



USAID
FROM THE AMERICAN PEOPLE

Capital Markets Project

IMPLEMENTING THE SRO PROVISIONS OF THE 2006 LAW OF UKRAINE ON SECURITIES AND STOCK MARKET: AN INTERNATIONAL PERSPECTIVE

Robert D. Strahota

Consultant, Financial Markets International, Inc.

USAID Capital Markets Project

SSMSC Roundtable on Self-Regulation

Kyiv

July 11, 2007

2006 LAW SRO PROVISIONS - PROS

- Membership in at least one SRO is mandatory for each licensed professional securities market participant (PSPM)
- The law seeks to establish by May 2009 a sole membership SRO for each of three categories of PSMPs
 - Securities traders
 - Institutional asset managers
 - Registrars and custodians

2006 LAW SRO PROVISIONS - CONS

- The law falls short of international best practices for SROs as set forth in the IOSCO Objectives and Principles of Securities Regulation (2003) (IOSCO Principles)
- The law fails to recognize the importance of market institutions that may perform some SRO functions more logically and efficiently.
 - The continued status of securities markets as SROs requires clarification
 - A securities depository would be a more logical SRO for securities custodians
- Liberal licensing practices for securities traders have created an unsound regulatory situation, which will make it difficult to attain the more than 50% membership requirement for a sole securities trader SRO
- There are a few technical issues re implementation

SOURCES OF SRO AUTHORITY

In most jurisdictions, there are three potential sources of SRO authority to engage in self-regulation:

1. The law directly grants authority to the SRO
 - Not necessarily a good idea because this pre-supposes that the SRO is qualified. Generally, it is better for the regulator to make that assessment objectively
2. The regulator delegates authority to the SRO after it licenses the SRO and determines that the SRO is competent to exercise the authority
 - A better idea, assuming the regulator is willing to delegate and makes the decision objectively
3. Members of the SRO and associated persons of members agree contractually with the SRO to be bound by self-regulatory requirements
 - A very good idea, but as part of its SRO oversight, the regulator should approve all requirements to ensure that they are fair and not anti-competitive

The three sources of authority are not mutually exclusive

IOSCO PRINCIPLES RE SELF-REGULATION

- IOSCO Principle 6 encourages, but does not require the use of SROs
- However, if SROs are used, IOSCO Principle 7 sets forth a number of specific recommendations regarding their qualifications and regulatory oversight
- The principal reason that Ukraine would not be considered to have fully implemented IOSCO Principle 7 is the failure to apply self-regulation to associated persons of SRO member firms, including monetary penalties against associated persons
- If this problem cannot be solved contractually, as per the prior slide, it should be solved legislatively
- On paper, other aspects of Ukraine's self-regulation give the appearance of compliance with IOSCO Principle 7. Reality is different.

QUALIFIED SECURITIES MARKETS SHOULD CONTINUE TO BE SROs

- Even if a sole securities trader SRO is established:
 - Ukraine's securities markets will not necessarily consolidate around that SRO
 - Qualified securities markets should continue to be SROs
- Two reasons why
 - The trend internationally is for securities markets to relinquish some SRO functions, particularly membership functions. However, any responsible market will wish to continue to handle its own market SRO functions, such as:
 - Enforcement of trading rules
 - Market surveillance
 - Listing standards
 - Some of Ukraine's regional markets are not responsible markets and do not perform these functions now. It would be illogical and unjust to expect a sole securities trader SRO to use limited resources for member self-regulation to perform market regulation of these markets.

A SECURITIES DEPOSITORY WOULD BE A BETTER SRO FOR SECURITIES CUSTODIANS

- Approximately 90% of Ukraine's securities custodians are licensed securities traders
- Even if PARD becomes a sole SRO, there is no assurance that all securities custodians will be PARD members because PSMPs only are required to join one SRO and the more logical SRO for a securities trader is a securities trader SRO
- However, if they wish to be involved directly in clearance and settlement of securities transactions, securities traders and custodians must be members of a depository
- Therefore, a depository that has in place the operating capacity and self-regulatory framework to handle clearing and settlement of securities transactions, and the confidence of traders and custodians in its ability to do so, is in a better position to serve as an SRO for both traders and custodians
- PARD should consider becoming a sole registrar SRO

THREE ALTERNATIVES FOR ESTABLISHING A SOLE SECURITIES TRADER SRO

Plan A. Take aggressive steps, justified by the weak state of regulation of licensed securities traders, to substantially reduce their numbers between now and May 2009. PFTS Association should be the sole securities trader SRO

Plan B. Overcome the 50% representation condition for a sole securities trader SRO by developing a consensus among principal markets to support the formation of a new member regulation SRO for securities traders. SRO market regulation would remain the responsibility of individual securities market SROs.

Plan C. Amend the 2006 Law to change the unity of 50% of securities traders' requirement to a more representative indicator, such as securities traders whose secondary trading transactions in corporate securities represent more than [50%] of secondary market trading volume in corporate securities measured in UAH and documented by transactions cleared and settled through Ukraine's authorized securities depository, or alternatively, as reported to SSMSC.

TECHNICAL ISSUES RE IMPLEMENTATION OF THE SRO PROVISIONS

1. The law does not require that a PSMP in one licensed category must be a member of the sole SRO for that category. The SSMSC's regulations should address this problem in order to prevent self-regulatory arbitrage; e.g. an irresponsible securities trader that is also securities custodian might join PARD only to avoid SRO regulation of trading activities by the sole securities trader SRO
2. Article 120 of the Commercial Code should be amended to make it clear that SROs organized as economic associations are permitted to affect the activities of their members in order to make self-regulation work. E.g. the SRO requires authority to suspend or revoke the membership of a member, which could effectively put the member out of business.

CONCLUSION

- Ukraine has spent eleven years tinkering with self-regulation without getting it right
- The 2006 law is far from perfect but it is a step in the right direction.
- As is the case with all securities laws, success depends on the quality of implementation and enforcement
- Self-regulation will not work unless it has the full support of the SSMSC and the securities industry.
- Both groups should take an enlightened approach that addresses the above problems and helps to move Ukraine's securities markets from fragmentation to consolidation.