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SSMSC STRATEGY AND ACTION PLAN FOR SRO DEVELOPMENT AND REGULATION ¹

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Introduction

The self-regulatory organization (SRO) provisions of the 2006 Law are a positive step forward in Ukraine's capital market development. The provisions make membership in at least one SRO mandatory for each professional securities market participant (PSPM) and they seek to establish one SRO for each of three categories of PSPMs by May 2009, through the requirement that an SRO may be registered as a sole SRO if it unites more than 50% of one category of PSPMs. If this second goal can be achieved, then three categories of SROs for PSPMs will be in a position to effectively exercise more substantial regulation of their member PSPMs and to accept greater delegation of SRO authority from the SSMSC.

Nevertheless, the SRO provisions are not ideal. They fall short of the best practice requirements of Principle 7 of the IOSCO Principles and perpetuate a major loophole in self-regulation by failing to address the authority to regulate and discipline associated persons of SRO member PSPMs. They also fail to take advantage of more natural securities industry SROs, such as stock exchanges and depositories that have built-in incentives for self-regulation because of the interaction of PSPMs that trade and clear and settle securities transactions. These shortcomings and proposed solutions are explained in more detail in Section IV.I of the Capital Markets Project (CMP) SRO Report and the comments on the SSMSC's draft SRO regulation included as Appendix D-2.

Three Alternative Strategies

We offer below three alternative strategies accompanied by an Action Plan for the SSMSC to consider. The principal difference among the three strategies is how the emergence of a sole securities trader SRO may be achieved. The strategies are not substantially different as they relate to the registration of sole SROs for institutional asset managers and registrars and custodians. The three strategies are as follows:

Plan A. Implement the SRO provisions as soon as possible to consolidate of SROs around the currently dominant SRO candidates, PFTS Association, UAIB and PARD.

Plan B. Overcome the 50% representation condition for a sole securities trader SRO, by developing a consensus among principal stock exchanges to support the formation of a

¹ "Report and Recommendations for Development, Operation and Regulatory Oversight of Self-Regulatory Organizations in the Ukrainian Capital Market", Appendix C. USAID Capital Markets Project.

new member regulation SRO for securities traders. SRO market regulation of securities traders 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 two authorized securities depositories.²

Of course, there are other strategies that could be suggested, but generally they would be less consistent with the objectives of the 2006 Law as enacted.

Plan A. Implement the SRO provisions as soon as possible to consolidate of SROs around the currently dominant SRO candidates, PFTS Association, UAIB and PARD.

Plan A is the strategy that was recommended in the October 27, 2006 CMP SRO Report, which was delivered to SSMSC. Here is the summary of this strategy that was set forth in the Executive Summary of the first draft of the CMP SRO Report.

“The SSMSC’s historical position regarding SROs has been reactive. Going forward, the SSMSC needs to become proactive. The SSMSC should recognize the sole SRO policy reflected in the 2006 Law as a clear message that the SSMSC should be taking affirmative steps to reduce the number of unnecessary and unqualified SROs currently present in the Ukrainian market. In addition to promulgation of the regulation for sole SROs, five key steps that SSMSC should take are:

- Proceed immediately to revoke the current SRO registration of the APSM, which was improvidently granted by prior SSMSC leadership.
- Implement the provision in the Guidelines for 2005-2010 Stock Market Development, approved by Presidential Decree 1648 (November 24, 2005), which calls for securities markets to meet minimum trade volume requirements, by adopting a rule that will revoke the registration and SRO status of any securities market and its related securities association that does not account more than 5% of the reported trading in any of several categories of securities for calendar year 2007.
- Review the registries of PSMPs maintained by the SSMSC for inactive PSMPs and all PSMPs that are not current in their reporting obligations, and publish a notice listing these PSMPs, indicating that if the PSMPs do not file all required information within 30 days of the notice, the PSMPs’ registrations will be revoked by the SSMSC.
- By rule, or if necessary by new legislation, recognize the PFTS Exchange as a securities market SRO.
- By rule, or if necessary by new legislation, recognize the MFS as a depository SRO.

² An alternative source of documentation that the SSMSC might use, if it considered the data to be more reliable, would be transactions reported by licensed securities traders to the SSMSC. Our view is that there might be less likelihood of “gaming” the statistics if actual transaction settlements were used, although we agree that false reporting to the SSMSC also should not be taken lightly.

Set forth below are the Pros and Cons of Plan A.

PROs	CONs
PFTS, UAIB and PARD are the SROs that demonstrate the greatest potential to enforce legislation & SRO requirements, what SROs are supposed to do.	SSMSC may not have the capacity to implement the plan.
PFTS Association is the clear leader in number of securities trader members who are the principal Ukrainian traders in terms of trading volume.	To avoid conflicts of interest due to the PFTS Association-PFTS Exchange relationship, this requires some governance and related changes recommended in CMP SRO Report §V.A.3. ³
UAIB qualified now for sole SRO status subject to minor changes in governing instruments.	Potential opposition from regional exchanges, traders to PFTS leadership
PARD qualified now for sole SRO status subject to minor changes in governing instruments and elimination of APSM.	
Too many unqualified securities traders are operating in Ukraine. SSMSC's registers of PSPMs are likely inflated and need to be purged.	
As securities depositories, MFS and NDU are in a better position than PARD (or APSM) to be SROs for custodians and other depository members.	

Discussion of Plan A. The author and the CMP continue to believe that Plan A is the best plan for the development of Ukrainian self-regulation. While we have not had an opportunity to discuss Plan A in any detail with the SSMSC, we note that this Plan was included in the draft CMP SRO Report delivered to SSMSC in November 2006. Since then, the SSMSC has renewed rather than cancelled APSM's SRO registration, for which there appears to be no justification. While SSMSC has not renewed the licenses of two regional stock exchanges, it is doubtful that its reasons for doing so are related to our recommended strategy for reducing the number of regional exchanges that do not meet specified trading volume thresholds. Overall, it is not clear that the SSMSC finds Plan A acceptable or practicable.

One of the reasons that the SSMSC may be reluctant to take steps to encourage consolidation of securities traders within PFTS Association as a sole securities trader SRO may be the concern whether PFTS Exchange, which is currently wholly-owned by PFTS Association, will continue to be the dominant Ukrainian securities market. This concern misses the point. Implementation of Plan A so that PFTS Association becomes the sole securities trader SRO would not require PFTS Association member securities traders to use the facilities of PFTS Exchange. Indeed, §V.A.3 of the CMP SRO Report sets forth steps that should be take to properly separate the governance and operations of PFTS Association and PFTS Exchange before PFTS Association would become a sole securities trader SRO.

³ The same conflicts and required changes would apply to any other SRO that is a stock exchange or an association owning an exchange.

One of our purposes in recommending Plan A to the SSMSC is to strengthen the securities trader industry in Ukraine by using the sole SRO provisions of the 2006 Law to help consolidate the industry into a smaller number of more active, financially responsible securities traders who are actually engaged in secondary trading activities. One of the strengths of Plan A is that it would cause securities traders, who are not currently members of the PFTS Association and who would be required to join PFTS Association if it becomes a sole securities trader SRO, to reexamine whether what they are doing currently requires them, and/or makes it cost effective for them, to continue to be licensed as securities traders with SSMSC and pay SRO dues to PFTS Association.

Ukraine has roughly 800 licensed securities traders, far too many than are warranted by the volume of secondary market transactions taking place in Ukrainian securities within Ukraine and offshore.⁴ This is a very unhealthy situation regarding the regulatory soundness of the Ukrainian capital market. By comparison, Poland, a country with comparable demographics to Ukraine and a much larger and better regulated securities market, has only 37 licensed securities firms and ten banks authorized to conduct brokerage activities.⁵

A number of Ukraine's licensed securities traders may be dormant or licensed solely to participate in privatization revenues shared by regional stock exchanges of which they are member-owners. As Ukrainian privatization winds down, this source of income should disappear. Since many of the securities traders that are members of regional exchanges and not also members or participants in PFTS Exchange, account for relatively small portions of domestic and offshore secondary securities trading, they will need to consider whether it remains economically worthwhile to remain licensed, whether they should become more active in secondary trading, or consolidate or merge with other licensed brokers, or whether they should drop out of the securities industry.

The SSMSC appears to be focusing instead on whether there are other organizations with trading facilities that might be more viable than the PFTS Exchange. In this regard, they have asked us to evaluate the potential SRO status of the USE and the Perspektiva trading information system. We have met with the USE and we are prepared to meet with Perspektiva. However, we wish to emphasize that consolidation of Ukrainian securities traders and consolidation of Ukrainian securities markets, while not unrelated, are separate issues. We are not suggesting that efforts should be directed to making PFTS Association the sole securities trader SRO because PFTS Exchange happens to be Ukraine's dominant securities market. We are suggesting that PFTS Association should become the sole securities trader SRO because it has already demonstrated the best self-regulatory capacity to do so and it has a larger plurality of active traders than any other Ukrainian organization.

We recognize that it would be possible for another more technologically advanced securities trading system to be introduced in Ukraine, which might surpass the PFTS Exchange's trading system in efficiency and acceptance. This assumes, of course, that the PFTS Exchange does not proceed with its announced plans to upgrade its own trading system. We can say, however, that based upon prior studies by the CMP and its knowledge of other trading systems, none of the other trading systems currently in use in Ukraine have the capability to overtake PFTS Exchange as a dominant trading system.⁶ More importantly, the

⁴ We would exclude veksel for these purposes since we understand that veksel may not be traded on a licensed market.

⁵ Source: Website of the Polish Financial Supervision Authority, www.knf.gov.pl, visited June 12, 2007.

⁶ See generally Robert Smith, "The Ukrainian Stock Exchange Environment: Challenges and Recommendations" (January 17, 2006).

SSMSC seems to be assuming (incorrectly) that if a new trading system were introduced in Ukraine that gained superiority in acceptance to the PFTS Exchange system, then the organizers of that trading system would be preferable to PFTS Association as a sole securities trader SRO.

This reasoning is fallacious for at least two reasons. First, in today's markets there is very little incentive for operators of trading systems to become SROs that are responsible for all self-regulation of their members or participants in the trading system. Generally, the operator is interested primarily in enforcing the rules of the trading system. In fact, the trend with demutualized for-profit markets is to shed themselves of SRO responsibilities for their members because these activities cost money and do not produce profits. Second, the 2006 Law requires a sole securities trader SRO to be a non-profit membership association. There is absolutely no assurance that if an operator with a superior trading system were to emerge in Ukraine that the operator would be organized, or would be willing to reorganize, as a non-profit membership association simply to qualify as an sole securities trader SRO.

In summary, it is conceptually incorrect to equate securities market consolidation with securities trader consolidation. The 2006 law envisions a sole securities trader SRO. The most logical candidate for this designation is the PFTS Association.

Notwithstanding our continued belief in the superiority of Plan A, Plans B and C below are being recommended as alternative strategies that would also achieve the SRO objectives of the 2006 Law.

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

The first key element of Plan B as it relates to securities trader self-regulation is to recognize that self-regulation may be divided into two component parts, an approach that has been adopted in other countries, including Canada and the United States,. The two parts are member regulation and market regulation. Member regulation of securities traders typically includes the following:

- Pre-qualification, qualification, certification and continuing training of securities trader members and their associated persons;
- Rules of conduct and ethical standards for members and associated persons relating to their dealings with customers, and their dealings with each other in unregulated OTC markets, including quotation and transaction reporting procedures;
- Prudential rules for members that may include higher capital requirements than the minimum required by the SSMSC as well as other safeguards intended to safeguard customers' funds and securities and make sure that customer assets are not being used to finance the member's business;
- Inspections of members for compliance with applicable securities legislation and SRO governing instruments, rules and procedures;
- Arbitration of disputes between members or associated persons and customers of members, and between members dealing in unregulated OTC markets; If a regulated market agrees, the membership SRO's arbitration process also could handle disputes between members arising from transactions on the regulated market;
- A disciplinary process that covers members' violations of securities legislation and the SRO's governing instruments, rules and procedures.

Member regulation of securities traders would be performed by a sole securities trader SRO uniting more than 50% of securities traders as members, as proposed below.

Market regulation of securities traders would include self-regulatory activities that are currently performed by individual licensed stock exchanges and trading information systems in which securities traders participate. Market regulation of securities traders typically includes the following:

- Ensuring that the securities trader and its associated persons meet and comply with the market trading rules of the stock exchange or trading information system;
- Training the securities trader and its associated persons in the use of the trading system;
- Market surveillance of trading that take place on the exchange or trading system;
- Unless delegated or contracted to another SRO, dispute resolution procedure for disputes that arise between securities trader members or participants in the market place; and
- A disciplinary⁷ process for sanctioning securities traders who violate the market's trading rules.

Market regulation of securities traders would be performed by each licensed securities market or trading system in which a securities trader is a member or participant.⁸ Accordingly, under Plan B, member regulation of securities traders would be consolidated in a single, new SRO while market regulation would remain the responsibility of individual licensed markets or trading information systems.

A second key element of Plan B is to attempt to develop a consensus among a sufficient number of licensed stock exchanges and trade information systems who collectively represent more than 50% of licensed securities traders that these markets should cede, transfer or contract their member regulation responsibilities to a new non-profit, member regulation SRO for securities traders. In our view, because of the number of their member securities traders, agreement of PFTS Association and USE to such a plan would be essential. Once such agreement is in place, other markets may be approached to join the plan and all licensed markets should be offered the opportunity to do so.

There are several ways in which a new sole membership SRO might be organized and owned, including proportional ownership by individual markets, or direct ownership by individual member securities traders. We tend to favor the latter option. However, the CMP would work with the SSMSC and individual markets to develop a consensus on the optimal structure.

The third element of Plan B would be to decide upon governing instruments, rules and procedures for a membership SRO. In our view, the governing instruments, rules and procedures of PFTS Association, subject to our comments thereon in Appendices E-1 through E-7, would provide a sound precedent for the governing instruments of a new membership SRO. Of course, such documents would have to be vetted and approved by the SSMSC

⁷ Market regulation in many jurisdictions also includes the rules for listing or admitting securities for trading on the exchange or trading system. This process may involve securities traders if, for example, they serve on a listing committee or the listing rules require securities traders to sponsor listings.

⁸ To add flexibility to Plan B, it also may be advisable for the SSMSC to permit individual stock exchanges or trading systems to subcontract market regulation to the membership SRO or to other licensed markets.

prospective markets whose members would participate in establishing the new membership SRO.

Set forth below are the Pros and Cons of Plan B.

PROs	CONS
Plan B is be more favorable to the continuation of regional exchanges compared to Plan A, which advocates elimination if they fail to meet minimal trading volumes.	Plan requires consensus building re structure, ownership and funding of a new member SRO. Securities market organizations have more important priorities.
New membership SRO may be more favorably perceived as independent of any specific trading market.	Plan is less likely to get rid of currently licensed, marginal securities traders whose presence does more harm than good.
Plan should be more attractive to SSMSC because it avoids SSMSC having to make sensitive decisions affecting regional markets and traders.	Plan may not save money for those regional markets and their member securities traders who were not devoting any resources to member self-regulation.
The markets have more of an incentive to act as SROs for market regulation in order to keep their own houses in order. There is less incentive to engage in member regulation, thereby strengthening the argument for a single SRO for member regulation.	

Discussion of Plan B. The concept of separating member and market regulation is fundamentally sound and reflects a current trend as many markets are demutualizing and becoming for profit institutions. The NYSE’s recent combination of its member regulation functions with the NASD is a prime example. The critical issue that Plan B depends upon is achieving a sufficient consensus among Ukraine’s exchanges and trading systems to support a new membership SRO for securities traders. If, after significant good faith efforts, it is apparent that such a consensus cannot be achieved, Plan C is recommended.

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 two authorized securities depositories.⁹

Plan C is written above in a manner that would permit the test proposed to be measured with certainty and to avoid attempts to manipulate the statistics. The secondary trading activity measured should not include government bonds since these are traded only by banks. To make sure the data is accurate, it would be based upon securities settlements that are recorded through Ukraine’s two authorized securities depositories for corporate equity and debt securities, MFS and NDU. UAH volume of trading rather than number of shares is used because use of the latter might create a statistical bias in favor of low-priced securities.

⁹ The 50% of trading volume threshold has been included in brackets since respectable arguments may be made in favor of a higher percentage, such as 75%, in order to ensure that an SRO represents traders that account for a dominant market share of secondary trading volume. See also note 1 *supra*.

Set forth below are the Pros and Cons of Plan C

PROs	CONs
<p>The proposal is intellectually honest and improves on the 2006 Law. Economic significance of securities traders represented is more important than absolute numbers. E.g., an SRO composed of the more than 400 securities traders who are not PFTS members would not be a representative SRO because its traders account for less than 10% of Ukraine’s secondary market activity.</p>	<p>There may be significant opposition to an amendment from industry groups that prefer not to have a mandatory SRO and as little costs and regulation as possible.</p> <p>There are always unforeseen risks whenever a technical issue is presented to a parliament.</p>

Discussion of Plan C. If we were at the stage where the Rada was considering how to write the SRO provisions of 2006 Law, a measure of SRO representation based upon economic significance rather than mere numbers of PSPMs would have made more sense for all three types of PSPM SROs. However, once the Rada has spoken, the SSMSC and others have an obligation to attempt to implement the law as written before going back to the Rada and saying: “Here’s why it won’t work.” This is the only reason Plan C is the third alternative strategy, rather than the first.

Action Plan

The October 27, 2006 first draft of the CMP Report included an Action Plan for implementation of Plan A. The Action Plan below is for implementation of Plan B, or if a consensus for a new securities trader membership SRO under Plan B cannot be achieved, implementation of Plan C. The steps recommended in the Action Plan are numbered and presented generally in the order recommended for their implementation. A number for a step that is followed by the letter B or C indicates that the step would be taken only under Plan B or Plan C, respectively.

ACTION PLAN FOR SRO DEVELOPMENT AND REGULATION

Responsible Person(s)	Description of Activity	CMP SRO Report ref. ¹⁰	Time Frame
CMP	1. Distribute Ukrainian translation of revised CMP SRO Report, except Appendices E-1 through G-4, to all parties. Distribute E, F and G Appendices to PFTS, UAIB and PARD, respectively, with copies to USAID and SSMSC. Transmittal letter should invite comments.	None	By 31/07/07
CMP, SSMSC, SROs	2. Hold roundtable in Kiev with RDS, CMP, USAID, SSMSC and SRO reps. to discuss how best to implement SRO provisions of 2006 Law.	None	On 11/07/07
SSMSC, CMP, SROs	3. Establish working group of CMP, SSMSC and SRO reps and hold 2-day retreat and work on revision of SSMSC Draft SRO reg. and proposed legislative changes.	Appendix D-2	By 13/09/07
CMP, PARD, PFTS, UAIB	4. Meet individually with three SROs (one day each) to discuss comments on their governing instruments, rules and procedures and further SRO-related assistance.	Appendices E-1 through G-4	By 13/07/07
CMP, SSMSC, PFTS, USE and other securities trader SROs	5. Based upon roundtable, and further discussions with potential securities trader SROs and SSMSC, reach a decision whether there is a consensus to establish a new membership SRO for securities traders as proposed in Plan B of Strategic Plan; if not, go to Plan C.	Appendix C	By 13/09/07
PFTS Exchange; other securities trader orgs. SSMSC; CMP	6. Resolve whether in light of 2006 Law, the exchanges and trade information systems may still be considered securities market SROs; if not, draft legislative amendment to give them SRO status.	§V.I.2	By 13/09/07
MFS, NDU, PARD, SSMSC, CMP	7. Resolve whether MFS and NDU may be considered SROs by virtue of their licensing as securities depositories by SSMSC; if not, draft legislative amendment to give them SRO status.	§V.I.3	By 13/09/07

¹⁰ The CMP SRO Report is "Report and Recommendations for Development, Operation and Regulatory Oversight of Self-Regulatory Organizations in the Ukrainian Capital Market (October 27, 2006), as updated through June 15, 2007, prepared by Robert D. Strahota, Consultant to Financial Markets International, Inc, USAID Capital Markets Project, Kiev. Terms used in this Action Plan are defined at p. 4 of the Report.

Responsible Person(s)	Description of Activity	CMP SRO Report ref.	Time Frame
SSMSC	8. Issue notice that licenses will be revoked with respect to any PSMPs included in SSMSC registries whose current existence cannot be confirmed by SSMSC or that do not become current in all filing obligations with SSMSC within 30 days of notice.	§V.A.4	By 30/09/07
SSMSC with CMP, SRO input	9. Finalize SRO-related changes to be submitted to Rada, including, if necessary, revised securities trader SRO test per Plan C and changes per Steps 7&8 above.	Appendix D-2	By 30/09/07
CMP with review by SSMSC, PFTS, USE and other securities trader orgs.	10B. Draft governing instruments rules and procedures for proposed sole securities trader, membership SRO .	Appendix C, Plan B	By 30/09/07
CMP, SSMSC, Key securities trader SROs	11B. Publicity, roll-out, one-day public seminar for proposed sold securities trader membership SRO.	Appendix C, Plan B	By 30/11/07
SSMSC with CMP and SRO input	12. Revise and issue proposed sole SRO regulation.	Appendix D-2	By later of 31/12/07 or adoption of legislation
SSMSC with CMP input	13. Review progress made in eliminating inactive and delinquent PSMPs from SSMSC registries; consider additional measures such as higher capital requirements and annual audited financial statements. Adopt final SRO regulation.	§V.A.4	By 31/12/07
SSMSC after considering additional comments	Adopt final SRO regulation.	Appendix D-2	By 15, 02/08
PFTS Association, PFTS Exchange with CMP input	14C. Develop specific language of amendments to governing instruments, rules and procedures relating to proposed sole SRO status of PFTS Association; identify and separate Association SRO personnel form Exchange operating personnel.	§V.A.3a&b	By early 2008 before Annual Meeting

Responsible Person(s)	Description of Activity	CMP SRO Report ref.	Time Frame
PFTS Association PFTS Exchange	15C. Membership adoption of amendments to governing instruments, rules and procedures relating to sole SRO status.	§VA.3a&b	2008 Annual Meetings
UAIB and PARD with CMP input	16. Develop specific language of amendments to governing instruments, rules and procedures relating to proposed sole SRO status.	§§V.B.3 and V.C.1c & F-G appendices	By early 2008 before Annual Meeting
PARD	17. Membership adoption of amendments to governing instruments, rules and procedures.	§V.C.3 & G appendices	2008 Annual Meeting
PARD-SSMSC	18. Apply for and receive registration as sole depository SRO.	None	After Step 17
UAIB	19. Membership adoption of amendments to governing instruments, rules and procedures.	§V.C.1c and F appendices	2008 Annual Meeting
UAIB-SSMSC	20. Apply for and receive registration as sole institutional asset manager SRO.	None	After Step 19
Proposed securities trader membership SRO	21B. Hold organizational meeting and adopt governing instruments rules and procedures; hold initial board meeting and appoint staff.	Appendix C, Plan B	Early 2008
Proposed securities trader membership SRO	22B. Proceed to register individual securities traders as members of organization to achieve 50% threshold.	Appendix C, Plan B	Asap after Step 21B
Proposed securities trader membership SRO. SSMSC	23B. Apply for and receive sole securities trader, membership SRO registration.	Appendix C, Plan B	Asap after Step 22B
PFTS Association, SSMSC	24C. Apply for and receive sole securities trader SRO registration.	Appendix C, Plan C	After Step 15C and membership threshold
3 sole SROs, CMP, SSMSC	25. Separate meetings to develop codes of ethics, covering securities transactions, for each sole SRO's staff and to discuss delegation by SSMSC of additional SRO authority, including training.	§§V.A.3.b; V.B.3; V.C.1.c	Asap after sole SRO designation