

Adhering to International Standards –

Will Ukraine Remove Itself from the List of Sad "Exceptions"?

Achieving maximum confidence of local and foreign investors in Ukraine's securities market and creating "transparent rules of the game" – such is the strategic objective of the decision announced at the Conference "Development of the Depository System in Ukraine: AUSD and MFS Merger" held April 16 in Kyiv.

by Yaroslav Falko, editor-in-chief, Olga Budnik

The conference was attended by shareholders of the All-Ukrainian Securities Depository (AUSD) and the Interregional Securities Union (MFS), representatives of the Securities and Stock Market State Commission (SSMSC) and State Commission for Regulation of Financial Services Markets (FSR), Ukraine's main exchanges as well as experts from the World Bank and USAID – U.S. Agency for International Development, which has been working in Ukraine since 1992 and implemented a large number of important social and economic projects.

Increasing the Number of Transactions

At first sight, this information may sound dry and boring. In fact, we are talking about an extremely important decision relating both to the prospects of Ukraine's economic development and financial interests of many Ukrainians who either already own domestic equities or plan to do so in the future.

What is the matter here?

The problem is broadly known to everyone who follows political and economic developments in our country.

Securities market is one of the oldest institutions of an established market economy and stock and bond transactions are one of its essential tools. However, the situation in such market in Ukraine is still far from international standards. The trouble is even not that "regulators and professional market participants do not have a full understanding of complex functions and special features of operations of registrars, depositories and clearing houses", as it was pointed out during the conference. Various conflict situations are constantly arising in Ukraine, when investors contest the "dilution" of their stakes, "loss" of documents of title by some apology for a registrar, other «cases of abuse and outright fraud». Raider takeovers making headlines as high-profile controversies since 2005 have become the talk of the town.

The problem is also that Ukrainian laws do not require that all transactions be executed on exchanges and settlements made in a clearing depository. This situation has become one of the reasons why only a bit more than ten percent of all trading volume is going through exchanges and the

reported trading level remains one of the lowest in Eastern and Central Europe, conference participants pointed out.

There is no doubt that ownership conflicts are as eternal as the change from day to night. On the other hand, the problems exist to be resolved. However...

Currently, Ukraine has two depository systems for securities: National Depository of Ukraine (NDU) and Interregional Stock Union (MFS).

Founded in March 1997 by market participants themselves, MFS was the first to enter the market after the Verkhovna Rada adopted the Concept Paper on Ukrainian Capital Markets Development (1996). This initiative was supported by international donors. As early as January 1999, the Government of Ukraine, World Bank and the U.S. Government signed a Memorandum of Understanding "regarding the creation of a clearing securities depository". During the following two years, USAID provided technical assistance to MFS, thus helping it become a multifunctional private clearing depository that supports the development of capital markets in Ukraine.

As of today, MFS is the only depository in Ukraine which has issues of stocks and fixed income corporate instruments on deposit. It provides services to over 1,100 market participants who own securities.

It is rather interesting to note for our topic that MFS's operating activities are modeled on the Canadian Securities Depository. But there are differences. As experts from EuroClear (one of the largest settlement system for international transactions in stocks and bonds) stated several years ago, unlike the Canadian Depository, the Ukrainian one "is not an officially recognized central depository". This somewhat limits the effectiveness of MFS in facilitating foreign investments and purchase of foreign equities by Ukrainian investors, specifically by non-state pension funds.

On the Eve of an Anniversary

The National Depository of Ukraine OJSC will celebrate its tenth anniversary in May. What is special about it is that 86 percent of NDU's shares are owned by the state: this stake changed managers moving from SSMSC to the Ministry of Finance to the National Bank to the Ministry of Finance and coming back to SSMSC.

Even before it was created, U.S. and Ukrainian Governments and the International Bank for Reconstruction and Development signed a Memorandum of Understanding regarding the creation of this clearing depository; but even back then, it was noted in the document that this institution will have no commercial functions and can perform only three functions – codification, standardization and international relations – during the effective period of the MOU.

However, since 2004, the Government of Ukraine has taken some actions in violation of the international MOU's principles. First of all, Acting Prime Minister of Ukraine Nikolai Azarov signed a state program for the development of the national depository system that provided for a significant expansion of NDU's powers. It prompted strong objections from market participants. On February 9, 2005, about 70 of them, including 26 Ukrainian and foreign banks, 40 dealers and a number of other market participants signed an "Open Letter" to the Cabinet of Ministers and Verkhovna Rada of Ukraine, where they voiced objections to the use of state budget funds to resolve problems that would either "have not existed at all or have been solved at the expense of market participants long time ago." The letter also points out that "government plans regarding the development of the government-owned depository system will make it impossible to continue developing the system in compliance with the principles of meeting the market needs and its self-regulation."

At the end of the same year, President Yushchenko signed the Decree approving two decisions made by the National Security and Defense Council: "On Actions to Improve Investment Climate in Ukraine" and "On Actions to Secure Guarantees and Improve Effectiveness of Ownership Protection in Ukraine." Specifically, the Decree provided for the creation, on the basis of NDU, a Central Securities Depository "controlled by the state and independent of influence from financial and industrial groups and market participants."

In pursuance of the Presidential Decree, in January 2006, the Cabinet of Ministers decided to ... abrogate the Memorandum of Understanding signed by the U.S. and Ukrainian Governments and the International Bank for Reconstruction and Development regarding the creation and main operating principles of a clearing depository. Fortunately, very strong objections were expressed by the Association of Ukrainian Banks (President – Alexander Sugoniako), Ukrainian Association of Investment Business, Professional Association of Registrars and Depositories and about 40 other market participants. In their letter addressed to the President of Ukraine, Cabinet of Ministers and Securities and Stock Market State Commission, the signers clearly outlined the problems that will arise if a central depository is owned by the government: leaks of confidential information, a loss of confidence in the securities market by foreign investors, a loss of competitiveness in world markets. USAID issued a press release saying it was deeply disappointed by the decision of the Government of Ukraine and concerned that such

unilateral decision may have an adverse impact on the market, investors, including non-state pension funds. The World Bank voiced its concern in the letter addressed to Ukraine's President Victor Yushchenko as well...

Finally, last April, on the initiative of the National Bank of Ukraine, there was established the All-Ukrainian Securities Depository OJSC, with one quarter of shares owned by the National Bank of Ukraine. Whereas... However, let's give the floor to experts.

Going by International Standards

"The depository industry structure in most countries of the world includes a single depository in a country," John Crowley, USAID Capital Markets Project Expert well-known for his successful work not only in other countries but in Ukraine and Russia, told International Courier reporter. "The reason for this is to cut transaction costs. If all transactions in a country are flowing through one depository, the cost per transaction is going down, i.e. costs are minimized. When Ukraine has two depositories, the costs to the country are almost doubled. If you look at American and European depository systems, their primary objective is to cut transaction costs."

"One other thing is important," John Crowley continues, "In spite of the fact that depositors, registrars and clearing houses perform different operations (activities) and have different responsibilities, one entity can cover different activities and different responsibilities.

For example, in the USA, Depository Trust Company (DTC) – the world's largest depository is also a custodian of assets and securities for US\$20 trillion, and functions as a clearing institution. This company is a member of the US Federal Reserve System. DTC is established as powerful infrastructure for contract settlements in corporate, municipal securities, mortgage-covered bonds; and settlements are both timely and at minimal fees. A similar example in Europe is Clearstream Banking S.A. founded as a depository, registrar and clearing house. In other words, this practice is common for all countries across the world – to have one depository. But there are two countries that are exceptions: Russia and Ukraine. But two depositories in Russia are slowly merging.

"You have been working in Ukraine for a long time. In your opinion, why do we have this situation in our country? Is this the result of a lack of market experience?"

"I do not know the history of the problem but it appears to be some kind of post-communist reflex, the understanding that a market economy should not have regulated monopolies. But, in fact, in this particular area we are talking about and in the market environment, a monopoly is efficient!"

There is another aspect to this problem. It was discussed in the analysis of Ukraine's depository system made by International Depository Expert of the USAID Capital

Markets Project Harry Cartner. He is a professional with thirty years of experience in securities transactions and has extensive experience working in developing countries, such as Algeria, Bulgaria, Cote d'Ivoire, and Mexico.

This is what Harry Cartner writes in his paper "Ukraine's Securities Depository System: Risk and Recommendations":

"An informal review of the ownership of depositories in 48 countries, both developed and emerging markets, shows that only in five countries was the depository controlled or partially owned by a government body". These, as you may have guessed, are former socialist countries - Bulgaria, Poland, Slovakia, Croatia, and the Czech Republic. They have national depositories with a portion of ownership held by the Ministry of Finance. However, Poland has already started the privatization of the Warsaw Stock Exchange and has also commenced planning the privatization of the national depository for securities. "The other countries have various ownership structures that involve primarily stock exchanges, banks, broker-dealers, investment funds, and other market participants, with some ownership by the central bank of the particular country."

"In order to achieve credibility – and maximum investor confidence," writes Harry Cartner, "it is important that the independence of the share registrar and depository be assured. Ideally, the share registry should be maintained by an independent third party, not the company itself. Similarly, the depository should be independent of the government and control of private groups. As the Russian experience demonstrates, lack of independence of these key market institutions fosters distrust, inhibits investment, and impairs effective corporate governance."

In brief, the problems that "surrounded" Ukraine's depository system cried for solution! And it is absolutely right that securities market participants in our country did not set off to invent a bicycle but used international experience and practices characteristic of countries with

well-developed market infrastructure. As reported at the conference, in March and April, AUSD and MFS shareholders decided to unite in a single entity. This is the first important step necessary for the stable development of securities and capital markets in Ukraine to work under international standards.

Our objective today is not to cover various technological details of events and subtleties of the depository's operation; that is why we will limit our coverage to brief comments of conference participants.

"The merger is almost complete," says Chairman of the MFS Management Board Nikolai Shvetsov. "A modern depository working in compliance with international standards will make investing and trading on Ukrainian capital markets more secure, and therefore more attractive for investors. It is important even what today's meeting shows: the creation of a single central depository is a transparent process."

"Pursuant to the 1999 Memorandum of Understanding signed by USAID, World Bank and the Ukrainian Government, USAID has provided technical assistance to MFS, helping it become a world-class clearing and settlement depository," says USAID representative Natalia Berezna. "We are proud of MFS's accomplishments to date, and stand ready to support it and AUSD as they go forward toward a successful merger."

"I want to emphasize that we are very optimistic and believe that the merger will happen and will be effective and favorable for investment climate in Ukraine," said USAID Capital Markets Expert John Crowley in a brief comment for our newspaper, "First of all, it will be positive for Ukrainian investors. Besides, the new depository will definitely attract foreign investors to the Ukrainian market, and, in its turn, foreign capital will significantly raise liquidity and valuations."