Capital Markets Project

USAID and Capital Markets Development in Ukraine 1995 – 2010

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Acknowledgements

Many USAID/Kyiv officials, private sector Ukrainians, and Government of Ukraine leaders contributed to and caused a major transformation of Ukrainian capital markets. These people deserve commendation. To mention all important actors from 1995 to 2010 would be impossible, but permit me to name a few:

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Ukraine Capital Markets: The list of committed and effective Ukrainians that helped build Ukraine's capital markets is long and impressive. It includes many leaders from the capital markets community, including central securities depository leaders of MFS and AUSD, securities exchange leaders, Government officials, bankers, broker-dealers, fund managers, and others:

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Executive Summary

This paper examines efforts by USAID and Ukrainians acting in concert for almost a decade and a half to develop capital markets to enhance economic growth. It reviews the efforts that USAID supported to establish three critical elements of effective capital markets: 1) a reliable central securities depository; 2) transparent and fair securities exchanges; and, 3) an efficient system of information disclosure about publicly listed companies. This paper outlines the rationale for the USAID support for capital markets reform, details the travails of project implementation, and offers lessons learned.

The rationale for USAID support of these three initiatives was compelling. When Ukraine asserted its independence in 1991, it had no stock exchange, no central securities depository, no market-based legal and regulatory framework, and no reliable disclosure of financial information. The communist economic system had collapsed, and privatization of state owned enterprises on a massive scale was occurring.

Achieving mass privatization required a secure method to record and protect stock ownership rights, so that ownership would not be lost or diluted by unauthorized acts of management. That custodial function is performed by a central securities depository that records the transfer of stock from seller to buyer and reconciles the share registry. This protects the voting of ownership rights at shareholders' meetings and the ability to buy and sell shares. That is fundamental for providing investors the confidence that a stock purchased is indeed a valuable and owned asset.

USAID provided funds and technical expertise to support the development of a central securities depository to achieve this necessary custodial function, now called the AUSD (All Ukraine Securities Depository) that effectively handles 99% of Ukrainian securities transactions. USAID and the World Bank continued support for this privately owned central securities depository despite attacks from a few who would benefit from a non-transparent and Government owned and operated securities depository. The details of this sustained support, and the challenges endured, are presented in this paper.

Privatization, and encouraging the purchasing of stocks, required a method to buy and sell them, and thus the need for a securities exchange. An exchange provides a transparent forum to discover the prices of stocks, and provides a link to a method of clearing and settlement that ensures the bargain made will occur: that shares and money will be securely transferred. USAID provided funds and technical expertise to assist the development of the PFTS (First Stock Trading System) based on the NASDAQ system, and to assist the legal and regulatory regime and capacity of the securities regulator, the SSMSC (Securities and Stock Market State Commission). This paper documents USAID efforts that resulted in several world class securities exchanges operating in Ukraine under regulatory oversight that is informed and diligent - - all acting in accord with international best practices.

If one is to invest via a securities exchange, with custodial ownership protected in a central securities depository, the first requirement for evaluating a purchase is reliable financial information. Such information flows from internationally accepted accounting standards, and a method to disseminate that information. USAID supported extensive training on International Accounting Standards and Financial Reporting Standards with the accounting profession, corporate CFOs, and SSMSC. USAID provided funds and technical assistance to develop a reliable disclosure system for financial information. The result is ESCRIN (electronic system for comprehensive information disclosure) based upon the U.S. SEC model, adopted and operated by the SSMSC, providing accurate and timely financial information via web-based access free of charge to the public. This paper details how USAID efforts, with dedicated SSMSC Commissioners and staff, resulted in Ukraine now having publicly available financial information, electronically, on all listed joint stock companies.

This paper also outlines several lessons learned. The first is the importance of linkages. Capital markets activities are highly linked and require simultaneous development. Securities markets only succeed in gaining investor confidence if all of the following are in place: clearing and settlement systems that ensure shares and money transfer simultaneously and reliably; a central securities depository that registers and maintains reliable ownership records; corporate governance procedures that protect shareholder rights; accounting that is accurate, in accord with IAS, and transparent via periodic public filings; Government agencies that effectively license exchanges, broker-dealers, collective investment funds, and monitor financial behavior, investigate and penalize fraud. Also linked are the Government policies on tax, fiscal, monetary, and privatization issues. Similarly, proper legal foundations are essential, such as a modern civil code and laws on shareholder and creditor rights, judicial enforcement of contracts, and protection of property rights. All of these inter-connected activities must be addressed properly to achieve a prevailing Rule of Law environment that fosters confident expectations about performance of contractual obligations in the capital markets, which creates economic growth.

Second, Ukraine illustrates that caution is necessary when USAID operates in a country where politics and business are keenly intertwined, and opportunities for corruption are vast. In a nation that operated for seventy years under central government control, political control over businesses is hard to relinquish, and temptations alluring. This means that USAID must be alert to Government and business cronyism and corruption, and be willing to address it - - as the U.S. Embassy and USAID in Ukraine have - - when the wrong behavior is so public that it will harm the overall success of capital markets development.

Third, remember that the circumstances calling for capital markets development in Ukraine, and most of the Former Soviet Union, were unusual. Ukraine has a highly educated population, a diverse economy, and infrastructure in place for water, sanitation, housing, transportation, and health. Restructuring of the economy had to occur because of the collapse of the communist economic regime, to be replaced by a market-based economic system. In these circumstances, USAID assistance was appropriate for developing capital markets. In nations without these precursors, or with dire needs for clean water, sanitation, health care, and personal security - - then priorities would be different.

Fourth, capital markets development is not *sui generis:* proven systems exist for securities trading, clearing and settlement, central securities depositories, and are commercially available. Use them. Likewise, rules and procedures governing capital markets activity are well established in financial centers around the world. Use them. Capital markets are inter-connected internationally and entering that connection should be a goal. Doing so means following IOSCO, OECD, and other respected standard-makers on best international practices.

Finally, facilitate profitability. Use the fact that securities markets provide opportunities for profit. Remember, the fact that macroeconomic benefits flow from properly structured exchanges is of little consequence to the investor who only seeks profit. But these macro-benefits will most rapidly flow from a securities exchange which, in the first instance, provides conditions for profit-making. Thus, design efforts to assist emerging capital markets by answering one question: what is required for investors to use an exchange *profitably*? Distilled to this essential question, it matters little whether securities exchanges operate with chalk boards or hand signals or with Stratus computers and palm-top terminals. What truly matters is *reliability* in three areas.

Reliability that trades clear and settle. Reliability that the custodial function protects ownership rights. Reliability that one can buy *and* sell on an informed basis, with price transparency, and with ease. Reliability here means a full confidence in the routine. This is like the confidence that your car will start or that the subway train will arrive to take you to work. One’s confidence fades if the car sputters or the train fails to show - - then you seek alternative transportation. So too will the investor quickly abandon a securities exchange with questionable clearance and settlement, doubtful custodial protection, or uncertain financial information and exchange liquidity.

Put simply, USAID efforts in Ukraine demonstrated that capital markets development in an emerging economy can be jump-started by establishing three fundamental requisites: dependable trading, and clearance and settlement systems; a strong custodial registry and shares depository system; and reliable financial information, readily available, that helps builds exchange liquidity.

Importantly, these three requisites must be accompanied by, and indeed flow from, a Rule of Law environment. It is critical to establish an institutional framework via a securities regulatory body (SSMSC) that effectively licenses, monitors, and enforces proper behavior by market participants.

This paper finds that the results of USAID's efforts in developing capital markets in Ukraine were transformative, and a model for such initiatives elsewhere.

USAID and Capital Markets Development in Ukraine 1995 – 2010

The success of a USAID capital markets development project cannot be measured like a stock portfolio, or company earnings, on a quarterly basis. Years, not months, of sustained good efforts are required for the achievement of success. Time, plus a commitment by the local citizens to reform their commercial laws, regulations, and financial institutions' operational practices, are essential for success in capital markets development. Unlike a new bridge to transport goods - - a bridge that you can point at or walk on - - capital markets development projects have layers of un-noticed requirements where the most valuable commodity USAID offers is not steel and concrete, but rather expert tenacity applied over time through Technical Assistance.

This report tells the story of three USAID successful capital markets development efforts in Ukraine, conceived fifteen years ago, tenaciously implemented, which have improved the economic well being of Ukrainians. USAID focused on achieving three objectives: 1) a central securities depository that is reliable; 2) a securities exchange that is transparent and fair; and, 3) a financial information disclosure system for publicly listed companies.

Why USAID Supports Capital Markets Development

Water is to agriculture as capital is to an economy. Businesses need capital to grow, to create jobs, to allow citizens to prosper and engage in productive activities that enhance purchasing power and thus create more jobs, and to generate taxes to support government. Government needs capital to fund public infrastructure projects, help its needy citizens, and support nation building.

Economic growth is enhanced in every nation with robust capital markets. Empirical evidence from a sample of eighty countries over a thirty year period shows that capital markets development breeds economic growth. The results are higher rates of GDP growth, increased investment, higher productivity, greater economic opportunity, and social well-being. Capital markets development reduces barriers to market entry for start-up companies, enhances competition, and creates new opportunities. "Free financial markets are the elixir that fuels the process of creative destruction, continuously rejuvenating the capitalist system."[1]

With the collapse of the Union of Soviet Socialist Republics, USAID decided to assist people from Almaty to Zagreb in developing their economies. Privatization on a massive scale was occurring, and that required securities exchanges, central securities depositories, legal and regulatory frameworks, and reliable financial information. Virtually all of these new-old countries have undergone privatization of most state owned enterprises (SOE), and developed functioning capital markets that facilitate investment, capital formation, job creation, and helped raised per capita incomes. When emerging market countries liberalize, they experience an average increase in GDP growth rate of over one full percent per year.[2] That is equivalent to US $2.3 billion annually for Ukraine.

I. Central Securities Depository in Ukraine

The first topic of this report on USAID capital markets efforts in Ukraine may seem odd - - the development of a central depository for stocks - - but it is not odd once one understands the critical function of a central depository for investors in every securities market in the world. A central securities depository plays a little known, but essential, role in any nation's capital formation process using securities markets.

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[1] Raghuram G. Rajani & Luigi Zingales, Saving Capitalism from the Capitalists (New York: Crown Business Books).

[2] Campbell Harvey and Christian Lundbald, "Does Financial Liberalization Spur Growth?" National Bureau of Economic Review working paper no. 8245.

USAID Capital Markets Leadership

In 1996, USAID commenced its project *Developing Securities Market in Ukraine* and within one year securities in blue-chip companies like Ukrnafta, Tsentrenergo, and Dniproenergo were trading on a newly created, USAID supported, stock exchange and providing price information for investors. USAID was a serious partner for those Ukrainians working toward market-based economic growth, and it supported the "Concept Paper on Ukrainian Capital Markets" adopted by the Verkhovna Rada in 1996. In March, 1997, the first central securities depository was created in Ukraine with USAID backing.

This paper will first clarify what a central securities depository does, and why its activities are critical to economic growth through capital markets. It will then review the pivotal role of USAID, and its ally the World Bank, in steadfastly supporting the creation and development of the central securities depository created by the private sector, the MFS (the Ukrainian acronym for the Interregional Securities Union). This is a story of USAID sustaining its commitment *despite* periodic, intense counter-efforts from certain Government of Ukraine officials, and their few private sector allies, to assert and impose Government control in contradiction to prevailing private sector preferences.[3] The result today of this USAID effort is a sophisticated private sector central securities depository that now handles 99% of the securities markets depository transactions in Ukraine, permitting the existence of securities markets where they never existed before.

What is a Central Securities Depository? A central securities depository is necessary to a well-organized capital market. It provides secure custody of ownership records of stocks. Very often the depository serves as a registrar and maintains a record of the owners of all securities for a company. For each broker-dealer and issuer, the depository maintains a record of its shares. Upon a securities trade and successful clearance and settlement, the depository records the transfer of the stock from the seller's account to the buyer's account, and then the depository reconciles the registry to insure that it is in balance. The depository/registrar often provides other critical services such as issuing material for annual shareholder meetings and payment of

[3] See Appendix 1 Central Securities Depository Development Chronology.

dividends, calculating the votes at annual shareholders meetings, and mailing other information required by law to shareholders.

Confidence Lost… and Money

"Shareholders are not defended without a central securities depository. Confidence in the stock market has been bruised by secret company meetings at which share registers have been altered. Because of this, the MMM investment fund collapsed costing millions of Russians their savings."

Dmitry Vasilev, Chairman of Russia's Federal Stock Commission, May 20, 1996.

While the ownership of the depository can take many forms, it is important that it be independent, free from abuse by a small group of market participants or government interference. When the depository/registrar is not independent, this fosters distrust. Too often in emerging economies, there are reports of ownership records being struck from the depository's registry, adversely affecting foreign and domestic investment and good corporate governance. For example, during Russia's early privatization efforts in 1995, a UK-based metals group, Transworld, purchased a 20% stake in the Krasnoyarsk aluminum smelter (the second-largest smelter in the world and then worth $60 million). Yet, within six months the Krasnoyarsk management decided it did not want "foreign meddling" at a shareholders' meeting, so they simply struck Transworld from the share registry. Because there was no central securities depository in Russia to protect ownership rights, and the Krasnoyarsk management controlled its own company registry, it could so wantonly act. An act that virtually ended foreign direct investment in Russia until the protection of foreign ownership rights was established.

The lack of independence in the depository/registrar functions has been particularly problematic in emerging economies. International experience has shown that investors will not enter - - or will quickly abandon - - a securities market that has an unreliable depository and thus doubtful custodial protection. Custodial protection is essential if investors are to believe they actually have share ownership, and that this ownership will not be lost or diluted by unauthorized acts of management. Without custodial protection, foreign investment will not occur - - or will cease - - and domestic funds will stagnate in banks, be hidden off-shore, or be invested in other nations, all deterring economic growth.

> **No Depository = Manipulation**
>
> The manager of Templeton Emerging Markets Investment Trust, the largest fund for the emerging markets sector in 1996, at over $465 million, complained:
>
> "India is still the worst market to deal in. I bought a stock 18 months ago. When it went up 150%, I wanted to sell it, but couldn't. It has now fallen 150%, but I still can't sell it. The depository registration has taken 500 days. Why? Because the company's president knows the best way to drive up the share price is to avoid the depository and restrict circulation."

When Ukraine asserted its independence in 1991, it had no stock exchange, no central securities depository, no market-based legal and regulatory framework, and no reliable financial disclosure. The State owned all major enterprises, and different approaches to mass privatization were being tried throughout the Former Soviet Union. In Ukraine, this meant the mass privatization of over 12,000 open joint stock companies (JSC) and 24,000 closed JSC. The total number of new owners/shareholders reached 17.5 million Ukrainians. Mass privatization would quickly create millions of first-time, unsophisticated shareholders with small stakes of shares. That situation posed an opportunity for some Ukrainians, often those who were managers of the businesses being privatized, to pursue the purchase and consolidation of small stakes of shares toward a controlling interest (25%) or a blocking interest (50%). These same individuals also understood that confirmation of ownership in a registry would be critical for two reasons: both to confirm their ownership of the securities, and to eliminate the share ownership of another person's ownership of the same securities. That situation facilitated efforts of local oligarchs with political influence to capture state owned enterprises (SOE). When Ukraine tried limited privatization without a central securities depository yet in place, rightful owners were too often deleted from company-kept registries, particularly of key industrial companies. Dniproshyna company stunned foreign investors when its managers dramatically diluted shareholder value by issuing new shares to themselves and a selected investor at a fraction of their market value.

USAID in Ukraine took on these privatization challenges, and in 1995 commenced supporting inter-connected efforts such as establishing a transparent stock exchange, reliable custodial record keeping, corporate governance and information disclosure, and drafting related laws and regulations. USAID, in close coordination with the World Bank, has effectively assisted a diligent SSMSC and private sector Ukrainians, and sustained capital markets projects every year since then.

Why are Securities Markets Important?

Why are securities exchanges - - and their requisite facilities the central securities depository and the clearing and settlement systems - - important for the growth of the Ukrainian economy? There are multiple reasons:

- Price discovery, providing independent valuation of company performance.
- Intermediation between buyers and sellers.
- Promotion of capital flows.
- Reduction in capital formation costs.
- Transformation of savings into investment.
- Corporate governance.

Securities markets provide a price discovery mechanism. This information is valuable to mobilize capital effectively. The idea of price discovery was also particularly appealing to nations undergoing a massive transition from SOE to privatized companies. Because it is difficult to accurately value a massive number of SOE being newly privatized, if some shares were already traded in the securities market then potential investors could see how the marketplace values a company. The more liquid the securities market, the more accurate and hence valuable the price information would be. However, because of many flaws in the various privatization schemes tried in the Former Soviet Union nations, securities markets during the initial privatization transformation did not provide informed price discovery.[4] Yet, beyond that aberrational one-time period, the price discovery function remains valuable to efficiently allocate capital.

Securities markets provide a place for citizens to invest their savings. Liquid, safe, and transparent securities markets permit citizens to invest their money so that over time they receive a return that at least matches, and hopefully surpasses, inflation. That was not possible with Ukrainian bank deposits, or with hard currency "under the mattress."

Securities markets are also important for the success of *funded* pension reform. Nation's everywhere now recognize the insustainability of the "pay-as-you-go" pension system of transfer payments from an ever-smaller workforce to an ever-greater retired population (Pillar I); and thus have enacted funded systems called "Pillar II" and "Pillar III" pension reform. Pillar II envisions some level of *mandatory* contributions by workers with a limited amount of a worker's wages being invested in the domestic securities markets through individual accounts of and belonging to the worker. Pillar III systems encourage *voluntary* contributions that are likewise invested in mostly domestic capital markets, and accumulate tax-free, also in individual accounts. The objectives with Pillar

[4] The promise of quick economic transformation based upon voucher privatization using securities exchanges and investment funds did not work. In many nations the opportunity to grab and loot proved too tempting. And, absent enforcement for a delict, compelling.

The Ukrainian voucher privatization program limited enterprise directors and workers to a purchase of only five percent of shares for voucher certificates, and an additional five percent for cash. This incremental approach to shares acquisition was adopted by Ukraine out of fear of repeating the mistakes made in Russia's large-scale mass privatization program where old managers became new owners and often looted the enterprises. The result was that this Ukrainian approach prohibited strategic investors from purchasing large enough blocks of shares to insist on real change at companies. And, it also led to the fraudulent capture of shares by business managers from unsophisticated voucher holders. This approach of incremental ownership in Ukraine is one of the main reasons why privatization did not bring the benefits from privatization to Ukraine that occurred in Poland, Hungary, Czech Republic, and East Germany. Those countries generally limited domestic voucher privatization to 40%, and then held tender offers for a 60% stake being sold to one strategic foreign investor that had experience in the sector, and a good management record.

Privatization efforts that sell controlling blocks to pre-qualified foreign corporations that have a history of success in the same industry do well. The method to achieve this was detailed in the USAID supported research: Background for Financial Markets Development in Ukraine. Charles Seeger and Hugh Patton, 2000, Privatization Chapter, pp. 36-43. http://www.fmi-inc.net/news/pdfs/greenbook.pdf

II and III systems are to force and promote savings to enhance later pension payment levels, create pools of capital that can be an engine for economic growth, and reduce the burden on the pay-as-you-go "Pillar I" system.

Securities markets can also provide the mechanism for international portfolio capital to gain exposure to different emerging markets. Twenty years ago a diversified portfolio of a major U.S. pension fund or mutual fund might have less than 5% of its assets in emerging markets. Today, 15% or more is the norm in the emerging market asset class. And, portfolios are now common that are 100% invested in emerging markets. Such funds specialize in equity exposure via Indian funds or Eastern European funds - - but those investments require good local securities markets to capture that exposure. A good local securities market can thus attract needed international capital to the nation.

Longer term, securities markets provide a forum where enterprises can raise money. Companies will be able to turn to the securities markets and accomplish initial public offerings, or secondary offerings, and raise less costly capital for expansion and job creation.

Securities markets provide an "exit strategy" for strategic investors. Strategic investors buy big blocks of shares, and invest "know-how" and capital in enterprises. But such investors need an exit. In other words, assuming every aspect of the business plan goes well, how do investors get their principal back and capture the return? If there are liquid securities markets where a public offering of shares can be executed, this can provide the needed exit strategy, and domestic and foreign strategic investors will be more likely to invest in Ukraine.

Securities markets play a key role in corporate governance. The price of shares of a company listed on a stock exchange rises and falls, and thereby provides a kind of "report card" on management's performance. That is, if management performs poorly, or if a firm has poor corporate governance practices, shareholders "vote with their feet" (i.e., sell their shares), and this puts downward pressure on the share price. A lower share price, in turn, puts pressure on management to improve performance. The pressure is most acute, of course, if managers themselves own shares – then they personally feel the pain of the declining share price. Conversely, if managers of one firm see the managers of another firm with good corporate governance practices gaining wealth from the firm's rising share price, this will encourage these managers to introduce good corporate governance practices at their own firms. Or, if the share price becomes cheap enough, the company can be taken over and the management fired by the new owners. The fear of this possibility can be an effective incentive for management to perform.

Overview of Ukraine's Capital Markets

What *were* the trading hours of the *Kyiv Stock Exchange*?

Yes - - let us not forget how steep was the road from a communist economy in 1991 that did not tolerate and had no need for stock markets, to a market economy today where a Ukrainian securities exchange, PFTS, trades shares with a market capitalization of US $564 million on over 900 listed securities at the market peak in early 2008.

When USAID opened its Mission in Kyiv in 1992, seventy years of a USSR central controlled economy was all Ukrainians knew. However, the collapse of the USSR was instructive because it was widely viewed as the failure of an economic regime based upon communalism, and its former citizens wanted to try free markets for free people. Because mass privatization was occurring for over 36,000 SOE, representing an unprecedented economic restructuring, USAID Ukraine decided to support economic growth through the following Technical Assistance efforts:

- Creation of a securities exchange, PFTS (the Ukrainian acronym for the First Stock Trading System).
- Legal, regulatory, and oversight expertise to the Securities and Stock Market State Commission (SSMSC).
- Systems and operational expertise for the central securities depository, MFS (Ukrainian acronym for Interregional Securities Union).

- Legal and policy drafting support for the Verkhovna Rada and Cabinet of Ministers on capital markets development issues.
- Accounting and corporate governance reform, including disclosure of business plans and financial information by issuers of securities.

In short, USAID provided early critical support for Ukraine's economic development on virtually every function required to help develop previously non-existent capital markets infrastructure. Each multi-million dollar USAID initiative had its successes and travails. The cumulative positive impact for Ukraine is undeniable when one reviews the successes of its current functioning capital markets system that operates in accord with best international practices (or is striving to do so) with full knowledge of the necessary laws, regulations, and operational systems.[5]

History of USAID support for the Central Securities Depository

One illustrative successful capital markets component is the central securities depository that serves 99% of the securities transactions. Its lineage starts with the 1996 efforts of USAID supporting the creation of a securities exchange, the PFTS, and the follow-on effort to establish the central depository, the MFS, as an open joint stock company, transparent to the SSMSC and public, and operating in accord with international best practices of a central securities depository.

In 1997, the initial founders of the MFS were the leading banks, stock exchanges, and broker-dealers of Ukraine. This ownership structure, comprised of leading market participants, matches international practice where banks play a key role as custodians and act on behalf of their clients as broker/dealers.[6] The long serving

[5] This economic impact is quantified *infra* in this paper's section on Economic Impact.

[6] Key actors were Ukrsotsbank; First Ukrainian International Bank (PUMB); Oschadny Bank; Privatbank; Business Invest; Sea Transport; Slavutych Capital; PFTS Stock Exchange; and National Bank of Ukraine. The ownership structure initially was: 62.5% to banks, 25.9% to broker/dealers, 10.8% to exchanges, and 3 (0.8%) to others.

As will be detailed *supra*, the ownership changed in 2008 with the transformation of MFS to AUSD (All Ukraine Securities Depository), with the respected National Bank of Ukraine receiving 25% ownership in the new AUSD. Importantly, 75% remains under private control of banks and securities market participants.

leaders of this central securities depository, Mykola Shvetsov and Yuriy Shapoval, have consistently sought to implement international best practices since the beginning.

The MFS began as an open joint stock company, filing its annual report with the SSSMC and making it available to the public. Because cost of transaction execution is a critical factor for all market participants, the fees charged and operating costs are kept at a minimum. It services the accounts of over 4,100 market participants including issuers, custodian banks and traders, stock exchanges, securities registrars and foreign depositories, who hold securities, equity and debt, in electronic format (dematerialized form) rather than certificate form. It performs depository and clearance and settlement functions (transfer of securities positions) only for electronic securities. In compliance with international norms, it has established a Delivery vs. Payment (DVP) system using an account at the National Bank of Ukraine (NBU).

The MFS earned an excellent reputation among all market participants for its honesty, competency, and transparency of operations. The MFS maintained this reputation despite attempts by certain individuals in the Government and a few industrial allies to impede its activities.

Its operations are based on the North American model of depositories. An analysis of the flowchart of the operations of the depository shows that it mirrors the Canadian Depository for Securities (CDS), except that it does not handle the money settlement portion of transactions.[7] It immobilizes the securities in its nominee account for the custodian/broker-dealer. Once the custodian/broker-dealer representing the buyer electronically wires the funds to the MFS Special Depository Account at the NBU, it matches the order and the funds. It then transfers the securities to the custodian brokers account for the purchaser, and electronically transfers funds to the custodian brokers account for the seller from the MFS Special Depository Account. If the custodian is a bank, the funds are wired to its account at the NBU. If it is not a bank, then the funds are wired to the broker/dealers account at its bank.

[7] See Appendix 2 Clearance and Settlement. The mechanics for this little understood and yet critical function for successful exchange operations are detailed here.

Memorandum of Understanding on a Market-Owned Central Securities Depository between the Government of Ukraine, Government of United States, and World Bank

After the founding of the MFS with USAID support to achieve a state-of-the-art privately-owned depository, the USAID and World Bank gained agreement with key Government of Ukraine officials that the private sector was to be the engine of economic growth. The private sector would be developed so as to have the capacity to generate the needed resources to complete market reforms in Ukraine. These efforts by the World Bank and USAID with key Government of Ukraine officials occurred in the context of the mass privatization effort underway at the time.

In December of 1997, the law on National Depository System was approved by the Verkhovna Rada and called for the creation of the National Depository of Ukraine (NDU) owned and controlled by the Government. The World Bank and USAID, with the help of key Ukrainians in the private sector committed to reform, understood the danger of this Government action and how negatively it could affect capital markets development. Accordingly, in 1998, the World Bank added as a “Conditionality” to its loan to the Government, that the Government must support the creation of a private sector owned securities depository; and, that the Government would not create unequal conditions for that depository if a State-owned depository were to be created. That Conditionality was intended as political protection for the MFS.

To support that Conditionality, and to provide assistance to the MFS, the USAID launched its Capital Markets Infrastructure Development Project. These USAID and World Bank efforts culminated in the Memorandum of Understanding (MoU) between the Government of Ukraine, the Government of United States, and the World Bank. This MoU was signed January 25, 1999, by Deputy Premier Sergiy Tigipko, SSMSC Chairman Oleh Mozgoviy, NBU Governor Viktor Yushchenko, and USAID Mission Director Gregory Huger. The MoU reinforced a commitment to free markets, and stated that the three parties would assist Ukraine’s securities industry to:

- build an industry-owned clearing depository capable of servicing all licensed securities markets and stock exchanges;
- affect the voluntary merger of all existing or planned Ukrainian depositories into a single centralized clearing depository, predominately privately owned, and operated by the securities market participants; and
- develop a strategic development plan for Ukraine's securities market infrastructure that will rationalize and optimize its scarce resources.

That MoU further provided that, although the parties did not object to the establishment of a National Depository of Ukraine by the Government of Ukraine, it was agreed that any such entity would have *no commercial functions* whatsoever and would engage in only three functions: codification, standardization, and international relations within the effective period of the MoU. This MoU stated that it would govern Ukrainian policy for a private sector market-owned central securities depository for a decade, to 2010.

The National Depository of Ukraine: *De Jure* versus *De Facto* Existence, and the Consequent Re-occurring Travails

However, in May 1999, the extant tendency of some Ukrainian officials to seek Government control over economic apparatus surfaced again. In May 1999, the National Depository of Ukraine was established as an open joint stock company with the State owning 86% managed by the SSMSC, the National Bank of Ukraine owning 4%, and the remaining shares owned by market participants, including one share owned by the MFS. SSMSC Commissioner Victor Ivchenko was named Chairman of the NDU as it was created in compliance with the Law, "On the National Depositary System and Specifics of Securities Circulation in Ukraine". In July 2001, the Cabinet of Ministers transferred the 86% State ownership in the NDU to the Ministry of Finance. The MFS under its private sector ownership, continued over the next few years to develop, gain market share dominance, enhance its technical skills, and gain the respect of market participants.

When President Victor Yushchenko came to power in early 2005 with the Orange Revolution in late 2004, a “new” State Program for the Development of the National Depository System was advocated by SSMSC Commissioner Ivchenko and approved. Under that new Program, the NDU was to be assigned all possible depository powers. In addition, the Program included several unusual features on money and powers for the NDU. The new Program for the NDU asserted the following:

Pigmy Freak

“The NDU is a pigmy freak of our own making… In my opinion, there is only one remedy: recognize our mistake and terminate the NDU”

Sergiy Tigipko, former Vice Premier of Ukraine. *Business Magazine*, November 2000.

- Requires UAH 900 million ($176 million) from the State Budget, and UAH 1.1 billion ($215 million) in fees from market participants over 2005-2010, without any explanation of possible expenditures;
- Intends to resolve market infrastructure problems that derive from existing legislation on taxation, currency regulation, foreign investment, etc.- - problems whose resolution required proper State regulation, not additional public funds;
- Intends to start from scratch and set up a system of securities ownership records not coordinated in any way with the other infrastructure components of the market;
- Intends to set up numerous costly elements (a new national information network, a separate data transfer system, a safekeeping vault), which would increase the cost of transactions in the market;
- Assigns functions to the depository system that are alien to it, e.g., the development of a real estate market, and risk-hedging in commodity markets - - none of which are in line with international best practices.
- Provides the NDU with numerous real property facilities, including a sanatorium in the Crimea.

According to the NDU website, the NDU development program anticipated the following funding from 2005-10.

NDU Five-Year Development Plan Budget, in UAH millions:[8]

	2005	2006	2007	2008-2010
State Budget (UAH) millions	140 ($27.3 ml)	205 ($40 ml)	250 ($48.8 ml)	300 ($58.6 ml)
Fees (UAH) millions	0	250 ($48.8 ml)	250 ($48.8 ml)	600 ($117.2 ml)
Total (UAH) millions	140 ($26.9 ml)	455 ($88.9 ml)	500 ($97.66 ml)	900 ($175.78 ml)

Because of these massive proposed funding requirements for the NDU activities, projecting over US $210 million in new fees, the market participants voiced strong objections to this program. Following passage of the State Budget for 2005, market participants including 26 domestic and international banks and 40 broker/dealers, signed an open letter to the Cabinet of Ministers and the Verkhovna Rada opposing this remarkable State Budget support to the NDU.[9]

Yet, despite the strong objections of the leading securities market participants to the NDU enhanced powers, large budget, and fee taxing authority, nonetheless more Presidential Decrees followed. A Decree on October 28, 2005, repudiated the prior Government position that had supported the private sector created central securities depository, and instead empowered the NDU with full depository functions, under the

[8] In subsequent years, it has been reported that substantial funds allocated to the NDU were unaccounted for. See: *Liga Business Inform*," GoU Accused of Intention to Ruin the Depository System of Ukraine." www.liga.net/news/178229.html, February 14, 2006; Report of the Chief Control Authority audit of the NDU, September 16, 2008; NBU Governor Stalmakh letter to the National Security Defense Council First Deputy V. Ohryzko, June 2009; *The Dzerkalo Tyzhina (The Mirror of the Week)* on findings of alleged misappropriation of NDU funds. June 7, 2009.

[9] Letter of February 9, 2005, expressed the signatories' objection to the use of public funds to address problems that they stated were either non-existent, or that had been resolved by market participants. It expressed concern that the State's NDU program would result in substantial increases in the cost of securities transactions, and that Ukrainian securities might move to alternative record-keeping systems abroad. Finally, the letter noted that the State's program for a Government-owned depository system would make it impossible to continue developing the system under the principles of market needs and self-regulation, as agreed to in the January 1999 MoU.

control of the State. This consolidation of power at the State level was directly contrary to international best practices for the development of a market-oriented privately-owned central securities depository.

That Decree was followed by a general shareholders' meeting of the NDU in December 2005, whose agenda included expanding NDU operations. At this meeting, based on the State's ownership of 86% of NDU shares, the NDU was granted permission to engage in commercial operations as a fully-functioning depository - - in *complete disregard* of the long standing Government of Ukraine commitment, memorialized in the January, 1999, MoU. This startling reversal was then followed by the unilateral decision of the Cabinet of Ministers on January 18, 2006, to terminate the 1999 MoU between the Government of Ukraine, the World Bank, and the United States Government which had endorsed supporting only a market-based, private sector owned and operated central securities depository.[10]

USAID Objection

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

USAID Kyiv Office
January 20, 2006

The Protest of Market Participants, USAID, and World Bank

Outrage followed among the securities market participants, as they opposed what was widely believed to be an NDU inspired action.[11] The USAID, the World Bank, and market participants all presented strong written condemnation of this Government repudiation of its long-held position in support of a private central securities depository

[10] This was the well publicized MoU signed by Deputy Premier Tigipko, NBU Governor Yushchenko, and SSMSC Chairman Mozgoviy, with the US Government and the World Bank.

[11] See the *Economika,* 14 February 2006: That publication reported:

"Only ignoramuses are unaware that 90% of the debate around the single depositary in Ukraine is far from being a professional discussion of the expediency of this or that particular model. The cause of the debate is named Viktor Ivchenko. This person has been hatching plots since 1999 to change the current principles of the stock market operations. The market had successfully parried those attacks in the past, but the positions of Ivchenko have dramatically strengthened following the Orange Revolution. The trick is that he is husband of Vera Ulianchenko, President Yushchenko's personal assistant." www.economika.com.ua/print/top/article/9004.html.

that had the trust of market users. At this point, in early 2006, the securities markets of Ukraine were progressing nicely, foreign investment in Ukraine was up, mutual funds and pension funds were developing, and the importance of an independent and trusted central securities depository was well established by the MFS. The MFS had earned strong allies among the leading market participants.

The USAID, World Bank, and market participants' protest of the Government's action sent an important signal to market-oriented Ukrainians. The immediate result was that no attempt was made by the NDU toward building operational capacity, and there commenced a series of efforts toward merger of the MFS and NDU, with the SSMSC and USAID actively involved. The USAID Capital Markets Project proposed an "Action Plan for Merger" of the central depository systems with the following elements:

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

Because the MFS and the SSMSC (manager of the 86% State ownership of the NDU) deemed such a merger an effective way to end the *de facto* versus *de jure* disruptions, a Task Force was formed with the support of USAID to implement this merger.

One critical problem was evident early on, however, and was succinctly stated by Mikhail Royko, President of the Amadeus-Index PFTS Investment, “NDU assets are a quite fictional thing.”[12] This assessment that the NDU was not a real central securities depository, and without many assets pertaining to that function, was widely set forth in the media.[13] Accordingly, the merger discussions faded with several steps of mis-direction along the way, including a court filing by the NDU seeking to obtain a license from the SSMSC, an attempted effort by the NDU to dilute MFS shareholder’s stake, and efforts by MFS shareholder PrivatBank to gain control of MFS.

To find a way out of this contentious impasse, the key actors decided to create a “new wrapping” around the MFS, which would be a win-win situation. NBU Governor Voldymyr Stelmakh and SSMSC Chairman Anatoliy Baliuk led this reform effort. They proposed that the MFS would transform itself into the All-Ukrainian Securities Depository (AUSD) with the National Bank of Ukraine holding no more than a 25% stake, and the leading stock market private participants holding the remaining 75%. This included the Ukrainian Inter-Bank Currency Exchange, the PFTS Exchange, and 19 Ukrainian banks such that all shareholders or affiliates would own not more than 5% each in AUSD. The idea was to permit the AUSD (successor to the MFS) to be better able to raise funds for technological enhancement, and to emphasize that the MFS / AUSD had earned an impeccable reputation, despite periodic criticism from the NDU.

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[12] Statement of Mikhail Royko President of the Amadeus, Index PFTS Investment, *Kommersant*, June 22, 2007.

[13] *The Dzerkalo Tyzhnia (The Mirror of the Week)*: “So, are there any successes (by the NDU) to date? Mildly put, none whatsoever. State budget funds allocated for NDU needs in 2005-2008 had been quite tangible (UAH 117.6 million), of which at least one portion (UAH 6.2 million) has been misappropriated (according to the results of the Chief Control Authority audit dated 9/16/2008). This audit confirmed that NDU is a loss making operations, which fact had not prevented the NDU management from buying, for instance, five Toyotas to the tune of UAH 991,300. This fact and other findings of the State audit have been widely covered by this newspaper and other printed organs, - - but no administrative sanction ensued as a result”. June 7, 2009, http://www.zn.ua/2000/2040/66650/

Anatoliy Shapovalov, First Deputy Governor of the NBU, explained that this decision to create the AUSD was a direct result of wanting to resolve the on-going conflicts between the NDU and MFS, because those two had failed to work out a model for their merger. The Securities Commission Chairman Anatoliy Baliuk supported the National Bank's effort: "The NDU is not likely to integrate with AUSD and the market will not even notice its absence." The MFS Chairman Mykola Shvetsov stated he was sure the creation of AUSD would "terminate, totally and completely, the conflict between the MFS and the NDU, provided all the arrangements were implemented." This idea of a new AUSD depository, with private sector control, was opposed by NDU Chairman Victor Ivchenko.

On April 18, 2008, the founder's meeting of the All-Ukrainian Securities Depository occurred. The shareholders unanimously approved the decision to establish AUSD, with the MFS shareholders accepting the revised share ownership. Throughout the remainder of 2008 and into 2009, details were worked on by PricewaterhouseCoopers and the Ukrainian law firm Sayenko Kharenko, with significant USAID Technical Assistance support from its Capital Markets Project. The MFS and AUSD shareholders worked effectively toward achieving the operational capacity of the new entity, under the new share's allocation, with slow but continuing goodwill and progress.

However, in parallel with this process, the NDU ran a publicity campaign in opposition to the AUSD merger. One media article even suggested the allegation of a possible misuse of USAID funds because assets purchased with USAID funds for MFS were being transferred to a different entity (AUSD) than the entity *originally named* to receive the funds. However, because the USAID assets were contributed to MFS without restriction, and with the sole goal of the advancement of a privately-owned central securities depository for Ukraine and that goal remained in place, the allegation was readily dismissed as without merit.

Another tactic by the NDU backfired. The NDU lobbied the Presidential Secretariat, urging it to direct the National Securities and Defense Council to request that the National Bank of Ukraine designate the NDU as the central securities depository of Ukraine, and eliminate the AUSD. The written response of NBU Governor Volodymyr Stelmakh offered a devastatingly frank critique of the NDU, suggesting operational deficiencies, misappropriation, damage to the international image of Ukraine, and poor comparison with the AUSD (excerpts follow):

> *"The NDU operations have not resulted in adequate development of the relevant infrastructure, despite allocations from the state budget worth tens of millions of hryvnia… Today, the NDU share on the depository services market is only 0.75% demonstrating extremely low trust of stock market participants for it.*
>
> *Moreover, the inspectors of the Principal Control and Inspections Committee of Ukraine have revealed the facts of improper use of millions allocated from the budget by the depository.*
>
> *The NDU managers have actually proven incapable of fulfilling the relevant NSDC decision, thus hampering significantly the development of Ukraine's stock market and damaging investment image of the country.*
>
> *On the other hand, the International Stock Union (MFS) has been dominating the depository services market lately with a share of 99%. In this situation, SSMSC and the National Bank of Ukraine, stock market participants as agreed with the President of Ukraine, initiated establishing a new legal entity [*the AUSD*] with an equity capital transparent structure in which the State will take part."*
>
> V. Stelmakh
> Governor of the National Bank of Ukraine

Promptly thereafter, in June 2009, the SSMSC Chairman Baliuk, the World Bank, and USAID all wrote similar letters supporting the NBU Governor Stelmakh's position.

On September 10, 2009, the shareholders of AUSD and MFS voted to approve the merger, and elected a supervisory board. The assets and contracts of MFS, and its single property complex, were transferred to AUSD. The AUSD became fully operational in October 2009, continuing its MFS/AUSD 99% market dominance.

> **Letter to Ms. Janina Jaruzelski**
> **Director, USAID Mission in Ukraine**
>
> "Please accept our heart-felt gratitude for the USAID participation and assistance in the development of a fully functional clearing Depository in Ukraine provided since 1997… Steps pursuant to the creation of a central securities depository in Ukraine have constantly been taken by the MFS Depository jointly with USAID experts, and by participants of the stock market of Ukraine, for the purpose of creating a central securities depository, transparent securities market, and of ensuring the proper level of corporate governance in Ukraine."
>
> **Vasyl Rohovyi**
> **Supervisory Board Chair**
> **All Ukrainian Securities Depository**
> **June 19, 2009**

Nonetheless, in early 2010 the intrigue continued, epitomized by the headline, "NDU Board Chair Tries to Make Use of Lame Duck President Yushchenko Last Days". [14] Importantly however, media reports and NBU Governor Stelmakh's letter indicated that the National Bank of Ukraine was taking the position that the central securities depository should be privately owned and operated. This is the long-held position of the USAID and the World Bank, which has consistently been presented to numerous Government of Ukraine officials, including the "*Joint USAID/WB PTAP Position Note on Establishment of a Central Securities Depository of Ukraine", June 24, 2009*, provided to the Prime Minister of Ukraine and key Government officials. The markets' perspective on the persistent NDU actions was summarized by Ukrsotsbank Board Chairman, Boris Timonkin, as he noted that the NDU has a tiny percentage of market share, and:

> "*This number proves that market participants do not trust NDU, but like Phoenix, each time the NDU depository has risen from the ashes. And, every single time… this is an extended farce*."[15]

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[14] *The Economic Izvestiya*, February 19, 2010. The newspaper reported that a meeting was held at the President's Secretariat, where Viktor Ivchenko tried yet again to capture the central securities depository for the NDU. Reportedly, the NBU officials Governor Stelmakh and First Deputy Shapovalov reminded Ivchenko of the failed attempts in 2007 of the NDU merger with the MFS, because the NDU left the negotiating table when it was shown its valuation was much lower than of MFS. Ivchenko was unwilling to merge on terms that would result in the central securities depository being controlled by market participants.

[15] Interfax Ukraine, February 26, 2010.

Importantly, in 2010 and forward, the new Government has the opportunity to take a fresh look at the *de facto* AUSD and *de jure* NDU, and urge a merger of the two. The resulting entity could combine the AUSD competence and market confidence, with the NDU name and national designation. The objective is to obtain national and international recognition for one central securities depository for Ukraine. The rationale for this exclusive recognition is that Ukrainian companies and the Government need as much access to global capital markets as possible. However, depositories in major markets (DTC/NSCC, Euro-Clear) will not open correspondent accounts in Ukraine until there is one depository with the designated status of “central” securities depository. The current situation inhibits portfolio investment in Ukraine.

Ukraine now has *de facto* one central depository for equity and corporate bond issues with the capacity for book entry ownership and transfer. This entity is the AUSD resulting from the merger of the AUSD with the MFS, with over 99% of the depository transactions in Ukraine. Despite this factual transactional dominance by AUSD, the NDU holds a license as a central depository, and the NDU regularly announces new initiatives which present an appearance of activity that does not comport with AUSD factual dominance. Efforts should be made to end any confusion. The Government could be guided by the consistent and oft repeated joint World Bank / USAID position:

> "We believe that the authorities should recognize the reality of the market today and take pragmatic decisions, leading to sustainable capital market growth and efficient use of public resources. They should welcome and support the emergence of a strong, professional, and capable player in the form of a merged MFS/AUSD entity, and entrust it with the demanding and critical role of a CSD".[16]

[16] Excerpt from the Joint USAID / World Bank PTAP Position on Establishment of a Central Securities Depository of Ukraine.

> **Unwavering USAID Support**
>
> "We succeeded to a considerable degree because USAID provided money for systems, diligent experts, and unwavering support for achieving one trusted and privately-owned Central Securities Depository in Ukraine."
>
> **Mykola Shvetsov**
> **President of All-Ukrainian Securities Depository (AUSD). February 11, 2010.**

Indeed, in mid-September 2010, at the first General Shareholder meeting of the National Depository of Ukraine held in three years, the SSMSC (Securities Commission) voted its 86% stake in the NDU to dismiss the NDU management leader Victor Ivchenko. Appointed as the new NDU Supervisory Board Chairman was Vasyl Rohovyi, who does the identical job at the AUSD. Rohovyi will also represent the interest of the NBU, and the Bank owns more than 22% of AUSD. The media reported that this SSMSC and NBU action was designed to speed up the creation of one merged and nationally recognized central securities depository, one that brings the AUSD's competence and earned respect, and that could also soon carry the imprimatur of the NDU name. This was reported in the media as a major development for the AUSD, and for providing Ukraine one competent central securities depository (AUSD) with the imprimatur of the Government.[17]

However, maneuvering continued as the NDU management sought to derail this transformative vote, and stop the change in management and ownership. NDU management did so by urging that the meeting and vote should be "officially unrecognized," because the Cabinet of Ministers had not approved the SSMSC's action.[18] That technical procedure requiring written approval of SSMSC actions by the

[17] The Economic Izvestia, "NDU Cleans Up Its Act," 17 September 2010, which quotes the World Bank senior financial expert Anzhela Prigozhyna: "The sooner the single central depository is created in line with international best practices and with a high level of credibility on the part of investors and market participants, the sooner Ukraine will be in a position to offer investors quality infrastructure and depository services needed both to develop the domestic stock market and to attract foreign investments."

[18] Kommersant Newspaper, "*NDU Shareholder's Meeting called without CabMIN Permission*" 16 September 2010. Immediately after the meeting, Victor Ivchenko announced that the results of the meeting could not be recognized nor deemed official because the Cabinet of Ministers had not approved the SSMSC's action. In short, the key market participants in support of AUSD, and achieving a merger with NDU in order to capture the one central depository designation, continued to press forward and now with the support of the SSMSC (dominated 86% shareholder NDU and the prestigious NBU all toward the same objective). Yet, there is no reason to believe that some limited and yet effective political opposition in favor of government control will none-the-less continue.

Cabinet of Ministers did ultimately cause the meeting, and the vote dismissing the NDU Management, to be "unofficial." All such agenda items were thus postponed until the next regular shareholder's meeting in the first quarter of 2011.

Significantly, in late November 2010, a letter on reform objectives was provided to the Managing Director of the International Monetary Fund in Washington DC, Dominique Strauss-Kahn, by Prime Minister Mykola Azarov, Finance Minister Fedir Yaroshenko, and the Governor of the National Bank of Ukraine Volodymyr Stelmakh. That letter to the IMF from these Ukrainian leaders included this point:

> *"To improve the function of securities clearance, increase market confidence, and foster capital market development, <u>we intend to create a single central depository by merging the two existing depositories</u> in 2011. The state will limit its involvement to developing appropriate legislation and regulatory frameworks, and minimize use of public funding." (emphasis added).*

USAID will continue to support that effort, as called for by these Government of Ukraine leaders. USAID will continue to support the Government and the AUSD efforts to have one effective "national" central depository with the State's statutory imprimatur. Then, one truly effective and Government designated central securities depository can take the necessary steps to advance the integration of Ukraine with the liquid markets of Western Europe, the United States, and Asia.[19]

These remaining operational and legal improvements will be achieved with USAID's help. But, that help will properly be an *ever-diminishing* level of assistance. And someday soon all of the efforts of USAID will be a memory, because the central securities depository of Ukraine and all its related securities markets facilities will be sustained and prosper solely because of Ukrainians.

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[19] See USAID Capital Markets Project report "Strategic Alliance Considerations for All Ukrainian Securities Depository", May 14, 2009, for a series of remaining challenges and improvements in the central securities depository.

II. Effective Securities Exchanges in Ukraine

The second topic of this report examines the USAID support for effective securities exchanges in Ukraine. As noted previously, securities exchanges offer numerous macro-economic benefits to an economy.[20] Further, every Former Soviet Republic undergoing massive privatization of SOE in the 1990s believed that a securities exchange would facilitate whatever voucher or stock ownership distribution system was being contemplated.

In 1991, the Ukrainian Stock Exchange was established with a well intentioned $5 million grant from France, resulting in rows of gleaming terminals linking the Exchange electronically with brokerages in several major cities in Ukraine. Yet, one week's total trading volume was a minuscule $18,000. It was a market with no liquidity. That Exchange's dormant status can largely be traced to its adoption of tough listing requirements based on the French and German model, designed to protect investors from the risks inherent in lesser developed companies. The problem was that these sound listing requirements with serious financial disclosure could not then be met by virtually any Ukrainian companies. Thus, while strict requirements for listing were mandated in order to protect investors, that intended protection cost the market its very role as an exchange.

In 1995 in Kyiv, an association of over 300 fledging broker-dealers and bankers established a securities trading system as a private sector member-owned non-profit organization with listing requirements that could be met. USAID responded to requests for assisting this securities exchange development by providing consultants and financial assistance to exchanges seeking assistance. The principal counter-party was the "First Stock Trading System" (PFTS in Ukrainian acronym) with USAID providing Technical Assistance and NASDAQ software. PFTS rapidly came to dominate Ukrainian securities trading. About 140 stocks were regularly traded on the PFTS in

[20] See *supra* pp. 7-11. Macro-economic benefits include: price discovery for providing independent valuation of company performance; intermediation between buyers and sellers; promotion of capital flows; reduction in capital formation costs; transformation of savings into investment; and corporate governance.

1997, and by 2000 the number of listed securities (most not actively traded) had grown to almost 900. Almost 85% of securities exchange transactions in Ukraine were conducted through PFTS in 2003-2005. In 2005, PFTS trade volume almost doubled from the previous year, with major brokers reporting increased earnings of 50% greater than the previous year.

During this period, the SSMSC licensed other securities exchanges and trading systems that met appropriate requirements. The SSMSC licensed eight regional securities exchanges, and two electronic trading platforms.[21] In late 2005, a new trade and information system, "Perspectiva," applied to the SSMSC for a license. The application was filed by the Regional Stock Union, an association owned by five Dnipropetrovsk based broker/dealers including a bank. Perspectiva proffered to trade a number of securities actively circulating in the housing market. These securities included special-purpose bonds issued to fund construction projects, shares and investment certificates of real estate funds, as well as pledge letters and new types of mortgage securities. Some market participants viewed Perspectiva as an innovator of new products; others viewed it as a possible "pocket" entity for Dnipropetrovsk. Perspectiva did withstand scrutiny by the SSMSC, and over time became a respected organizer of broker-dealers.

In 2006, the PFTS remained dominant at over 80% of volume, the Ukraine Stock Exchange at about 15%, with eight small regional exchanges. The regional exchanges were established in many cases principally to capture the "facilitation commission" of 1% of proceeds for sales of SOE via the exchange. It was also suspected that when an occasional trade was transacted through a largely dormant regional exchange, that the purpose was to artificially inflate the price of the traded issue. Accordingly, the State Property Fund Chairman, Valentyno Semeniuk, announced that the SPF would support the selling of SOE on foreign exchanges, such as the London Stock Exchange.

[21] *SSMSC Licensed Electronic Trading Platforms*: PFTS Trade Information System; South Ukrainian Trade Information System.

SSMSC Licensed Securities Exchange: Ukraine Stock Exchange; Pridneprovsk Stock Exchange; Donetsk Stock Exchange; Lugansk Stock Exchange; Ukrainian Interbank Currency Exchange; Kiev International Stock Exchange; Ukrainian International Stock Exchange; Crimea Stock Exchange.

In 2007, the overall Ukrainian securities exchanges trading volume was among the most actively increasing in the world.

In 2008, the global financial crisis saw the PFTS index drop over 80%. While the “market” collapsed, the securities exchange systems and the SSMSC regulatory oversight did not.

Importantly, USAID support had gone well beyond supporting effective trading systems and PFTS operational technical assistance.[22] USAID also supported projects for establishing an effective legal and regulatory framework for securities markets, institutional development, and capacity building. The USAID premise was that securities markets were not only trading systems, but indeed were “economic environments” that required proper legal and regulatory frameworks for *licensing* actors such as broker-dealers and exchanges, *monitoring* their behavior through periodic reports and compliance investigations, and *enforcing* sanctions against bad actors including fines or revoking licenses. USAID actively supported efforts to assist legal and regulatory framework development at the Rada, SSMSC, Pension Fund Administration within the Ministry of Labor, the Financial Services Regulator, and projects for reforming accounting, and education and training efforts toward sound corporate governance practices. This comprehensive approach, appreciating and understanding the importance of linkages, was a major contribution by USAID that bolstered broad reform of the capital markets.

The Government of Ukraine adopted legislative and regulatory rules for developing its capital markets, largely in conformance with international best practices. Yet, a close review of many initiatives reveals inconsistencies and contradictions. For example, plans to support the development of capital markets comporting with international norms conflict with the Government’s desire to maintain controlling ownership of the leading SOE that would be most attractive to the market, thereby delaying privatization. Similarly, the delays in passing a Joint Stock Company law that

[22] See Appendix 3 Chronology on Securities Exchange Developments.

protects the rights of minority shareholders discouraged investment. The inconsistencies between promulgated policy objectives, versus actual practices, had a dilatory impact on the development of the non-bank sector of the economy. In 2006, for example, a snap-shot of capital markets revealed the following:

- Over 30,000 joint stock companies had unprotected shareholders due to the lack of good corporate governance legislation, blocked by special interests.

- The Government preserved its special interest stakes in the statutory funds of joint stock companies, entrenching regional interests, and adversely affecting the development of a liquid securities market.
- No privatization strategy existed for blue-chip Ukrainian enterprises that would permit such companies to be privatized via foreign investment, and consequently gain technical "know-how" to enhance international competitiveness, and add quality to domestic securities available for investment by citizens and institutional investors such as non-state pension funds Pillars II and III.
- Both the securities regulator SSMSC, and the Financial Services Regulator (FSR), lacked adequate legal and institutional independence, were subject to political intervention on policy issues, all resulting in a random and weak enforcement/compliance culture.
- Large-scale pension reform was used as a political tool, resulting in not only a detriment to pension reform, but also to insufficient sound investment instruments.

Despite these impediments, the PFTS facilitated the expansion of capital markets in Ukraine, and the value of exchange trades was greater than Ukraine's Eastern European neighbors.[23] The Ukrainian over-the-counter market, or off-exchange market, was far larger and more liquid than the PFTS because such a market has no public

[23] The ratio of securities market capitalization to GDP was as follows in 2005: Ukraine 35%; Poland 31%; Hungary 30%; Romania 17%; Lithuania 38%.

listing requirements, is totally party-contractual, with disclosure requirements only as the transacting parties demand.

The PFTS, under the leadership of Irina Zarya, continued to grow and dominated the “on-exchange” securities trading with over 80% of total market volume. The PFTS also sponsored an annual conference every Fall in Crimea, with USAID support, and that conference came to be an “information Mecca” for the Ukrainian securities market participants, further adding to the stature of PFTS.

In late 2005 and early 2006, media reports began to appear about several Ukrainian investment brokerages becoming dissatisfied with the PFTS allegedly aging electronic quote-driven system, and desiring more product to trade. A group of PFTS members organized an informal Ukrainian Stock Club, and they requested that PFTS upgrade the trading system to an order-driven system (deemed more efficient and responsive than the quote-driven PFTS system), and apply to the SSMSC for a license as a “securities exchange” rather than a “trading system,” purportedly to permit members to provide wider services and participate in privatization auctions.[24] The Ukrainian Stock Club publically urged the PFTS to update its technology and obtain an “exchange” license (PFTS held a long and established license as an SSMSC approved Electronic Trading Platform). Otherwise, the Club members asserted they would establish a new order-driven securities exchange.[25] Despite PFTS leadership commitments of good-will, the Ukrainian Stock Club commenced their effort.

The Club subsequently entered into an agreement with the Russian Trading System (RTS) Stock Exchange that provided know-how, technology, and needed capital. The agreement stipulated that RTS would own 49% of the Ukrainian Exchange, with the remaining 51% distributed to the 21 leading Ukrainian brokerage companies comprising the Club. Together, RTS and the members committed over $10 million dollars in capital to the venture, and full operations of the Exchange were launched in

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[24] “Go Halves”, Evheniy Zaitsev, *The Economic Izvestia*, 19 December 2005.

[25] “Trading System not in a Hurry to Become a Stock Exchange,” Alex Taran, *DELO Newspaper*, 1 February 2006.

March of 2009. Within two months the Ukrainian Exchange asserted that it accounted for almost half of all securities exchange trades in Ukraine.[26] However, it was widely rumored among securities market participants that such a remarkable claim of volume may have included a substantial number of "wash" trades that did not clear and settle with a real "money-for-shares" transaction. The actual facts remain unknown.

The effect nonetheless caused the PFTS to re-evaluate its market position. The PFTS announced a "strategic alliance" with the Moscow Interbank Currency Exchange (MICEX) to modernize PFTS and expand services. In late April, 2009, just one month after the launch of the Ukrainian Exchange with its order-driven system, PFTS unveiled its own order-driven technology and offered new services. The two competing systems are similar, with the capacity to provide comparable services.

It should be noted that these developments involving PFTS, and the formation of the Ukrainian Exchange, have often been reported as reflecting perhaps slow reform by a comfortable PFTS, or personal rivalries. One cannot discount the entrepreneurial zeal of both RTS and MICEX, as their Russian market growth was either saturated or stymied, and they sought expansion in Ukraine.

The result is that in 2010 Ukraine has two efficient, modern, transparent securities exchanges competing with each other to better serve their customers. The Ukrainian Exchange currently dominates trading in equities markets, while PFTS dominates trading in Government securities.

It should also be noted that media commentators have raised concern about the fact that the role of the Russian Trading System (RTS) and the Moscow Interbank Currency Exchange (MICEX) now means that *Russian* enterprises control 95% of securities exchange activity in Ukraine.[27] The suggestion is offered that Russian ownership is worrisome, or even a cause for alarm. While perhaps understandable, history tells us that enterprises that buy assets take care of them.

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[26] "PFTS Loses Monopoly on the Stock Market of Ukraine" *DELO Newspaper*, 2 July 2009.

[27] "Ukrainian Stock Exchanges Controlled by Russian Capital," *EASTWEEK*, 6 January 2010.

This situation is reminiscent of the concern in the United States in the 1980s as the financially ascendant Japanese began to buy iconic American assets. In the heart of America's financial center, New York, the Japanese (Mitsubishi Corporation) purchased Rockefeller Center, Radio City Music Hall, and other Manhattan office buildings. In Hollywood, the Japanese (Sony Corporation) purchased Columbia Pictures. At that time, a prominent Harvard scholar published the book *Japan as Number One: Lessons for America*, and it was an instant sensation. Now thirty years later, those U.S. based assets purchased by Japanese enterprises still continue to contribute to America's economy, with no thought today given to concerns about levels of foreign ownership. Likewise, the Ukraine Exchange with RTS ownership, and the PFTS with MICEX ownership, are doing well,[28] and consistently developing liquid securities markets for Ukraine.

In short, the sustained support of USAID for developing capital markets over fifteen years resulted in effective securities exchange systems, a legal and regulatory framework, institutions that regulate and participate in these markets, and enhanced capacities of the SSMSC, FSR, and many private sector associations. These USAID efforts proved to be the nurturing catalyst that ultimately led to successful and competing world class securities exchanges in Ukraine, able to attract outside capital for expansion.

[28] In the first quarter of 2010, the Ukrainian stock market achieved record high growth with investment funds reporting up to 30% profits; the PFTS index grew by 64% and the Ukrainian Exchange index grew by 62%; compared with 16% for Russia's RTS index and 10% for Poland's WIG-20. The number of securities transactions in Ukraine has also grown by about 900% year-on, representing a substantial increase in the number of market participants, favorable for maintaining liquid markets.

III. Financial Disclosure

To better understand the USAID support for financial disclosure, let us suppose a situation. The Director of Financial Disclosure at a Securities Commission (like the SSMSC) is in charge of collecting and disseminating to the public the statutorily mandated financial and business plan information required of all joint stock companies. That Director's husband is the head officer of a company that sells this very same information. The Securities Commission Financial Disclosure Director announces in June that the financial information on all joint stock companies will be available and disclosed on the Securities Commission's website by the Fall. That same June day, her entrepreneurial husband announces that the financial disclosure information is available, for sale, *now*.[29]

Message understood: information is valuable.

In 2001, USAID launched the International Business Standards and Corporate Governance project which sought to create a new culture of financial disclosure and accountability.[30] The goal was to transform the culture of governance of Ukrainian enterprises in a way that would foster increased investment and job creation. USAID supported the development and adoption of new laws, regulations, and institutions that would advance financial disclosure. A comprehensive effort was necessary because there was a sociological dimension to making these laws, regulations, and institutions effective: achieving reliable financial disclosure in Ukraine required a deep-rooted change of mentality among corporate actors. Thus, USAID focused on changing the behavior of corporate managers, shareholders, financial intermediaries, investors, and regulators, with the goal of ultimately institutionalizing reliable financial disclosure.

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[29] Such events occurred and are detailed in two Ukrainian media reports:
"*Access Denied: It is Available for Money Only*," Business, #27, July 2002;
"*They Went Too Far*," Money Microeconomics and Business, Dzerkalo Tyzhnya Web, #38, October 2002.

[30] The IBS CG Project was supplemented by USAID's Commercial Law Center Project (CLC), which started in 2000. While the CLC Project did not directly cover financial disclosure, it was instrumental in developing draft laws, monitoring and expertise of the normative-legal acts, harmonizing Ukrainian legislation with EU legislation, improving the overall legal framework, and promoting the effective system of legal protection—all of which helped lay the groundwork for future advances in financial disclosure.

USAID and the Government of Ukraine commenced this effort by implementing a set of measures aimed at creating a nationwide disclosure system for financial and business activities of joint stock companies, in accordance with international standards. This involved teaching internationally accepted accounting standards, the adoption of new regulations on financial disclosure by the SSMSC, the implementation of a new issuer's electronic reporting system, and processing and publicizing standard financial information using modern information technologies. The goal was to align Ukraine with international best practices of corporate governance, which would permit the integration of Ukraine in European and global investment markets.

Achieving these measures was difficult because Ukraine was only just developing the basic elements of a modern financial system: protection of property rights, a commercial code, and enforcement mechanisms. The importance of financial disclosure, accounting standards, and corporate governance was a new concept throughout the Former Soviet Republics. The early consequence of this was limited access to capital and slow economic development.

One OECD principle of corporate governance is that, "Information should be prepared, audited, and disclosed in accordance with high quality, internationally recognized, standards of accounting, financial and non-financial disclosure, and audit." But historically in Ukraine, financial statements were prepared for tax purposes, not to offer investors guidance; and they were based on "National" standards of accounting that were not in compliance with International Standards of Accounting (ISA) or International Auditing Standards (IAS).

USAID and the Government of Ukraine undertook to remedy this through a transitioning effort, providing extensive training in international standards of accounting and auditing. With the support of USAID, the SSMSC conducted in-depth accounting training for almost 1000 publicly traded issuers with the objective of transforming their financial statements to meet international standards for the fiscal year ending 2003. A good *voluntary* beginning, but inadequate in a universe of 12,000 public companies in Ukraine.

Thus, USAID supported the Government of Ukraine efforts to draft and adopt new laws *mandating* financial reports to be prepared on the basis of ISA and IAS. Mandating the transition to international standards was expected to promote capital investment, reduce the off-shore transfer of cash and other assets, and provide more reliable tax collection. The principle that in a well regulated market, “accurate information is key,” was advanced by USAID supporting the SSMSC.

In 2005, USAID began the Capital Markets Project (CMP) to focus on institutional strengthening for both financial regulators and leading market infrastructure organizations, while continuing to promote the use of ISA and IAS and international financial reporting standards (IFRS). The USAID and Government of Ukraine goal was to convert the entire Ukrainian financial community to IFRS and IAS in order to create accurate and standardized financial information on which local and international investors could rely.

Once the financial information would be in this new and reliable format, the USAID and Government of Ukraine wanted to disseminate it. The chosen method was modeled on the U.S. Securities and Exchange Commission Electronic Data Gathering, Analysis, and Retrieval system (EDGAR). It performs automated collection, validation, indexing, acceptance, and forwarding of submissions by companies required to file forms with the SEC. Ukraine’s new system would be called ESCRIN (Electronic System for Comprehensive Information Disclosure) and serve the same purpose as EDGAR: “to increase the efficiency and fairness of the securities market for the benefit of investors, corporations, and the economy by accelerating the receipt, acceptance, dissemination, and analysis of time-sensitive corporate information filed with the agency.”

ESCRIN development commenced in 2006 as part of the Protocol of Cooperation between the SSMSC and USAID. This Protocol mandated that all publicly listed companies on Ukrainian stock exchanges would have to file quarterly, annual, and special reports *electronically* with the SSMSC through the ESCRIN system. All reports would immediately be available to the public, free of charge. USAID support was contingent upon the SSMSC fully supporting the development of ESCRIN and assisting in its institutionalization.

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

In October, 2009, the SSMSC approved the ESCRIN system and signed a resolution mandating that all publicly traded companies in Ukraine must submit their financial information electronically through that system.[31]

On July 15, 2010, a ceremony took place at the Kiev Hyatt Regency marking the formal transfer of ESCRIN from the USAID to the SSMSC. The importance of this event was reflected by the attendees: Vice Premier Minister Serhiy Tigipko, U.S. Ambassador John F. Tefft, SSMSC Chairman Tevelyev, USAID Mission Director Janina Jaruzelski, Deputy Minister of Finance Tetyana Yefimenko, First Deputy Minister of Economy Anatoliy Maksyuta, SSMSC Commissioner Mykola Burmaka, people's deputies Ihor Prasolov and Vladislav Lukianenko, National Bank of Ukraine Governor member Roman Shpek, Chief of Party of the USAID Capital Markets Project Ann Wallace, heads of Ukrainian stock exchanges, and 40 Ukrainian print and broadcast media from across the country.

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[31] ESCRIN reflects the requirements of the Law of Ukraine "On Securities and Stock Market," 2006; and the "Joint Stock Company Law," 2008. ESCRIN implements the electronic document flow with an electronic digital signature, as provided by the Presidential Decree of October 20, 2005, No. 1497/2005 "On Top Priority Actions Regarding the Implementation of Innovative Information Technologies," which required an electronic data flow by 2010 for all appropriate Government agencies.

Vice Premier Tigipko said of ESCRIN:

> *"The national economy has come into possession of one more viable instrument of the stock market transparency and of the timely access of its participants to the information they need".*
>
> *"Attracting capital is an extremely important factor for the economic development of Ukraine. This new information disclosure system will have a significant role in this process, since it will ensure the transparency of domestic and foreign investments".*

U.S. Ambassador John Tefft described ESCRIN:

> *"This is a system that provides business and financial information openly on publicly traded companies to all interested parties, free of charge, and on a real time basis. This is vital to the integrity of Ukraine's capital markets. ESCRIN will help create a business and investment friendly environment that is key to the economic future of this country."*

SSMSC Chairman Tevelyev emphasized that ESCRIN demonstrated, "Ukraine's commitment to international reporting standards." Ann Wallace emphasized that, "ESCRIN means more and better information. And better information means stronger and more stable markets. Information creates confidence, and confidence, in turn, greater economic growth".[32]

The goal of ESCRIN is simple and essential. It provides timely and accurate disclosure by publicly listed companies to provide investors with sufficient business and financial information to make an informed investment decision. This disclosure also forms the basis for the regulators' program to protect investors and take enforcement actions for violations of the law. This flow of reliable information on a real time basis helps combat market fraud and build confidence in the capital markets. ESCRIN was designed on the following core principles:

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[32] Samples of the extensive media coverage of the ESCRIN ceremony are found in Appendix 4.

- Compliance with European Standards of disclosure and international best practices of information flow;
- Conformity with Ukrainian legislation;
- Ease of preparation of reports by public companies facilitating compliance with international norms;
- Format and design to promote understanding by investors;
- Use of modern technology, including electronic digital signatures in accordance with Ukrainian legislation;
- User-friendly software for companies to create reports using electronic templates that permit companies to insert narrative texts and charts prepared in commonly used text processing software like Microsoft Word;
- The system would enable XML technology for tagging data for financial statements and other data and web-based technology for public display of the reports, as well as for access by SSMSC central and regional offices (this provides regional offices with the ability to conduct their regulatory review of the reports by a simple query of the SSMSC database).

In short, with USAID support the SSMSC successfully implemented the ESCRIN system that is bringing reliable financial information and accountability to Ukraine's capital markets, and improving the SSMSC's ability to provide prudent and effective regulation of the securities markets.[33]

[33] The ESCRIN system addresses the following international norms:

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

IV. Economic Impact in Ukraine

The success of USAID efforts in Ukraine developing capital markets, as measured in jobs and economic impact, is compelling. All of the following Ukrainian institutions have significant securities department activities, or are solely dedicated to the securities markets:[34]

- Banks: Approximately 125 of the 198 registered banks in Ukraine are active in the securities markets.
- Broker-Dealers: There are over 740 registered broker-dealers in Ukraine.
- Securities Exchanges: There are 10 registered securities exchanges in Ukraine.
- Self Regulator Organizations (SRO): Over 1905 registered participants.
- Regulators: Monitoring and compliance is conducted by at least three government regulators.
- Pension Funds: There are 109 private pension funds.
- Asset management companies: The SSMSC has issued 388 licenses for asset management.
- Collective investment institution (incl. Mutual funds): 239 funds are registered.
- Insurance Companies: 475 companies are so registered.

The combined economic activity of all of these institutions is conservatively estimated as follows:[35]

- Approximately 18,000 securities industry jobs;
- Annual salaries of UAH 1,300 million ($257 million);
- Total office rents of UAH 79 million ($9.8 million);
- Total computer and IT spending of UAH 200 million ($25 million);
- PFTS Mkt Capitalization UAH of 350 billion ($44 billion).

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[34] Appendix 5, "Ukraine Securities Markets Participants," provides a list of these many entities.

[35] These job and economic impact numbers are estimates compiled from Ukrainian securities industry agency's annual reports and data collection of the relevant regulatory agencies. This includes data from the NBU, SSMSC, FSR, PARD, UAIB, AUSD, PFTS, MICEX, RTS and other Ukrainian securities industry participants.

This is occurring in a nation that not long ago had no securities exchanges, no central securities depository, no market-based legal framework, no ESCRIN.

This economic impact is occurring because USAID made a commitment with the Government of Ukraine to create a central securities depository, and securities exchanges, that were privately owned and operated with world class systems, and that earned the trust of investors and securities market participants. USAID supported the related legal and oversight requirements for an integrated securities market. USAID sustained that commitment for years, and Ukraine is better for it.

V. <u>Lessons Learned</u>

Bold and transformative efforts were undertaken by USAID with the Government of Ukraine, and Ukrainian citizens, to create effective capital markets where none had existed. The circumstances were unusual: the communist economic system collapsed; a nation was re-born; and massive privatization of SOE was an imperative. Looking back, as this paper demonstrates, the achievements over fifteen years are remarkable. The efforts behind these achievements offer lessons for future successes in Ukraine, and offer lessons applicable to similar efforts in other nations.

<u>Economic precursors</u>. The circumstances of mass privatization in the Former Soviet Union nations were unique. These nations had highly educated populations, diverse economies with a broad range of industries, and had water, sanitation, housing, and health infrastructure in place. Nationwide restructuring of the economy was going to occur because of the collapse of the communist economic regime, and be replaced by a market-based economic system. In these circumstances, USAID assistance was appropriate and effective for developing economic growth in the nation. In nations

without these precursors, and with dire needs for clean water, sanitation, health care, personal security, and access to capital - - then priorities would be different.

<u>Support Capital markets Inter-connectedness</u>. Capital markets activities are highly linked and require simultaneous development. By example, securities markets activities only succeed in gaining investor confidence if all of the following are in place: clearing and settlement systems that ensure shares and money transfer simultaneously and reliably; a central securities depository that registers and maintains reliable ownership records; corporate governance procedures that protect shareholder rights; accounting that is accurate, in accord with IAS, and made transparent through periodic public filings; Government agencies that effectively monitor financial behavior, investigate, and penalize fraud. Also linked are all the Government actions that affect tax, fiscal, monetary, and privatization policies. Similarly, proper legal foundations are essential, such as a modern civil code, and financial laws on shareholder and creditor rights, judicial enforcement of contracts, and protection of property rights. All of these inter-connected activities must be addressed properly to achieve an overall, predictable, Rule of Law environment that fosters "*confident expectations*" about participating in a nation's capital markets operations, creating economic growth.

<u>Sustain Resolve</u>. Achieving success in capital markets activities takes years of sustained efforts. USAID in Ukraine demonstrated an on-going commitment to capital markets development activities, linked across all required legal and economic functions, for fifteen consecutive years. That resolve has proven invaluable to ultimate successes.

<u>Address Political and Business Inseparability</u>. Politics and business are keenly intertwined in a nation that is going through massive economic restructuring. For example, when thousands of SOE were being divested of state ownership via mass privatization and moved to the private sector, the opportunities for corruption and misappropriation of assets were vast and tempting. Scandals and egregious behavior were a part of every Former Soviet Union country's privatization approach. But, some approaches were more effective than others, and less prone to misappropriation. In a nation that operated under central government control for seventy years, political control

over businesses is hard to relinquish, and temptations alluring. In Ukraine, USAID was alert to Government and business cronyism and corruption, and willing to address it when the wrong behavior became so public that it harmed the overall success of capital markets development. While some level of corruption will always exist in nations undergoing transformation, the USAID in Ukraine did stress that there needed to be vigilant efforts to eradicate it. USAID plays an important role in bringing these possibilities to the attention of the host nations' leaders, and pushing to improve a Rule of Law based economic environment.

Cultivate Allies. In Ukraine, the USAID and World Bank formed an allegiance early on, and sustained it. There were often joint initiatives, joint letters to Government officials, and joint Memorandum of Understanding as the USAID and World Bank worked together with Government agencies and together established productive relationships with hundreds of private sector entities. Trusting relationships were developed by the USAID with institutions it supported, such as the PFTS stock exchange, the MFS now AUSD central securities depository, and also with banks and investment companies that became active in these markets, and self-regulatory organizations such as the Professional Association of Registrars and Depositories, the Association of the Ukrainian Stock Traders, the Ukrainian Association of Investment Businesses, and scores of others. Diligent efforts with regulators such as the NBU, the SSMSC, the Financial Services Regulator kept doors open for continuing policy dialogue. Communication among these allies for reform is important to maintain, and to use the collective leverage when necessary. Forming allies is invaluable.

Remember Fundamentals. No economy has ever moved beyond rudimentary economic activity without robust capital markets. The positive relationship between capital markets development and economic growth has proven incontrovertible. USAID continues to serve a pivotal role in Ukraine helping build its capital markets in accord with the world-proven free-market model, characterized by three important elements:

- *Property rights*. First, the government must respect and guarantee property rights. Absent a legal and regulatory system to enforce agreements and contracts, capital markets will remain undeveloped.

- *Financial intermediation*. Second, a developed capital markets system distributes risk widely (diversification) and efficiently (to those who can best bear it), thereby reducing the risk premium and the cost of funds. This financial intermediation is played by a host of private institutions, including banks, stock markets, pension funds and insurance companies, who collect savings and allocate them to investors, using a variety of financial institutions and instruments.

- *Institutional infrastructure*. Third, developed capital markets systems require an institutional infrastructure that fosters a predictable Rule of Law environment to deal with obstacles to broadened access to credit: the perils of limited information; and moral hazard (excessive risk, theft, or fraud). This is dealt with through financial infrastructure such as a central securities depository; clearance and settlement systems; Government financial regulatory agencies like the NBU, SSMSC, and FSR that license, monitor, and enforce behavior; and business-knowledgeable commercial courts.

These three elements underpin every successful capital market and are required in order to nurture a culture of economic growth within a rule of law environment. Over the past two decades, Ukraine and most of the former Soviet Block countries have liberalized their economies by opening their borders to trade, promoting external investment, and tapping into international capital markets. A developed capital markets sector with competitive, transparent, and fair markets provides the greatest increase in economic growth for any nation.

<u>Apply Existing Systems</u>. Capital markets development is not *sui generis* nor *ad-hoc*. Correct and proven systems exist for securities trading, clearing and settlement, central securities depositories, and are commercially available. Use them. Likewise, rules and procedures governing capital markets activity are well established in financial centers around the world. Use them. Capital markets are inter-connected

internationally and entering that connection should be a goal.[36] Doing so means following IOSCO, OECD, and other respected standard-makers on best international practices.

Facilitate Profitability. Capital markets provide opportunities for profit. While they of course also facilitate capital formation and provide other macroeconomic benefits, a focus on achieving *profit* is critical, because that is what the prospective exchange user cares about. The larger capital markets macroeconomic benefits that flow from properly structured exchanges are of little consequence to the investor, but these macro benefits will most rapidly flow from a securities exchange which, in the first instance, meets the investor's needs and provides conditions for profit-making. Thus, in efforts to assist emerging capital markets, begin by considering what are the essential requisites for a successful securities exchange, and simply ask: what is required for investors to use an exchange *profitably*?

Distilled to this essential question, it matters little whether securities exchanges operate with chalk boards or hand signals or with Stratus computers and palm-top terminals. What truly matters is *reliability* in three areas.

Reliability that trades clear and settle. Reliability that the custodial function protects ownership rights. Reliability that one can buy *and* sell with ease. Reliability here means a full confidence in the routine. This is like the confidence that your car will start or that the Metro train will arrive to take you to work. One's confidence fades if the car sputters or the train fails to show - - then you seek alternative transportation. So too will the investor quickly abandon a securities exchange with questionable clearance and settlement, doubtful custodial protection, or uncertain financial information and exchange liquidity.

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[36] As a personal vignette, often during the period of mass-privatization in different nations, when serving as an economic advisor, I would be told, "We want a New York Stock Exchange, but, you know, the [Romanian/Kazakhstanian/etc.] way." My response was always the same: "There is no such Kazakhstanian way, there is the money way."

Put simply, USAID efforts in Ukraine demonstrated that capital markets development in an emerging economy can be jump-started by establishing three fundamental requisites: a dependable clearance and settlement system; a strong custodial registry and shares depository system; and reliable financial information that builds exchange liquidity.

Importantly, these three requisites must be accompanied by, and indeed flow from, a Rule of Law environment. It is critical to establish an institutional framework via a securities regulatory body (SSMSC) that effectively licenses, monitors, and enforces proper behavior by market participants.

This paper finds that the results of USAID's efforts in developing capital markets in Ukraine were transformative, and a model for such initiatives elsewhere.

Charles M. Seeger
Kiev Ukraine / Washington DC
January 2011

APPENDIX 1

Chronology of the Central Securities Depository

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

- 1996—Verkhovna Rada adopts a Concept Paper for the Development of the Capital Markets in Ukraine.

- March 1997—Interregional Securities Union (MFS) is established as an open joint stock company by market participants in order to serve as a depository for Ukrainian companies and trading systems exchanges.

- December 1997—The Law "On the National Depository System" is approved. The Law provides for the establishment of the National Depository of Ukraine (NDU).

- 1999/2000—USAID provides technical assistance to MFS to strengthen its work as a fully functional depository that can support the development of a capital market in Ukraine.

- January 1999—Memorandum of Understanding among the Government of Ukraine, the World Bank, and the Government of the United States of America "On the Development of a Securities Industry-Owned Clearing Depository" is signed.

- May 17, 1999—The NDU is established as an open joint stock company with the State Securities and Stock Market Commission controlling 86% of its shares, the National Bank of Ukraine holding 4.4%, and the remaining shares, 9.6% owned by 21 market participants, including 1 share owned by MFS. SSMSC Commissioner Viktor Ivchenko is appointed to head the NDU.

- June 22, 1999—Presidential Decree "On the General Basis for the Operations of the National Depository System of Ukraine."

- July 2001—Cabinet of Ministers adopts a resolution transferring the management of State's 86% ownership in the NDU to Ministry of Finance. A new "*State Program for the Development of the National Depository System*" adopted, assert broad new NDU powers and budget.

- December 2004—President Victor Yushchenko, Orange Revolution, comes to power. State Program for the Development of National Depository System inforced.

- February 2005—Protest letter by leading securities markets participants in opposition to the new NDU Program and remarkable budget and fees proposed.

- October 2005—A Presidential Decree issued that empowered the NDU with all possible depository functions, and repudiated the long standing Government position supporting a privately owned and operated central securities depository.

- December 7, 2005—Cabinet of Ministers adopts a resolution to transfer management of State's 86% ownership in the NDU back to the SSMSC, as provided in the 1997 Law "On National Depository System."

- December 14 and 23, 2005—NDU holds a general meeting of shareholders that, among other issues, approves a decision to empower NDU to operate as a fully-functioning depository, including authority to clear and settle transactions on Ukrainian exchanges.

- January 18, 2006—Cabinet of Ministers passes a resolution to terminate the MOU with US Government and World Bank.

- January 20, 2006—Condemnation of this Government action by the USAID, the World Bank, and securities market participants.

- March 16, 2006—USAID and SSMSC hold task force meeting to discuss the merger of the MFS and NDU, and to formulate an action plan for the establishment of a Ukrainian central depository.

- June 21, 2007—After months of tension and inability to resolve shareholding structure issues, NDU withdraws from the negotiations with the MFS on establishing a single depository in Ukraine.

- December 2007—After the failed negotiations between the NDU and MFS, the National Bank of Ukraine (NBU), in collaboration with several banks and stock exchanges, approved a decision to create the All-Ukrainian Securities Depository (AUSD). This entity will result from a merged MFS. Experts believe this means NDU will have to leave the depository services market.

- April 18, 2008—The foundation meeting of the creators of the "All-Ukrainian Securities Depository" (AUSD) took place. The meeting unanimously approved a decision to establish the AUSD, and set forth MFS shareholders new ownership.

- February 27, 2009—MFS shareholders agreed to an arrangement of the merger of the MFS with the AUSD through the procedure of purchase and sale of the MFS single property complex in favor of AUSD.

- May 2009—The NDU lobbied the National Securities and Defense Council to make the NDU the Central Depository of Ukraine and to eliminate the AUSD. NBU Governor Stelmakh denounces the NDU position. USAID and World Bank also oppose the NDU.

- June 2009—SSMSC granted the AUSD with the depository and clearance & settlement licenses.

- June 24, 2009—*USAID/World Bank Joint PTAP Position Note on Establishment of a Central Securities Depository of Ukraine* sent to the Prime Minister and various Government officials.

- September 10, 2009—The shareholders of AUSD voted to approve the new issue of shares (to MFS shareholders) to complete the merger and elected a new supervisory board.

- October 2009—AUSD becomes operational. Various lawsuits underway by the NDU to stop the AUSD.

- February 2010—NDU abandons court claim challenging AUSD depository license.

- Spring 2010—New President and Government in place.

- September 2010—A rare NDU shareholders meeting was held, with the SSMSC voting the Governments 86% ownership. The Board of the NDU dismissed the existing NDU management, and replaced them with a group that supports the creation of a single, Government recognized CSD, by merging the AUSD and NDU and thus giving AUSD the imprimatur of the Government designation as the nation's sole NDU.

- September 2010—The NDU challenged the shareholders meeting action, because the SSMSC did not have written authorization from the Cabinet of Ministers to take the action it did. Thus, the minutes of the NDU shareholder meeting were not signed, casting doubt on the legal impact of its decisions. A meeting with the same agenda was called for November 17, 2010.

- November 2010—The NDU challenge to the September NDU shareholder vote was sustained. The next meeting of the NDU shareholder with the same agenda will be held in 2011.

- November 2010—In a letter to the IMF, the Ukraine Government financial leaders (Prime Minister Mykola Azarov, Finance Minister Fedir Yaroshenko, and the Governor of the National Bank of Ukraine Volodymyr Stelmakh) affirmed the GoU intention to merge the AUSD and NDU.

APPENDIX 2

Clearance and Settlement

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

At the Core

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

The Group of Thirty, Global Clearing and Settlement, Washington, D.C. 2003.

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

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

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

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

We Need Obedient Clients

In 1994, in India, each share certificate was counted, stamped, and settled by hand. During a flood of foreign investment, the manager of Hong Kong Shanghai Banking Corp., one of India's leading custodial agents for foreign investors, complained:

"We have 300 staff. The maximum they can count in a day is 50,000 share certificates. We have to ask clients not to trade more than we can count."

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

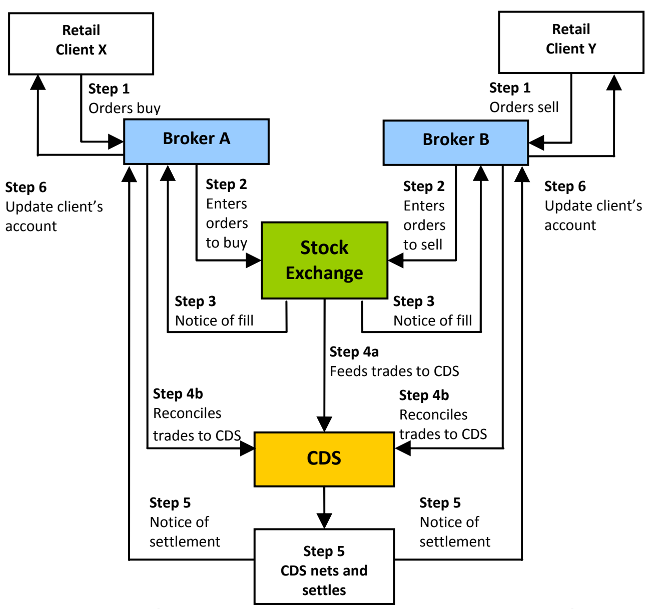
There are several ways of structuring this guarantee function:

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

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

Process of Clearance and Settlement

Canadian Clearance and Settlement System



Step 1: Broker/Dealer **A** buys security and Broker/Dealer **B** sells security for clients.

Step 2: Brokers/Dealers **A** and **B** execute the trade by entering the order on an exchange.

Step 3: Stock exchange sends a "fill notice" of the trade to Brokers/Dealers **A** and **B.**

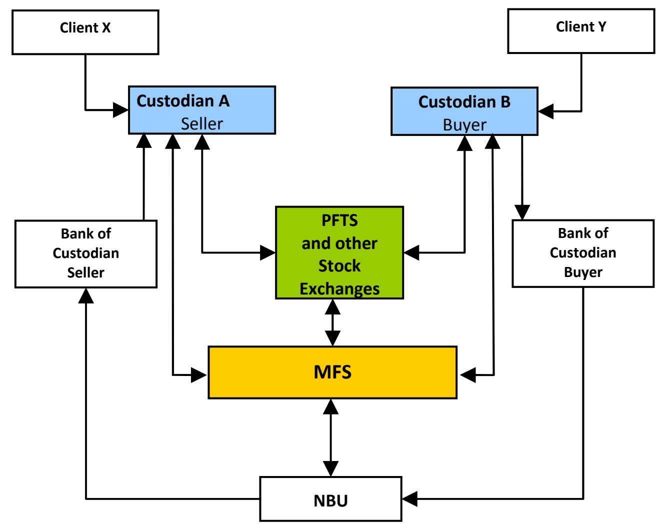
Step 4a: Stock Exchange sends trade to Depository.

Step 4b: Brokers/Dealers **A** and **B** and the stock exchange send details to the Depository.

Step 5: On **T+3**, the Depository transfers cash and securities between the accounts of Brokers/Dealers **A** and **B** and notifies the brokers to the transaction.

Step 6: Brokers/Dealers **A** and **B** report the final transaction and update the accounts of their respective clients for funds and securities.

MFS Clearance and Settlement System



APPENDIX 3

Securities Exchange Development Chronology

Selected events reflecting the legal, regulatory, and operational aspects of securities markets development in Ukraine.

- 1991 – Ukraine Law on Securities and the Stock Exchange; Ukraine Law on Business Associations.
- 1992 – Ukraine Law on Privatization of State Property.
- 1994 – The Presidential Decree "On Investment Funds and Investment Companies."
- 1995 – The Presidential Decree "On the Securities and Stock Market State Commission," established the SSMSC as the Ukrainian agency charged with the regulation of the securities market.
- 1995 – USAID responded to requests from the GoU to assist securities exchange development by working with an assortment of over 300 fledging broker-dealers and banks desiring to establish a securities exchange as a non-profit, privately-owned and operated, securities market.
- 1996 – The Ukraine Verkhovna Rada (Rada) adopted the "Concept for Functioning and Development of the Ukrainian Securities Market"; Ukraine Law on State Regulation of the Securities Market in Ukraine.
- 1996 – PFTS Association of broker dealers was founded.
- 1997 – Ukraine Law on the National Depository System and Specific Features of Electronic Circulation of Securities.
- 1997 – PFTS Electronic Trading Platform became operational. The PFTS trading system, based on NASDAQ software, was created with technical assistance and financial support of USAID.
- 1997-2003 – The SSMSC licensed two Electronic Trading Platforms: PFTS Trade Information System; South Ukrainian Trade Information System. And, the SSMSC licensed eight securities exchanges: Ukraine Stock Exchange; Pridneprovsk Stock Exchange; Donetsk Stock Exchange; Lugansk Stock Exchange; Ukrainian Interbank Currency Exchange; Kiev International Stock Exchange; Ukrainian International Stock Exchange; Crimea Stock Exchange.

- 1997-2005 – USAID assisted the PFTS in becoming compliant with IOSCO International Best Practices, and in working with the SSMSC on all aspects of securities markets regulation.

- 1998 – The World Bank added as a “Conditionality” to its loan to Ukraine that the GoU must support the creation of a market-based securities depository linked to all SSMSC licensed securities exchanges.

- 1999 – Presidential Decree “On General Principles of Functioning of the National Depository of Ukraine.”

- 1999 January – The MoU between the GoU, World Bank, and the United States via USAID, reinforced a commitment to free markets and committed all three signatories to support only privately owned and operated securities market institutions.

- 1999 May – The National Depository of Ukraine (NDU) was established with 90% plus GoU ownership, with a highly restricted NDU role in securities markets, not in competition with the existing MFS central securities depository while MFS operated for the PFTS and other securities exchanges.

- 2000 – The number of listed securities at PFTS approached 900, however 140 stocks are regularly traded.

- 2001 – Ukraine Law on Collective Investment Institutions (Corporate and Unit Investment Funds).

- 2002 – Presidential Decree “On Measures for Corporate Governance Development.”

- 2002 – IOSCO Principles for Ongoing Disclosure and Material Developments Reporting by Listed Entities.

- 2002 January – PFTS provides free access to PFTS trading results via Internet by the address www.pfts.com/uk/tsystem/sstats_common.php.

- 2003 – IOSCO Principles Regarding Disclosure of Management Discussion and Analysis of Financial Conditions and Results of Operations.

- 2003 – Ukraine pension reform progresses with the passage of the legislative framework from Pillar II (mandatory) and Pillar III (voluntary) individual accounts with investments in Ukrainian securities traded on SSMSC licensed securities exchanges.

- 2003 March – PFTS organized and carried out the Round table “Development of the Eurobonds Market of the Ukrainian Issuers in Ukraine.”

- 2003 August – The Requirements to a level of disclosure of the information by issuers of bonds at passage of PFTS Listing procedure, requirements to a level of the liquidity, necessary for inclusion of bonds to the PFTS Listing are established, regulation on the institute of markets-makers of the corporate bonds market is authorized.

- 2004 – PFTS amended its 2002 Trading Code governing the conduct of traders permitted to use the system.

- 2004 March – PFTS has begun trades in the state bonds issued with the purpose of repayment of a state duty on compensation to companies the tax to the added value. At present these securities are the most liquid state bonds on the secondary market.

- 2004 June – PFTS members have presented Address to the candidates for elections of the President of Ukraine, which contained the record of quantitative and qualitative indicators which performance will assist an output of a financial system of Ukraine on a new level of development. Among them: creation of legal basis in corporation governance of joint-stock companies, quantitative increase in the free circulation of shares of the enterprises which are in a state ownership, impossibility of administrative redistribution of the property, optimization of the taxation of citizens on operations in the securities market, maintenance of real independence of judicial authority and consideration of corporate disputes in specialized courts etc.

- 2005 – Ukrainian Stock Club established. Comprised of leading members of the PFTS Association, the Club pressed PFTS management to improve software and receive licensing from the SSMSC as a stock exchange.

- 2005 – A new State Program for the Development of the NDU as it interrelated with the PFTS and other exchanges was approved. The NDU was granted extensive new powers to intervene in the securities markets activities, and an ample operating budget, and fee rendering powers, in order to do so.

- 2005 – Presidential Decree “To Improve the Investment Climate in Ukraine”; Ukraine Action Plan to Improve the Investment Climate in Ukraine, approved by Presidential Decree; Main Directions for Stock Market Development in Ukraine for 2005-2010, approved by Presidential Decree.

- 2005 February – PFTS members have referred to the Cabinet of Ministers and Supreme Rada of Ukraine with the address concerning the rejection of the Decision of the Cabinet of Ministers of Ukraine #1707 from 12.21.04 About the Statement of the State Program of Development of National Depository System of Ukraine as such, that is not equitable to the National Interests of Ukraine.

- 2005 June – PFTS Members have referred to the Cabinet of Ministers of Ukraine with the Address to provide an openness, transparency of the process of privatization in Ukraine by the means of sale of the state share holdings on the regulated securities market.

- 2005 October – A Presidential Decree repudiated the previous GoU position that supported only private-sector owned and operated securities markets institutions, asserting a greatly expanded GoU role in securities markets.

- 2005 November – PFTS was accepted to the World Federation of Exchanges (WFE). WFE is the largest international professional association of stock exchanges, which unites 115 members, including NYSE, LSE, NASDAQ, Tokyo Stock Exchange, Moscow Interbank Currency Exchange, RTS etc.

- 2006 – Ukraine Law on Securities and Stock Market.

- 2006 – Following the demutualization of PFTS, a new entity was established under the name of PFTS Exchange. PFTS trade volumes grow. However, the ageing software hampered the capability of PFTS from offering its members and customers the type of services demanded, especially in the way of quote driven technologies, Internet trading, straight through processing etc.

- 2006 – The SRO called the Ukrainian Stock Traders Association was established by Perspectiva. The PFTS also sought this SRO status, but this required that 50% of licensed brokers were members, but due to some brokers displeasure at the lack of technological progress at PFTS, some investment firms chose to switch to the association created by Perspectiva Exchange. Perspectiva ultimately secured the required minimum and was licensed by SSMSC as the single broker-dealer SRO called the “Ukrainian Stock Traders Association (AUFT).”

- 2006 January – The Cabinet of Ministers formally terminated the 1999 MoU between the GoU, the World Bank, and USAID which had previously endorsed supporting only market-based, private-sector owned and operated, securities markets institutions.

- 2006 February – The leaders of the securities markets industry, with the support of USAID and the World Bank, protested the GoU action and effectively curtailed the GoU previously announced expansive intrusive agenda by the GoU via the NDU into the securities markets.

- 2006 February – The Stock Market Club initiates effort to establish a new stock exchange. Members issued an ultimatum to PFTS management and, unsatisfied with progress, the Club formally initiated effort to create a new stock exchange with quote driven technologies and full licensing, envisaging a single exchange platform.

- 2007 – The PFTS had over 80% of securities market volume in Ukraine, and Ukraine's growth in securities exchange trading volume was among the most actively increasing in the world.

- 2007 February – PFTS Stock Exchange joined the International Association of Exchanges of the Commonwealth of Independent States countries. IAEx of CIS accounts for 20 members from 9 CIS countries. IAEx's members are the major players on CIS securities and FOREX markets.

- 2007 September – Launched UTX Index (Ukrainian Traded Index).

- 2008 – PFTS takes action to respond to the threat of the new competition. With USAID support, PFTS visited several exchanges and evaluated technologies and systems in EU countries with USAID support. Following meetings with their counterparts in Europe, PFTS management decided to conduct a tender to identify and select the best alternative at the most competitive price (2008-09).

- 2008 – Ukraine Joint Stock Company Law.

- 2008 March – PFTS signs cooperation agreements with Warsaw Stock Exchange and, later, Vienna Stock Exchange.

- 2008 October – The Ukrainian Exchange is registered as a legal entity. Cooperation of the Ukrainian Stock Club members and the Russia Trading System (RTS) achieves the goal of establishing a new exchange. RTS received a 49% stake in the exchange and 51% was distributed among 21 Ukrainian companies.

- 2008 December – The Ukrainian Exchange is licensed. The SSMSC grants the Ukrainian Exchange license to conduct activities as a securities exchange.

- 2009 January 20 – Trading on the Ukrainian Exchange order-driven market is launched in the testing mode. This was a unique technology for the Ukrainian market. The Ukrainian Exchange asserts it will capture over 50% of the market by the end of 2010.

- 2009 March – The Ukraine Exchange entered into an agreement with the Russian Trading System (RTS) for RTS to provide know how, advanced technology, and a capital infusion for expansion. The Ukraine Exchange promptly it had surpassed the PFTS in trading volume (a claim that was suspect by many securities markets participants).

- 2009 March 26 – Trading was open on the Ukrainian Exchange. Over 80 of the most liquid stocks of Ukrainian issuers were admitted to trading. The Ukrainian issues are traded on an anonymous bidding market with the possibility of connect broker systems and conducting online trading. Two months after this launch, the Ukrainian

Exchange accounts for almost half of all exchange trades in the country, whereas previously 90% of trades were executed at PFTS.

- 2009 April – The PFTS announced its “strategic alliance” with the Moscow Interbank Currency Exchange (MICEX) to modernize its trading system and offer new securities product for trading.

- 2009 April – PFTS unveils its own “order driven” technology. With the assistance of Moscow International Exchange (MICEX), and only a month after the Ukrainian Exchange opens, PFTS introduces order driven services.

- 2009 May – The Ukrainian Exchange launchers repo market services.

- 2009 June – The Ukrainian Exchange asserts that it has surpassed the PFTS in terms of volume traded.

- 2009 June – The USAID and World Bank issued its joint PTAP Note emphasizing the importance of privately-owned and operated securities markets institutions.

- 2009 September – The Ukrainian Exchange introduces the Central Counterparty (CCP). This provides investors with anonymity in settlement. It announces a next step to introduce a derivatives market for a wide spectrum of the Ukrainian financial instruments.

- 2009 October – Bloomberg begins to publish market data of the Ukrainian Exchange.

- 2009 December – The strategic investor MICEX of Moscow purchases controlling interest in PFTS.

- 2009 December – RTS begins process to decrease its share in the Ukrainian Exchange to 40%.

- 2010 May – Ukrainian Exchange launches derivatives trading on the UX index.

- 2010 September – The annual PFTS conference in Crimea showcases officials from the Russian Trading System (Ukraine Exchange backers) and the Moscow Interbank Currency Exchange (PFTS backers) and outlines the competitive strategies of these two prominent and competing exchanges.

APPENDIX 4

ESCRIN (electronic financial disclosure system) Media Reports

Note: This Appendix will consist of samples of extensive media coverage throughout Ukraine covering the July 15, 2010, ceremony on the formal transfer of ESCRIN for the USAID to the SSMSC. [Presently in PDF form] This coverage highlights the USAID contribution and provides quotes from:

Vice Premier Minister Serhiy Tigipko

U.S. Ambassador John F. Tefft

SSMSC Chairman Tevelyev

USAID Mission Director Janina Jaruzelski

Deputy Minister of Finance Tetyana Yefimenko

First Deputy Minister of Economy Anatoliy Maksyuta

SSMSC Commissioner Mykola Burmaka

APPENDIX 5

Ukraine Securities Market Participants

This offers a mere representative review of participants, and is not intended to be comprehensive. Omission of the name of any firm implies nothing.

Banks: Approximately 125 of the 198 registered banks in Ukraine are active in the securities markets, including:

Brokbusinessbank
Delta Bank
Erste Bank
Eximbank
Finans and Credit Bank
Forum Bank
ING Bank
Kreditprombank
Megabank
Nadra Bank
Oschadbank
OTP Bank
Pivdenny Bank
PrivatBank
Raiffeisen Bank Aval
Rodovid Bank
Santannan Financial
SEB Bank
Swedbank
Ukrainian Professional Bank
Ukrgazbank
Ukrsibbank
Ukrsotsbank
VTB Bank
Zembank

Broker-Dealers: There are over 740 registered broker-dealers in Ukraine, including:

Amadeus Index PFTS Investment Fund
Atlanta Capital
Business Invest Investment Co.
DFK Slavutych Capital
Dragon Capital
ITT Investment Company
KINTO
On-Line Capital
TEKT
Troika Dialog Ukraine

As of results of 2009 the best traders (top 10) in category of *trading by shares* are:

Art-Capital
BG Capital
Dragon Capital
Foyil Securities New Europe
Group Investment Standard
Navigator Invest
Regata Investments
Sinkom
TASK-Broker
Ukrainian Stock Center

As of results of 2009 the best traders (top 10) in category of *trading CII securities* are:

Altus-Finance
Investment Capital Ukraine
Firm International Kyiv
First Stock Broker Company
KUB
Premium Capital
Regata Investments
Stock Company Finex-Ukraine
TASK-Broker
Velbin

As of results of 2009 the best traders (top 10) in category of *trading by corporate bonds* are:

Art-Capital
Investment Capital Ukraine
Financial Group "Consulting & Investments"
Finansist
Foundation of Industrial Development
Premium Capital
Renesans-Capital
Stock Company Finex-Ukraine
Stock Company Favorit
Troika Dialog Ukraine

Securities Exchanges: There are 10 registered securities exchanges in Ukraine, including:

East European Stock Exchange
Innex Stock Exchange
Kyiv International Stock Exchange
Perspectiva Stock Exchange
PFTS Stock Exchange
Pridneprovsk Stock Exchange
Ukrainian Exchange
Ukrainian Interbank Currency Exchange
Ukrainian International Stock Exchange
Ukrainian Stock Exchange

Depositories of Securities[37]

All Ukrainian Securities Depositary (AUSD)
National Depositary of Ukraine (NDU)

SRO[38]. Total number of SRO participants – 1905

Association of Ukrainian Stock Traders (AUST) -- 703
Professional Association of Registrars and Depositaries (PARD) -- 816
Ukrainian Association of Investment Business (UAIB) -- 380

[37] Source: SSMSC Official web-site: http://www.ssmsc.gov.ua/ShowPage.aspx?PageID=646

[38] Source: SSMSC Official web-site: http://www.ssmsc.gov.ua/ShowPage.aspx?PageID=381

Regulators: Monitoring and compliance is conducted by several government regulators, including:

The National Bank of Ukraine (NBU)
Banks

The Securities and Stock Market State Commission (SSMSC)

Broker-Dealers	Registrars
Collective Investment Institution	Securities Issuers
Custodians	SRO
Depositaries of securities	Stock Exchanges

The State Commission of Regulation of Financial Markets (FSR)

Credit unions	Insurance Companies
Financial Companies	Non-State Pension Funds

Pension Funds: There are 109 private pension funds, including:

Corporate non-state pension fund of National Bank of Ukraine
Emerit-Ukraine
Europa
First National One-ended Pension Fund
IFD Capital
NFP of Ukreximbank
Professional Pension Fund of Ukrainian Independent Trade Union of Power Engineering Specialist
STIROL
Ukraine
VSI

Asset management companies: As of December 1, 2009 SSMSC issued 388 licenses for asset management, including:

Academy Investments
DAN
Financial Aktiv
Investment Capital Ukraine
ITT-Management
KINTO
Management Service
Premiyer Asset Management
Profi Asset Management
Rodovid Asset Management

Collective investment institution (incl. Mutual funds):

The total number of Open-ended CII by net asset value as of Q#, 2009: 29

Altus-Strategichnyi
Altus-Zbalansovanyi
KINTI-EQITY
Klassychnyi
Konkord Dostatok
Sparta Zbalansovanyi
Parex Ukrainskyi Zbalanvovanyi Fond
Premium-Fond Indeksnyi
Premium Fond Zbalansovanyi
Parex Fond Ukrayinskyh Obligatsyi

The total number of Interval CII by net asset value as of Q#, 2009: 45

Deposit+	Platinum
Dostatok	Sotsinvest-Garant
Interval	TASK Ukrayinskyi Capital
Konkord Perspektiva	Tekom-Stabilnyi Dohid
Narodnyi	Tekt-Invest

The total number of Close-ended CII by net asset value as of Q#, 2009: 165

Centr Invest-2	Synergiya-4
Garantyini Investitsii	Premier Estate Investment
Golden Verteks Fond	Rozumyi Capital
Investitsiynyi Capital II	VIK
ITT-Capital	Ukrayinski Zbalansovani Investitsii

Insurance Companies: The total number of registered insurance companies as of Q3, 2009: 475.