearing account contains a short position, the system will move the short position and the funds related to the short position into the AUCD's Buy In account. A Buy In trade is then executed against this account to cover the short position. The Buy In is executed by the AUCD on whichever trading facility it deems best suits the AUCD's purposes.

Sell out accounts are also maintained in the system for use by the AUCD. A Sell Out account is a special purpose account used when a custodian's clearing account contains a money debit balance, i.e. the custodian did not pay his full money settlement obligation. The AUCD would take charge of all deliveries made to the defaulting custodian and follow Sell Out processing procedures.

### **1.3 Business Operating Environment**

The systems being developed for the AUCD are intended to make the interaction between the various parties involved in the Ukrainian Capital Market more effective and efficient. These parties are:

- 1 Clearing Depository organization (AUCD)
- 2 Broker/Custodians
- 3 Issuers
- 4 Registrars
- 5 The National Market System
- 6 National Depository of Ukraine and other depositories
- 7 Settlement Bank

#### **1.3.1 The AUCD**

The AUCD does not intend to have direct face-to-face contact with the investing public. The Custodians will be responsible for, among other things, accepting deposits of securities and other activity related matters concerning the investors' holdings in the Depository. The AUCD and its related interfaces and activities with the other capital market participants is described in this section and throughout the document.

### **1 3 2 Broker/Custodians**

Members of the AUCD will hold both a brokerage license and a custodian license. However, not all custodians will function as brokers and not all brokers will function as custodians. There will therefore be market participants who fall into one of the three following categories:

- 1 Participants who conduct both a brokerage business and a custodian business
- 2 Participants who conduct only a custodian business
- 3 Participants who conduct only a brokerage business

Brokers who desire to execute trades for individual investors whose security holdings are with a custodian utilizing the services of the AUCD have a choice of:

- a) signing a contract with the custodian responsible for the client's security holdings. The contract would commit the custodian to be responsible for settling the trades for those client accounts that the broker has the right to manage
- b) opening an account with the AUCD
- c) submitting the trades for settlement in the non-guaranteed settlement Trade for Trade mode

Financial institutions, large investors and later foreign investors may use one or many broker/custodians for trading and another broker/custodian for settlement. The settlement broker/custodian functions not only as a custodian but also as a Settlement Agent. In this case, trading instructions are given by the Institution or its agent to a broker. Confirmation of the matched trade is communicated to the settlement broker/custodian. The settlement broker/custodian upon affirming of the trade also accepts the settlement responsibility. The system will accept the trade affirmation and move the settlement obligation from the executing broker to the settlement broker/custodian member (Settlement Agent). Should the executing broker not be a member of the AUCD nor have a contract with an AUCD custodian to accept settlement responsibility for trades executed by the broker, then the Institutional Trade is channeled through Trade for Trade process which failing affirmation by the Settlement Agent, the trade would automatically be permitted to fail.

At the end of each business day the AUCD will prepare in machine processable form, a record of custodian holdings and transactions to support the balances. It will be the responsibility of the custodian to report any discrepancies within a three business day period or the records of the AUCD will be assumed to be correct. Further, it is the responsibility of all custodians to update their omnibus details records in their own systems within 24 hours after the trade settlement date.

### **1 3 3 Issuers**

There are interfaces required for Issuers of Bearer Securities and Non-Documented Securities.

#### **1 3 3 1 Interface to Issuer—Documented Bearer Securities**

In the first implementation of the AUCD, bearer securities will not be eligible for services of the AUCD. The unique processing requirements of the bearer certificate will be

studied and a separate document describing the functional specifications for bearer certificate processing will be produced and circulated for comment

#### 1 3 3 2 Interface to Issuer—Non-Documented Securities

Pursuant to the effective legislation the issuers shall be recognized as the AUCD clients along with custodians and other depositories. If the decision was taken to issue securities in a non-documentary form the issuer must conclude an agreement with the AUCD on servicing the securities issue and deposit a global certificate. While depositing a global certificate the AUCD shall open an issuer securities account for the issuer. The agreement for servicing the share issue must also envisage opening in the AUCD of an account where the issuer's treasury stock will be held, as well as servicing issuer's transactions in issued securities. The AUCD shall complete a consolidated registry for non-documentary securities upon the request of the issuers whose global certificates are deposited with the AUCD.

#### 1 3 4 Registrars

If registered securities are issued in documentary form the ownership rights are accounted (transfer of ownership is performed) by a registrar. A share certificate issued in accordance with the SSMSC requirements serves as a document confirming the ownership rights to securities issued in documentary form.

Documentary securities can be immobilized in AUCD. This means that the registered securities issued in documentary form shall be reregistered from beneficial owner or nominal holder name to the name of AUCD as a nominal holder. Share certificates shall be cancelled and kept with the registrar.

The immobilized registered securities shall be accounted in the registry system on the account of the nominal holder – the depository in which these securities were immobilized, i.e. in the AUCD.

The fact of immobilization of registered securities shall be confirmed by an immobilization certificate issued in the name of the AUCD. The immobilization certificate shall be issued to the AUCD by the registrar.

In case there is a need to compile a registry of registered securities, the registrar, with which the AUCD is registered as a nominal holder, shall send to the AUCD a written order/instruction to compile a consolidated register. Such a register shall be compiled on the basis of sub-registers submitted by custodians and/or consolidated registers transferred by other depository with which the AUCD maintains correspondent relations. The total number of a security recorded with the registrar on the account of the AUCD as a nominal holder should equal the aggregate number of the security on the securities accounts custodians-participants which have transferred them to the nominal holder. The latter amount should be equal to the number of securities indicated in the immobilization certificate.

At the initial stage of AUCD development the registries shall be reconciled “manually” (reconciliation will not be automated) The AUCD shall produce reports indicating a total number of each issuer securities recorded in the name of the AUCD as a nominal holder The registrar will reconcile this data with the total amount of securities recorded in the name of the AUCD as a nominal holder Any differences should be immediately investigated and resolved

The reverse process of (opposite to) immobilization is materialization, i e the transformation of immobilized documentary securities into documentary form For this purpose the respective amount of registered securities shall be written off from the account of a nominal holder with the registrar and credited to the account of the securities owner The registrar shall issue to the owner or the AUCD (as dictated by AUCD procedures) a new securities certificate The records of ownership rights to documentary securities shall further be kept within the registry system maintained by the registrar

### **1 3 5 The National Market System**

The National Market System is a broad reference to all the regulated marketplaces in Ukraine which will produce as its product a matched trade The trading methodology of each regulated marketplace may differ but the matched trade, if submitted to the AUCD, will be subject to the AUCD clearing and settlement rules and procedures The matched trades submitted to the AUCD will be either subject to contractual settlement, i e , subject to the AUCD settlement guarantee, or Trade for Trade processing, not subject to the AUCD settlement guarantee and therefore subject to non-settlement

The Clearing, Settlement and Depository systems are designed to integrate with the publicly regulated automated trading systems in the Ukraine which are collectively referred to in this document as the National Market System (NMS) These systems will be linked to the AUCD for purposes of reporting trades executed in the NMS for clearance and settlement in the AUCD The linkage will be over the best and most appropriate communications facilities available utilizing record formats specified by the AUCD

The only trades which will be accepted into for clearance and settlement processing in the AUCD are trades in AUCD eligible securities In order to sell depository eligible securities through the National Market System, the investor must first have the securities deposited with one of the AUCD broker/custodians Short selling is not supported by the AUCD This is in keeping with its overall responsibility of controlling systemic risk Trading in securities not eligible in the AUCD will follow the rules and procedures in force before the creation of the AUCD The remainder of this section is concerned only with depository eligible securities

### **1 3 6 The National Depository of Ukraine and other Depositories**

At this time the interfaces between the NDU, AUCD and other depositories is beyond the scope of the workplan directing the functionality of the AUCD

### **1 3 7 Settlement Bank**

The preferred Settlement Bank model is the use of the National Bank, failing to acquire such services, the best available commercial bank should be chosen based upon availability, reliability, proficiency, and willingness to supply liquidity when required

### **1 4 Settlement Guarantee Fund**

The Settlement Guarantee applies only to those share and money settlement obligations which have been accepted into the contractual settlement process and are a result of the multi-lateral netting of trades. The only trades which would not be subject to the Settlement Guarantee would be those trades specifically indicated Trade for Trade. If the AUCD is to be able to guarantee settlement, it must be in a financial position to make good on any defaults in existing settlement obligations. The Settlement Guarantee Fund is intended to provide the required source of funds to make good on settlement defaults. The Settlement Guarantee Fund must be considered the last line of defense in ensuring the orderly settlement of trades. Before going to the Settlement Guarantee Fund the AUCD must first make every effort to have the defaulting custodian make good on the default. Only in the event that the custodian is unable to remedy the default will the AUCD make use of the Settlement Guarantee Fund to meet its settlement obligations. The Settlement Guarantee Fund is a pool of cash and collateral placed under the control of the AUCD by its custodians. The fund is drawn upon to obtain funds needed to settle obligations when those funds are not provided by the AUCD custodian as required by the AUCD rules.

The level of contribution to the Settlement Guarantee Fund will bear some relationship to the size and normal settlement obligations for each custodian. The actual formula for determining the level of required contributions to the Settlement Guarantee Fund and the procedures for management and use of the fund will be determined by the Board of Directors of the AUCD.

### **1 5 Insurance**

In addition to reliance on the Settlement Guarantee Fund, each custodian should have appropriate insurance in place. Insurance coverage for such hazards as fire, flood, storm damage, sabotage, business interruption etc. are usually arranged individually by each custodian. There should also be fidelity insurance coverage and professional indemnity coverage for risks relating to the fraudulent or erroneous actions of employees of the participants. The AUCD should also be covered by this type of insurance.

## **2 Clearing**

### **2.1 General Overview & Assumptions**

The purpose of the Clearing System is to prepare trades for settlement. The Clearing System supports trade reporting, trade correction and trade affirmation functions. Trade affirmation is required when a trade is executed for an Institutional Investor and the clearing broker/custodian is different than the settlement broker/custodian. The Institutional investor receives a confirmation of the trade from his settlement custodian named in the trade and instructs his settlement custodian to affirm or reject the trade. Where the trade is affirmed by the settlement custodian, the settlement custodian assumes the settlement obligation of the clearing broker/custodian named in the trade.

Not all brokers will have a custodian license as required by law to be a member of the AUCD. These brokers will have to have a correspondent relationship with a member of the AUCD who will assume the clearing and settlement obligations for the non-member broker. The identity of these ineligible brokers will be part of the trade information record and included in the relevant reports and inquiries.

The Clearing System will examine all trades for whether they are eligible for contractual settlement wherein the AUCD guarantees the net settlement obligation or whether the trade is to be processed as a Trade for Trade transaction whereby the AUCD assumes no settlement responsibility but does provide the accounting and control process for a Delivery versus Payment facility between the original parties to the trade.

### **2.2 Accepting Trades from National Market System**

Trades are received by the Clearing System at the end of each trading day. Trades in non-depository eligible securities will be rejected and returned to the submitting member of the National Market System. These trades will continue to follow rules and procedures in effect prior to implementation of the AUCD. Trades requiring physical settlement are not accepted in the AUCD Clearing or Settlement process.

In order to clear and settle the trades, whether Contractual or Trade for Trade, certain information must be present, if required, in the trade record to guide the settlement process:

- Name of Executing Broker

- 2 Number of Custodian Sub-Account in which the trade will settle
- 3 Number of Custodian Sub-Account in which an Institutional Trade will settle, if not affirmed
- 4 Trade for Trade/Contractual Settlement Indicator
- 5 Client Account number (required for Institutional Trade)

#### **2.2.1 Illustrations Of Trade Types**

2.2.1.1 Individual Investor Trade—The individual investor will have an account with a custodian and the investor will decide which brokers will have the authority to execute trades.

on their behalf. The Individual Investor may utilize the brokerage services of the custodian with which he has a custodial account or he may utilize the services of a broker who has a contractual agreement with the Individual Investor's custodian which permits the broker to manage the holdings designated as under the control of the broker. The matched trade record then would contain the following:

- 1 The identifier of the executing broker
- 2 A custodian sub-account number which identifies the custodian sub-account in which the trade will settle who will perform both the clearing and settlement function
- 3 Trade for Trade indicator, if applicable

***System function***

- 1 Add the trade to the custodian clearing account
- 2 Mark trade as *unsettled*
- 3 Mark trade as "contractual settlement" or Trade for Trade

2.2.1.2 Institutional Trade—Institutional investors utilize the services of Custody Banks which will in Ukraine be Custodians in the AUCD. The Institutional Investor often utilizes multiple brokers for trade execution but only utilizes one custodian for the settlement of the institution's trades. The custodian for the institutional investor requires that the AUCD communicate trade confirmations to the custodian and if the custodian agrees with the trade, the custodian settles the trade on behalf of the Institutional Investor. This is true both for a contractual settlement or a Trade for Trade settlement. If the custodian does not agree to settle the trade on behalf of the Institutional Investor, the settlement obligation remains with the executing broker and his custodian or if the broker has no agreement with a custodian to clear and settle the broker's trades, the trade will not settle because the broker has no ability to clear or settle a trade in the AUCD. The example which follows assumes that the executing broker is not an employee of the custodian but is rather a broker who has a contractual relationship with an AUCD to clear and settle his trade obligations. The matched trade record then would contain the following:

- 1 The identifier of the executing broker
- 2 A custodian omnibus sub-account number which identifies the custodian
- 3 The Executing Broker Proprietary Sub-Account (which will be utilized to settle the trade should the custodian not affirm the trade on behalf of the institutional investor)
- 4 Client Account Number
- 5 Trade for Trade Indicator, if applicable

***System function***

- 1 Add the trade to the executing broker's custodian clearing account and mark trade as *unsettled* and *unaffirmed*

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- 2 Produce a trade confirmation and communicate to the settlement broker/custodian
- 3 Upon receipt of affirmation move trade settlement obligation to settlement broker/custodian by relieving the trade from the executing broker's custodian clearing account and adding the trade to the settlement broker/custodian clearing account and mark trade as *unsettled*
- 4 Mark the trade as "contractual settlement" or Trade for Trade

2.2.1.3 Proprietary Sub-Account Trade—A proprietary account trade occurs when a broker or a custodian trade for their own account, i.e. the broker is the beneficial owner of the securities in the account. These security holdings must be kept separate from the omnibus account (should one exist) for the broker or custodian. The matched trade record would then contain the following:

- 1 The identifier of the executing broker
- 2 A custodian proprietary sub-account number which identifies the broker or custodian proprietary account that will be utilized in the settlement function
- 3 Trade for Trade indicator, if applicable

### *System function*

- 1 Add the trade to the custodian clearing account
- 2 Mark trade as *unsettled*

Mark trade as "contractual settlement" or Trade for Trade

## 2.3 Reporting Trades

New trades, accepted or rejected, are reported to broker/custodians at the end of each day.

### *System functions*

- 1 Produce a report of all buys and sells for each executing broker at the end of each trading day and send to marketplaces which submitted the trades. In addition, each settling custodian named in the trade will receive a report of all buys and sells for each executing broker.
- 2 Produce a trade confirmation for all Institutional trades which involve an executing broker that is not an employee of the named settling custodian. a report of all unaffirmed trades for each custodian at the end of each day.
- 3 Produce a report of all affirmed trades for the Institutional Investor's custodian and the executing broker and his custodian.
- 4 Produce a copy of all reports for the AUCD.

## 2.4 Trade Inquiries

The AUCD has access to all available on-line information in the system. Broker/custodians will receive file transfers of the trade data and will provide their own in-house inquiry facility. Broker/Custodians will have no on-line inquiry access to the system.

For AUCD staff, the system will allow inquiries on all

- 1 unsettled trades
- 2 unaffirmed trades
- 3 settled trades within a six month time frame

## 2.5 Trade Affirmation Processing

If the Settlement broker/custodian does not agree with the details of the trade, changes can be made and submitted to the clearing broker/custodian to the trade. If the clearing broker/custodian does not accept the changes, they can return the confirmation to the settlement broker/custodian with further changes. This process of sending modified confirmations between the clearing and settlement broker/custodian can continue until the morning of settlement date. Once the settling and executing broker agree on the changes, the broker will determine if a new trade is required in order to accomplish the agreed upon changes. If no new trade is required and agreement is reached the changes are entered into the system via the affirmation process. Change can be made to the basic terms of the trade such as price and quantity but only for a lesser price or quantity.

### System functions

- 1 Accept a change to the status of the trade from *unaffirmed* to *affirmed*. The affirmations will be delivered to the AUCD via file transfer from the settlement broker/custodian or via paper delivered to the AUCD for input by authorized employee of the AUCD. For valid, affirmed trades, generate offsetting entries (money and securities) to the executing broker/custodian clearing account and to the settlement broker/custodian clearing account, effectively moving the obligation to settle the trade on settlement date from the executing broker/custodian to the settling broker/custodian.

## 2.6 Trade Correction

Broker-to-broker trades cannot be corrected once they are locked in by a member marketplace of the National Market System and accepted by the AUCD, but corrections can be made to the investor side settlement instructions for a trade (i.e., the client identifier was entered in error). Where the confirmation/affirmation process has been invoked, the settlement terms contained in the confirmation may be changed by the executing broker and the terms contained in the affirmed confirmation will be used in the settlement process.

Broker to broker trades can have the settlement instructions changed anytime up to the settlement date. The investor side of trades that do require affirmation by a settlement broker/custodian cannot be changed once affirmed.

### System functions

## All Ukraine Clearing Depository Functional Specifications

- 1 Process changes to the investor side of broker to broker trades that are entered by the executing broker Changes are communicated to the AUCD via the marketplace which originally sent the matched trade to the AUCD utilizing the trade number generated by the AUCD and as communicated in the Purchase and Sales Report to the Clearing broker/custodian Direct communication with the executing broker's Participant Services Representative of the change will suffice while volumes are low and in case of emergency The trade corrections can be sent as a file transfer at the end of each trading day
- 2 Process changes to the investor side of unaffirmed trades All changes must be entered by the executing broker
- 3 Where a change is made to the Custodian Sub-Account in an *unaffirmed* trade, a new confirmation is required and the old confirmation should be removed from the unaffirmed file

### 2 7 Trade Cancellation

Trades can only be canceled by the marketplace which submitted the trade Canceling a trade affects both the buyer and the seller and both the broker and the investor sides of the trade Canceling a trade will also cause the custodian component of institutional trades to be canceled whether affirmed or unaffirmed

A cancellation of a trade can only take place before settlement date The system will provide a complete audit trail of all canceled trades

#### System functions

- 1 Remove the associated trades from the appropriate broker/custodian (buyer and seller) clearing accounts
- 2 Adjust the unsettled and unaffirmed records in the broker/custodian (buyer and seller) depository accounts
- 3 Produce a report of all canceled trades for the involved executing brokers, settlement custodians, and the AUCD

### 2 8 Managing Clearing Accounts

Because short selling is not encouraged in Ukraine, it is expected that a AUCD broker/custodian will rarely find himself in the position of being unable to deliver the securities required to meet his sell obligations Because of the settlement guarantee policy of the AUCD, trades accepted for contractual settlement will not be permitted to fail but will be supported in the settlement process through the execution of a Buy In

#### System functions

- 1 On Settlement Date all "buys" and "sells" for each security for each depository clearing account are netted Where the result of the netting process results in a net "sell" or short balance, the short balance is applied against the applicable custodian clearing account The shares are moved by the "net seller" custodian from the seller's depository sub-account, omnibus or proprietary, into the clearing account

## All Ukraine Clearing Depository Functional Specifications

- 2 If there were insufficient shares available to satisfy the net short position requirement any remaining short share balance in the clearing account is recorded against the responsible AUCD participant and subject to Buy In processing
- 3 A broker/custodian can prevent the Buy In process by making the required shares available to the AUCD to fulfill the Buy In quantity requirements anytime before the Buy In is executed The broker/custodian can cover the default by an inter-account transfer from the custodian's proprietary account to the AUCD Buy In account

**Buy In Process** Assuming the custodian does not cover his short position as explained in above the following steps will occur

- 1 The AUCD custodian responsible for the depository sub-account which paid for but did not receive its securities will be notified of the default and told of the Buy In being performed on its behalf
- 2 The moneys that would normally go to the seller is re-directed to the AUCD Buy In Account along with a record of the Buy In required
- 3 The AUCD Surveillance Department will prepare Buy In Orders for execution on one of the NMS Trading System marketplaces The Buyer will be the AUCD utilizing the funds in the Buy In Account at the Settlement Bank and if necessary, the Settlement Guarantee Fund
- 4 The Buy In should be for the earliest possible delivery date to reduce the liquidity risk faced by the buyer The Buy In should be a Trade for Trade transaction
- 5 Should the Guarantee Fund need to be deployed to compensate for any shortfall generated in the Buy In, the AUCD custodian will be required to replenish the Guarantee Fund for the shortfall
- 6 The Buy In trade should have a fee associated with it which is punitive in nature
- 7 The AUCD Surveillance Department will monitor the settlement of the Buy In Trade and upon completion of the trade will enter an Inter account Transfer moving the securities to the original buyer of the failed trade
- 8 Unlike the Sell Out Process, it is not recommended that there be any delay in the Buy In Process Money has been paid without delivery of the securities and the deprived buyer is losing access to certain benefits of ownership that the AUCD would be expected to compensate for In addition the system will not permit the sale of the Paid For but not received securities
- 9 Should a record date have occurred during the period that the securities were in a Paid for but not received status, the AUCD will assume responsibility for seeing that the aggrieved buyer receives the corporate entitlements that went with the Record Date process

## All Ukraine Clearing Depository Functional Specifications

- 10 A partial delivery may have been made to the receiving custodian. The Buy In procedures must recognize that this is the case.

The Buy In process discussed here permits sufficient controls over the process which will result in the Paid For but not received securities being delivered to the aggrieved buyer. Should there be no securities available at any reasonable price, the AUCD will have the right to refuse to honor the settlement commitment. The funds will be returned to the original buyer along with reasonable compensation for the inconvenience. If a partial delivery was involved in this aborted Buy In, the aggrieved buyer has the right to reject the partial delivery and upon return of the shares should receive the confirmed contract value. The failing broker/custodian will be responsible for all damages associated with the failure. The Buy In process is an exception process which is supported by a proper mix of automation and manual procedures. Additional automation can be considered when warranted.

### Sell Out Process

On Settlement Date, the AUCD custodian and the Settlement Bank will receive a settlement statement. On settlement date, the AUCD custodians have until the Funds Due cut off time at the Settlement Bank to have the necessary funds in the AUCD account at the Settlement Bank. Should the Settlement Bank be unable to collect all or a portion of the funds due, a settlement default will be considered to have taken place. The AUCD will provide the required settlement funds through various means at its disposal, e.g. excess operating funds, letters of credit, etc. As a last resort, the Settlement Guarantee Fund will be employed to cover the default monies. The consequence of a settlement default for money will result in the AUCD taking control of all contractual settlement deliveries being directed to the defaulting custodian. The AUCD in concert with the defaulting AUCD custodian will determine which deliveries if any should be completed and which should be Sold Out. The Sell Out of defaulted buy transactions will take place on the NMS System as Trade for Trade transactions with either negotiated settlement dates or normal rolling settlement. The choice of settlement cycle is the AUCD's.

What follows is the sequence of events when a AUCD custodian fails to meet his money settlement obligation.

- 1 The Settlement Bank immediately notifies the AUCD Settlement Department of the default.
- 2 The AUCD Settlement Department instructs the Settlement Bank how the funds are to be provided. If necessary, the bank is instructed to move funds from the Settlement Guarantee Fund in the exact amount to cover the default amount. The AUCD Surveillance Department will request the system to mark all long securities in the clearing account of the defaulting custodian for delivery to the AUCD Sell Out account.
- 3 The System will proceed with the Pass Two Settlement Process transferring control over the default shares to the AUCD Sell Out account.
- 4 The AUCD Surveillance Department will review the share deliveries in its account which are marked for Sell Out. The following sub-processes will take place.

## All Ukraine Clearing Depository Functional Specifications

- a The AUCD and the AUCD custodian review the share deliveries which are being held in the AUCD Sell Out Account Agreement is reached on which security holdings should be re-delivered to the original depository sub-account identified with the failed settlement and which should be Sold Out
  - b The AUCD Surveillance Department will complete the agreed upon re-deliveries through use of the Inter-account Transfer
  - c The AUCD Surveillance Department will prepare Sell Out Orders for delivery to the NMS System for execution The Seller will be the AUCD utilizing its depository holdings in the Sell Out Account and all proceeds of the sale will go to the AUCD
  - d An outcome of the review in Step a could reveal that the funds will be available in a time satisfactory to the AUCD In which case, the AUCD would hold the Sell Out Orders awaiting the funds and should the funds arrive, the AUCD would perform the re-deliveries as in step b Should the funds not arrive, the Sell Out Orders would be released and penalties increased
  - e Because of the share netting effect, it is always possible that the day's deliveries may not be sufficient to cover the money settlement deficit If this were to be the case, the AUCD would review the detail buys and sells which netted and decide which holdings within the broker/custodian's depository sub-account(s) should be frozen by the AUCD or moved to the Sell Out account until a decision can be made as to whether they will be required for a Sell Out
- 5 Clearing and settlement will be controlled by the Settlement department for money and share settlement Care should be exercised in determining settlement date so that if the Settlement Guarantee Fund was used, the Settlement Guarantee Fund does not become undercapitalized
  - 6 As each Sell Out trade settles, the AUCD must make certain that the Settlement Guarantee Fund is reimbursed for monies borrowed
  - 7 It is possible that the total proceeds of the Sell Out Trades may be for greater than the default amount This could happen If at the completion of the Sell Out activity total reimbursement to the AUCD has been made including any penalties levied, the AUCD will return the excess to the AUCD custodian
  - 8 Where the Sell Out trades do not generate sufficient monies to cover the amount owed the AUCD, the custodian will be notified to make up the shortfall or face further punitive action
  - 9 Should a Record Date occur during the period that the AUCD is holding the Sell Out securities in its Sell Out account, the AUCD will accrue all rights and entitlements

The Sell Out processes discussed here permit sufficient controls over the security holdings which have not been paid for This is an exception process which is supported by a proper mix of automation and manual procedures Additional automation can be considered when warranted

## **2.9 Clearing Balancing & Reconciliation**

All custodians' clearing accounts should end the day with a zero share balance. If however there have been any fails to deliver, the share shortage is moved to the AUCD Buy In Clearing Account. The offset to this short position is a Fully Paid for position in the custodian sub-account on whose behalf the Buy In is being performed. The Buy In account should balance to the Fully Paid For positions or there is a problem with the system.

Custodians will maintain a clearing account in their internal accounting systems which is a parallel account to the clearing account for the custodian in the AUCD. The custodian will want to ensure that these two accounts are reconciled periodically and that any differences are researched and corrected.

### **3 Settlement**

#### **3.1 General Overview & Assumptions**

Settlement is the exchange of unencumbered (i.e., “free”) securities for funds. Settlement will be book-based (i.e., directly interfaced to the Clearing Depository System). The system is to provide two forms of settlement, Contractual Settlement and Trade-for-trade Settlement. These forms of settlement are philosophically different and have distinctly different processing characteristics. Consequently, each form is explained separately starting with Contractual Settlement.

##### **Contractual Settlement**

What Contractual Settlement means is that the AUCD guarantees to deliver securities that have been bought and paid for and will take responsibility for dealing with the situation where the sold securities have not, in fact, been delivered by the selling broker/investor. Similarly, the AUCD guarantees to deliver funds for securities that have been sold and delivered. By posting contractual settlement trades to a clearing account, the extent of the AUCD’s guarantee to deliver securities becomes the net long position by security for all trades posted to that clearing account. The obligation of the broker to deliver securities to the AUCD is similarly the net short position by security showing in the clearing account. In the case of funds, the net figure to pay or receive will be calculated across all trades in the clearing account.

##### **Trade for Trade**

Trade-for-trade is used in its purest sense. Each trade is settled with an explicit delivery of fully-paid-for securities against an explicit payment of “good” funds for these securities. There is no netting of either securities or funds in the settlement of trades in the Trade-for-trade system; settlement remains strictly between buyer and seller. Similarly, there is no guarantee of settlement provided by the AUCD for trades tagged to settle on a Trade-for-trade basis.

##### **Settlement Cycle Processing**

The system will use a two pass process to effect settlement. The first pass creates the Settlement Statements for all custodians and deals with the obligations (securities and funds) between broker/custodians and the AUCD. The second pass of the settlement cycle deals with settlement obligations (securities only) between the AUCD and their broker/custodians.

The settlement cycle assumed in this document is a three day settlement cycle (T+3 is settlement date). Both securities and money will settle on the same day (T+3) in a DVP environment. This is merely for purposes of illustration. The settlement cycle can be changed to one more suitable to the Ukrainian circumstances.

Trade for Trade transactions will settle within the system's settlement cycle unless the transaction contains an override settlement date in the original trade submission from the National Market System

### **3 2 Settlement Statements**

Settlement Statements provide settlement broker/custodians with their net cash position on settlement date. All trades that have reached settlement date will appear on the settlement statement for the custodian and will form part of the net cash calculation. The net cash position for a custodian is to either pay funds to the AUCD or receive funds from the AUCD.

Settlement statements are produced on the first pass of the settlement cycle. Trade for Trade settlement obligations are listed separately and never netted.

#### **System functions - first pass**

- 1 On the morning of T+2 produce a Preliminary T+3 Settlement Statement for each custodian. If the custodian has no settlement activity on that day, produce a "nil" report.
- 2 The Settlement Statement will list all trade obligations due for settlement and the money amount due to or due from the AUCD. These trades are posted to the custodians Clearing account.
- 3 The Settlement Statement will list all unaffirmed trades that will settle against the broker/custodian clearing account.
- 4 On the morning of T+3 process any affirmations received the night before.
- 5 On the morning of T+3 net all buys and sells and make required deliveries into the custodian's clearing account. This movement of shares into the clearing account will then make these shares available for re-delivery to net buyers. Should there be any fails to deliver, the money implications will have to be taken into consideration in creating the revised Settlement Statement to be prepared.
- 6 Flag all trades included on the Settlement Statement of T+3 so that they do not appear on the Settlement Statements of subsequent days.
- 7 At the completion of First Pass, produce final Pay and Collect figures with instructions to the Settlement Bank for delivery and receipt of same. These instructions are contained in a summary report indicating which custodians are due to receive or due to pay funds to the AUCD.

#### **System functions - second pass**

- 1 On the afternoon of T+3, determine if all funds owing to the AUCD have been paid to the Settlement Bank (see next section). If all funds have been received, increase the depository clearing account balance for all net buyers. If the funds have not been received from that custodian, the depository clearing account is not increased for the net buy. The securities are moved from the broker/custodians clearing account to the AUCD Sell Out account and they will be sold-out by the AUCD in order to recover the unpaid funds (see *Handling Fails*).

### **3 3 Transferring Funds**

The AUCD handles cash at the custodian level, not at the client investor level  
Broker/custodians deal with the cash side of trades at the individual investor level

The cash to be received from custodians or paid to custodians is detailed on the Settlement Statement produced during the first pass of the settlement cycle. A summary report is produced for the Settlement Bank and acts as instructions to the Settlement Bank to receive funds from custodians for credit to the AUCD's settlement account or disburse funds from the AUCD's settlement account to the custodian. These instructions are issued on the morning of T+3. Confirmation of cleared funds credited to the account of the AUCD must be received by the agreed upon cut off time which would permit the funds disbursements from the AUCD's account at the Settlement Bank to be made on T+3 to the custodian designated as a net receiver of funds.

Once payments due to the AUCD are received and verified, they are applied to the clearing accounts of the appropriate settling broker/custodians.

#### **System functions**

- 1 Print a Settlement Statement indicating the net cash position for each custodian with the details of each transaction and a Summary of amounts due to and due from custodians for the Settlement Bank
- 2 Provide for posting funds received by the AUCD into the custodian's clearing account and allow for correcting postings
- 3 Print a final list of payments received and not received based on the payments due
- 4 Indicate to the second pass of the settlement cycle, which custodians have failed to pay all or some of the funds due from their Settlement Statement
- 5 Where it is known that there will be a short position in a custodian's clearing account, the funds associated with that short position are excluded from the calculation of net funds for that custodian. The funds associated with the short position are moved into a Buy In account and held by the AUCD to cover the cost of the Buy In.

### **3 4 Handling Fails**

Failed trades can occur at two levels

- 1 a custodian fails to pay funds,
- 2 a custodian fails to deliver securities,

The custodian's failure to have the required funds or securities and the remedial measures to be taken by the AUCD is covered in Section 3 8 on Managing Clearing Accounts

### **3 5 Book Entry Settlements**

Depository sub-account balances are reduced by the net sell for that ISIN on the particular settlement date. The other side of this transaction (required for double entry bookkeeping) is the custodian's clearing account.

## All Ukraine Clearing Depository Functional Specifications

Depository sub-accounts cannot contain a short security position. If after the netting process, the net quantity required for settlement would in fact cause a custodian sub-account to go short for any reason, the settlement quantity that would cause the negative depository position will be rejected in the Pass 1 process on Settlement Date. The short position remaining in the custodian's clearing account will be moved to the AUCD Buy In account and the selling custodian's depository sub-account would remain with a zero balance (See *Buy In Process* in the Managing Clearing Accounts Section)

At the beginning of the second pass the system will determine if the custodian has paid all funds owing to the AUCD (i.e., the clearing account of the custodian does not have a debit cash balance). If all funds have been received, the custodian clearing accounts are increased by the net buy trades. The other side of these transactions (required for double entry bookkeeping) is the delivering custodians' clearing account(s). If all funds have not been received, the AUCD Sell out accounts are increased by the net buy quantity being moved from the delivering custodian clearing account(s). After all movements have been made from the delivering custodian clearing accounts to the receiving custodian clearing accounts the Intra-Account transfers from the custodian clearing account to the appropriate depository sub-account should be made. These Intra-account movements should be transmitted by the custodians to the AUCD before the Pass One process commences. The Intra Account Movements will be based upon the Preliminary Settlement Statement, the custodians records and his knowledge of any changes that impact the Preliminary Settlement which would result in a different Final Settlement Statement. As a result of these Intra-Account movements, the securities side of all market custodians' clearing accounts should be flat at the end of the second pass of the settlement cycle. However, if there was a failed delivery, one or more custodians could have a *failed to receive* from the AUCD resulting in a long position in their clearing account. Long positions in the clearing account should be classified as Fully Paid For and be moved to the custodian depository sub-account(s) account and remain with that classification until the AUCD completes the required Buy In process and moves the securities into the clearing account.

### System functions

- 1 Apply all net sell share deliveries and fully paid for net buy receives (per the Intra-Account movements) that have reached settlement date to their respective depository sub-accounts and the appropriate custodian's clearing account according to conventional double entry bookkeeping rules
- 2 Ensure that a reduction in a depository sub-account from a net sell delivery will not create a short position in the omnibus or proprietary depository account and reject that quantity that would create such a short position. As a result, the custodian's clearing account is updated for the actual quantity delivered and the short quantity will be moved to the AUCD Buy In Account
- 3 Drop from the system all unaffirmed trade confirmations that have reached settlement date

### **3 6 Fees**

### **3 7 Penalties (As a Result of Buy In/Sell Out Processing)**

### **3 8 Cash Balancing & Reconciliation**

The Settlement Statement is a critical report in the balancing and reconciliation process. The Settlement Statement describes the net cash obligations that each custodian has to pay or receive from the AUCD on a daily basis.

In general, the money to be received into the AUCD from custodians for settlement purposes should equal the amount that is to be paid out to those participants who are due to receive funds from the AUCD on a daily basis. There are the following exceptions to this rule:

- 1 Where penalties and fines are levied and collected through the Settlement process
- 2 The Settlement Statement includes settlement fees payable to the AUCD

In both of these cases, the amount paid out will equal the amount to be received, however, a portion of the amount to be paid will be paid to the AUCD rather than a custodian.

Several sources need to be considered when balancing the net intake of funds to the net outflow of funds. In the event of a failure to pay by a broker, the Settlement Guarantee Fund, operating funds, lines of credit, etc., must also be considered as a source of funds.

There is also a need to balance to the bank statement issued by the Settlement Bank on daily basis. It is possible for the Settlement Statement to indicate that everything is in balance, however, due to an error in the AUCD records or the Settlement Bank records, there could still be a serious financial problem.

The funds set aside in the AUCD Buy In accounts must be balanced and reconciled with the AUCD security positions that are in the accounts. The money balances shown in the Buy In accounts should also appear in the bank statement of the AUCD as money held in the account.

There is a need to reconcile any borrowed funds used to finance custodian settlement defaults with the amount that is in default and the Sell Out process underway to recover the funds.

#### **System functions**

- 1 Produce a report that reconciles the funds to be received and the funds to be paid out through the settlement process each day
- 2 Produce a report that reconciles the funds held in AUCD Buy In accounts with the short positions in that account
- 3 Produce a report listing the securities held as collateral in the Sell Out account

### **3 9 Settlement Cap**

Every broker/custodian will be given a settlement cap based on an evaluation of their financial resources. Each depository eligible security will be given a margin value based on the market price volatility of that security.

## All Ukraine Clearing Depository Functional Specifications

Daily, each unsettled trade will be valued. The value will be derived by multiplying the quantity of the trade by the current market price and the margin value. The result is a calculated trade value.

The calculated trade value is compared to the original value of the trade and a delta is calculated. Positive deltas are ignored and negative deltas are used to decrease the settlement cap value. A report is produced showing broker's whose settlement cap is below zero or approaching zero. AUCD management will use this report to contact broker/custodians who have exhausted their settlement cap.

### System functions

- 1 Maintain settlement caps for each broker/custodian
- 2 Calculate the values of unsettled buy trades
- 3 Compare the calculated trade value to the original trade value and generate a delta amount
- 4 Reduce a broker's settlement cap by all negative deltas
- 5 Produce a report showing those brokers that have exceeded or are approaching their settlement limit
- 6 Provide a feature whereby when the AUCD decides that the settlement cap should not be exceeded, all trades which would cause the cap to be exceeded would be automatically changed to Trade for Trade status

### 3 10 Settlement Reporting

Following is a summary of the reporting requirements for the Settlement System

- 1 A daily Settlement Statement specifying the settlement obligations of every custodian. A custodian will have a net amount to pay to the AUCD, a net amount to receive from the AUCD or a zero balance. A Settlement Statement will be produced in all three cases. A copy of this report is required for each custodian and for the AUCD.
- 2 A daily Settlement Summary produced from the Settlement Statements. This report will list the custodians due to pay funds to the AUCD and the amounts to be paid, the custodians due to receive funds from the AUCD and the amounts to be received. One copy of this report will accompany the payment instructions issued to the Settlement Bank.
- 3 At the end of the second pass of the settlement cycle, a report describing the status of all custodians' clearing accounts.
- 4 A report of all Buy In and/or Sell Out activity generated by the system.
- 5 A report showing the content of all Buy In and Sell Out accounts with a non-zero balance.
- 6 A report showing all brokers exceeding their settlement cap or with a settlement cap approaching zero.
- 7 A report of activity in the Settlement Guarantee Fund including payments made into and out of the fund and the collateral retained in support of those payments made from the Fund.

8 A Report of future settling trades

## **4 Depository**

### **4.1 General Overview & Assumptions**

The Depository System will support the operations of the AUCD. Broker/custodians and Issuers of dematerialized securities can open an account in the AUCD to support the Initial Public Offering (IPO) or the safekeeping of Treasury Stock.

Custodians will at a minimum maintain one omnibus sub-account for their clients and one proprietary account for their personal holdings. Additional omnibus and proprietary accounts may be opened when the custodian agrees to allow a broker to manage one or more custodian client accounts. The custodian sub-account number is a critical link between the National Market System and the Depository System. In the event that an incorrect depository sub-account is entered at the time of trade input, the correct depository sub-account number must be entered before the trade settles.

### **4.2 Depository Functions**

#### **4.2.1 Opening an Account**

The AUCD will open all accounts for participants.

##### **Process Flow**

- 1 Participant completes application and legal agreement with AUCD,
- 2 AUCD reviews application, legal agreement and verifies broker and custodian licenses of applicant, in the case of Issuers no license requirements exist,
- 3 AUCD retains copy of all documents in their new accounts file and sends original off site to records retention center,
- 4 AUCD assigns depository sub-account number(s) and enters application into "Open Account Screen",
- 5 depository account application is filed in date order,
- 6 System produces report of all new accounts

#### **4.2.2 Account Maintenance**

Changes may be required to a participant's account information for various reasons such as, the signing of a new contract with a non-member broker who will utilize the custodian for clearance and settlement of the non-member's trades, a change of address or change of name. The participant will complete an account maintenance form with the details of the information to be changed. The Depository will also determine that the changes are being requested by the account holder by inspecting their identification. Account maintenance forms are forwarded to the AUCD for entry into the Depository System.

##### **Process Flow**

- 1 Participant completes and signs account maintenance form with changes required,
- 2 AUCD checks for authorized signature and completeness of form,

## All Ukraine Clearing Depository Functional Specifications

- 3 AUCD files a copy in their account maintenance files and forwards account maintenance form to records retention center,
- 4 AUCD enters the changes in an "Account Maintenance Screen" and files account maintenance form in date order

### 4 2 3 Closing an Account

The AUCD is responsible for opening and closing accounts for participants and will close an account upon the written request of the participant

Once the data is entered, the system will check to ensure that there are no securities or pending activity remaining in the account. If this is true, the account will be closed by the system. Back-dated entitlements which occur for a closed account will be posted to a suspense account.

### 4 2 4 Deposits

The only securities that will be accepted for deposit are securities that have been made depository eligible by the AUCD. Each custodian will have access to a query facility to learn of depository eligible securities. When a deposit request is made by the custodian, the AUCD system will check that the security is eligible for deposit.

**4 2 4 1 Certificated Registered Security**--A deposit form will be completed by the custodian and submitted to the Registrar together with the security certificates or a certificate of immobilization and a transfer to "AUCD Sub-registry" form signed by the investor or nominal holder. The transfer form will instruct the Share Registrar to transfer the ownership from the nominal holder or beneficial owner to the nominal holder name of the sub-registry held by the AUCD. The share certificates or certificates of immobilization should be clearly marked "CANCELLED" utilizing a nonerasable substance.

When the Registry completes the transfer to the control of the sub-registry in the AUCD, the AUCD will be notified of the depository sub-account, beneficial owner and client account to be credited for the deposit and a new certificate of immobilization prepared. A copy of the certificate of immobilization will be kept by the AUCD on its premises and the original will be sent off site for recordkeeping purposes.

The Registrar will keep all certificates processed in the course of this transaction. The Registrar should punch holes through the certificates to further prevent the certificates from accidentally being used in a fraud. The cancelled certificates should be stored for the length of time required by the law on evidence. The cancelled certificates should be stored in a safe records retention area.

### Process Flow

- 1 AUCD custodian enters deposit transaction into AUCD system, examines appropriate documents and forwards documents along with transfer document generated as a result of the deposit transaction to the Registrar,
- 2 AUCD custodian sends transmittal to Registrar by courier each day,
- 3 Registrar confirms to AUCD the transfer into the nominal holder name of the AUCD, by electronic record,

#### 4 AUCD confirms deposit to custodian

##### 1 Deposit to custodian

**4.2.4.2 Non-Certificated**—As of January 6, 1999, the two forms of non-certificated securities will be combined into one. This discussion will therefore only deal with the non-certificated form which is currently in the MFS. The procedure to deposit the global certificate both the temporary and the permanent is known but is briefly explained here. When an issuer first pursues the non-certificated route to support a new issue, he gives a temporary global certificate to the AUCD until the actual amount of shares to be issued are known. When the issue size and its ownership is finalized and certified by the issuer, the new global certificate is given to the AUCD along with an electronic record of all nominal holders, custodian sub-accounts, client numbers and beneficial owner information for the issue. The electronic records would be edited for eligible securities and depository account numbers. Transactions failing the edit will be suspended. The acceptance of the responsibility for keeping the record of holdings for the issue is not final until all suspense items are researched and resolved. Until that time, the security will not be eligible for clearing and settlement services.

##### 4.2.5 Materialization

The AUCD must have the ability to accept a transaction which will permit holding positions in the AUCD sub-registry to be materialized if the security is of the Registered Certificated type. The investor, through his custodian, requests that the AUCD withdraw the position from the investor's account with the custodian and instruct the registrar to move the shares from the AUCD sub-register to the main registry and issue a share certificate in the investor's name.

A Materialization request may not cause a depository account to go "short". At the time the Materialization request is entered by the AUCD, the system will verify that the account has sufficient quantity to fulfill the request, otherwise the transaction is rejected.

The custodian will transmit the Materialization request by file transfer or terminal to AUCD where the request will be entered into the Depository System. The system will check that the investor has sufficient balance to service the request. In the case of an Omnibus account, the system will be checking against the aggregate position of all investors having positions maintained in that account. If there is insufficient position, the system will reject the transaction and produce a report of all rejected transactions at the end of the posting cycle.

Included with the Materialization request will be registration instructions to be used by the registrar to update the registry and produce the certificates for the investor. The registration instructions will be forwarded to the registrar by the AUCD together with the Materialization request. The new certificates will be forwarded by the registrar to the requesting custodian for re-delivery to the investor.

#### Process Flow

## All Ukraine Clearing Depository Functional Specifications

- 1 the custodian confirms the identity of the investor and completes the Materialization form together with registration instructions,
- 2 the custodian transmits the Materialization form to the AUCD via file transfer or terminal where it is entered into the Depository System,
- 3 if the transaction is rejected, a report is produced and forwarded to the custodian,
- 4 the system will reduce the depository account for the withdrawn quantity and move the quantity to a "pending status" and recording date of submission to registrar,
- 5 the AUCD will forward to the registrar, the registration instructions together with a signed transfer form requesting the movement of shares from the sub-registry to the main registry,
- 6 the registrar will enter the change of registered ownership (plus beneficial owner, minus AUCD) in the share register for the Issuer and produce a share certificate evidencing the new registration,
- 7 the registrar forwards the share certificate to the AUCD who forwards the share certificate by courier to the custodian for re-delivery to the investor and the "pending" status indicator to complete and records the date of entry in the registrar's books ,
- 8 Custodian receives report of both successful and rejected withdrawals,
- 9 System prepares an Aged Materialization Report for the AUCD to monitor service levels of the Registrar(s)

### **4 2 6 Inter-Account Transfers—for free**

Inter-account transfers are defined as movements of security positions between depository accounts for "free" (i.e., there is no cash settlement associated with the transfer) Inter-account transfers are always initiated by the custodian who currently holds the position in their account (the transferor) or the AUCD operating under authority of its rules

The custodian will complete an inter-account delivery request screen which will be processed at close of business or at the opening of the next business day

The AUCD depository system will check to ensure the transferor has sufficient "free" quantity to satisfy the transfer request If the "free" quantity is not sufficient, the transfer transaction is rejected and a report is produced for all rejected transfer transactions This report is forwarded to the custodian in electronic form Where the inter-account delivery request was successful, the system will produce an electronic notice to be sent to both the transferor and transferee confirming the transfer

#### **Process Flow**

- 1 Custodian completes an inter-account delivery request screen entry,
- 2 AUCD system determines if there is sufficient quantity to satisfy the transfer,
- 3 an insufficient quantity will result in the transfer transaction being rejected with notification to the transferor,
- 4 if successful, system produces notice to transferor and transferee,

- 5 custodian receives report of both successful and rejected transfers,

#### **4 2 7 Inter-Account Transfers—for money**

Inter-account transfers for money are defined as movements of security positions between depository accounts for money in a DVP environment. The AUCD will function as an Electronic Trade Comparison provider and expect that both deliver and receiver enter the necessary data to generate the agreement to deliver/receive. The movement of shares and money will take place on Trade Date +3 or the override settlement date.

##### **Process Flow**

- 1 Custodian completes an inter-account delivery or receive versus payment instruction
- 2 AUCD performs the matching function
- 3 Transactions which match proceed to settlement in the Trade for Trade or Contractual Settlement Systems
- 4 Transactions which do not match are returned to submitter and forwarded to the named contra party for possible resolution

#### **4 2 8 Intra-Account Transfer**

Intra-Account Transfers are utilized by the custodian to make the appropriate deliveries into his clearing account to settle his net sell settlement obligations or appropriate deliveries from his clearing account to the appropriate sub-accounts to settle his net buy settlement obligations.

##### **Process flow**

- 1 Each custodian should prepare the required intra-account transfers by settlement date and submit them through the communications system
- 2 There should be at least one intra-account transfer per security which has a securities settlement
- 3 The number of intra-account transfers required per security will depend on the number of sub-accounts involved in satisfying the required delivery either from or to the custodian's clearing account

#### **4 2 9 Suspending Securities**

Securities can be suspended for trading settlement purposes. A suspension is entered or removed by the AUCD. Trades already accepted by the system will continue to settle but no new trades will be accepted from the National Market System on suspended securities. Suspended securities cannot be transferred through an inter-account transfer except by the AUCD. This will thwart attempts to effect off-market settlement of suspended securities.

#### **4 2 10 Suspending Accounts**

This activity will preclude new trading activity from being recorded on the books of the AUCD for clearance and settlement. All currently pending activity would be permitted to complete. All safekeeping and depository activities would be allowed.

#### **4 2 11 Blocked Positions**

The system has the capability of blocking securities from having its ownership changed without specific intervention on the part of the AUCD. While this is a broad definition statement and the system has the basic infrastructure for implementing the blocking function to serve many purposes, the implementation of the feature will start with just two major blocking functions. These two functions will permit the AUCD to duplicate the two legally required blocking functions of the Registrar. The two functions are as follows:

1. Blocking will function to honor Ukrainian court or empowered government agency directives to freeze specific assets, all or partial quantities, of an AUCD broker/custodian security holdings as recorded in the AUCD. The AUCD will not be more responsible for the consequences of executing this function than a Registrar is currently today. Should a review of current Registrar rules be silent on the subject then the AUCD rules should specifically exempt the AUCD from any accountability for actions of the court or government agency.
2. Blocking will function to perfect the lien of a Lender should an AUCD custodian wish to borrow money utilizing the securities for which they are the owner (proprietary account) and which are not already blocked. The request for the block is initiated by the AUCD custodian and the AUCD will perform the blocking function at the directive of the AUCD custodian.

Recording of the block involves not just the blocking of access by the owner of the securities but recording who is in control of the securities and has the authority to remove the block. The removal of the block may result in the securities being returned to the control of the original AUCD custodian or the movement from the depository account of the owner to the depository account of another owner.

Because the AUCD custodian, Ukrainian court, government agency or lender is now in control of these securities, the owner of the blocked securities can only regain control by the court, government agency or lender authorizing the return of control.

Securities held in an omnibus sub-account while subject to blocking are blocked within the records of the AUCD custodian responsible for the omnibus account and not in the records of the AUCD. The exception to this would be if a Ukrainian court or government agency specifically applied their directive to the omnibus account as opposed to a client of an omnibus account.

#### **Process Flow**

1. Function One as defined above. The court order or government agency directive must be delivered in writing to the AUCD offices. The order or directive will be for the blocking of specific amounts of specific securities.

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The AUCD will apply the block as directed and the Court or Government Agency will be placed in control of the blocked securities. Before anyone can be recorded in the system as being in control of securities they must first be recorded in the AUCD system as a AUCD custodian. The court or government agency would be a special category of participant with no capability other than to be placed in control of securities. No trading or security settlement activity can take place in such an account nor would any billing apply. The AUCD would send a statement of blocked securities to the owner, the AUCD custodian, and the Courts or Government Agency.

The removal of the block would be by written directive of the Court or Government Agency. The block removal would either return control to the AUCD custodian who had been in control at the time of the block or the directive would be for seizure of the blocked securities. The removal of the block would be on a record by record basis as indicated in the directive. The seizure would be likewise. The AUCD would perform the function.

2 Function Two and Three as defined above. The AUCD Custodian will request the AUCD to block securities for purposes of obtaining a loan from a lending institution. The blocking request will be as follows:

1 specific amounts of specific securities.

The AUCD custodian will forward the request for the blocking and the AUCD will apply the block(s) as requested. The Lender should be recorded in the AUCD system as being in control of the securities. A statement of the blocked securities will be forwarded to both the borrower AUCD custodian and the lender.

The removal of the block would be by written directive of the Lender. The block removal would either return control to the AUCD custodian who had been in control at the time of the block or the directive would be for seizure of the blocked securities. The removal of the block would be on a record by record basis as indicated in the directive. The seizure would be likewise. The AUCD would perform the function.

3 Seized securities are moved to Special Accounts set up to accommodate the seizure by non-participants of the AUCD and ownership changes to the Holder of the Special Account. The assets in these accounts must be withdrawn or moved via an Inter Account Transfer to a custodian for safekeeping. They cannot be left in the Special Account indefinitely.

4 Blocking and unblocking are accomplished through use of a block/unblock code. The AUCD will perform the block and unblock against the depository holding records of the AUCD Account Holder.

5 Seizure is accomplished through use of the Inter Account Transfer. The AUCD will perform the seizure against the depository holdings records of the AUCD Account Holder which are currently blocked.

Blocking as defined here is not expected to be a major function of the AUCD but it is a requirement which must be capable of being done from the opening day of the AUCD. Registrars today are presumed to be required to perform the function and therefore the AUCD must do the same. The functionality is achieved through use of common AUCD transactions,

viz the Inter Account Transfer, a block/unblock quantity by reason process plus AUCD procedures

#### **4 2 12 Dormant Accounts**

There is no action required for accounts with positions but with no activity. The system will provide an ad hoc report facility for accounts with no positions and no activity. This report can specify the period of inactivity.

#### **4 2 13 Fees and Billings**

These must be decided on in the future. Transaction based fees will be applied and processed through the system on a daily basis but collected on a cyclical basis to be determined.

#### **4 2 14 Balancing and Reconciliation**

Where AUCD is the sub-registry, the total positions for each security in the sub-registry at the AUCD must agree with the registrar's record of total quantity in the AUCD sub-registry. Periodic reconciliation is required between the records of the AUCD and the registrar. At initial implementation of the AUCD, the reconciliation should be on a daily basis. The system will provide reports on the total holdings by security in all depository accounts for comparison with the records of the registrar. The reports will include deposit and pending withdrawal transactions.

For non-certificated securities, the total quantity in the AUCD depository positions must be balanced and reconciled to the total amount of the global certificate on a daily basis.

#### **4 2 15 Reporting**

The following reports will be produced by the system for the AUCD and AUCD Custodians:

- 1 daily net position and activity report for all transaction types
- 2 daily report on deposit activity
- 3 new accounts
- 4 account maintenance
- 5 exception report on rejected inter depository account movements
- 6 exception report on rejected withdrawals
- 7 fees and billings - list of charges
- 8 holders of record by date by security

#### **4 2 16 Inquiries**

On-line inquiries are only available to the AUCD staff. Inquiries are available for:

- 1 transaction history on accounts
- 2 unsettled trades
- 3 unaffirmed trades

4 deposits and withdrawals

## **5 Corporate Actions/Entitlements**

### **5.1 General Overview & Assumptions**

In order to process corporate actions the system must be able to prepare an accurate list of the Beneficial Owners for a security on the effective date of the corporate action. Corporate actions are processed based on positions in a depository account. Therefore short positions evidenced in the Buy In Accounts would not be included in the list of Beneficial Owners but the AUCD would know to whom a corporate entitlement is owed. For Sell Out accounts the Beneficial Owner is the AUCD.

There are, in general, three types of corporate actions and each type has its own effective date:

- 1 Distribution types of corporate actions such as cash and stock dividends, rights and warrants where the distribution takes place on a payable date based upon the list of Beneficial Owners established on Record Date
- 2 Capitalization types of corporate actions such as mergers, splits, name changes etc. where the effective date is usually the close of business on the record date
- 3 Privilege types of corporate actions such as tender offers and conversions which usually have expiration dates after which time the investor can no longer take advantage of the privilege

The system in its initial implementation will handle the following types of corporate actions:

- 1 cash dividends
- 2 stock dividends
- 3 splits
- 4 Beneficial Owner Lists for use by the Registrar in handling Administrative Activities such as voting, mailing annual reports, etc

#### **Common System Functions**

- 1 The system maintains a diary including the record date, the effective date and other information about the nature of the corporate action. The AUCD will update the diary system when the facts of a corporate action are known.
- 2 The system automatically produces a data base of Holders of Record at the Proprietary Account and Omnibus Sub-Account Holder level at the close of business on the record date for all securities that have a corporate action pending.
- 3 The AUCD balances the total position shown on the Holders of Record report to the AUCD sub-registry position maintained by the registrar. Any discrepancies must be investigated and resolved.
- 4 For cash dividends, stock dividends and splits on immobilized securities, the registrar will furnish the cash or authorization to distribute electronic shares for all securities on the books of the registrar in the name of the AUCD as nominal holder.

- 5 The system calculates entitlements based on holdings for each depository sub-account and distributes the cash dividend, stock dividend and splits according to the reconciled Holders of Record from Step 3 above. Should the result of the distribution result in a fractional share to any depository sub-account, the fraction should be subjected to a cash in lieu process and the results entered into the daily settlement figure for the custodian.
- 6 Where the Registrar has requested a list of Beneficial Owners, the AUCD must request that its custodians furnish a list by Beneficial Owner which balances to the total securities in the Holders of Record data for the Record Date. The Beneficial Owners data base is then forwarded to the Registrar in electronic form.
- 7 For dematerialized securities, the balancing step with the Registrar is omitted from the above steps.

Once the records of the AUCD and the independent registrar or global certificate are in balance, the corporate action is processed according to the parameters laid out in the following section.

Late announcements for corporate actions present special problems. In some cases, the payment date for a dividend may have passed by the time the late announcement becomes known. The system must be capable of reconstructing Holders of Record reports for late announcements. Further, the AUCD custodians must be capable of producing Beneficial Owners data retroactively.

## **5.2 Corporate Actions**

### **5.2.1 Cash Dividends**

The Issuer's Paying Agent will pay the AUCD the cash dividends owed to the AUCD as supported by A Holders of Record data base which is produced for the Record Date and balanced to the records of the independent registrar or global certificate share amount. The AUCD will use this data base to pay the cash dividend to the custodians via their daily Settlement Statements.

Where there is a security position in a Buy In account on the record date, the cash dividend owed must be calculated and collected on payable date and remitted to the contra-side on the failed trade. The custodian who has paid for but not received the securities is not carried on the books of the AUCD as the owner. The money will be collected and paid through cash adjustments in the daily settlement process.

#### **System Functions**

- 1 The system includes a diary system for entering information about cash dividends. This information will include the record date, the payment date and the dividend rate (i.e. UAH per share).
- 2 On the record date for cash dividends produce a Holders of Record data base on a security by security basis.
- 3 Allow updates to the Holders of Record report based on the reconciliation with the independent registrar (immobilized security) or within the AUCD (dematerialized).

- 4 Because the AUCD is not receiving the cash dividend for the securities in the Buy In accounts, the system will have to collect the dividend via the Payable Date daily settlement statement from the original defaulter and pay the dividend to the custodians with a Fully Paid for but not Received share balance

### **5 2 2 Stock Dividends**

Stock dividends will be applied directly to the depository sub-accounts. A Holders of Record report will be produced and reconciled with the records of the registry.

The registrar will furnish the AUCD with the authorization to pay the dividends owed to the AUCD custodians. Where fractional shares are calculated in the distribution of the shares received from the registrar for credit to the depository accounts, the fractions will be subjected to cash in lieu processing with the cash proceeds being processed through the daily settlement. The AUCD will sell the leftover securities to cover the cash in lieu processing.

Where there are short positions in a Buy In account on record date, the Holders of Record data base will note that fact and it will be necessary to short those accounts on payable date for the amount of the stock dividend owing on the short positions and additional shares purchased via the Buy In procedures. The additional shares will then be distributed to the Paid for but not Received share positions in the system. This will be controlled manually as each Buy In is performed.

On payment date the registrar will confirm the total amount of the stock dividend payable to the AUCD. This amount will be longed to a special distribution account in the AUCD.

The AUCD will distribute the stock dividend to all depository sub-accounts according to what was held on record date. The system will long the depository sub-accounts and short the special distribution account. At the end of this process the special distribution account should be flat.

If the special distribution account is long after all processing is completed, this will indicate that fractions were involved and the remaining position represents the rounding of the dividend at the depository account level. The AUCD will sell the excess shares and place the proceeds into the dividend revenue fund of the AUCD.

### **System Functions**

- 1 The system includes a diary system for entering information about stock dividends. This information will include the record date, the payment date and the dividend rate (i.e. the number of additional shares per original share).
- 2 On the record date for stock dividends produce a Holders of Record data base for all sub-accounts on a custodian by custodian basis.
- 3 Allow updates to the Holders of Record report based on the reconciliation with the registrar.
- 4 Identify short positions in Buy In accounts on the record date and calculate the dividend owing on those short positions. If the dividend owing includes a fractional amount, round the dividend up to the next whole share. The dividend will be subject to Buy In under the same rules that apply to the short position in the Buy In account. Upon completion of the

Buy In(s) the stock can then be distributed to the Paid for but not Received share positions under control of the Surveillance department

- 5 Upon confirmation from the registrar that the dividend has been paid, release the dividend into the system Depository sub-account positions are updated according to their holding on record date A special depository account is used as the “other side” of the transaction for balancing purposes
- 6 Produce a report of all transactions through the special depository account The closing balance in this account should be zero A long position in this account represents fractional shares that may be sold

### **5 2 3 Stock Splits**

- 1 Stock splits will be applied directly to the depository sub-accounts utilizing the same procedures as described in Stock Dividends

### **5 2 4 Reverse Splits**

Reverse splits will be handled in a manner reverse to that specified for the stock split

### **5 2 5 Rights & Warrants**

The issuance of rights and warrants will occur through the registrar who will utilize the Holders of Record data base produced by the AUCD on the Record Date All rights and warrants processing will occur outside the AUCD environment until such times as it is justified as an imperative feature

#### **System Functions**

- 1 On record date for the issuance of all rights and warrants produce a Holders of Record data base on a sub-account by custodian basis
- 2 Allow updates to the Holders of Record data base based on the reconciliation with the independent registrar and the need to cover short positions in Buy In accounts

### **5 2 6 Name Changes**

Name changes result from changes made to the security master file If there is no change in the ISIN number, there are no processing implications to the depository system Where there is a change in the ISIN number, it is necessary to convert all existing positions in depository sub-accounts to the new ISIN number

#### **System Functions**

- 1 Convert all existing positions, unconfirmed and unsettled trades to the new ISIN number
- 2 Maintain an audit trail from the old ISIN number to the new ISIN number such that any references to the old ISIN number can be switched to the new ISIN number

### **5 2 7 Tender Offers**

To be defined at the appropriate time

## **6 Archiving**

### **6.1 General Overview & Assumptions**

At month end all transactions in the system which are more than 3 months old will be taken off the system and spooled to an archive file. The archive file will be retained for 5 years.

Archived transactions will need to be restored back into the system for research purposes. There needs to be a link to new ISIN numbers if there has been a change since the archive file was made. Inquiry functions must be on a date-select basis.

Back-ups of all files are required on a daily, weekly and monthly basis. Daily back-ups are recycled weekly, weekly back-ups are recycled and monthly back-ups are retained for 5 years.

## **7 Role of the Settlement Bank**

In the settlement of security transactions the AUCD will use a specific bank for the payment and receipt of funds. This bank will be referred to as the “Settlement Bank”. All custodians must use the Settlement Bank when settling trades with the AUCD, whether the trade involves the receipt or payment of funds.

There are two principal issues to be considered in selecting the Settlement Bank:

1. the ability to “clear” funds such that the AUCD is guaranteed that funds paid on settlement day are irrevocable, “good” funds,
2. the ability of the Settlement Bank to provide sufficient risk management on the custodians such that the payment of settlement funds proceeds smoothly.

### **7.1 The Ability to Clear Funds**

The AUCD must be assured that the funds received from its custodians in settlement of their obligations are irrevocably committed to the AUCD and are not subject to reclaim at a future date (known as “good” funds). The delivery of securities is contingent upon the receipt of “good” funds. The AUCD will turn around and pay these funds out to custodians who are in a net position to receive funds each day. Therefore, the AUCD must be able to rely on the funds received through the Settlement Bank. The custodians must be able to rely on the fact that funds received from the AUCD are also irrevocable and can be used for other purposes.

### **7.2 Risk Management**

A key consideration in the discussion of risk management is the convention that all settlements will take place on the settlement date. This convention is very important for a Settlement Bank. In the case of the settlement of retail trades this convention usually will not present any problem as the broker should already be in possession of the funds from the client. These funds can be moved to the Settlement Bank prior to the issuance of payment instructions from the AUCD. Where a broker decides to extend credit to an investor (i.e., commits to a purchase before receiving funds) potential problems can arise if the investor ultimately fails to pay the funds required to settle the trade on settlement date. Each day the Settlement Bank will be required to pay funds to the AUCD on behalf of the brokers that are in a net position to pay funds. The broker may or may not have sufficient funds in its account with their local bank for subsequent forwarding to the Settlement Bank to meet the payment required. The custodian’s bank, depending on its credit policies with its clients may wish to extend credit.

If the Settlement Bank does not receive the required good funds per the commitment by the broker to pay funds to the AUCD, there will be serious implications for the broker, the AUCD, for the broker’s clients and potentially for the entire market. The AUCD will treat the failure to remit funds as a failure to pay on the part of the custodian. Where the original trade followed the contractual settlement process, the AUCD will, if necessary, make good on the amount of the default out of the Settlement Guarantee Fund and will hold the defaulting broker’s securities as collateral for the amount of the default payment. The AUCD will sell

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out the securities received by the defaulting broker, securities that may already have been paid for by the clients of the custodian

Custodians who are prepared to extend credit privileges to their clients by accepting purchase orders prior to receiving funds will require a line of credit from their local bank. The intention would be to establish a line of credit which is sufficient to meet the normal settlement needs of the custodian and to prevent the local bank from refusing to honor a payment request to the AUCD's account at the Settlement Bank. The local Bank will presumably require adequate collateral in support of this line of credit.