



**USAID**  
FROM THE AMERICAN PEOPLE

**Capital Markets Project**

**REPORT AND RECOMMENDATIONS FOR  
DEVELOPMENT, OPERATION AND REGULATORY  
OVERSIGHT OF SELF-REGULATORY ORGANIZATIONS  
IN THE UKRAINIAN CAPITAL MARKET**

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**Final  
October 2007**



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## DEFINITION OF TERMS

2006 Law	Law of Ukraine "On Securities and Stock Market"
1996 Law	Law of Ukraine "On State Regulation of the Securities Market in Ukraine"
APSM	Association of Participants of Stock Market
Associated Persons	Individuals who are directors active in the management, managers, and employees of a PSMP who deal with customers or handle cash or securities
Board	Board of directors
CEO	Chief executive officer
CMP	USAID funded Ukrainian Capital Markets Project
CMP SRO Report or report	This report
EFAMA	European Fund and Asset Management Association
FMI	Financial Markets International, Inc.
FSR	Ukrainian Financial Services Regulator
FSR Law	Law of Ukraine "On Financial Services and State Regulation of Financial Services Markets"
GOU	Government of Ukraine
IOSCO	International Organization of Securities Commissions
IOSCO Methodology	IOSCO Methodology for Assessment of Implementation of the IOSCO Principles
IOSCO Principles	IOSCO Objectives and Principles of Securities Regulation
MFS	Interregional Stock Union (operational securities depository)
NASD	The U.S. National Association of Securities Dealers
NASD Regulation	A wholly-owned subsidiary of NASD
Nasdaq	The Nasdaq Stock Market
NDU	National Depository Union (alternative state-owned securities depository)
PARD	Professional Association of Registrars and Depositories
PFTS Association	First Ukrainian Securities Association
PFTS Exchange	First Ukrainian Stock Exchange
PSMP	Professional securities market participant (refers to a licensed entity)
RSU	Regional Stock Union Association
SPF	State Property Fund of Ukraine
SRO	Self-Regulatory Organization
SSMSC	Ukrainian Securities and Stock Market State Commission
UA APF	Ukrainian Association of Administrators of Pension Funds
UAH	Hryvnia (Ukrainian Currency)
UAIB	Ukrainian Association of Investment Business
UIBCE	Ukrainian Interbank Currency Exchange
USAID	United States Agency for International Development
USE	Ukrainian Stock Exchange



## I. Preface

This report has been prepared in response to the following requirement in my scope of work (SOW):

Provide a draft written assessment of the current state of SRO operations in Ukraine with a detailed step-by-step implementation program, including a draft regulation for the SSMSC and draft documents, e.g. charter and bylaws, disciplinary procedures, admission standards, educational and testing criteria, and certification procedures for the creation of effective SROs based on international best practices. The assessment should be vetted with CMP, USAID Mission and discussed with counterparts.

The premise for this deliverable is that in order for Ukraine to take the next step in its financial sector growth, one of the functions that must be advanced is the strengthening and empowerment of SROs, including PFTS, PARD, UAIB and others. The tasks specified in the SOW to achieve this objective are:

- Review the 2006 Law as to the powers provided for implementation of SROs in compliance with international best practices, and the existing regulations governing these institutions in the capital markets area.
- Implement a series of legal drafting initiatives in close coordination with the SSMSC to further develop SRO regulation.
- Hold meetings with the three major SROs (PFTS, PARD, UAIB) in the capital markets area, and the Ukrainian Association of Administrators of Pension Funds to determine their current operational/self-regulatory practices and how they envision the development and operations of SROs in Ukraine.
- Review the current governing instruments and rules of the SROs to determine their adequacy and make recommendations for improvements.
- Hold meetings with representatives of the SSMSC and the FSR regarding their views on the development of SROs based on international standards and how they should operate to develop and protect the market.
- Prepare draft materials and training manuals (as appropriate) for training in SRO best practices.
- Design and implement roundtables and customized training programs for SSMSC, PFTS, UAIB, PARD and UA APF members and staff focusing on SRO best practices.

This report would not have been possible without the input received from the persons I interviewed. They are listed in Appendix A. I extend special thanks to them and to the CMP team in Kiev, particularly CMP chief of party Nils Ekberg, former CMP chief of party Ann Wallace, Victor Stetsenko, Natalia Kravchenko, Victor Sizonenko, Oksana Gritsay, Natasha Lozitskaya, Tatiana Kotukhova and Anna Perminova. Their assistance was indispensable and their hospitality was outstanding.

## II. Executive Summary

### A. Two threshold questions

In assessing the potential for development of securities SROs in any capital market, there are two threshold questions that need to be considered:

1. Are there sufficient resources available so that SROs have the capacity to take on market development and regulatory responsibilities?
2. Is the government securities regulator willing to delegate authority to SROs so that they can do so?

Resources need to be assessed both in terms of personnel resources, including capacity and experience of SRO personnel, and financial resources. Based upon the interviews I have conducted, my conclusion is that the three principal securities SROs in Ukraine (PARD, PFTS Association and UAIB) have persons in leadership positions with the experience and ability to enable their SROs to take on more market development and regulatory responsibilities. The same is true for the pension administrators' SRO, UA APF, although it does not benefit from the SRO provisions of the 2006 Law, discussed in Section IV below.

Financial resources are a problem. The 2006 Law helps in this regard because the law attempts to establish that by May 2009 only one SRO for each of three specified categories of securities activity: (i) securities trading; (ii) institutional asset management; and (iii) depository (registrar and custodian) functions. Even with this consolidation, however, the Ukrainian securities industry is not that profitable, and the ability and willingness of market participants to provide the funding for further development of SROs is relatively inelastic.

The second threshold question that needs to be answered is whether the SSMSC is willing to delegate additional authority to SROs so that the SROs may take on a greater role in market development and regulation, to the extent that their financial resources permit them to do so. My limited meetings with the SSMSC staff suggest that the SSMSC is not opposed to further empowerment of SROs, although they do have an appreciation for some of the conflicts of interest that are inherent in self-regulation. The SSMSC staff is already working on a draft regulation to implement the provisions of the 2006 Law.<sup>1</sup> The SSMSC staff also has some uncertainty whether the SRO model established under the 2006 Law is optimal and, if not, whether they should seek legislative changes.

On the other hand, some of the market participants that I interviewed were more skeptical about the SSMSC's willingness to delegate more authority to SROs. One participant described the issue as a "chicken and egg" problem. When market participants suggest that more authority should be given to SROs, the SSMSC has responded that there are too many SROs at present to warrant doing so, or that the SROs are not sufficiently aggressive in dealing with their members. Implementation of the 2006 Law, as suggested in this report, would eliminate the multiple SRO problem.

A more serious concern, raised by some market participants, is that the SSMSC has been too permissive in the licensing and regulation of markets and professional securities market participants (PSPMs). This has significantly impeded the development of a robust, liquid, onshore securities market in Ukraine and it has resulted in significant structural and regulatory problems, such as the existence of 800 licensed securities traders, many of which do not

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<sup>1</sup> Comments on the first public version of the draft regulation are set forth in Appendix D.

appear to be involved in significant secondary trading activities. The market participants who share this view have suggested that the SSMSC needs to correct this situation before improvements may be made in self-regulation, but note that the SSMSC does not seem disposed to address these structural market consolidation issues. Accordingly, a respectable argument may be made that SROs should be given a greater opportunity to see what they can do.

My report is based upon the assumption that the SSMSC will proceed in good faith to implement the SRO provisions of the 2006 Law. Appendix C of the report outlines three alternatives for a Strategy and Action Plan that the SSMSC should consider as part of its implementation of the SRO provisions of the 2006 Law. Appendix D sets forth comments on the SSMSC's current draft SRO regulation and identifies certain shortcomings in SRO authorization and regulation that likely require legislative changes.

## **B. How should USAID and the CMP help?**

In the recommended SSMSC Strategy and Action Plan for SRO Development and Regulation (Appendix C), I suggest a number of positive steps that may be taken by the CMP to facilitate the SRO development process, focusing upon consolidation and support for the activities of the three principal PSPM membership SROs: PARD, PFTS Association and UAIB.

I do not recommend direct financial assistance by USAID of the CMP to any of the SROs. At this stage in the development of Ukraine's securities market, market participants should find it in their self-interest to support self-regulation. If the necessary funding for SROs from market participants is not present, even after all the comments, best practice models, education, training and enlightenment have been undertaken, this is a clear signal that market participants have more important priorities. While self-regulation is important and should be encouraged, self-regulation will not work without support from both the SSMSC and market participants.

My assessment of the principal securities SROs' and UA APF's capacity for SRO development is included in §V of this report and summarized below.<sup>2</sup>

## **C. PARD capacity for SRO development**

The financial resources problem is greatest with respect to the depository SRO, where PARD is the only logical candidate to become the sole SRO. PARD has suspended the few SRO functions it was conducting because it was losing membership to the APSM, which is no more than a "brass plate" SRO. APSM performs no SRO functions, but its fees undercut PARD's fees and its presence provides an SRO venue for about 200 registrars whose only interest in SROs is to fulfill the regulatory requirement that they join one.

PARD's current membership is sufficient to qualify it for sole SRO status under the 2006 Law. However, it is doubtful that PARD's current resources and its potential ability to raise membership revenues will enable PARD to undertake significant self-regulatory authority. At present PARD has annual budget of US \$160,000 and approximately 75% of licensed registrars are PARD members. Given the limited profitability of registrars, which limits

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<sup>2</sup> Shortly before the completion of this report, the CMP was asked by the SSMSC and individual SROs to review the governing instruments of the SROs. Since time is required to translate the governing instruments into English, rather than delay issuance of this report, a Supplement has been prepared, which includes as appendices comments on the additional SRO documents that have been reviewed. To date, these include documents submitted by UA APF, RSU and UIBCE.

PARD's financial resources, and the fact that registrar activity does not call for extensive self-regulation, if PARD is established as the sole depository SRO, PARD's SRO activities might best be focused on:

- Prequalification and certification, training and continuing education of members and Associated Persons;
- Promoting uniform securities registration procedures and forms;
- Implementing an ethics code that requires, among other things, adherence by members and Associated Persons to such uniform procedures; and
- Administering a disciplinary function whereby members and Associated Persons may be sanctioned for violations of the ethics code.

There are also conceptual issues and uncertainties regarding what should be the role of the depository SRO for PSMPs, as envisioned in the 2006 Law. For example, it is not clear why securities custodians should be placed with registrars in a depository SRO. Conceptually, PARD would fit better in the overall regulatory framework if it were only a registrar SRO. Most custodians are securities firms or banks engaged in securities activities. Securities custodians, like securities traders, must be members of a depository for business reasons if they are involved directly in the clearance and settlement of securities transactions. A more logical SRO venue for custodians would be a securities depository that has the operational qualifications and self-regulatory infrastructure in place and the confidence of its members to handle clearance and settlement of securities transaction, including resolution disputes. Over 90% of the persons licensed to perform custody services are firms licensed as securities traders and the 2006 Law requires a professional market participant to be a member of only one SRO. It is substantially more important that the securities trading firms become members of a sole securities trader SRO.

Copies of the PARD charter, by-laws and other rules and procedures are included in Appendices G-1 through G-5 along with my comments and suggested changes.

#### **D. UAIB capacity for SRO development**

Of the three principal PSPM SROs, UAIB appears to have the resources and capacity that come closest to matching the SRO authority that an institutional asset manager SRO might be expected to undertake. This is not to suggest that the PFTS Association does not have resources and SRO capacity. Clearly, it does. However, the responsibilities that are usually expected of a securities trader SRO are much more extensive than those normally undertaken by an asset manager SRO. The gap between resources and capacity and SRO expectations is greater in the case of the PFTS Association.

UAIB should have the ability to undertake all of the following SRO activities:

- Pre-qualification and certification of asset manager applicants and Associated Persons;
- Training and continuing education of members and Associated Persons;
- Implementation of an ethics code that requires, among other things, that members and Associated Persons adhere to advertising, performance reporting and other asset management standards that are consistent with both existing regulation and the requirements of the code; and
- Administration of a disciplinary function whereby members and Associated Persons may be sanctioned for violations of the ethics code.

Since it is logical to expect most asset managers of investment funds also to be asset managers for non-state pension funds, and to have common self-regulatory interests, it is logical that UAIB also should serve as an SRO for asset managers of pension funds.

Copies of the UAIB charter, by-laws and other rules and procedures are included in Appendices F-1 through F-4 along with my comments and suggested changes.

## **E. PFTS Association capacity for SRO development**

Of the three categories of PSPM SROs authorized by the 2006 Law, the securities trader SRO is clearly the most important. SROs comprised of securities firms are found in many countries' securities markets. Many countries do not have asset management or securities depository SROs. The principal reason that securities SROs are more important is the greater degree of interaction that takes place among securities firms and between firms and public investors. Both of these factors generate correspondingly greater needs for the introduction of traditional SRO functions, subject to regulatory oversight.

The only realistic candidate among current securities market SROs to become the sole securities trader SRO is the PFTS Association. The PFTS Association does not currently represent more than 50% of the licensed securities traders. However, the PFTS Exchange, which is wholly-owned by the PFTS Association, is the dominant securities market in Ukraine, accounting for roughly 86% of the current UAH volume of reported transactions in corporate securities on Ukraine's securities markets. All of the members of the PFTS Exchange, who account for this volume, are members of the PFTS Association.

PFTS Association has the capacity to undertake:

- Pre-qualification and certification requirements for member firms applicants and Associated Persons;
- Qualification, examination, training and continuing education of Associated Persons of licensed member firms;
- Ethical principles and codes of conduct, that apply to member firms and their Associated Persons, including provisions regarding sales practices, advertising an dealers with public investors;
- Prudential rules applicable to member firms that may exceed but are not inconsistent with regulatory requirements;
- Arbitration or similar dispute resolution mechanisms for disputes between member firms, and between member firms or Associated Persons and member firm customers;
- Administration of a disciplinary process applicable to member firms and Associated Persons.

Before PFTS Association is recognized as the sole securities trader SRO, however, there are governance and organizational changes that should be addressed with respect to the PFTS Association-PFTS Exchange relationship. *See* §V.A.3.a below.

Even if PFTS Association qualifies to become the sole SRO for securities traders, however, neither self-regulation or direct SSMSC regulation of securities traders will be effective unless the SSMSC takes steps immediately, and seeks legislation if necessary, to substantially reduce the number of currently licensed securities traders in Ukraine. *See* §V.A.4 below.

Copies of the PFTS Association charter, by-laws and other rules and procedures are included in Appendices E-1 through E-7 along with my comments and suggested changes.

## **F. UA APF capacity for SRO development**

UA APF, is the principal association for Ukrainian pension fund administrators. Unlike the sole SRO provisions of the 2006 Law applicable to PSPM SROs, the legislation governing SROs in the pension industry does not provide for sole SROs or mandatory SRO membership. It would be desirable to amend applicable legislation to require a sole, mandatory SRO for pension fund administrators. UA APF has been recognized by the FSR as a voluntary SRO. UA APF represents a substantial majority of the pension administrators, measured by assets under management and has the capacity to function effectively as an SRO for this industry group.

## **G. Analysis of Ukrainian SRO model and remaining problems**

The Ukrainian SRO model should be analyzed:

1. From a business standpoint as to whether it makes sense in terms of the manner in which the Ukrainian securities market is currently structured.
2. From a regulatory standpoint as to whether it complies with international best practices as reflected in the IOSCO Principles.

From a business standpoint, there is nothing fundamentally bad about the 2006 Law's concept of three separate membership SROs for three categories of PSMPs. Clearly, the requirements that all PSMPs must be members of at least one SRO and that there must be only one SRO for each category of PSMPs are positive steps.<sup>3</sup> The former requirement is necessary to make all PSMPs subject to self-regulation, a preferable pre-condition to delegation of regulatory authority. The latter requirement is desirable in order to prohibit competing SROs and the risks of a race to the bottom in establishing self-regulatory standards. This is a current problem in the Ukraine with respect to APSM's presence undercutting PARD's ability to impose self-regulation on its members.

Nevertheless, the SRO model established under the 2006 Law is not optimal because it fails to take advantage of market institutions that are more natural and logical SRO candidates. As noted in §III.C above, a securities depository SRO would be a more natural and logical SRO for securities custodians.

Similarly, while many jurisdictions have membership association SROs for securities firms, this should not preclude licensed securities markets from continuing to act as SROs if they have the capacity to do so. Before enactment of the 2006 Law, all of Ukraine's licensed securities markets were registered with the SSMSC as securities market SROs. The 2006 Law changes matters because it envisions a sole securities trader SRO that will be responsible for all licensed securities traders regardless of the market or markets in which the traders are participants. The 2006 Law leaves unanswered the question whether securities markets themselves may still be regarded as SROs. Securities markets should have continued SRO status because they perform many market regulation functions directly with respect to their individual markets, including market surveillance, enforcement of trading rules, and enforcement of listing standards.

The question whether securities markets still may be deemed SROs after the establishment of a sole securities trader SRO under the 2006 Law remains important for two reasons. First, a

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<sup>3</sup> The requirement for mandatory membership in at least one SRO is not new and appears to have first been established by Article 2.1 of SSMSC Regulation, approved by SSMSC Resolution dated March 18, 2002 No. 107, registered MinJustice September 27, 2002 No. 787/7075.

market, such as the PFTS Exchange, may wish to use its own resources and personnel for self-regulation of its market rather than contracting with a sole securities trader SRO to do so. Second, it seems unjust to suggest that a sole securities trader SRO should be required to expend its membership's resources to engage in self-regulatory activities with respect to some of Ukraine's regional securities markets, which are not currently performing any SRO functions. The focus of a sole securities trader SRO should be member regulation, not market regulation.

From a regulatory standpoint, international best practices regarding the use of SROs are very general. SROs are encouraged by IOSCO Principle 6 but not regarded as a requirement. However, if SROs are used, IOSCO Principle 7 regarding regulatory oversight should be observed. On paper, both the SRO standards in the 2006 Law and the standards for SRO status under prior legislation would suggest that Ukraine satisfies IOSCO Principle 7. On paper, there are sound standards for recognition of SROs, inspection of SROs to make sure they are properly discharging SRO functions, and withdrawal of SRO authority if they are not.

In practice, there is a major disconnect. Registration of APSM, a "brass plate" SRO for registrars, has undermined PARD and prevented PARD from discharging SRO functions that it is otherwise capable of fulfilling. The SSMSC has also registered as securities market SROs a number of markets other than the PFTS Exchange, USE and UIBCE that are not currently performing any SRO functions. Therefore, it cannot be concluded that the Ukrainian SRO model is operating in accordance with international best practices pursuant to IOSCO Principle 7.

The draft SSMSC's Regulation on Self-Regulatory Organizations of Professional Stock Market Participants, intended to implement the SRO provisions of the 2006 Law is not fully compliant with IOSCO Principle 7. The reason is that the proposed regulation does not provide for an SRO being able to apply its rules, including disciplinary procedures, to Associated Persons of the SRO's members. Also, the draft regulation does not authorize SROs to levy monetary penalties on Associated Persons of their members. The comments on the draft regulation (Appendix D) recommend solutions to both of these problems. It is possible, however, that applying SRO requirements and sanctions directly to Associated Persons of SRO members may require a legislative solution.

### **III. SSMSC Strategy and Action Plan for SRO development and regulation**

A recommended SSMSC Strategy and Action Plan for SRO Development and Regulation is included in Appendix C of this report. Three potential strategies are outlined for the SSMSC's consideration:

**Plan A. Implement the SRO provisions as soon as possible to consolidate 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 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 authorized securities depository, or as reported to the SSMSC.<sup>4</sup>**

It should be noted that Plan A was recommended to the SSMSC in the initial October 27, 2006 draft of this report. However, as explained in Appendix C, the SSMSC does not appear committed to Plan A. It is possible that the SSMSC does not believe it has the ability to overcome likely opposition from regional stock exchanges and some PSMPs to enable it to implement Plan A. The author and CMP still believe that Plan A is preferable and, accordingly, Plan A has been retained in Appendix C with additional explanation as to its advantages. However, to present the SSMSC with strategy alternatives, Plans B and C also being offered along with a step-by-step Action Plan that indicates how Plans B and C might be implemented.

## **IV. Analysis of Ukrainian SRO model and remaining problems**

### **A. What are the requirements for establishing SROs under the 2006 Law?**

The key points relating to the establishment of SROs under the 2006 Law are set forth in Articles 2.2, 16.4, 48 and 49 and may be summarized as follows:

1. An SRO must be a not-for-profit, membership association.
2. The members of an SRO must be PSMPs that are legal entities, not individuals.
3. The 2006 law recognizes at least three types of SROs; those engaged in:
  - a. securities trading;
  - b. institutional asset management;
  - c. depository activities (registrars and custodians).
4. An SRO must be created according to the criteria and requirements of the SSMSC.
5. A PSMP (other than a stock exchange or depository) may not engage in the activities for which it is licensed unless it is a member of at least one SRO.
6. SROs shall be formed in conformity with the principle of one SRO per each type of professional securities market activities.
7. An SRO must represent over 50% of professional stock market participants in one of the three types of professional activities.
8. Sole SRO status is acquired on the date of registration by the SSMSC.
9. The SRO rules and standards shall be mandatory for all members of the SRO.
10. The SRO must have assets worth at least UAH 600,000 at its disposal to ensure its statutory activities.

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<sup>4</sup> The information that licensed securities traders are required to report to the SSMSC is quite comprehensive and would be sufficient to identify licensed securities traders whose transactions in corporate equity and debt securities, onshore and offshore, account for more than 50% (or any higher threshold) of total trading activity in these securities. However, the SSMSC has not compiled such statistics and it is possible that the SSMSC may not have the software or manpower to do so. See SSMSC Resolution No. 279 dated June 8, 2004 "On Approval of the Regulation on the Procedure of Preparing of Administrative Data Concerning the Activity of Securities Traders and Filing Relevant Documents with the SSMSC", registered MinJustice September 9, 2004 No. 1122/9721.

## **B. What are the responsibilities of SROs under the 2006 Law?**

The responsibilities of SROs under the 2006 Law are addressed in Articles 47-48 of §VI of the 2006 Law, regarding Regulation of the Securities Market.

Article 47.1 provides:

"Stock market regulation shall be performed by the State and by self-regulatory organizations."

Article 48.2 of the 2006 Law provides in relevant part:

"The objective of activities of self-regulatory organizations of professional stock market participants shall be to provide for activities of professional stock market participants, which are members of the self-regulatory organization, as well as to develop and approve rules, and standards of professional behavior and conduct of the relevant type of professional activities."

## **C. What powers may be delegated to SROs under the 2006 Law?**

Article 49 of the 2006 Law provides:

"Article 49. Delegation of Powers on Stock Market Regulation to Self-Regulatory Organizations

1. With regard to each type of professional activities, Securities and Stock Market State Commission may delegate to a self-regulatory organization the following powers:

- collection, summarization and analytical processing of data on conduct of the relevant type of professional activities;
- inspections of the performance of the relevant type of professional activities, compliance with the requirements of the securities law, and rules and standards of professional conduct;
- submission to it of a request, mandatory for review, on the termination (suspension) of the license to perform a certain type of activities by a professional stock market participant; and
- certification of stock market specialists;
- issuance of licenses to persons that perform professional activities in the stock market.

Securities and Stock Market State Commission, in line with the procedure established by same, may delegate other powers to self-regulatory organizations.

2. Securities and Stock Market State Commission shall delegate to a self-regulatory organization powers on stock market regulation according to the procedure set by the Commission in response to the application of this organization.

Within one month after receiving an application from a self-regulatory organization, Securities and Stock Market State Commission shall make a decision on delegation or refusal in delegation of powers to the self-regulatory organization.

3. A decision on delegation of powers to a self-regulatory organization shall indicate the following:

- the name of the self-regulatory organization to which the powers are being delegated;
- the powers being delegated;
- the period for which the powers are being delegated; and
- the procedure of state control over execution of the delegated powers.

4. A decision on delegation of powers to a self-regulatory organization shall be subject to state registration with the Ministry of Justice of Ukraine, as a normative and legal act, and shall be made public according to the law.

5. The period of powers delegated to a self-regulatory organization shall be extended according to the same procedure as the one that is set for obtaining them.

6. A self-regulatory organization shall have the right to submit an application on delegation of additional powers thereto only upon the condition of satisfactory execution of powers that were previously delegated."

#### **D. When do the SRO requirements become effective?**

Item 1 of Section VII "Closing provisions" of the 2006 Law indicates that Article 48.1 of the law, which requires one SRO for each type of professional securities market activities, shall not come into effect until three years after the effective date of the law, which is May 2009. Similarly, Item 4 of Section VII indicates that PSMPs have three years after the 2006 effective date of the law to bring their activities into compliance with the law.

#### **E. What SROs may a PSMP join?**

The 2006 Law requires each PSMP to be a member of at least one SRO but the law does not clearly specify that the participant's SRO must be the SRO that is primarily related to the activities for which the participant is licensed.

Article 26.5 of the 2006 Law provides that combining activities on management of assets of institutional investors with other types of professional stock market activities is prohibited, so there should be no issue that institutional asset managers will join UAIB as the sole asset manager SRO.<sup>5</sup> UAIB's position is also assured in this regard because the SSMSC currently relies upon UAIB to pre-qualify and certify to the SSMSC applicants for an asset manager's license. Therefore, asset management firms should have no reason to join an SRO for securities traders or depositories since they may not engage in these activities through the same legal entity.<sup>6</sup>

However, Articles 26.3 and 26.4 of the 2006 Law provide that the activities of a securities trader may be combined with activities of a securities custodian and activities on maintenance of registries of registered securities owners may be combined with activities of a securities custodian and a securities trader. It is possible, therefore, that a PSMP licensed as both a securities trader and securities registrar and/or custodian might find it desirable to be a

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<sup>5</sup> Article 2.1 of the SSMSC Regulation No. 415 that the approved in 2004 for asset manager SROs requires that members be asset management companies in possession of an appropriate license (SSMSC Decision No. 415 dated September 29, 2004 "On Approval of a Regulation of a Self-Regulated Securities Market Organisation of Asset Management Companies", registered MinJustice October 19, 2004 p. No.1333/9932).

<sup>6</sup> Of course, there are a number of PSMPs that conduct several securities activities, including asset management, but do so through separate affiliated entities. In these circumstances, each PSMP entity that is licensed will have to join at least one SRO.

member of both a securities trader SRO and a depository SRO even though only one SRO membership is required by the 2006 Law. However, some securities traders that are also custodians or registrars might decide that membership in a depository SRO is not necessary. In this regard, over 90% of the persons licensed to perform custody services are also firms licensed as securities traders.

If a PSMP is licensed as both a securities trader and a custodian and/or registrar, it is substantially more important that the PSMP should be a member of a sole securities trader SRO. It is plausible that some licensed securities traders might prefer to join a depository SRO to the exclusion of a securities trader SRO. One reason for doing so might be the desire of securities traders to avoid higher membership fees charged by the securities trader SRO. Another might be the securities trader's preference not to be subject to the fair conduct rules for securities traders that the securities trader SRO will be expected to have in place.<sup>7</sup> I have recommended that the SSMSC address this problem in its draft regulation by including the following requirement:

Every professional stock market participant shall be a member (participant) in at least one SRO, which must be the SRO for the type of professional stock market activity in which the participant is primarily engaged. A professional stock market participant that is a licensed securities trader must be a member of a securities trader SRO.<sup>8</sup>

While implementation of these recommendations would prevent SRO regulatory arbitrage, it would not ensure that securities traders also engaged in securities custody activities join a second, depository SRO since the 2006 Law requires membership in only one SRO. As pointed out in §IV.I.3, below, a more logical SRO arrangement would be for securities traders that are also custodians to be subject to the requirements of a securities depository SRO, such as MFS, and for PARD to function primarily as a registrar SRO.

## **F. How do the SRO requirements of the 2006 Law differ from the 1996 Law?**

Under the 1996 Law SROs were voluntary associations and there could be more than one SRO per category of PSMP. The 2006 Law (Article 16.4) requires a professional stock market participant to be a member of an SRO,<sup>9</sup> and it provides that there may be only one SRO for each of the three specified types of stock market activity (Article 48.1). Articles 48 and 49 of the 2006 Law are more proactive and comprehensive than former Article 17 of the 1996 regarding registration of SROs and delegation of authority to SROs. For example, under Article 49, an SRO may apply for authority to be delegated and the SSMSC has 30 days to respond to an application. However, any authority that may be delegated to an SRO under the 2006 Law arguably could have been delegated to an SRO under the residual clause in the last sentence of former Article 17 of the 1996 Law.<sup>10</sup> Article 48.4 of the 2006 Law adds a new requirement that an SRO must have assets of at least UAH 600,000. Article 8.10 of the 1996 Law, which authorizes the SSMSC to order SROs to eliminate violations of securities laws and to produce documents, and Article 9, second clause, which authorizes the SSMSC to inspect SROs, both remain in effect.

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<sup>7</sup> PFTS Association already has adopted Rules of Fair Practice. See Appendix E-3.

<sup>8</sup> See Appendix D.

<sup>9</sup> As pointed out in note 3 *supra*, the requirement for PSPM membership in at least one SRO was adopted by SSMSC resolution in 2002.

<sup>10</sup> However, this would require that the SSMSC delete or amend the current requirement in the regulation adopted under SSMSC Resolution No. 243 (September 10, 2002) that an SRO represent more than 60% of the PSMPs engaged in a certain type of professional activity.

## **G. What is the status of SROs under the FSR Law?**

Since the FSR Law defines financial services to include investment services markets, it is also necessary to consider the FSR Law's provisions as they relate to securities SROs.

The SRO provisions in Articles 1.9 and 16 of the FSR Law are inferior to the SRO provisions of the 2006 Law, primarily because the FSR Law makes SRO membership voluntary and the law does not provide any standards for registration of SROs or for delegation of governmental authority to SROs. The FSR is also given SRO authority separately in the Law of Ukraine on Non-State Pension Provision. However the pension funds law has the same shortcomings as the FSR Law in that SRO membership is voluntary and there are no express standards indicated for registration of pension SROs or delegation of authority to such SROs.<sup>11</sup>

One potential problem that could arise is that the FSR might register SROs for securities activities, which would be at cross purposes with the 2006 Law, which authorizes the SSMSC to register only one SRO for each of the three categories of securities activities. However, during my meeting with FSR representatives, they expressed no interest in doing so. In fact, the FSR staff indicated that they are satisfied with the current arrangement where pension fund managers may join an institutional asset manager SRO subject to SSMSC oversight.

UA APF is a pension fund administrators' SRO, which is subject to regulation by the FSR.<sup>12</sup> However, UA APF does not present conflicts with securities' SROs.

## **H. Do the securities SRO provisions comply with international best practices?**

The answer to this question is NO, both with respect to prior practices in registering and overseeing SROs and the proposed draft regulation for SROs under the 2006 Law. However, if the SSMSC were to accept the comments on the draft regulation provided in Appendix D, then on paper at least the SSMSC would be in compliance with IOSCO Principles 6 and 7 regarding self-regulation. What happens in practice remains to be judged by the SSMSC's future actions in implementing the 2006 Law.

From a regulatory standpoint, international best practices regarding the use of SROs are very general. SROs are encouraged by IOSCO Principle 6 but not regarded as a requirement. However, if SROs are present, IOSCO Principle 7 regarding regulatory oversight should be observed. IOSCO Principle 7 provides:

"SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities."

The IOSCO Principles provide useful guidance as to the regulatory oversight that should be required for SROs:

"The regulator should require an SRO to meet appropriate standards before allowing the organization to exercise its authority. Oversight of the SRO should be ongoing."

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<sup>11</sup> See Law of Ukraine "On Non-State Pension Provision", Articles 1 and 33.

<sup>12</sup> See §V.D below.

Moreover, once the SRO is operating, the regulator should assure itself that the exercise of this power is in the public interest, and results in fair and consistent enforcement of applicable securities laws, regulations and appropriate SRO rules.

The effectiveness of an SRO may be compromised due to conflicts of interest. The regulator should monitor and address the potential that may arise for conflict of interest. The regulator must ensure that no conflict of interest arises because of the SRO's access to valuable information about market participants (whether or not they are members of the SRO itself). The risk of conflict arising may be acute when the SRO is responsible both for the supervision of its members and the regulation of a market sector. (footnote omitted)

As a condition to authorization, the legislation or the regulator should require an SRO to:

- have the capacity to carry out the purposes of governing laws, regulations and SRO rules, and to enforce compliance by its members and Associated Persons with those laws, regulations, and rules;
- treat all members of the SRO and applicants for membership in a fair and consistent manner;
- develop rules that are designed to set standards of behavior for its members and to promote investor' protection;
- submit to the regulator its rules for review and/or approval as the regulator deems appropriate, and ensure that the rules of the SRO are consistent with the public policy directives established by the regulator;
- cooperate with the regulator and other SROs to investigate and enforce applicable laws and regulations;
- enforce its own rules and impose appropriate sanctions for non-compliance;
- assure a fair representation of members in selection of its directors and administration of its affairs;
- avoid rules that may create uncompetitive situations; and
- avoid using the oversight role to allow any market participant unfairly to gain advantage in the market.

Regardless of the extent to which self-regulation is used, the government regulator should retain the authority to inquire into matters affecting investors or the market. Where the powers of an SRO are inadequate for inquiring into or addressing particular misconduct or where a conflict of interest necessitates it, the regulator should take over the responsibility for an inquiry from an SRO. It is important, therefore, to ensure that the information provided by the SRO to the regulator allows these matters to be identified at an early stage.

SRO's should follow similar professional standards of behavior on matters such as confidentiality and procedural fairness as would be expected of the regulator." (footnote omitted)<sup>13</sup>

The IOSCO Methodology, a document intended to be used to measure a country's implementation of the IOSCO Principles, indicates that it is necessary to provide affirmative answers to the following questions for effective government oversight of self-regulation in order to be deemed "fully implemented" under IOSCO Principle 7:

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<sup>13</sup> IOSCO Principles, §7.3, pp. 12-13.

## *Key Questions*

### *Authorization or Delegation Subject to Oversight*

1. As a condition to authorization, does the legislation or the regulator require the SRO to demonstrate that it:
  - a) Has the capacity to carry out the purposes of governing laws, regulations and SRO rules consistent with the responsibility delegated to the SRO, and to enforce compliance by its members and Associated Persons subject thereto those laws, regulations and rules?
  - b) Treats all members of the SRO, applicants for membership and similarly situated market participants subject to its rules in a fair and consistent manner?
  - c) Develops rules that are designed to set standards for its members and to promote investor protection?
  - d) Submits to the regulator its rules, and any amendments thereto, for review and/or approval, as the regulator deems appropriate, and ensures that the rules of the SRO are consistent with the public policy directives established by the regulator?
  - e) Cooperates with the regulator and other domestic SROs to investigate and enforce applicable laws, regulations and rules?
  - f) Imposes appropriate sanctions for non-compliance with its own rules?
  - g) Where applicable, e.g., a mutual organization, assures a fair representation of members in selection of its Board and administration of its affairs?
  - h) Avoids rules that may create anti-competitive situations as defined in the Explanatory Note?
  - i) Avoids using the oversight role to allow any market participant unfairly to gain an advantage in the market?

### *Oversight*

2. Does the regulator:
  - a) Have in place an effective on-going oversight program of the SRO, which may include:
    - i) Inspection of the SRO;
    - ii) Periodic reviews;
    - iii) Reporting requirements;
    - iv) Review and revocation of SRO governing instruments and rules; and
    - v) The monitoring of continuing compliance with the conditions of authorization or delegation.
  - b) Retain full authority to inquire into matters affecting the investors or the market?
  - c) Take over an SRO's responsibilities where the powers of an SRO are inadequate for inquiring into and addressing particular misconduct or allegations of misconduct or where a conflict of interest necessitates it?

### *Professional Standards Similar to those Expected of a Regulator*

3. Does the law or regulator require the SRO to follow similar professional standards of behavior as would be expected of a regulator:
  - a) On matters relating to confidentiality and procedural fairness?
  - b) On the appropriate use of information obtained in the course of the SRO's exercise of its powers and discharge of its responsibilities?

### *Conflicts of Interest*

4. Does the law or regulator assure that potential conflicts of interest at the SRO are avoided or resolved? (footnotes omitted).<sup>14</sup>

On paper, both the SRO standards in the 2006 Law and the standards for SRO status under prior legislation would suggest that Ukraine satisfies most elements of IOSCO Principle 7. On paper, there are sound standards for recognition of SROs, inspection of SROs to make sure they are properly discharging SRO functions, and withdrawal of SRO authority if they are not.

In practice, there is a major disconnect. APSM has been registered even though it is no more than a "brass plate" SRO for registrars. This has undermined PARD and prevented PARD from discharging SRO functions that it is otherwise capable of fulfilling. The SSMSC has also registered as securities market SROs several markets other than PFTS Exchange, USE and UIBCE that do not appear to be exercising self-regulation over their members or market participants. Therefore, it cannot be concluded that Ukrainian self-regulatory practices are in accordance with international best practices pursuant to IOSCO Principle 7. *More specifically, it appears that, in practice, the SSMSC cannot answer YES to Key Questions 1(a) and 2(a) above. Under the IOSCO Methodology benchmarking process, a No answer to either of these Key Questions warrants a rating of "not implemented" with respect to IOSCO Principle 7.*

In terms of the SSMSC's draft regulation intended to implement the SRO provisions of the 2006 Law, the draft regulation is also not fully compliant with IOSCO Principle 7 because, as discussed in §IV.I.1 below, the proposed regulation does not provide for an SRO being able to apply its rules, including disciplinary procedures, to Associated Persons of the SRO's members, as required by Key Question 1(a) above, or to levy monetary penalties against members and Associated Persons.

## **I. What problems remain?**

By itself, the SRO model established under the 2006 Law is not optimal because: (i) it fails to address adequately the ability to regulate and sanction the conduct of individuals who work for SRO members; (ii) it fails to take advantage of market institutions that are more natural and logical SRO candidates, such as securities exchanges and securities depositories; and (iii) there appears to be a potential conflict with Article 120 of the Ukrainian Commercial Code. Each of these problems is discussed below.

### **1. Applicability of SRO requirements and sanctions to Associated Persons**

The 2006 Law, the SSMSC's draft implementing regulation and the current governing instruments of PFTS, UAIB and PARD do not adequately authorize SROs to regulate the

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<sup>14</sup> IOSCO Methodology, pp. 33-35.

conduct of Associated Persons of SRO member firms, nor do they permit the SROs to sanction such Associated Persons, including imposition of monetary penalties. The reason for this major omission is not entirely clear. The 2006 Law does not specifically address regulation of Associated Persons and it does not provide the SSMSC with any additional authority to levy monetary penalties. The SSMSC's authority to levy monetary penalties appears to be limited by Article 13 of the 1996 Law, which permits the SSMSC to levy fines against individuals for four types of administrative violations of the law specified in the Article, but requires that the procedures for such administrative violation cases must be in accordance with the Code of Ukraine on Administrative Violations.<sup>15</sup> The omission of SRO regulatory and disciplinary authority over individuals is a major problem that threatens the overall efficacy of self-regulation by Ukrainian SROs. The problem requires immediate attention.

There are two possible solutions, which are not mutually exclusive. The first is to simply amend the 2006 Law to provide enforcement authority to both the SSMSC and SROs to sanction individuals for a broader class of violations including securities law and SRO violations. Even apart from the issue of self-regulation, the failure of the Ukrainian securities laws to permit broader monetary and other sanctions against individuals is a major regulatory shortcoming that should be remedied by legislation. The comments on the SRO regulation that the CMP has submitted to SSMSC (see Appendix D) include a component on legislative changes that addresses this point.

The second solution is based upon contract law. Even if the SSMSC's authority to fine individuals is limited and not delegated to the SROs, it should not follow that the SROs lack any ability to regulate and sanction Associated Persons. The traditional SRO model used in most jurisdictions includes statutory powers that are delegated to SROs **and** additional powers that the SROs exercise through contractual agreements with their members. SROs may establish the ability to enforce their own rules and securities laws against their members and individuals who work for their members by reliance on the law of contracts. Parties may agree by contract to appropriate monetary penalties when one party breaches a contractual obligation.

To implement the second solution, I have recommended in my comments on each of PFTS', UAIB's and PARD's governing instruments that they should enter into uniform written membership agreements with each of their member firms whereby the member firm agrees to be bound by the governing instruments, rules and procedures of the SRO, including disciplinary rules that may provide for monetary penalties.<sup>16</sup> I have recommended that Associated Persons of member firms should be required by contract with the SRO to be bound to comply with SRO governing instruments and rules in the same manner as the member firms in consideration for their employment by their member firm and their recognition by the SRO as an Associated Person of the member firm. The comments on the SSMSC draft SRO regulation, included in Appendix D, also indicate how the SROs may be permitted to bind their members and Associated Persons of members to a disciplinary process that includes the ability to levy monetary penalties.

The recommendation that all Associated Persons of an SRO member should be subject to an SRO's jurisdiction does not mean that additional persons would have to be certified

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<sup>15</sup> Even if the SSMSC elected not to delegate enforcement powers to SROs now, the SROs' ability to fine Associated Persons of members firms is an essential authority that the SROs require in order to enforce their own rules.

<sup>16</sup> The SRO's governing instruments also should obligate the SRO to enforce compliance by its members and Associated Persons with applicable securities legislation.

immediately by the SSMSC. The first objective of the recommendation is to establish a legal framework within which all SRO members are required to take responsibility for all of their professional employees so that all professional employees, not just certified specialists, may be subject to disciplinary sanctions for violating securities regulations or SRO requirements, and the SRO member employing such persons also may be held responsible for failure to reasonably supervise such persons.<sup>17</sup> While it is also advisable for the SSMSC to require qualification of a broader class of Associated Persons of member firms, this qualification process may be implemented over a longer-time frame.<sup>18</sup> The more immediate priority is to establish SRO and member firm responsibility for all Associated Persons.

In summary, I recommend that both solutions to the current lack of regulation and sanctioning authority over Associated Persons of SRO member firms should be pursued.

## **2. Status of securities markets as SROs**

Before enactment of the 2006 Law, all licensed securities markets in Ukraine also were registered with the SSMSC as SROs. The 2006 Law changes matters because it envisions a sole securities trader SRO that will be responsible for all licensed securities traders regardless of the market or markets in which the traders are participants. The 2006 Law leaves unanswered the question whether securities markets themselves may still be regarded as SROs.

Securities markets perform many market regulation functions directly, including market surveillance, administration of market membership rules, enforcement of trading rules, and enforcement of listing standards. In many jurisdictions that recognize SROs, securities markets are the principal SROs, although other SROs, such as associations of securities firms, also may be present. In such jurisdictions, the presence of membership association SROs for securities firms does not preclude licensed securities markets themselves from acting as SROs if they have the capacity to do so.

The question whether securities markets still may be deemed SROs after the establishment of a sole securities trader SRO under the 2006 Law remains important for two reasons. First, a market, such as the PFTS Exchange, may wish to use its own resources and personnel for self-regulation of its market rather than contracting with a sole securities trader SRO to do so. Second, it seems unjust to suggest that the sole securities trader SRO should be required expend its membership association resources to engage in self-regulatory activities with respect to some of Ukraine's regional securities markets, which are not currently performing any SRO responsibilities. The focus of a sole securities trader SRO should be member regulation, not market regulation.

## **3. Status of securities depositories as SROs**

Securities depositories are not considered SROs under the 2006 Law or the Law on The National Depository System and Special Features of Electronic Circulation of Securities in Ukraine.<sup>19</sup> In many jurisdictions, securities depositories play important roles as SROs with oversight responsibilities for market participants involved in the clearance and settlement of securities transactions, although other SROs such as associations of securities firms,

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<sup>17</sup> This approach is what is envisioned by Principles 23 of the IOSCO Principles relating to the responsibilities of market intermediaries. The discussion under the Principle provides: "The management of a market intermediary should bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the whole firm." IOSCO Principles, §12.5.

<sup>18</sup> See recommendations in §VI below.

<sup>19</sup> The NDU is not currently performing any depository functions.

custodians and registrars also may be present. In the Ukraine, the depositories are subject to regulatory oversight of the SSMSC and other Ukrainian governmental entities and even if they are not formally recognized as SROs, the depositories necessarily must have rules applicable to securities custodians and traders participating in the depositories in order for the clearance and settlement process to work effectively. For these reasons, a qualified securities depository SRO in which most securities traders and custodians are participants would be a more natural and logical SRO for Ukraine's securities custodians than PARD or APSM.<sup>20</sup>

#### **4. Article 120 of Commercial Code of Ukraine**

One of the unusual provisions in the governing instruments of PFTS, UAIB and PARD is a provision indicating that the SRO does not have the right to interfere with the business of its members or restrict the ability of its members to provide services on the securities market.<sup>21</sup>

These provisions are extremely troublesome because they overlook and conflict with the very purposes of securities SROs, particularly mandatory SROs, which include:

- Establishing and administering qualification standards for entry and authorization to provide services in the securities market;
- Establishing and administering rules of conduct, ethical codes and similar requirements that affect the manner and conditions under which SRO members may provide securities services; and
- Conducting examinations, investigations and disciplinary proceedings with respect to SRO members, which in the case of serious violations of securities legislation or SRO requirements, may result in suspension or revocation of SRO membership so that a member's ability to render securities services would be suspended or terminated.

In short, the non-interference provisions included in the SROs charters are completely at odds with the basic purposes of SROs and need to be deleted or substantially qualified in order to remove any doubts that SROs may properly discharge their self-regulatory responsibilities.

Legislative change also appears necessary. It appears that the inclusion of these non-interference provisions in SRO charters is intended to address the requirement of Article 120 of the Commercial Code of Ukraine, which provides in part:

##### **Article 120. Business legal structure of enterprises**

It must be stated in regulation of association, that it is an economic association. Association does not have a right to interfere in economic activity of enterprises – participants of association.

Certainly a legal argument might be made that the express self-regulatory purposes of the 2006 law should be viewed as superseding Article 120 of the Commercial Code with respect to SROs organized as economic associations. However, in §VII of the 2006 Law, the drafters did consider other necessary amendments to the Commercial Code without addressing Article 120. This tends to weaken the argument for preemption and suggests that legislative change is necessary to modify Article 120, which applies by its terms even if the non-interference provisions in the SROs' charters are deleted or qualified. Accordingly, as part of the legislative changes relating to SROs that are being recommended to SSMSC in Appendix D, I recommend the following provision for insertion in the Commercial Code after paragraph 2 of

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<sup>20</sup> See also discussion under §II.C *supra*.

<sup>21</sup> See PFTS Charter, Article 3.2 (Appendix E-1), UAIB Charter, Article 4.14(a) (Appendix F-1) and PARD Charter, Article 2.3.1 (Appendix G-1).

Article 120 or in securities law amendments, whichever law Ukraine's legislative experts deem proper:

The provisions of Article 120 of the Commercial Code of Ukraine relating to economic associations shall not prohibit self-regulatory organizations authorized by other legislation from administering and enforcing self-regulatory functions with respect to their members, including qualification, conduct of business, ethical, disciplinary and dispute resolution requirements. The anti-monopoly legislation of Ukraine shall apply to such self-regulatory organizations.

## **V. Assessment of SROs and recommended improvements**

### **A. Securities trader SRO - PFTS Association<sup>22</sup>**

#### **1. Background**

The PFTS Association was founded in February 1996 and granted SRO status by the SSMSC in October 1997. There are over 240 securities trading firms from 19 cities and 15 regions that are members of the PFTS Association.<sup>23</sup> The PFTS Exchange, a joint stock company, is wholly-owned by the PFTS Association. The Association has a 15-member Board comprised entirely of PFTS members. The same persons serve on the Board of the PFTS Exchange. The same person serves as President and CEO of both the PFTS Association and the PFTS Stock Exchange.

The annual cost of membership in the PFTS Association is approximately US \$1,000. In addition, members who wish to have access to the PFTS trading system pay a one-time fee of \$500 and \$2,400 per annum. Based upon 240 members, this would mean that the current PFTS Association budget is about \$240,000.

The total staff of the PFTS Association/Exchange is approximately 30 persons. It is not possible to determine how many staff of the PFTS Association work full-time for the Association, since the staff also has responsibilities at the PFTS Exchange. There appears to be no clear delineation of regulatory vs. commercial operating responsibilities.

PFTS has an Arbitration-Disciplinary Committee. In 2005, the Association registered its Court with the Ministry of Justice under the 2004 Law of Ukraine on Arbitration Courts. The

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<sup>22</sup> At the request of SSMSC, I also met with USE to assess USE's potential to become a sole securities trader SRO. USE currently has 112 members, 28 of which are banks. This is less than 50% of PFTS Association's membership. USE's securities market activities are primarily devoted to participation in privatization auctions. There is limited secondary trading on USE, which accounts for roughly 5% of all secondary trading, significantly less than PFTS Exchange's 86% share of onshore secondary trading but more than any of Ukraine's other seven markets. As of the date of this report, I have not received English translations of USE's governing instruments, rules and procedures so it is not possible for me to assess USE's current SRO activities or express an opinion on USE's capacity to become the sole securities trader SRO. However, USE representatives expressed interest in the establishment of a new securities trader membership SRO, which would be consistent with Plan B in the Strategy and Action Plan for SRO Development and Regulation that is being recommended to SSMSC. See Plan B of Appendix C.

<sup>23</sup> Source: PFTS web site, [www.pfts.com](http://www.pfts.com), visited June 14, 2007. Only the Kyiv International Stock Exchange lists more SRO members (252); however, the Kyiv International Stock Exchange accounts for less an insignificant portion of secondary market trading activity. It is primarily an exchange for purposes of conducting privatization auctions.

2004 law makes the results of arbitration binding upon the participants, whereas under prior law, a party found liable under arbitration could appeal to the courts, an alternative that generally defeats the primary purpose of arbitration.

## **2. PFTS Association capacity for SRO development**

Of the three categories of SROs authorized by the 2006 Law, the securities trader SRO is clearly the most important. SROs comprised of securities firms are used in many countries' securities markets. Many countries do not have asset management or securities depository SROs. The principal reason that securities SROs are more important is the greater degree of interaction that takes place among securities firms and the greater degree of interaction that takes place between sales persons or representatives of securities firms and public investors. Both of these factors generate correspondingly greater needs for the introduction of traditional SRO functions, subject to regulatory oversight, such as:

1. Pre-qualification and certification requirements for member firm applicants and their Associated Persons;
2. Certification, examination, training and continuing education of Associated Persons of licensed member firms;
3. Ethical principles and codes of conduct that apply to member firms and their Associated Persons, including provisions regarding sales practices, advertising and dealings with public investors;
4. Prudential rules applicable to member firms that may exceed but are not inconsistent with regulatory requirements;
5. Rules applicable to transactions taking place off licensed securities markets;<sup>24</sup>
6. Arbitration or similar dispute resolution mechanisms for disputes between member firms, and between member firms or Associated Persons and member firm customers;
7. Examination of member firms; and
8. Administration of a disciplinary process applicable to member firms and Associated Persons.

The only realistic candidate among current securities market SROs to become the sole securities trader SRO is the PFTS Association. The PFTS Association does not currently represent more than 50% of the licensed securities traders. However, the PFTS Exchange, which is wholly-owned by the PFTS Association, is the dominant securities market in Ukraine, currently accounting for roughly 86% of the UAH volume of onshore secondary market transactions.<sup>25</sup> All of the members of the PFTS Exchange, who account for this volume, are members of the PFTS Association. Section V.A.4 below and Plan A under the recommended SSMSC Strategy and Action Plan for SRO Development and Regulation (Appendix C) set forth steps that the SSMSC should be taking to address the anomalous situation whereby PFTS Exchange members account for 86% of Ukraine's secondary securities trading even though SSMSC records indicate that they represent only 30% of licensed securities traders.

One of the SSMSC's concerns about conceding the dominance of PFTS Exchange appears to be the fact that only about 5% of Ukraine's current trading activity in corporate equity and debt securities takes place onshore through licensed securities markets. This concern seems illusory. While statistics have not been published regarding which traders account for the

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<sup>24</sup> Of course, licensed securities markets should be responsible for establishing rules for trading on their markets, subject to approval of the SSMSC.

<sup>25</sup> Note 24 *supra*.

approximately 95% of trading that is off-exchange, the logical hypothesis would be that the PFTS members with the dominant domestic and international customer base would also account for the overwhelming portion off-exchange trading as well. However, the matter does not have to be left to conjecture. The transaction data that SSMSC receives all licensed securities traders would enable SSMSC or a designated contractor to confirm the hypothesis.<sup>26</sup>

In the longer-term, it would be desirable for the PFTS Association to be fulfilling all eight of the SRO functions listed above. However, considering what the SSMSC may be willing to delegate to a securities trader SRO, it is my opinion that the SSMSC would probably wish to share responsibility for No. 2 (qualification of individuals) because of the revenue that certifications produce for the SSMSC, that No. 5 (regulation of off-market transactions) would have to be explained to the SSMSC and discussed before delegation, and that the SSMSC may be unwilling to cede No. 7 (inspection of member firms) to the PFTS Association at present, even if the PFTS Association were able to demonstrate that it has the current resources to undertake inspections. It is doubtful that PFTS Association's current budget would permit it to undertake a robust inspection program.

PFTS Association is capable of representing the interests of its members before governmental authorities.

PFTS representatives have indicated that they would be interested in working with the CMP to develop an Action Plan for SRO development.

### **3. Recommended improvements**

#### ***a. Governance of PFTS Association and PFTS Exchange<sup>27</sup>***

Before PFTS is recognized as the sole securities trader SRO, there are governance and organizational changes that should be addressed with respect to the PFTS Association-PFTS Exchange relationship. These include:

- Separation of commercial operating and any self-regulatory responsibilities that remain in the PFTS Exchange, including separate staff, budgets and accountability for commercial operating and self-regulatory activities;
- Governance for the PFTS Association; and
- Separate publicly available audited financial statements for the PFTS Association and PFTS Exchange.

When US consultants assisted in the establishment of the PFTS Association and PFTS Trading System in the Ukraine, they based their recommendations on the US model of the National Association of Securities Dealers, a member-owned not-for profit securities association, which is the only such SEC registered SRO association in the United States, and which at the time owned 100% of Nasdaq, an automated inter-dealer quotation system. Since that time, views on governance of SROs, particularly SROs that control securities markets, have changed considerably.

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<sup>26</sup> See note 4 *supra*.

<sup>27</sup> While these comments are directed to the PFTS Association and PFTS Exchange, I would have substantially the same comments regarding separation of self-regulatory and commercial operating functions with respect to any Ukrainian stock exchange or trading information system that exercises self-regulatory functions.

In the NASD's case, driven, in part, by a major enforcement problem involving collusion among NASD market makers, the subsequent SEC and US Department of Justice enforcement proceedings, an independent study (the Rudman Report), and the decision to transform Nasdaq into a publicly-owned stock exchange, the NASD self-regulatory and market components were placed in a separate NASD subsidiaries, NASD Regulation, Inc., and Nasdaq, each under a separate governance structure. A principal objective of the reorganization was to strengthen the independence and objectivity of the SRO component.

Today, there is no uniform best practice regarding how markets or their self-regulatory components should be structured. For example, the New York Stock Exchange (NYSE) does not have a separate SRO subsidiary like NASD Regulation. However, even before the NYSE Group became a public company, it placed its SRO functions in a separate regulatory unit, and the Chief Regulatory Officer heading that unit reported directly to the independent directors comprising the Regulatory Oversight Committee of the Board rather than through the NYSE CEO. Subsequently, on November 28, 2006, NASD and NYSE Group announced a plan to consolidate their member regulation operations into a combined organization that will be the sole US private sector provider of member firm regulation for securities firms doing business with the public.<sup>28</sup>

The Technical Committee of IOSCO issued a Consultation Report in March 2006 concerning "Regulatory Issues Arising from Exchange Evolution" (IOSCO Consultation Report). Two observations in the IOSCO Consultation Report regarding self-regulatory functions conducted by a stock exchange SROs are noteworthy:

"C.1. Governance arrangements

Most regulators have focused on governance arrangements as the primary means of ensuring that exchanges have robust arrangements for maintaining a proper balance between the exchange's commercial interests and its regulatory responsibilities".<sup>29</sup>

"C.2. Separation of functions within an exchange

An important element in ensuring that an exchange's regulatory responsibilities are not compromised by its commercial interests is the maintenance of organizational arrangements that place divisions between the commercial and regulatory functions".<sup>30</sup>

The IOSCO Consultation Report's observations are consistent with a similar study by the IOSCO Emerging Markets Committee,<sup>31</sup> and with an earlier IOSCO Issues Paper, which indicates:

"In recognition of the public good, and the degree of conflict of interest in a member-owned exchange, it has been common for an exchange to be required to have public directors on its Board to represent the interests of the community, beyond the member-owners. These public directors generally are expected to serve as a check on conflicts of interest in a self-regulatory organization and promote integrity in the Board's

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<sup>28</sup> US SEC Press Release 2006-195. Additional information regarding the plan may be found in Securities Exchange Act Rel. No. 34-55495 (March 20, 2007) available on the SEC's website, [www.sec.gov](http://www.sec.gov) and on the NASD's web site, [www.nasd.com](http://www.nasd.com).

<sup>29</sup> IOSCO Consultation Report, p. 12.

<sup>30</sup> *Id.* at p. 14.

<sup>31</sup> Exchange Demutualization in Emerging Markets", IOSCO Emerging Markets Committee (April 2005). See also "Self-Regulation in Financial Markets: An Exploratory Survey", International Council of Securities Associations (September 2006).

decision-making. In contrast, the boards of most commercial enterprises are required to consider only the best interests of the corporation and its shareholders in making decisions."<sup>32</sup>

**How do these potential conflicts between an exchange SRO's commercial interests and its self-regulatory responsibilities affect the PFTS Association and its wholly-owned subsidiary, the PFTS Exchange?**

First, while the PFTS Stock Exchange Charter provides in Article 5.3 for a Stock Exchange Board, it is troubling that Article 5.3 of the Charter provides that "Governance of the Stock Exchange shall be exercised by the Founder directly or by the Director of the Stock Exchange." This is a poor governance practice for a public institution, such as the Exchange. The Charter should be amended to provide that governance is exercised by the Stock Exchange Board.

Second, there is a clear regulatory consensus, based upon the authorities cited above, that responsibilities for stock exchange commercial operations and self-regulation should be separate. In PFTS' case, the responsibilities are under the same CEO and there is no separation of staff between commercial operations and self-regulation.

Third, regardless of whether securities markets are intended to remain as SROs under the 2006 Law and regardless of whether the SSMSC decides to delegate additional regulatory authority to SROs, there are some regulatory responsibilities that should be performed by, or on behalf of, the PFTS Exchange. At a minimum these are:

- Surveillance of trading on the market, including oversight of market participants to make sure that they are adhering to prescribed trading rules and procedures and not engaging in manipulative activity.;
- Administration of PFTS trading rules and certification of traders; and
- Administration of listing requirements.

Ideally, the PFTS Exchange should be entitled to decide whether it wishes to carry out these responsibilities directly with assigned PFTS Exchange personnel or whether it wishes to contract for these activities to be performed by PFTS Association staff. And, ideally, the SSMSC should recognize the PFTS Exchange as a securities market SRO separate and distinct from the PFTS Association, so that the PFTS Exchange is a position to make the above choice.

Before the 2006 Law was adopted, distinctions between the organization and self-regulatory responsibilities of the PFTS Association and PFTS Exchange were not critical because these responsibilities related only to trading on the PFTS Exchange. This is no longer the case. If the PFTS Association achieves more than 50% representation of securities traders and is recognized by the SSMSC as the sole securities trader SRO, the PFTS Association, PFTS Exchange and the SSMSC need to understand that the PFTS Association will then have broader SRO responsibilities to its securities trader members and that separate budgets and financial accountability of the PFTS Association and PFTS Exchange are required to ensure that securities trader fees paid to the Association are not being used for support of the PFTS Exchange and vice versa.

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<sup>32</sup> "Issues Paper on Exchange Demutualization", Report of the IOSCO Technical Committee (June 2001), p. 10.

These potential conflict issues should be assessed in terms of the realities of the Ukrainian market, rather than academically. As noted above, the PFTS Exchange members account for roughly 86% of all reported onshore securities trading on Ukraine's securities exchanges. While there exist 500+ other licensed securities traders, wherever they may be and whatever they may be doing, it does not appear that they are engaged in significant secondary trading activity. PFTS should not be required to undertake unnecessary governance changes to address a potential conflict that is immaterial because the persons affected by the potential conflict are not bona fide participants in secondary securities market activities. The better approach, explained, in §V.A.4 below is direct action by the SSMSC to reduce the number of licensed securities traders through more robust regulatory requirements that should lead to industry consolidation.

For these reasons, except as described below, I do not recommend any changes in the composition of the Board of the PFTS Association or PFTS Exchange as essential at this time, either in order to accommodate non-PFTS Exchange member representatives or to add independent public directors. The present composition of the Board is representative of the principal participants in the Ukrainian capital market. When the PFTS Association becomes the sole securities trader SRO, its governing instruments should continue to be based upon a one member, one vote principle. At that time, all members will have an opportunity to decide by voting whether to change the composition the PFTS Association Board.

Over the longer term, it would be preferable for the PFTS Association Board to add or substitute several independent public directors. Independent board members can contribute significantly to the decision-making of the Board. They can bring an objective view to the evaluation of the performance of the Association Board and Association management. In addition, they can play an important role in areas where the interests of Association management and Association members may diverge such as executive remuneration, succession planning, and the audit function.

At present, neither the PFTS Association nor the PFTS Exchange is optimally organized to carry out self-regulatory responsibilities. If the PFTS Exchange wishes to continue to use its own staff to conduct the above-described self-regulatory activities that are normally conducted internally by a licensed securities market, the PFTS Exchange should establish a small number of staff members dedicated solely to this activity who report to a senior officer who is not responsible for the PFTS Exchange's commercial activities. The senior officer, in turn, should report, not to the CEO, but directly to the PFTS Exchange's Board.<sup>33</sup>

At the PFTS Association level, there should be a small staff separate from the PFTS Exchange Staff, which is dedicated solely to self-regulation of PFTS Association members. In order to properly separate the PFTS Association's SRO functions from the commercial activities of its wholly-owned PFTS Exchange subsidiary, the CEO of the PFTS Association should **not** also be the CEO of the Exchange. Because of the PFTS Association's 100% ownership interest in the Exchange, its principal asset, it is appropriate that both the PFTS Exchange CEO as well as the Association CEO may serve on the Association Board. However, the PFTS Exchange CEO should report to and serve at the pleasure of the PFTS Exchange Board, and the PFTS Association CEO should report to and serve at the pleasure of the PFTS Association Board.

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<sup>33</sup> An alternative would be for the PFTS Exchange to contract self-regulatory responsibilities to a small regulatory unit within the PFTS Association. In such circumstances, the PFTS Exchange should pay the Association for such services since self-regulatory oversight of the PFTS Exchange is a dedicated function separate and apart from the Association's general responsibility to act as an SRO for its members.

Finally, separate audited financial statements of the PFTS Association and PFTS Exchange should be filed with the SSMSC and made publicly available. In order to properly assure the separate use of PFTS Association and PFTS Exchange assets, the financial statements should be prepared as follows. The PFTS Exchange financial statements should be presented on a separate basis without any consolidation with the parent PFTS Association. The PFTS Association financial statements should be presented on a "parent company only" basis whereby the PFTS Exchange is not fully consolidated but is shown on one line in each of the PFTS Association balance sheet and profit and loss statement as an investment of the parent PFTS Association accounted for under the equity method of accounting.

***b. Comments on PFTS Association governing instruments and rules***

Copies of the PFTS Association Charter, By-Law on Membership, Regulation on Certification and disciplinary and arbitration procedures are included in Appendices E-1 through E-7 along with my comments and suggested changes. In addition, PFTS Association and PFTS Exchange should have a code of ethics, covering securities transactions, for their staffs.

**4. Licensed securities trader problem**

Effective self-regulation of licensed securities traders will require prior reduction in their numbers, including possible re-licensing or re-qualification under more robust regulatory criteria. I share the view expressed by several market participants that the approximately 800 licensed securities traders in Ukraine and the manner in which they have been licensed and are currently operating make it very difficult for the SSMSC to exercise effective direct regulation of such traders. If direct regulation is not effective, it is very doubtful that a sole securities trader SRO will have any significant success in self-regulation of this universe of traders.

The core of the problem is that the most of these securities traders are not engaged in secondary securities market activities.<sup>34</sup> They have no community of interest with the much smaller number of traders that are engaged in such activities. Accordingly, many have minimal incentive to comply with licensing requirements and they are unlikely to have any incentive to support or contribute to the costs of self-regulation by a sole securities trader SRO. At present, many of these 500+ traders are members of regional securities markets that are not imposing any self-regulation on their members. If the 2006 Law had recognized this problem and provided a more realistic criterion for identifying a representative SRO for securities traders than the 50% of licensed traders' requirement, this problem might have solved itself because it is likely that many of these traders would relinquish their licenses and drop out of the industry rather than bear the costs of mandatory membership in a bona fide SRO that will enforce self-regulation.

Unfortunately, the 50% membership requirement of the 2006 Law prevents this natural elimination solution. If the GOU, and more specifically the SSMSC, does not address this problem and take steps immediately to reduce the number of licensed securities traders operating in Ukraine, it may not be possible to create a responsible sole securities trader SRO by the May 2009 target date provided in the law. The failure to do so will not necessarily be fatal to self-regulation, assuming it is agreed that the 2006 Law permits securities markets to exercise self-regulation over their members. Under this scenario, as privatization winds down

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<sup>34</sup> Other than participating in the economic benefits of privatization auctions through regional markets, it is not entirely clear what the more than 500 licensed traders who are not PFTS Association-PFTS Exchange members are doing to earn a livelihood in the securities industry.

(after 2009), it is likely that most of Ukraine's regional markets and their securities trader members may "die a natural death".

However, waiting for the natural death solution to occur leaves a very unhealthy situation regarding the regulatory soundness of the Ukrainian capital market. Consider that Poland, a country with comparable demographics to Ukraine and a much larger and more soundly regulated securities market, has only 37 licensed securities firms and ten banks authorized to conduct brokerage activities.<sup>35</sup> The SSMSC's unwillingness to effectively impose robust regulatory requirements for licensed securities traders, which would reduce their number, results in a situation where some of these 500+ licensed traders may be controlled by criminal elements and may be using their licensed status to engage in illicit activities, such as market manipulation, money laundering and facilitation of flight capital transactions. A recent World Bank staff report highlights this problem. Here are some excerpts:

"The regulatory and supervisory framework for securities markets and Non-Bank Financial Institutions (NBFIs) suffers from serious deficiencies."

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"SCSSM [the SSMSC] does not have the legal authority to trace the ultimate beneficial owners of the entities that it supervises, nor to carry out background check on these owners. SCSSM has no internal procedures in place to trace ultimate beneficial owners through the chain of controlling companies, and no arrangements in place with other institutions to carry out background checks on these owners. Therefore, no entity currently licensed by SCSSM to operate on the securities market has been subject to a fit and proper test of its ultimate beneficial owners."<sup>36</sup>

If the World Bank staff report is correct and that SSMSC has no way of knowing who are the beneficial owners of the PSMPs it has licensed, the integrity of the PSMP licensing process may be seriously undermined. As an IOSCO member, the SSMSC is required to use its best efforts to become a signatory to the IOSCO Multilateral MOU for information sharing by 2010. The regulator's ability to obtain beneficial ownership information regarding licensed intermediaries, customer accounts and issuers is a core requirement of the Multilateral MOU. If the SSMSC does not have this authority, it should seek the authority through legislation.

The Strategy and Action plan for SRO development and regulation (Appendix C) includes several suggestions regarding steps that the SSMSC should take to deal with the problem of licensed but unqualified securities traders.

## **B. Institutional asset manager SRO – UAIB**

### **1. Background**

UAIB was established in 1996 and registered by the SSMSC as an SRO in 1997. Prior to 2002, UAIB was a multi-functional organization and included a number of investment funds, including privatization funds, among its members. In 2002, a decision was made to become an asset manager SRO. At present, of the 250 members, 98% are asset managers, which include asset managers of investment funds and non-state pension funds, and 2% are brokers.

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<sup>35</sup> Source: Website of the Polish Financial Supervision Authority, [www.knf.gov.pl](http://www.knf.gov.pl), visited June 12, 2007.

<sup>36</sup> World Bank Concept Note, "Developing Capital Market Conditions for the Introduction and Development of Second Pillar Pensions (revised draft March 8, 2007), p.6. A "fit and proper" evaluation is one of the requirements for implementation of Principle 21 of the IOSCO Principles relating licensing of securities intermediaries.

Members pay a \$2,000 entrance fee and \$1,000 annually, which would make UAIB's annual budget approximately \$250,000. UAIB has a current staff of ten persons.

UAIB has experienced recent membership growth. Its goal is 300 members by 2007. At present, UAIB satisfies the more than 50% membership requirement to be designated as a sole SRO for institutional asset managers under the 2006 Law. UAIB's ability to attract members is enhanced substantially by the fact that the SSMSC has authorized UAIB to pre-certify applicants for an asset manager's license from the SSMSC.<sup>37</sup> In addition to the pre-certification function, UAIB collects, analyzes and publishes data regarding its members' investment management activities. UAIB views its current role as first, representing the interests of its members before the government and second, ensuring members' compliance with UAIB rules. UAIB has a code of ethics and a disciplinary committee.

## **2. UAIB capacity for SRO development**

Of the three principal SROs, the UAIB appears to have the resources and capacity that come closest matching the SRO authority that an institutional asset manager SRO might be expected to undertake. This is not to suggest that the PFTS Association does not have resources and SRO capacity. Clearly, it does. However, the responsibilities that are usually expected of a securities trader SRO are much more extensive than those normally undertaken by an asset manager SRO. The gap between resources and capacity and SRO expectations is greater in the case of PFTS.

One reason that the level of expected SRO activity should be less for an asset manager SRO compared to a securities trader SRO is that securities traders do business by interacting with each other. Therefore, they have a common interest in being able to trust each other to abide by an agreed set of trading and clearing and settlement rules and in the event of disputes, an agreed set of arbitration procedures. Asset managers, by contrast, compete with each other and their only interaction would be transactions through securities traders. Nevertheless, responsible asset managers do have common interests in ethical principles and upholding and strengthening the standing of their profession by way of minimum entry standards and continuing professional education.

UAIB should have the ability to undertake all of the following SRO activities:

- Pre-qualification and certification of asset manager applicants and Associated Persons to the SSMSC;
- Training and continuing education of members and Associated Persons;
- Implementation of an ethics code that requires, among other things that members and Associated Persons adhere to advertising, performance reporting and other asset management standards that are consistent with both existing regulation and the requirements of the code; and
- Administration of a disciplinary function whereby members and Associated Persons may be sanctioned for violations of the ethics code.

Since it is logical to expect most asset managers of investment funds also to be asset managers for non-state pension funds, and to have common self-regulatory interests, it is logical that UAIB also should serve as an SRO for asset managers of pension funds.

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<sup>37</sup> Apparently, the SSMSC's delegation of pre-certification authority to UAIB was done pursuant to an SSMSC Regulation adopted under Resolution 243 (September 10, 2002). §1.1 of this Regulation permits delegation of such authority to an SRO if it represents not less than 60% of the PSMPs permitted to engage in a certain type of professional activity.

UAIB also is capable of representing the interests of its members before governmental authorities.

UAIB representatives indicated that they would be interested in working with the CMP on SRO development issues and have already contacted CMP staff regarding ethics code and member advertising issues.

In order for UAIB, or any other SRO, to be effective, it is critical that it adequately represent the interests of its members. UAIB's members include both asset management companies for public investment funds and pension funds and asset management companies that are more analogous to venture capital or real estate development firms. The regulatory interests and needs of these different constituencies will not always be the same; for example, performance reporting and its measurement often will be different. At some point in the future, it may make sense for these different constituencies to divide into separate SROs. From the standpoint of securities regulation, self-regulation of asset managers of public investment funds and pension funds is the more important SRO priority.

### **3. Recommended improvements**

Copies of the UAIB charter, membership rules, ethical and disciplinary codes are included in Appendices F-1 through F-4 along with my comments and suggested changes.

UAIB should consider adoption of an arbitration code for resolution of disputes between UAIB members and their clients. I recommend the PFTS Association Arbitration Code as an excellent model that might be adopted for such purposes. See Appendix E-6. UAIB also should have a code of ethics for its staff, which covers securities transactions.

## **C. Depository activities (registrars and custodians) SROs**

### **1. PARD**

#### ***a. Background***

PARD was established in 1996. PARD has over 600 members, including licensed registrars, securities custodians, a number of issuers that maintain their own share registries, and Ukraine's two licensed securities depositories, MFS and NDU. At present PARD represents 41% of the securities custodians and approximately 75% of the licensed registrars. This membership would qualify PARD to be designated as the sole depository SRO under the 2006 Law.

PARD charges members a one-time \$100 entrance fee and an annual fee of \$300 per annum, which is payable in quarterly installments. PARD's annual budget is approximately \$160,000. PARD's membership has suffered recently because its constituency of registrars is not that profitable and it is possible for registrars to join APSM, which is no more than a brass plate SRO, for as little as US \$50 per annum.

PARD has 15 employees and several regional affiliates. Each affiliate employees at least two specialists. PARD's Board is elected by members and serves a three-year term, so that all directors are elected every third year.

PARD has an ethics code and a By-Law on a tertiary court intended to serve as an arbitration forum. However, at present PARD is not performing any SRO functions and has declined to accept delegation of SRO functions from the SSMSC as long as APSM exists as a competing SRO. PARD is willing to accept SRO responsibilities if it becomes the sole depository SRO

***b. PARD capacity for SRO development***

Even if there is a consolidation of registrars under PARD as the sole depository SRO, and PARD were to be able to raise its fees somewhat, PARD would still have a very limited budget to support SRO functions. Given the limited profitability of registrars, which limits PARD's financial resources, if PARD is established as the sole depository SRO, PARD's SRO activities might best be focused on:

- Prequalification and certification, training and continuing education of members and Associated Persons;
- Promoting uniform securities registration procedures and forms;
- Implementing an ethics code that requires, among other things, adherence by members and Associated Persons to such uniform procedures; and
- Administering a disciplinary function whereby members and Associated Persons may be sanctioned for violations of the ethics code.

Over 90% of the persons licensed to perform custody services are firms licensed as securities traders and the 2006 Law requires a professional market participant to be a member of only one SRO. It is substantially more important that the securities trading firms become members of a sole securities trader SRO. Since a second SRO membership is not required, it is possible that many licensed securities trader firms that provide securities custody services will elect not to voluntarily join the depository SRO, believing that membership in a securities trader SRO is all that is required and necessary to represent their interests.<sup>38</sup> As pointed out in §§II.C and IV.I.3 above, a well-qualified depository SRO that has the confidence of securities traders and custodians involved in securities clearance and settlement would be a more logical SRO for securities custodians.

The future role of registrars in Ukraine is also uncertain under a draft law on the System of Depository Record Keeping in Ukraine, which is pending in the Ministry of Justice and may be taken up by the Rada.<sup>39</sup>

Although PARD is clearly the only viable candidate for sole SRO status for its category of PSMPs, it should be noted that despite evidence of problems in the registrar industry, including the maintenance of double registries and elimination of names from some registries, neither PARD nor APSM have ever referred such violations to the SSMSC for enforcement action. This is an issue that needs to be explored more broadly, including whether current legislation is sufficient to provide remedies for registrar violations.

PARD is capable of representing the interests of its members before governmental authorities.<sup>40</sup>

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<sup>38</sup> PFTS representatives have indicated that over 90% of persons licensed to perform securities custody are already members of PFTS

<sup>39</sup> The December 1, 2005 draft of this proposed law, which is the last version available in English that I was able to review, is so poorly prepared that it is impossible to predict what may happen if it is taken up by the Rada.

<sup>40</sup> For example, at its 10<sup>th</sup> Annual Conference on October 15, 2006, PARD membership adopted a resolution criticizing the proposed depository legislation pending in the Ministry of Justice.

*c. Recommended improvements*

Copies of the PARD Charter, By-law on Membership, ethics, disciplinary and arbitration procedures are included in Appendices G-1 through G-5 along with my comments suggested changes. In addition, PARD should have a code of ethics covering securities transactions for its staff.

**2. APSM**

*a. Background*

The CEO and sole employee of APSM indicated in mid-October that he was sick during the duration of my mission and would be unable to meet with me. Accordingly, the information about APSM set forth below was obtained from other market participants that I interviewed.

APSM was established by a group of registrars who did not wish to pay even the modest level of fees charged by PARD. APSM was granted SRO status by the SSMSC in 1997. The annual cost of membership in APSM is reported to be approximately US \$50 per annum, although it is not clear that even this amount is being collected. APSM's sole employee is its CEO. APSM is believed to have just under 200 members. APSM has never performed any SRO functions.

*b. APSM capacity for SRO development*

None. APSM is no more than a "brass plate" SRO. APSM performs no SRO functions, but its fees undercut PARD's fees and its presence provides an SRO venue for registrars whose only interest in SROs is to fulfill the regulatory requirement that they join one.

*c. Recommendation*

APSM should not be licensed as an SRO because APSM has no capacity to act as a responsible SRO, one of the threshold requirements for SRO status recommended by Principle 7 of the IOSCO Principles. The SSMSC and PARD should work together constructively so that PARD may be recognized as a sole SRO as soon as possible.

**D. Pension fund administrators SRO – UA APF**

UA APF, is the principal association for Ukrainian pension fund administrators. It was founded in May 2006 and currently has ten member administrators whose administration accounts for 85% of open private pension fund assets and service to 65% of open private pension fund participants.

UA APF recently was recognized by the FSR as a voluntary SRO. Unlike the sole SRO provisions of the 2006 Law applicable to PSPM SROs, the legislation governing SROs in the pension industry does not provide for sole SROs or mandatory SRO membership. It would be desirable to amend applicable legislation to require a sole, mandatory SRO for pension fund administrators. UA APF represents a substantial majority of the pension administrators, measured by assets under management and participants served and has the capacity to function effectively as an SRO for this industry group.

UA APF has expressed interest in working with the CMP to develop its SRO model.

## **VI. Pre-qualification, training and continuing education of PSMPs and Associated Persons**

The three principal PSPM membership SROs have the capacity and expertise to provide additional pre-qualification, certification, training and continuing education for their members. At present, only UAIB is involved in pre-qualification activities whereby it certifies asset manager applicants to the SSMSC for licensing. There is no reason why similar authority could not be given now to the PFTS Association to the exclusion of other securities market SROs who are not qualified to provide such pre-qualification and certification. For example, SSMSC should require by rule immediately that new applicants for a securities trader license and applicants required to renew their licenses, must be pre-qualified and certified by the PFTS Association. This would encourage more securities trader membership in PFTS Association. It would add a "second pair of eyes" to the securities trader licensing process.

Once PARD is granted sole SRO status, PARD is also qualified to provide pre-qualification and certification of registrar applicants, including registrars and Associated Persons who are required to renew their licenses or qualifications.

At present, the SSMSC is integrally involved in the training process, both in terms of providing SSMSC staff as trainers and examiners, and in approving training vendors. As part of its regulatory oversight function of SROs, it is appropriate for the SSMSC to pass upon SRO qualification and training requirements for Associated Persons of PSMPs and proposed PSMPs. However, training might better be subdivided between training regarding the requirements of the securities law and related legislation and training related to the SRO members' professional interests and development. Overall, training might be improved if the SSMSC's direct involvement were limited to the law and related legislation and the SROs were given more discretion regarding professional development training.

There is some sentiment among the persons I interviewed that the SSMSC approved courses are not particularly demanding. The current training framework may be designed as much to provide additional compensation to SSMSC staff than to enhance the professional development of market participants.<sup>41</sup> It would be preferable in the case of training and continuing education that does not relate specifically to the securities law or secondary legislation for the SROs, not the SSMSC, to decide upon the persons that may provide this training.

The present SSMSC training requirements are that no more than three persons of a PSMP must be qualified via training and examination and re-qualified at three-year intervals. The three person requirement probably was a good requirement when the Ukrainian market started over ten years ago. However, the requirement overlooks the fact that if there are more than three Associated Persons, over time all Associated Persons should be appropriately qualified because any Associated Person who is managing a PSMP or dealing with customers, cash or securities, has the potential to harm investors and put the PSMP at risk is the Associated Person does not has not been properly trained and qualified. All Associated Persons in supervisory positions within a PSMP should be required to meet a higher qualification threshold. More objective qualification standards, documented by passing a written examination, should be required for entry level and supervisory Associated Persons.

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<sup>41</sup> This is not to suggest that such compensation is improper. However, it should be paid only for services related to training regarding the securities law and secondary legislation, not to SSMSC staff for other training where persons other than the SSMSC staff have greater expertise.

Ideally, each PSMP should have in place a system of internal controls and supervisory procedures designed to assure that all Associated Persons who are employees are subject to supervision by Associated Persons qualified at the manager or supervisor level of the PSMP. This is an important area where the SSMSC and the three membership SROs need to work together to move from the current three-person examination and qualification standard to more comprehensive examination and qualification regime for all Associated Persons of each PSMP.

## **VII. Conclusion**

It is probably somewhat of an overstatement to suggest, per my Statement of Work, that "strengthening and empowerment of SROs" is one of two critical steps necessary for Ukraine to take the next step in financial sector growth. My view, which is supported by interviews with private sector market participants, is that there are more important market development problems that need to be addressed. These problems include:

- Foreign exchange and tax reforms so that the PFTS Exchange, Ukraine's only securities market of any significance, actually becomes a securities market on which most transactions in its listed securities actually take place, rather than the present venue of choice, which is offshore;
- Implementation of a modern disclosure and financial reporting system, the other critical step identified in the Statement of Work;
- Substantial improvements in corporate governance, including passage of a joint stock company law that is enforceable and reflects international best practices;
- An improved legal framework for regulation of a single central securities depository;
- A new trading system for the PFTS Stock Exchange, which is based primarily on order match principles, but which also has market making capability and provides the retains the flexibility to attract and accommodate the needs of all market participants;
- Strengthening the capacity of the SSMSC to act independently as a competent and respected securities regulator;
- Continued emphasis on reducing corruption, which remains more of a problem in Ukraine than in most countries at a comparable stage of capital market development; and
- Clear signals from the GOU that it remains committed to development of market-based institutions.

Notwithstanding the above problems, further development of SROs clearly is a positive step that realistically may be implemented to improve the quality of the Ukrainian securities market and its regulation. The recommended SSMSC Strategy and Action Plan for SRO Development and Regulation (Appendix C) provides a roadmap of the steps that should be taken to achieve this objective.