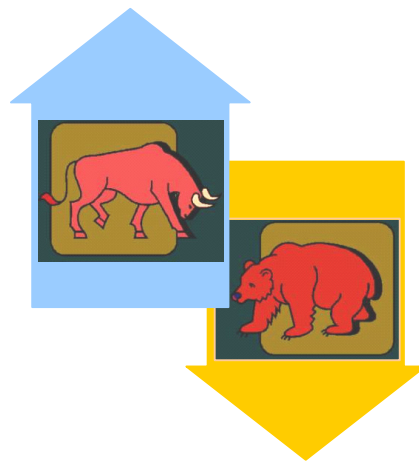




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Capital Markets Project

THE UKRAINE STOCK EXCHANGE ENVIRONMENT: CHALLENGES AND RECOMMENDATIONS



Prepared by:
Robert L. Smith
International Adviser
Capital Markets Development

January 17, 2006

Robert L. Smith is a senior securities exchange professional with over 30 years diverse experience in regulation, operations, trading and management. He has an in-depth understanding of international best practices for exchange operations and oversight, having held positions with the U.S. Securities and Exchange Commission, NASDAQ, Chicago Board Options Exchange, and with leading investment intermediaries. Mr. Smith has significant direct experience in emerging markets including work in Kazakhstan, Thailand, China, Kyrgyzstan, and Georgia.

Preface

This paper presents an analysis of securities exchanges in Ukraine, focusing in particular on whether the existing institutions have the capacity and independence to support a truly dynamic financial sector for Ukraine. While the focal point of the paper is the Ukrainian exchange environment, the role of the regulator, the Securities and Stock Market State Commission, is examined in the context of its impact on the development of stock exchange operations supporting true price transparency and planning for pension reform investments.

In order to more fully speak to these challenges and better understand the role Ukraine's securities exchanges can and should play in responding to them, the following analysis of the current status of Ukraine's stock exchange operations was undertaken:

- **Background--History** – review of the historical development of Ukraine's securities exchanges, the current political and financial issues exchanges face, and the role of the GOU, the private sector, and international donor community.
- **Technical Capacity Analysis** – evaluation of the capabilities of key exchanges active in Ukraine against requirements for a well-regulated and dynamic trading market, measured against international best practices for this market place. The analysis included, but was not limited to, a review of issues such as pricing, information disclosure, listing requirements, and the ability to service the full range of domestic and international customers. This analysis was benchmarked against several comparable markets.
- **International Best Practices** – comparison of Ukraine's exchange operations against international best practices, including a review of compliance with IOSCO Principles for operation of stock exchanges.

The paper is intended to provide a baseline for future technical assistance to improve the operations of securities exchanges to meet market needs and contains short and medium term recommendations. The ultimate goal is to stimulate discussion and policy debate on issues of critical importance to Ukraine's long-term securities market development, while also helping to establish consensus supporting needed changes in existing institutions, providing a firm foundation for a vibrant and truly dynamic capital markets sector in Ukraine.

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Abbreviations

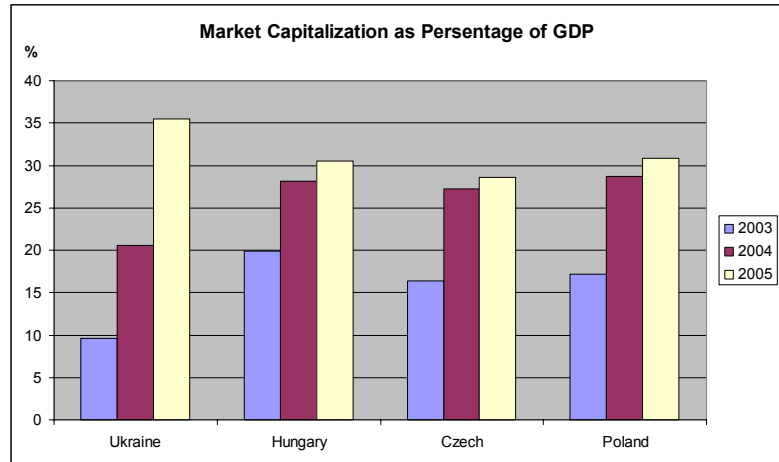
| | |
|-------|--|
| COM | Cabinet of Ministers of Ukraine |
| ETS | Electronic Trading System |
| GDP | Gross Domestic Product |
| GOU | Government of Ukraine (i.e., the COM and the various ministries and agencies, but not the Presidential Administration, the Verkhovna Rada or the courts) |
| IFRS | International Financial Standards of the International Accounting Standards Committee |
| IOSCO | International Organization of Securities Commissions |
| JSC | Joint Stock Company |
| MFS | Interregional Stock Union (operational clearing depository for securities) |
| MOF | Ministry of Finance of Ukraine |
| NBU | National Bank of Ukraine |
| Rada | Verkhovna Rada (Parliament) |
| PFTS | Persha Fondova Torhova Systema, (First Ukrainian Securities Trading System). |
| SOP | State owned property |
| SOS | State owned shares |
| SPF | State Property Fund of Ukraine |
| SRO | Self-Regulatory Organizations |
| SSMSC | Securities and Stock Market State Commission |
| UAH | Hryvnia (Ukrainian Currency) |
| USAID | United States Agency for International Development |
| WFE | World Federation of Exchanges |

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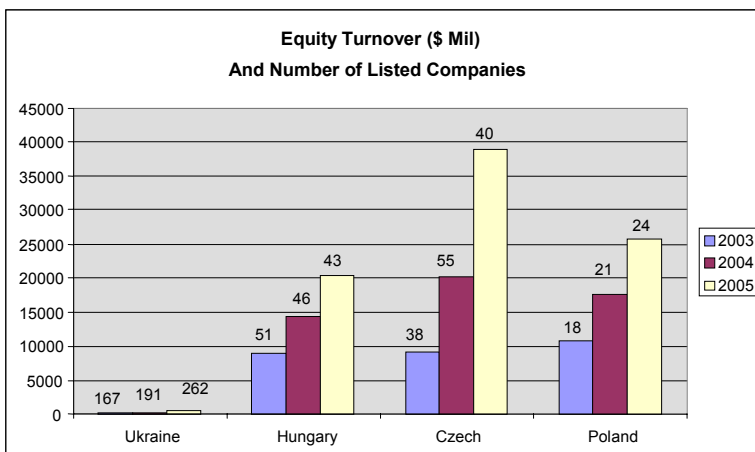
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Executive Summary

In the past three years the Ukrainian equity market has grown from one of the smallest in the region, representing 10% of GDP for 2003 to an estimated 35% of GDP for 2005. This dramatic growth in Ukraine's market capitalization when compared to Hungary, Poland and Czech Republic is explained by the positive effect of the Orange Revolution. Although there are 262 listed companies, the market is highly concentrated, with the market capitalization of the 10 largest companies representing about 57 percent of the market. Despite this growth, the equity market is highly fragmented, lacks price transparency, and is illiquid. Free float by public companies is estimated at about 4 percent of market capitalization. It is estimated that some 90 percent of securities transactions occur outside the organized market.



Sources: SSMSC, PFTS, European Federation of Stock Exchanges, and World Bank



Sources: SSMSC, PFTS, European Federation of Stock Exchanges, and World Bank

The low liquidity in the Ukrainian market as compared to the CE3 countries is attributed to corruption, inappropriate political intervention, and concentration of ownership of privatized companies in the hands of Ukraine's six major financial groups. This results in low market liquidity due to the low number of shares available for trading. Recent political intervention is evidenced by the Presidential Decree dated

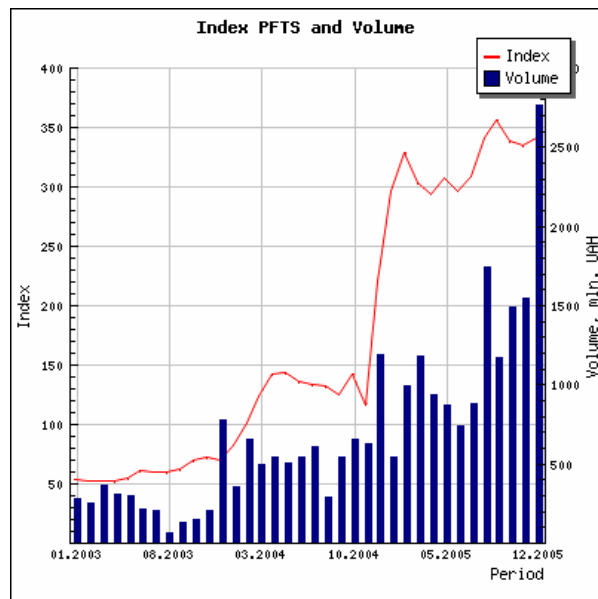
November 24, 2005 (November 25 Decree). This Decree directed that pension funds invest only in shares listed on a "securities exchange." Likewise the Decree mandated that State owned shares be sold and traded over stock exchanges, and that state owned enterprises must be listed on stock exchanges. Yet the existing stock exchanges lack the institutional capacity to provide a fair and transparent market for this State dictate. These directives, if implemented, will favor the financial security of weak "pocket" exchanges at the expense of a vibrant capital market and pension reform. Support of dormant stock exchanges can only lead to price manipulation and further corruption.

The current fragmentation of the market flows from decisions made to facilitate mass privatization in the mid 1990s, in which the regulator, acting more as an administrator of the market than a regulator, licensed regional stock exchanges to handle privatizations of local enterprises. Today, Ukraine has 10 trade organizations licensed by the SSMSC, 8 of

which are registered as a stock exchange, and 2 registered as trade information systems (electronic trading systems), which is well in excess of the market needs.¹

The two most active trade organizations are PFTS, an electronic trading system, which accounts for more than 86% of all trading volume, and the Ukrainian Stock Exchange, which accounts for approximately 13% of trade volume. The remaining 8 trade organizations, 7 exchanges and one electronic trading system, are practically dormant, but with random trading, further exacerbating the fragmented market, and adversely affecting price and liquidity.

These dormant trade organizations remain open solely in the hope of participating in privatization and sale of state owned shares (SOS), capturing the facilitation commission of 1 percent of the sale proceeds of SOS. It has also been widely noted that when an occasional trade is transacted through these organizations it is seemingly done solely for the purpose of artificially inflating (manipulating) the price of the traded issue.²



Source: PFTS

“The PFTS trading platform transacts the lion’s share of agreements for securities in Ukraine. PFTS index is the only acknowledged “thermometer” which precisely shows the political and economic “temperature” of the Ukrainian securities market.”

Economic News, Ukraine 2004

Despite the dominance of the PFTS trading system in the Ukrainian market, the SSMSC has refused to grant PFTS the status of a “stock exchange.” This weakens the ability of this dominant institution to serve the needs of the Ukrainian market, particularly in view of the above noted Presidential Decree. This action by the regulator not only adversely affects PFTS’s operations but also results in significant adverse affects on the GOU privatization program and the development of non-state pension funds.

Investors need a securities exchange that offers safety, price transparency, inexpensive order execution, and liquidity, which is not available in Ukraine due to fragmentation and lack of compliance with well know standards for exchanges. In addition, further fragmentation of this market is expected if as reported the SSMSC considers favorably the application of a new trade and information system, the Perspektiva system.³

The adverse effect of the SSMSC’s institutionalization of a fragmented securities market has been recognized by the State Property Fund, which recently publicly stated that it

¹ The SSMSC has also licensed 794 securities traders, 370 independent registrars, 143 custodians, 2 depositories and 10 self-regulatory organizations which has further fragmented the development of an organized securities market given the size of the current market.

² Manipulation can take many forms artificially influencing either reported volume or price discovery. Most regulated securities markets prohibit such activity. The current legal framework does not prohibit manipulation, provide for sanctions or other enforcement remedies. Such manipulations adversely affect the rights of investors, resulting in lack of confidence in the market and no true price discovery.

³ SSMSC Considers Registration Documents of a New Trade and Information System, Perspektiva. *UABANKER*, December 28, 2005.

would seek to initiate privatization of blocks of stock of State owned companies through Western stock exchanges. In support of this position, the State Property Fund Chair, Valentyna Semeniuk, stated that assets can be sold on Western markets at a price higher than on the domestic market.

I am going to do everything possible to tap into foreign markets. It is possible now to go to the London Stock Exchange and other exchanges, so as to get a better price for such stocks.

*Valentyna Semeniuk, Chair, SPF,
December 22, 2005*

It has been argued that the failure of the GOU to address the effects of its actions on the fragmentation of the Ukrainian market will bring increased pressure on the regulator to improve its performance in accordance with international norms or become further marginalized by the competitive forces from the EU. GOU intervention coupled with the failure to take appropriate regulatory actions in accordance with stock market rules that are clear to developed markets and the whole world will result in Ukraine facing increased competition from Western markets, including the EU countries. This will further marginalize Ukraine's position, both domestically and internationally, to the detriment of the country and its citizens.⁴

Technical Capacity Assessment

The International Organization of Securities Commissions (IOSCO) has issued international best practices for establishment and oversight of securities exchanges. These widely accepted standards are employed by the regulator in its licensing and oversight function as well as internally by trade organizations, as benchmarks to assess the regulatory framework, standards and practices, corporate governance criteria, and transparency, leading to a well-regulated market.

Critical benchmarks include, but are not limited to the following: general issues of fragmentation and centralization of prices, market liquidity, access to trade data and more technical issues such as best execution rules, opening/closing price determination, and execution of block trades. These internationally recognized benchmarks were used to assess the Ukrainian regulatory environment, with particular emphasis on strengthening the SSMSC licensing and oversight procedures, the operations of the two principal exchanges---the PFTS and the Ukrainian Stock Exchange---and the role of SRO's in Ukraine's regulatory program.

While a comprehensive institutional capacity study was not feasible, it was possible to assess generally the operations of the SSMSC, the principal exchanges and the SRO regime and provide recommendations for improvement of operations in an effort to strengthen its market structure as more fully detailed in this report. In summary, it was easy to conclude that Ukraine continues to lag behind on many measures for international best practices in securities exchanges and the legal/regulatory framework.

Key Recommendations

The short and medium term recommendations focus on the Ukrainian securities exchanges and are not intended to encompass or address the sum of the challenges facing the securities market. Hopefully the recommendations will produce not only discussion and policy debate but will result in positive changes in the institutions that

⁴ The Development of Non-Bank Financial Institutions in Ukraine: Policy Reform Strategy and Action Plan, World Bank ECSPF Draft Study, October 2005.

provide the foundation and framework for a vibrant and truly dynamic securities market in Ukraine.

- SSMSC should immediately recognize, register, and license the PFTS as a “stock exchange.” It accounts for 86% of the trading in the Ukrainian regulated market, is privately owned and operated, and enjoys the respect of market participants, and continues to develop its capacity to serve the market in a fair and transparent manner.
- International donor support should be given to strengthen PFTS’s operations in support of privatization and non-state pension fund operations. Key areas for technical support include the following:
 - Listing standards should be improved for first tier companies to establish corporate governance and information disclosure based on international norms leading to investment opportunities, particularly for non-state pension funds.
 - Price discovery should be enhanced by requiring transactions in securities of listed companies to be conducted or reported over the trading system eliminating off the market transactions.
 - Best execution rules for transactions should be implemented and enforced.
 - Move to a real time settlement of transactions no later than T+3 required by international norms.
 - Market order system should be reviewed and improved, where necessary, to insure effective operation of this system.
 - Auction procedures should be reviewed for compliance with international norms in support of price transparency, particularly for privatization over this electronic exchange.
 - Improved training of broker/dealers should be implemented, including continuous education programs to enhance exchange operations.
 - SRO operations should be enhanced to provide for effective control and enforcement of broker/dealer operations.
- Steps should be taken to consolidate the remaining mostly dormant stock exchanges through voluntary mergers or license revocation improving the price transparency critical for privatization and non-state pension fund investments. In view of the dormant status of these institutions, it is highly recommended that licenses be revoked to eliminate the problems resulting from fragmentation of the market. Limited resources should be consolidated to improve the operations in the market.
- The licenses of inactive broker/dealers should be revoked.
- Every effort should be made to address the adverse consequences of the November 24, 2005 Presidential Decree.
- The SSMSC should implement more visible and effective licensing procedures, securities market oversight, supervision, regulatory and enforcement presence.
- In order to improve its regulatory function, the SSMSC should request an IOSCO assessment of its institutional capacity and regulatory operations leading to improvement of its operations and increased trust and respect for this critical regulator.

- The GOU, SSMSC, and market participants, with international donor organization assistance, should conduct a shared program to encourage open joint stock companies, particularly proposed privatized companies, to be listed and traded on a well-regulated exchange and available to portfolio investors including non-state pension funds.
- The SRO system needs to be revised to meet international norms including improved and continuous training and licensing of market professionals, as well as enforcement powers to discipline members who fail to meet training requirements and violate codes of conduct to the detriment of the market.
- The international donor community should coordinate its activities to develop a consistent plan for the GOU that promotes a free market based economy without unnecessary and inappropriate government interference in its operations.

1. Importance of an Organized Securities Market ⁵

Organized securities markets play a critical role in the development of a vibrant economy by reducing the time and cost for issuers, buyer and sellers or their agents, in executing transactions in securities, equity or debt, at a transparent and fair price. In countries with liquid, safe and transparent securities markets, citizens can invest their funds at a rate of return that matches and hopefully surpasses inflation.

Securities markets are essential to pension reform. In Ukraine, Pillar II and Pillar III pension reform requires pensioner contributions be invested primarily in domestic securities, creating a portfolio of investments, that not only serve as an engine of growth for the economy, but will permit prudent investments insuring payment of expected pensions at retirement. Securities markets are also important because they provide the necessary “exit strategy” for pension funds and other strategic investors. As pension funds monitor their investment portfolio and plan for long term payout requirements for pensioners, the funds require the ability to promptly “exit” from a declining investment coupled with an immediate “entry” into securities that meet both the long-term and short-term needs of participants – pensioners.

Today, Ukraine’s securities markets fail to provide this essential “exit/entry” possibility. In addition, the Ukrainian securities markets lack the diversity of investment alternatives, including instruments coupled with inflation hedges, to meet the long-term investments required for sustainable pension reform.

Thus, there are two essential functions provided by an effective securities market: price discovery and market liquidity. The securities market provides the mechanism for establishing a “fair and objective price” for a security based on the opinions of hundreds or even thousands of investors that effect transactions in the securities market. The market serves to bring together many “willing buyers” and “willing sellers” to establish a fair price.

Market liquidity promotes investors’ confidence that once they *purchase* a security that, if desired, the security can be easily *sold* – the ability to provide easy “*entry and exit*” from their investment. Market liquidity generally has three major characteristics:

- market depth – orders are available at prices above and below the current equilibrium price.
- market breadth – the market can handle large orders without large fluctuations in the price of the security.
- market resiliency – the market quickly attracts new orders after price changes due to market imbalances.

To establish and maintain market liquidity requires continued attention from market participants, the GOU, and the regulator, SSMSC. Government policies clearly affect market liquidity. For example, the tax regime has a significant impact on whether investors are active in the securities market or keep assets in bank deposits. Today, Ukraine’s tax policy favors bank deposits where interest income is not taxed while income on debt securities is taxed.

⁵ See, Charles M. Seeger and Hugh C. Patton, Background for Financial Markets Development in Ukraine, dated January 1, 2000 and Charles M. Seeger, Securities Exchange Essentials, 1996, The World Bank publication, for a detailed discussion of the importance of securities markets in emerging markets, including a focus on the Ukrainian securities market.

Liquidity is also affected by transaction transparency. Investors want to know on a real-time basis the price and volume of securities traded. This information can be made available by computers, ticker tapes or compiled and published at the end of each trading session on web sites and/or the news media.

In addition, liquidity is affected by exchange listing requirements. Listing requirements should operate to bring a variety of issuers' securities to the market. However, they should not be used as "selection" criteria, which implies merit review or investment quality. Listing requirements should naturally mandate a continuous flow of reliable business and financial information to the market, but be unbiased. If listing criteria are highly exclusive, issuers, particularly in emerging markets may not be able to meet these requirement. The converse is also true. If listing requirements are too low, many marginal companies will list but investors confidence in the market will not exist.

One effective listing strategy, followed by many emerging markets, is to establish a "two-tier" listing program. The top tier companies, the strongest companies, are required to meet international standards of disclosure including disclosing financial statements prepared in accordance with international accounting and auditing standards and possibly three years of reported profits. The second- tier companies follow less stringent informational requirements but are nonetheless allowed to obtain the benefits provided by the securities market, e.g. access to cheaper capital.

To meet the demands for price transparency and real-time settlement of transactions, stock exchange structures have changed dramatically. Over the past few years technology and globalization have changed the definition of the term "securities exchange." While in the past there were floor exchanges, and some electronic exchanges, today, most securities exchanges are electronic systems. Today, brokers sit in one room or in their offices and conduct trades over a computer screen and this "virtual exchange floor" is connected by internet to brokers and dealers in various regions of the country providing for critical price transparency and leading to the best price execution for all participants in the market no matter where they are located.

...The floor versus screen debate largely seems a dead issue. Practically everywhere exchanges have moved to screen trading... Where floors persist, they reflect the dogged fight that floor brokers put up against abandoning their home....

Report on Price Discovery and Competitiveness of Trading Systems
October 3, 2000⁶

The Toronto Stock Exchange, the Bulgarian Stock Exchange, and the Bucharest Stock Exchange are electronic "stock exchanges." On April 20, 2005 Archipelago Exchange (ArcaEx), the worlds largest electronic trading system, a licensed stock exchange and SRO in the United States, and the New York Stock Exchange, the world's largest stock exchange, announced a proposed merger creating a combined entity, the NYSE Group Inc. The merger will combine the world's leading equities market with the most successful, totally open, fully electronic exchange. International best practice has recognized and incorporated modern technology to further address real time execution of transactions and the demands of globalization.

⁶ Price Discovery and the Competitiveness of Trading Systems, A Report to the FIBV (International Federation of Stock Exchanges) Annual Meeting, Brisbane –3 October 2000, by Stephen Wells.

2. Background on the Development of the Ukrainian Stock Market

Soon after gaining independence, Ukraine began to address the development of its securities market. Laws were passed creating the legal framework for the development of the market. This legal framework was expanded by Presidential Decrees that supplemented the legal framework during this time of rapid reform required of an independent State. Amendments to the initial laws were continuously being made to address deficiencies in earlier legislation and to provide for further development of the market. The first stock exchange, the Ukrainian Stock Exchange, was established in 1991, with the support of a grant of \$5 million from the French government to the GOU.

This was followed by the establishment of a market owned and operated electronic trading system, First Securities Trading System (PFTS) in 1996.

- | | |
|------|--|
| 1991 | <ul style="list-style-type: none">• Law On Securities and the Stock Exchange• Law On Business Associations |
| 1992 | <ul style="list-style-type: none">• Law on Privatization of State Property |
| 1994 | <ul style="list-style-type: none">• The Presidential Decree "On Investment Funds and Investment Companies." |
| 1995 | <ul style="list-style-type: none">• The Presidential Decree "On the Securities and Stock Market State Commission," established the SSMSC as the Ukrainian agency charged with the regulation of the securities market. |
| 1996 | <ul style="list-style-type: none">• The Ukraine Verkhovna Rada (Rada) adopted the "Concept for Functioning and Development of the Ukrainian Securities Market."• Law On State Regulation of the Securities Market in Ukraine |
| 1997 | <ul style="list-style-type: none">• Law On the National Depository System and Specific Features of Electronic Circulation of Securities. |
| 1999 | <ul style="list-style-type: none">• Presidential Decree "On General Principles of Functioning of the National Depository of Ukraine." |
| 2001 | <ul style="list-style-type: none">• Law On Collective Investment Institutions (Corporate and Unit Investment Funds) |
| 2002 | <ul style="list-style-type: none">• Presidential Decree "On Measures for Corporate Governance Development" |
| 2005 | <ul style="list-style-type: none">• Presidential Decree "To Improve the Investment Climate in Ukraine."• Action Plan to Improve the Investment Climate in Ukraine, approved by Presidential Decree.• Main Directions for Stock Market Development in Ukraine for 2005-2010, approved by Presidential Decree. |

Subsequently, in 1997, the private sector supported the creation of another critical capital markets institution with the establishment of a securities depository owned and operated by market participants, Interregional Stock Union, (MFS).

While the GOU has taken major legislative and other steps to develop its capital market, a close review of these initiatives reveals many inconsistencies and contradictions in its efforts. For example, plans to support the development of a capital market with the necessary international norms required to promote a functioning economy conflict with the State's desire to maintain ownership of enterprises, thereby delaying privatization. Similarly, the failure to pass a joint stock company law that protects the rights of minority shareholders discourages investment. The lack of a coherent strategy for the final phase of regulatory reform has had a significant impact on the development of the non-bank sector of the economy. Specifically:

- There are in excess of 30,000 joint stock companies with millions of unprotected shareholders given the lack of good corporate governance legislation, which has been blocked for many years by entrenched special interests in the Rada;
- GOU preserved the government's special interest stakes in the statutory funds of joint stock companies, further entrenching regional interests and adversely affecting the development of a liquid market;
- Ukraine's securities market regulation is outdated leading to a superfluous regulatory regime resulting in the establishment of a random and weak enforcement/compliance culture;

- Both the securities regulator and the financial services regulator lack adequate legal and institutional independence. This results in political intervention in the decision making process already hampered by under-funding and political appointments at top management levels;
- Large-scale pension reform has been used as a political tool. This political intervention has resulted in not only a detriment to pension reform but also to the advancement of the economy; and
- Failure of the GOU to implement a coherent privatization strategy has adversely affected the Ukrainian securities market, which lacks blue-chip Ukrainian enterprises, with the strong possibility that key enterprises will be privatized abroad leading to further lack of quality investments required for a capital market and the needs of insurance companies and non-state pension funds.

Based on experience of other markets, both privatization and pension reform can significantly impact the development of the capital market leading to real growth in the economy and a better standard of living for citizens. Yet the lack of a clear and coherent GOU strategy for these activities may well result in continued corruption in the privatization process and the failure of effective investment alternatives for non-state pension funds. The short-term effect is continued investments in bank deposits but the long-term effect is that pension reform will experience a crisis resulting in lack of required payouts to pensioners.

Privatization. The GOU has announced an ambitious privatization plan for 2006, which includes a list of 518 companies and a list of 25 companies planned for 2007. Unfortunately the list does not include larger companies like Ukrtelecom, Odessa Port Plant, Azot or Dnipropetrovsk Aggregate Plant and key hotels in Kiev like Dnipro, Sport and Ukraine. However there continues to be speculation in the press that Ukrtelecom will be privatized in 2006 with bidders from France, Germany, Russia and possibly some Ukrainian participants. While the actual method of sale for the program was not provided as part of the GOU plan, given events occurring in the market, coupled with the November 2005 Presidential Decree, it is expected that many enterprises will be offered over the pocket exchanges with all of the related problems, e.g. lack of a realistic price for State enterprises, no opportunity for purchases of quality investments by non-state pension funds, etc.

Pension Reform. Ukrainian pension reform commenced in 2003 with the passage of the legislative framework to reform the mandatory State pension system, and establish Pillar II and Pillar III (Non-state pension funds.) The legislative framework provides for several conditionalities for the establishment of Pillar II including the creation and effective operation of Pillar III funds. As of October 2005 there were 48 non-state pension funds, which includes 38 general funds opened to a broad range of contributors, 7 corporate funds and 3 occupational funds. The SSMSC had licensed 78 asset management companies and 86 custodians to support non-state pension fund activities as of the end of 2005.

To date, these funds have collected 21 million uah and enrolled 40, 000 members. Due to the undeveloped securities market, most of these assets are held as bank deposits.

A recent decree of the Cabinet of Ministers, dated December 15, 2005, indicated that the most preferable time for the introduction of Pillar II is 2008-2009. Based on elementary actuarial estimations for Pillar II introduction, with the maximum contribution of 7% allowed

by law for females up to age 35 and males up to age 40, Pillar II will have contributions of 9 billion uah in 2009, and in 2010 there will be an additional 12 billion uah.

The critical question for policy makers is “Where and how will these assets be invested for the benefit of pensioners?”

Currently the pension legislation requires that non-state pension funds’ assets be invested in shares and bonds of Ukrainian enterprises that are listed and traded on a licensed trade organization-stock exchange or electronic system. In addition, the legislation requires that the trading system must have at least 25% of the total volume of trading activity on all Ukrainian securities market. Today, PFTS is the only trade organization that meets this requirement. However, The Presidential Decree of November 2005 will adversely impact this investment strategy to the detriment of pension reform.

In addition, the Rada is currently considering a draft law, which passed its first reading in December 2005, which amends the existing law and permits investments in corporate bonds that are merely “placed” with a trade organizer. This proposed amendment permits bond issuers to bypass all “listing” requirements of the fragmented trade organizations. Also, since the bonds will not be “listed” there will be no liquidity for these bonds.

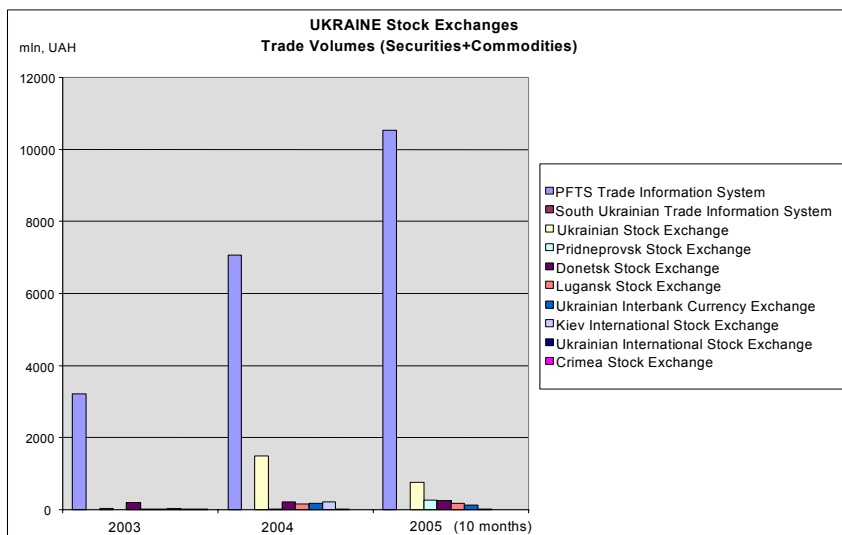
In summary, the problems are numerous and acute. They are: lack of financial instruments, lack of disclosure meeting international norms, and lack of transparency and liquidity in the fragmented securities market. Market manipulation will become the norm flowing from the weak regulation of the securities market. As noted above the development of high investment quality financial instruments will be further negatively affected by implementing the provisions of the November 2005 Presidential Decree limiting investments by pension funds to instruments traded only on stock exchange. One notable securities market expert has expressed the view that these developments further institutionalize a non-transparent securities market and merely favor the financial security of weak “pocket” exchanges and interested parties.

Development of the domestic market is further hampered by the fact that many quality domestic companies seek financing abroad resulting from the lack of incentive to float an issue on the domestic market that is highly fragmented and fails to provide a realistic market value for the enterprise. In the last year four Ukrainian companies have listed on foreign markets. For example, on February 11, 2005, Ukrproduct Group, a large dairy company, listed its shares on the London Stock Exchange, one of the worlds most liquid and reputable stock markets. The company sold approximately 27.2 % of its shares and raised \$ 11.3 million. This listing was followed by XXI Century a Kiev based real estate developer and property manager in December 2005. The company floated 32% of its shares on the London Stock Exchange at \$10.40 suggesting a value for the company of some \$370 million.

If the GOU fails to take immediate action to address many of these problems, Ukraine will face increasing competition from the liquid markets in the West, which will have far reaching consequences for the development of its securities market and its economy. The GOU protectionist mentality evidenced in many of its programs will not achieve their goal but may well become a self-fulfilling prophecy as they force more companies and transactions to move overseas to safer and better-regulated markets.

3. Overview of the Current State of the Ukrainian Securities Exchanges

The SSMSC has licensed 10 organizations, 8 of which received a license as a stock exchange and two received licenses as electronic trading platforms. This system is far in excess of the markets needs. Despite the dominant preference throughout the world for computerized systems, the licensing process in Ukraine continues to be based on an outdated distinction as to the trading system design—electronic system or open outcry system.



Source: SSMSC, PFTS, USE – 2005 (10 months)

Five of the trade organizations are located in Kiev, four in various regions of Ukraine and the tenth in the Autonomous Republic of Crimea. Although trade organizations are an essential foundation of a modern securities market, the duplication and existence of “pocket” exchanges have contributed to rent-seeking behavior, fragmentation and poor corporate governance.

A recent news article⁷ reports that Ukraine will soon have a new trading platform. It is reported that there is pending before the SSMSC an application for a new trade and information system called “Perspectiva.” The application was filed by the Regional Stock Union, an association owned by five Dnipropetrovsk based broker/dealers including a bank. It is reported that Perspectiva will trade a number of securities actively circulating in the housing market. These securities will include special-purpose bonds issued to fund construction projects, shares and investment certificates of real estate funds, as well as

“There are many platforms to do trades-both in Kyiv and in the regions. There is no need to create a new platform to enter the market. We have many platforms where securities trades are performed in the interests of certain individuals, so it is always possible to use such platforms to that end.”

*Yevhen Hryhorenko, General Director
Ukrainian Investment Business Association
December 28, 2005*

pledge letters and new types of mortgage securities. Several market participants view this new trade organizer, which is to be an electronic trading system, with skepticism and consider it to be just another “pocket” entity.

Based on data for 2003-2005⁸, PFTS accounts for approximately 86% of the trading activity in the Ukrainian market.

The second most active exchange accounts for less than 13% of the trading activity in the market. The other 8 exchanges are almost dormant and continue their limited operations solely with an eye toward participating in the State Property Fund privatization process receiving their 1% facilitation commission on the sale of State owned shares.

⁷ SSMSC Considers Registration Documents of a New Trade-and Information System “Perspektiva”, UABanker, net, December 28, 2005.

⁸ Data for 2005 is for the first 10 months of the year.

Trading Volume on Ukrainian Trade Organizations for 2004 and 2005

| | 2004 | | 2005 (January-May)* | |
|--|--------------|-------------------|---------------------|-------------------|
| | UAH bln. | % Of total volume | UAH bln. | % Of total volume |
| Stock Exchange | | | | |
| 1 Kyiv International Stock Exchange | 0.32 | 2.45% | 0.00 | 0.07% |
| 2 Donetsk Stock Exchange | 0.29 | 2.21% | 0.01 | 0.15% |
| 3 Pridneprovsk Stock Exchange | 0.04 | 0.34% | 0.27 | 4.66% |
| 4 Ukrainian Interbank Currency Exchange | 0.27 | 2.03% | 0.07 | 1.15% |
| 5 Ukrainian International Stock Exchange | 0.04 | 0.27% | 0.01 | 0.09% |
| 6 Ukrainian Stock Exchange | 2.11 | 16.02% | 0.73 | 12.87% |
| 7 Crimea Stock Exchange | 0.03 | 0.22% | 0.00 | 0.01% |
| 8 Lugansk Stock Exchange | 0.23 | 1.75% | 0.05 | 0.88% |
| Total volume, Stock Exchange | 3.34 | 25.29% | 1.13 | 19.88% |
| Electronic Trading Systems | | | | |
| 9 First Securities Trading System (PFTS) | 9.9 | 74.66% | 4.56 | 80.10% |
| 10 South Ukrainian Trade-information System | 0.00 | 0.04% | 0.00 | 0.02% |
| Total volume, Trading Systems | 9.86 | 74.70% | 4.56 | 80.12% |
| Total volume, Stock Exchanges and Trading Systems | 13.20 | 100.00% | 5.69 | 100.00% |

Source: Securities and Stock Market State Commission, CASE Ukraine. Data for 2005 is the latest publicly available data.

Many market observers and experts have noted that the occasional trades transacted over these trade organizations are generally done for the purpose of artificially inflating (manipulating) the price of the traded issue. An informal review of the trading prices for six companies reflected wide pricing swings on eight of the licensed trade organizers over a one-month period with no apparent reason for the dramatic changes in prices. For example, one construction company's shares reported prices of a low of 1.15 uah with a high of 43.47 uah. Another company had a share price on the eight trade organizers ranging from a low of 1,010 uah to a high of 5,005 uah.

Local business and finance media covering the Ukrainian securities market have noted the following examples reflective of a fragmented market:⁹

- *Trades at the Ukrainian Stock Exchange and the Pridneprovsk Stock Exchange are not worth analyzing. Trade volumes were uah 734.16 million and uah 265.3 million respectively. Options to buy steel pellets are the main instrument traded on these exchanges. There is obviously something fishy going on because options are traded quite actively but in fact access to these trades was not open to all. (Note: To remain in existence, this exchange trades commodity options and stocks and debt securities are traded only on a random basis.)*
- *Nothing exciting at the Ukrainian Interbank Currency Exchange either. They trade small blocks of Ukretelecom "options" with trade volume a mere uah 79.7 million in six months! (Note: These options are not financial instruments but merely convey the right to obtain a telephone number.)*

"You will probably say that this is science fiction. Not at all. These are just the realities of the Ukrainian Stock Exchanges and of the securities market in Ukraine. "

*Economic News, Ukraine
August 15, 2005*

⁹ Ukrainian Stock Exchanges Facts File, Economic News, August 15, 2005

- *Kyiv International Stock Exchange (KISE) is even less impressive, with a trading volume of uah 10.2 million. Some company's shares are traded at such exorbitant prices that one's hair literally stands on end. For example, OJSC Recreation and Trade Center shares are traded at uah 800 per share, or 16,000 times nominal value. OJSC Ukrneftepererabotka, an oil refinery, shares are sold at uah 371.96 or 1,400 times its nominal value. All in all, five (!) companies traded at KISE fall within this proportion of the nominal value/sale price range. Obviously, they have been accidentally overlooked by Ukraine when identifying the Ukrainian blue chip companies!*
- *At the Donetsk Stock Exchange, OJSC Special Chemical Machine Building Company, leads the list of total trade volume and can be deemed a candidate for the Top Market Capitalization Award. With statutory capital of uah 77.564 million, the Donetsk Exchange managed to sell a block of this company's stock for 247.5million uah or 34 uah for shares with a nominal value of 0,25. This beats even the 200 million uah valuation by some experts of a 1.74% block of Kryvorizhstal stocks! Should the Government take a closer look at this precious "gem"? Probably not. Unfortunately, this company's stock traded at 1.25 uah on the Interbank Currency Exchange.*

Standard & Poor's classifies the Ukrainian securities market as a Frontier market, which is the smallest market classification in their index of exchanges, ranking just below emerging markets. Included in this classification are more than 20 countries grouped according to geographical location in Europe, Africa, Asia and Latin America. The European Frontier Markets Group includes Ukraine and the neighboring States of Romania, Slovenia, Slovak Republic, Croatia, Bulgaria, Estonia, Lithuania and Latvia. Standard & Poor's considers PFTS as the dominant Ukrainian exchange in preparing its index calculation.

European Frontier Market Group-2004

| Indicator/ Country | Ukraine | Romania | Croatia | Slovenia | Lithuania | Estonia | Slovak Republic | Bulgaria | Latvia |
|---|----------------|----------------|----------------|-----------------|------------------|----------------|----------------------------|-----------------|---------------|
| Capitalization \$mln | 11,778.4 | 11,786.0 | 10,958.6 | 9,676.8 | 6,462.8 | 6,202.6 | 4,410.2 | 2,804.0 | 1,655.0 |
| Capitalization/ % GDP | 18.76 | 16.73 | 32.23 | 30.24 | 29.38 | 58.76 | 10.76 | 11.40 | 12.73 |
| Av. monthly volume stock trades \$mln | 16.73 | 78.62 | 41.18 | 97.49 | 38.65 | 68.97 | 13.59 | 42.58 | 9.16 |
| Local Index | 260.13 | 4,364.7 | 1,565.8 | 4904.5 | 293.4 | 448.8 | 326.6 | -- | 413.6 |
| -change %, 2004/2003 | 204.60 | 100.96 | 32.12 | 24.75 | 68.16 | 57.09 | --- | --- | 81.09 |

Source: Standard & Poor's and PFTS

As a Frontier market, Ukraine has one of the smallest equity markets in its peer group both as to capitalization and average monthly trading volume. The Ukrainian market monthly trading volumes have been relatively modest as compared to other countries in the Frontier Market Group. As noted below, this is due in part, to the fact that over 90% of the trades are conducted off the regulated market and currently the Ukrainian regulatory regime does not require share trades to be conducted or reported to a regulated market. The dramatic rise in the Ukrainian local stock index for 2004 is attributed to the positive results flowing from the 2004 Orange Revolution. Ukraine's market capitalization as a percentage of GDP for 2004 is 18.76%, which is significantly below that of Estonia at 58.76% and below that of Croatia (32.23%), and Slovenia (30%).

Yet, the Ukrainian market has grown from one of the smallest in the region, with a market capitalization of 10 percent of GDP in 2003, to 18.76% for 2004, and current estimates are that it will reach 35% of GDP for 2005.¹⁰ One leading Ukrainian investment bank estimates that by the end of 2006 the Ukrainian securities market capitalization may reach \$35-40 billion, with a daily turnover between \$20 to 30 million. Market concentration is very high with the 10 largest companies representing approximately 57% percent of the trading volume.

Liquidity is very low with most security transactions taking place off any organized exchange or trading system. In fact it has been estimated that 90% of the trades are transacted off the regulated market. For 2005 and earlier years, the free float for public companies, shares available for sale excluding control shares, is estimated at about 4 percent of market capitalization further hampering market liquidity.

Among listed companies, only 40 seem to be regularly traded, with the five largest companies accounting for more than 75% percent of trades on the dominant trading market, PFTS. Most of Ukraine's largest enterprises, many of which have thousands of shareholders, as a result of mass privatization, are held in closed joint stock companies. Shares of closed joint stock companies may not be listed or publicly traded. Transfers of shares of closed joint stock companies must be offered to existing shareholders at non-transparent prices, which are often determined by management.

The majority of newly issued shares are distributed among existing shareholders or on pre-determined terms in order to avoid public trades. Recently several initial public offerings (IPO) of shares in Ukrainian companies have been transacted on foreign exchanges providing market values for the company with the added benefit of access to less expensive capital.

3.1 Settlement of Trades

Settlement is an inseparable and core element of securities trading. Settlement procedures include technical execution of concluded trades in accordance with current legislation and regulations. Settlement of trades requires communication with counter-parties and other settlement participants (custodians, registrars and banks).

Automatic settlement of trades has not been fully implemented at the dominant market, PFTS, due to the local equity market's low liquidity. All trades are presently registered in the form of buy/sell agreements. By law, at least one party to a transaction must be a licensed broker whose settlement department will be responsible for execution. Technically, execution of trades requires signing of agreements, timely compliance with their terms (including delivery/acceptance of securities and transfer/receipt of funds), providing information to other settlement participants (custodians, registrars and the clearing depository). Besides trade execution, settlement departments track their clients' portfolios, payment of dividends, etc.

The settlement system in Ukraine is governed by the rules set by the SSMSC and has a three-tier structure. At the bottom there are registrars. Every stock issuer has to register its shares with a registrar who keeps the register of all of its shareholders. Custodians, who are licensed brokers, hold investors' shares and often act on their behalf, represent the second tier. Custodians are listed with the registrars as nominal holders. At the top is

¹⁰ Estimate based on data furnished by CASE Ukraine, SSMSC, and PFTS.

the depository, Interregional Stock Union (MFS), which serves as the nominal holder for custodians.

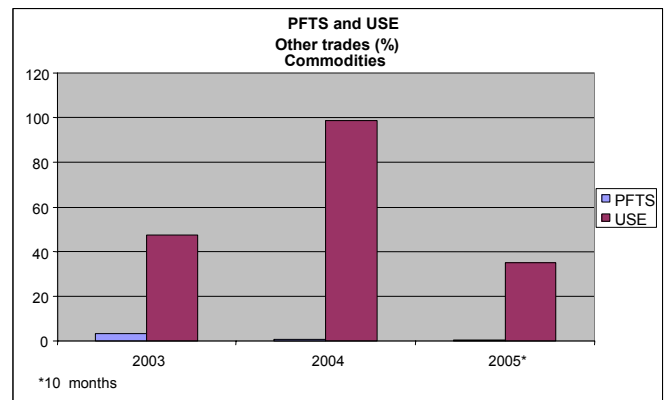
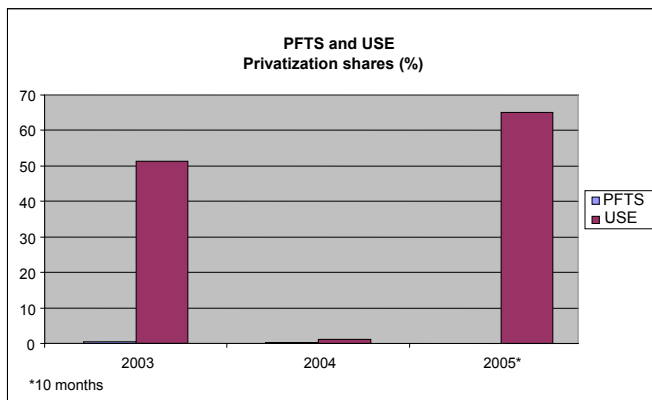
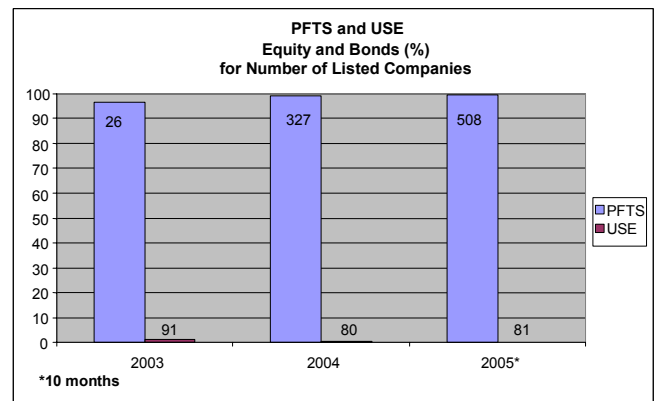
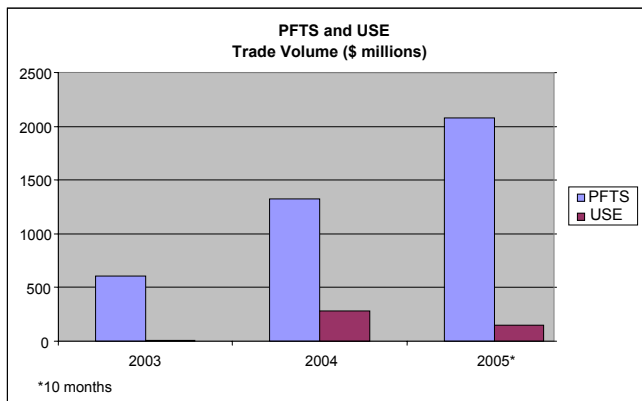
If an investor buys shares in a company, he becomes a shareholder and has to be registered with the company's registrar. If the buyer and seller of the shares are represented by the same custodian (who is registered as a nominal holder of the stock), the ownership changes take place at the custodian level only. Otherwise, the custodian, or custodians, must report the transaction to the MFS depository and the registrar who then changes the register. Foreign investors can also hold their shares with local brokerage houses that serve as a custodian in this case.

While the bulk of shares traded in Ukraine were issued in the process of mass privatization in documentary form, as was required by privatization law, equity market legislation also allows issuance of shares in electronic form. In this case, the issuing company registers the whole share issue as a global certificate, which is deposited with the MFS, as the nominal holder.

The use of buy/sell agreements is costly and not effective in meeting international standards of T+0 or T+3 for trade settlements. These standards require that the delivery of the security and the transfer of money take place simultaneously or T+0 but in no event later than 3 days. It is important that exchanges and depositories meet these international standards to avoid systemic risk of a failure on the part of either party to the transaction to promptly honor its obligation. Ukraine should implement this standard promptly.

4. Comparison of PFTS and Ukrainian Stock Exchange Operations

As indicated earlier, PFTS is the dominant trade organizer in Ukraine accounting for 86% of the trading activity on the regulated market for 2005. The second most active trade organizer is the Ukrainian Stock Exchange, which accounts for approximately 13% of the trading activity on the regulated market. To provide a basis for recommendations on how best to address the problems of the fragmented securities market in Ukraine, it is important to understand the development and current status of the operations of these two major trade organizers.



Sources: SSMSC, PFTS and Ukrainian Stock Exchange.

4.1 PFTS Development and Operations

PFTS Association is a self-regulatory organization, SRO, which, under a license from the SSMSC, is one of the SRO's for brokers and dealers in Ukraine. It currently has 188 members licensed as securities traders including banks, investment companies and local brokerage houses. These securities traders represent 17 cities and 14 regions of Ukraine. The Association's charter and by-laws, publicly available on the PFTS web site, provide that each member has one vote on all issues relating to its activities.

The Association's fifteen-member board of directors is comprised of some of the most influential securities market participants. The Association holds annual general meetings and its work is supported by an Administrative Office, headed by the President of the Association, Irina Zarya, four committees and two expert councils.

Regional Operation of PFTS Association

- Kiev
- Dnipropetrovsk
- Donetsk
- Kharkiv
- Lviv
- Zaporizhzhya
- Odessa
- Vinnytsa
- Kherson
- Luthansk
- Crimea
- Ivano-Frankivsk
- Poltava
- Khmelnytsky

The Association is considered one of the most proactive leaders in the securities market promoting and fostering international best practices for the development of the market and the economy. Its annual calendar of events includes not only the general shareholders meeting, regular meetings of its board of directors and committee meetings but programs and roundtable discussion on current problems and issues in the market. For example, it sponsored a roundtable discussion on the "Development of the Eurobond Market of Ukrainian Issuers in Ukraine," and in cooperation with the United States State Department of Financial Monitoring PFTS held a "Conference on Anti-Corruption and Money Laundering Issues." It sponsors an annual International Forum of Ukrainian Capital Market Participants at which GOU officials, international experts and others gather to discuss challenges facing the Ukrainian securities market. The 8th Annual International Forum of Ukrainian Capital Market Participants was held in September 2005.

In addition to these public events, PFTS continues to modernize its internal operations. For example, as a follow-up to the Conference on Anti-Corruption and Money Laundering, PFTS updated its software to help detect money laundering and other suspicious activities on its market. In 2004 PFTS amended its 2002 Trading Code governing the conduct of traders permitted to use its trading system.

PFTS also continues to update the methodology for the calculation of the PFTS Index, established in 1997, to meet changing market demands. PFTS Index is a market value-weighted measure reflecting the dynamics of liquid stocks comprising the index. The index is calculated daily, based on closing prices in hryvnia; the value for any given day equals the index's total capitalization divided by the capitalization on October 1, 1997, and multiplied by 100 (the index base). Composition of the index is revised monthly in order to reflect the most liquid stocks. As of December 30, 2005, PFTS Index included 10 companies, of which Ukrtelecom and Nyzhnyodniprovsk Pipe Rolling had the highest weight of 16 and the third-place company, Ukrnafta, was weighted at 15%. PFTS Index closed at 353 on December 30, 2005, the last day of trading for the year; its highest level of 365 was achieved in September 2005 and its historical low of 16.52 was registered in 1998.

In addition, several local brokerage companies maintain their own stock market indices. These include KAC-20, KP-Dragon, and Sokrat. These brokerage houses, use the official prices posted by the PFTS, but adjust them in case of an obvious anomaly (which results from the Ukrainian market's immaturity). Unlike the PFTS Index, the KP-Dragon index is USD-based, which makes it a popular Ukrainian benchmark for international investors who track their portfolios in dollars. Since the Russian indices are also dollar-based, KP-Dragon provides a convenient basis for comparison.

In 2004 PFTS, together with the news agency Cbonds, created new Ukrainian corporate bond market indices: PFTS-Cbonds and PFTS-Cbonds/TR. These indices are based on the main principles of European Bonds Commission.

PFTS has created an Internet Portal "IStock," which provides free access to information on the financial activities of Ukrainian issuers. The information provided on IStock is the disclosure filed by public companies with the SSMSC. To promote improved disclosure by public companies in Ukraine, PFTS has sponsored an Annual Report Competition for Ukrainian banks and industrial issuers.

The Association owns the **PFTS Trading System**. It is registered as a trade and information system (TIS) and licensed under existing Ukrainian legislation. This electronic trading system, developed in 1996, with technical support from USAID, allows security brokers to trade in PFTS listed securities, inter-regionally from their offices, in an on-line mode through leased communication lines. The Trading System operates in Kiev and thirteen other regions in the country. The Trading System operates as a multi-functional system that allows for different trade and settlement technologies meeting the most demanding business needs of market participants.

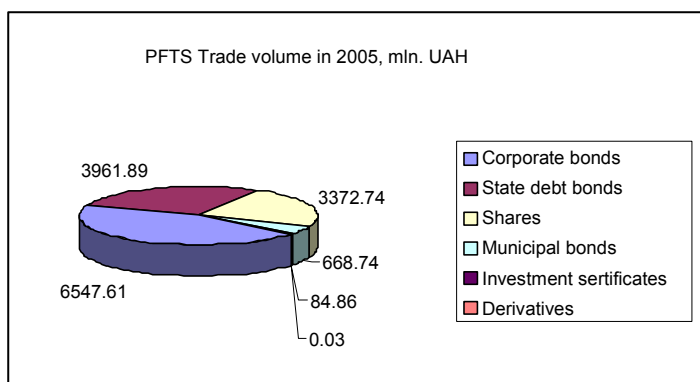
Currently, with IT support from the PFTS Technical Center, the Trading System consist of several sub-systems: quote driven market, auction market, DATEX system or order driven market, and OVD or government bond market based on the principles of an order driven market.

The quote driven market is a dealer driven market in which transactions are settled based on firm quotes in the secondary market on a daily basis. The buyer/seller can settle the transaction according to international norms of delivery versus payment or settle the transaction based on agreement between the parties. The DATEX or order driven market, currently being tested under a pilot program, is based on a market with competing offers. When fully operational the trades on this market will be conducted in accordance with international standards of delivery versus payment (T+ 0). Transactions in this market will not be completed unless the buyer has deposited funds into an escrow account and the seller has immobilized the corresponding number of securities in a special deposit account in the MFS depository. The order driven market will only trade securities that have been approved for listing and have been included in the First Tier of PFTS quotations.

The government bond trading system of PFTS is an order driven market and has an on-line connection to the National Bank of Ukraine (NBU). The reliability of the system and its user- friendly interface allows PFTS to handle all secondary trades in government securities. In addition, PFTS has created an "Auction Market" which permits competing proposals from auction participants based on the specific terms and conditions of the auction.

The Trading System handles, on a regular and continuous basis, the broad range of securities available for trading on the Ukrainian securities market. It currently trades the following securities: shares, government bonds, municipal bonds, corporate bonds, state treasury notes, savings certificates, investment certificates and other securities issued in compliance with Ukrainian legislation.

The securities listed on PFTS are divided into three listing levels based on their liquidity. In 2005 the first level included the twelve most liquid stocks and bonds, the second tier had 95 companies and the third tier included 419 companies. The first-level companies have the largest capitalization, which accounted for over 40% of the market's total capitalization in 2005.



Source: PFTS

Top Ten Companies Listed and Traded on PFTS / 2005

| Ranking | Company name | Capitalization, in UAH Billions | Capitalization, in USD Billions |
|-------------------------------|--------------------------------------|---------------------------------|---------------------------------|
| 1 | Kryvorizhstal (steel) | 16.02 | 3.17 |
| 2 | Ukrtelecom (telecom) | 12.98 | 2.57 |
| 3 | Ukrnafta (oil) | 11.21 | 2.22 |
| 4 | Illich Steel Works, Mariupol (steel) | 9.12 | 1.81 |
| 5 | Northern GOK (steel) | 7.76 | 1.54 |
| 6 | Azovstal (steel) | 7.46 | 1.48 |
| 7 | Aval Bank (banking) | 5.80 | 1.15 |
| 8 | Poltava GOK (steel) | 4.49 | 0.89 |
| 9 | Zaporizhstal (steel) | 4.37 | 0.86 |
| 10 | Avdeevka Coke (steel/coke) | 4.14 | 0.82 |
| Share in total capitalization | | 56.7% | |

Source: PFTS

By sector, steel companies were the leader last year, accounting for 53% of the stock market's total capitalization, followed by telecommunications.

Kryvorizhstal and Ukrtelecom were the two largest companies based on market capitalization, with USD 3.17 mil. and USD 2.57 mil, respectively for the year ended December 2005. The performance of "blue chips" is important not only because they are the largest companies traded but also because they are the main component of the PFTS stock market indices, the most widely used indicator of Ukrainian stock market performance.

The PFTS web-portal provides real time ticker-tape data on the trading activity on its market in both Ukrainian and English. Composite information is given at the end of the trading day including the updated PFTS Index. Information on total demand and supply and capitalization is given on a daily basis as well. It also publishes a daily bulletin, the *PFTS Inform*, which provides information on PFTS trading activity, the Association's

activities, decisions of the PFTS Board and committees, and perspectives on the Ukrainian securities market.

On December 30, 2005, PFTS announced that the PFTS Association was the first trade organizer in the Ukrainian securities market to have been admitted to the World Federation of Exchanges (WFE). The WFE is the global trade association for the exchange industry. Its membership is comprised of 56 regulated exchanges from all regions of the world. Together these exchanges account for over 97% of the world stock market capitalization.

PFTS Lacks Stock Exchange Status

Although PFTS is recognized, both domestically and internationally, as the Ukrainian “stock exchange” it has been unable to obtain registration and licensing from the SSMSC as a “stock exchange.” Unfortunately for PFTS and the development of the securities market, the SSMSC’s failure to grant PFTS “stock exchange” recognition continues to further weaken the market and runs contrary to the norms of a competitive market economy. As described above, PFTS has outpaced its closest competitor, the Ukrainian Stock Exchange, as well as the other 8 trade organizers.

On July 7, 2005, the founders of the OJSC “PFTS Stock Exchange” which included 22 securities traders and the PFTS Association submitted an Application for “stock exchange” status to the SSMSC. The SSMSC denied the Application on September 9, 2005.

As a matter of immediate priority the Government should license PFTS as a formal exchange and establish it as the main functional Ukrainian market place in international bodies.

*World Bank
October 2005 ¹¹*

The Ukrainian 1991 Securities Law sets forth the following requirement for the establishment of a “stock exchange”: (1) the applicant should be **registered** as a joint stock company, (2) the joint stock company should have among its founders at least 20 securities brokers-dealers, holding permits (licenses) for commercial and commission activities with securities; and (3) founders are to pay at least 10,000 untaxed minimal individual salaries (UAH 170,000) into the statutory capital of the joint stock company. Following establishment of the joint stock company the next step in the process is to apply to the SSMSC for a **license** to operate as a stock exchange.

The SSMSC’s official denial stated four violations of effective legislation as the basis for its denial of the PFTS Stock Exchange Application to establish a joint stock company. The **first** stated violation was an alleged failure to comply with the share issuance provisions on the establishment of a joint stock company provided by the Law on Business Associations and the Commercial Code of Ukraine. The **second** stated violation was the failure of the State duty payment documents to comply with regulations of the State Tax Administration governing the duty required for share issuances. The **third** alleged violation was that the PFTS Association, as one of the founders of the joint stock company, contributed its ownership rights to the Trading System, as payment for its shares. The **fourth** alleged violation was the failure of the PFTS Stock Exchange to comply with provisions of the legislative norms on the foundation of a stock exchange.

Several legal experts have reviewed the SSMSC official denial and concluded that the alleged violations reference only general provisions of the legislative norms without any

¹¹ See the World Bank Study “The Development of Non-Bank Financial Institutions in Ukraine: Policy Reform Strategy and Action Plan” dated October 2005.

specific violation of these norms. As stated above the 1991 Securities Law requires at least 20 licensed securities traders among the founders of a joint stock company seeking to obtain registration and licensing as a stock exchange but leaves the door open for other entities to be among the stock exchange founders, e.g. PFTS Association representing 188 members who hold title to the PFTS Trading System. In summary, it appears that the SSMSC did not have a legal basis to deny the Application based on a strict reading of the provisions cited in its denial. In addition, one legal expert noted that it appears that the SSMSC denial resolution, which is general in its wording, fails to comply with SSMSC's procedures established by law requiring the regulator to provide a "legal justification" for its refusal.

Whether PFTS is called a trading organization or a stock exchange may appear to be simply semantics. Nothing could be further from the truth. The inability of the PFTS Trading System and the PFTS Association of 188 securities traders to be licensed as a "stock exchange" and use this term as part of its name and in its advertising can only continue to disadvantage the status and operations of PFTS compared to other Ukrainian "exchanges." And as noted above, this artificial distinction is not in line with internationally recognized practice.

Even more damaging to PFTS are specific directives contained in the GOU Action Plan, which was included in the Presidential Decree dated November 24, 2005.¹² The directives in the Action Plan affecting PFTS, the private pension fund sector and the privatization process are:

- Amendments should be drafted to the laws of Ukraine on pension funds which would require funds to invest **only** in securities listed and traded at "**stock exchanges**" (emphasis added) or those securities the rating of which conforms to the investment level by the national scale specified by the legislation of Ukraine;
- Proposals to be developed and submitted to the Cabinet of Ministers, including as needed respective draft regulations, for the following actions:
 - 1) Sale of State-owned blocks of shares in companies that are 25% or more owned by the State **exclusively** via "**stock exchanges**";
 - 2) Introduction of preliminary quoting and sale of 5%-10% of State holdings in companies to be privatized through **stock exchanges** for the purpose of determining the real value of such shares;
- Mandatory **stock exchange** listing procedures for JSCs with over 60% State holding and participation in such listing of JSCs with less than 60% State holding.

The reasons for these restrictive provisions in the GOU Action Plan are not transparent *but the effect of these provisions is clear*. **First**, the trading and sale of all State owned enterprises would be listed and traded on "pocket" exchanges with little or no price transparency to the detriment of the privatization process. **Second**, pension reform will stall as investment strategies are dictated by GOU intervention requiring pension funds to "enter/exit" on poorly regulated securities markets lacking price transparency and liquidity. **Third**, the status quo of a fragmented market will continue to be the norm for the Ukrainian securities market. **Fourth**, PFTS, the market owned and operated trade organization, recognized both domestically and internationally, as the only real Ukrainian "exchange" will be hampered operationally and economically. **Fifth**, the Ukrainian securities markets, the economy and its reform agenda will fall further and further behind.

¹² Action Plan to Improve the Investment Climate in Ukraine, approved by the Presidents Decree dated November 24, 2005.

Recent Developments on PFTS Exchange Status

Several continuing developments have added extra wrinkles to the Ukrainian stock exchange environment resulting in further instability in developing a securities market that serves the needs of a dynamic and transparent securities market.

Leading broker/dealers, who formed an unofficial association in 2003, the Ukrainian Stock Union, with the goal of further development of the securities market, announced on December 12, 2005 that they were going to establish a new stock exchange due to the failure of PFTS to obtain “stock exchange” status. They expressed concern with the passivity of PFTS in defending their interest and seek to merge with PFTS to create this new exchange. Later news articles indicated that the desire of this organization was to be involved in privatization auctions, which as noted above has recently been restricted by Presidential Decree to trade organizations having the status of a stock exchange.¹³

The most current news on these activities is that following negotiations with PFTS, a decision on creating a new stock exchange has been postponed until February 1, 2006. During this time PFTS is to determine whether they have any reasonable expectation of receiving exchange status and further developing the current order-driven capabilities of the PFTS Trading System.

The response of the PFTS Association to these initiatives was to become more aggressive in their challenges to the SSMSC denial of exchange status. At a press conference on December 28, 2005 the Association’s Board Chairman, Boris Timonkin, claimed that SSMSC denied PFTS access to the privatization trading market. SSMSC Chief of Staff Mikhail Nepran denied the allegation. In the opinion of stock market participants, this crisis between PFTS and the SSMSC will result in another dismissal of PFTS’ application to receive “exchange status.”

“So far, PFTS is the only regularly operating entity performing the exchange functions. No one will be able to substitute it quickly.”¹⁴

*Aleksander Panchenko
Deputy General Director
Millennium Capital Company*

The actions of the Ukrainian Stock Union appear to be in response to the actions of six of the dormant stock exchanges to pool their funds and activities in accordance with a mutual activity agreement, without creating a legal entity, to create a new inter-exchange system.¹⁵

It will be important for the international donor community to continue to monitor these activities, as part of their technical assistance program, to see the SSMSC’s regulatory response to these activities including its transparent steps to create a fair and transparent market place, not only for privatization but also for pension reform, that best serve the Ukrainian market. In this connection, in accordance with international best practices, the SSMSC’s regulatory response should address whether the dormant exchanges have the technical capacity to undertake its mutual agreement and whether this “new inter-exchange system” can operate as proposed without a license from the regulator. The regulator’s response to these actions will be critical to establishing the necessary “trust” in its regulatory role.

¹³ Interfax-Ukraine December 12, 2005, Interview Roman Sazonov, President Socrat Investment and Finance Group and Vadym Hryb, President Tekt Investment Company. “Our requests are understood but not always carried out. For instance PFTS has never received the status of an exchange”

¹⁴ “PFTS Refuses to Chip In and Accuses SSMSC of Corruption”, Kommersant-Ukraine, December 28, 2005.

¹⁵ Mutual Activity Agreement dated December 09, 2005 by Kyiv International Stock Exchange, Donetsk Stock Exchange, Ukrainian International Stock Exchange, Pridneprovsk Stock Exchange, Luhansk Stock Exchange, and Crimean Stock Exchange.

4.2 The Ukrainian Stock Exchange Development and Operations

The Ukrainian Stock Exchange was established in 1991 based on a Cabinet of Ministers Decree.¹⁶ It was funded by a French grant to the Ukrainian government of \$5 million. It began operations in January 1992 as a securities exchange based on the traditional “out-cry system” to establish daily prices for securities. At the time of its establishment, the GOU and the French Government signed an agreement providing for an electronic trading platform, including IBM hardware and related software. It does not appear that currently this electronic system is used and market participants report that the software is outdated. The SSMSC granted it the status of an SRO in June 1998.

Under its charter, USE is a not-for-profit non-commercial closed joint stock company. Although it could not be verified, it is reported that its statutory capital is 222 common shares, of which the President, Mr. Oskolskiy, and his family own a large block and other legal entities and securities traders own the remainder.

Unfortunately, there is little information or transparency on the operations of this exchange. From the limited data on its trading operations, trading is limited to mostly commodities, random trades in privatization enterprises and negligible transactions in other securities.

Trade sessions are sporadic with trade sessions for the first six-months of 2005, the latest public data available, of 36 compared to 149 session in 2004. For the six-months ending on June 2005 there were a total of 104 trade contracts, 95 of which were derivatives or options to buy goods. In summary, as can be seen from the following chart, unfortunately the Ukrainian Stock Exchange has failed to develop to meet the demands of the current and anticipated market.

Comparison of PFTS and Ukrainian Stock Exchange

| | Key Factors | PFTS Association/ Electronic Trading System PFTS | Ukrainian Stock Exchange (USE) |
|----|--|--|--|
| 1 | Initial funding | USAID technical assistance project, including hardware and software. | In 1991 GOU leased the building to the USE. In 1992 GOU received French grant for establishment of the USE. |
| 2 | Ownership for the software, hardware and exchange building | Market owned | Unclear but appears to be privately controlled. |
| 3 | Ownership structure | 188 members, one member, one vote | Unclear. Closed JSC with 222 shares. Shares distribution among the owners is not disclosed. |
| 4 | Membership | 188 brokers | 122 brokers |
| 5 | Membership intersection | 31 (16.5%) | 31(26.5%) |
| 6 | SRO status | Yes, 188 members | Yes, 117 members |
| 7 | Average 2003-2005 Number of listed securities | 367 | 84 |
| 8 | Average 2003-2005 Est. Trade volume, \$ Mln. | 1,157 | 147 |
| 9 | Average 2003-2005 Share of the Market, % | 84.16% | 7.79% |
| 10 | Average 2003-2005 Equity and Bond trade volume, % of Trade volume | 98.45% | 0.53% |
| 11 | Average 2003-2005 privatization shares trade volume, % of Trade volume | 0.20% | 39.20% |
| 12 | Average 2003-2005 Commodities and other trades, % of Trade volume | 1.35% | 60.27% |
| 13 | Major Sources of Revenue | Fees for the securities trade services. | Fees for the commodities trades, privatization trades, and lease of space to commercial bank and educational institution |

¹⁶ It should be noted that the SSMSC was only established by Presidential Decree in 1995.

5. Importance of Effective Regulatory Oversight

The International Organization of Securities Commissions (IOSCO) has established standards for regulators in all key aspects of a securities market including the effective operations of stock exchanges and electronic trading systems. The *“Objectives and Principles of Securities Regulation”* which was recently updated in May 2003, sets out a set of core principles that are implemented by regulators in both developed and emerging markets. IOSCO has also issued other reports addressing key segments of the regulators oversight of the securities market, including *Supervisory Framework for Markets*, issued in May 1999, and *“The Influence of Market Makers in the Creation of Liquidity”* issued in May 1999.

It is important that the SSMSC take immediate steps to address many of the issues noted above to insure that Ukrainian investors, particularly pension funds, have access to a fair, honest, and orderly market that supports the growth of the economy. This will require that the regulator creates a regulatory framework for market oversight in accordance with international best practices that establish: objectives, mechanisms for achievement, monitoring that objectives are achieved, and effective enforcement action for violations. Failure to take the necessary steps will further weaken the frontier market currently existing in Ukraine.

- First, to address the current fragmentation in the market, with eight or nine dormant exchanges, the SSMSC should cease registering and licensing new trade organizations, and re-examine or withdraw its approval of the existing trade organizations that are unable to comply or operate in accordance with the initial licenses. This would eliminate the many “pocket” exchanges that result in lack of confidence in the market.
- Second, the regulator should prohibit market manipulation, misleading conduct, and other fraudulent and deceptive conduct which distorts price discovery, distorts prices and unfairly disadvantages investors. Integrity of the markets depends upon fairness and is an important part of investor protection.
- Third, the regulator should establish a fair and transparent licensing process that eliminates fragmentation of the market and creates a marketplace that meets the demands of the market. Independent review of this issue may be required.
- Fourth, the regulator should establish and enforce regulations for meaningful price transparency for both pre-trading and post-trading requiring that the information be made publicly available on a real-time basis.
- Fifth, the regulator should create a disclosure system, in compliance with international norms established by IOSCO, which requires public companies to provide business and financial information to the market on a timely basis. The regulator should have effective enforcement powers to insure compliance with these standards.
- Sixth, the regulator should review the types of securities to be traded. Currently trade products and instruments that are not securities, such as Ukrtelecom options for telephone numbers and commodities, are traded on many exchanges primarily as a source of revenue. These different instruments, which are not securities, merely confuse investors and hinder the development of a real securities market.

Conclusions

In order to develop a capital market that can support economic growth, privatization and pension reform, it is essential that the GOU takes steps to implement an effective program for its capital markets regulator and the key institutions required for effective functioning of this market based on international norms. Without a coherent program, free of inappropriate and unnecessary political intervention, Ukraine will be marginalized in its efforts to continue its reforms and attract both domestic and foreign investment. The following recommendations suggest a short-term and interim strategy for achieving this goal:

- SSMSC should immediately recognize, register, and license PFTS as a “stock exchange.” It accounts for 86% of the trading in the Ukrainian market, is privately owned and operated, and enjoys the respect of market participants, and continues to develop its capacity to serve the market in a fair and transparent manner.
- International donor support should be given to strengthen PFTS’s operations in support of privatization and non-state pension fund operations. Key areas for technical support include the following:
 - Listing standards should be improved for first tier companies to establish corporate governance and information disclosure based on international norms leading to investment opportunities, particularly for non-state pension funds.
 - Price discovery should be enhanced by requiring transactions in securities of listed companies to be conducted or reported over the trading system eliminating off the market transactions.
 - Best execution rules for transactions should be implemented and enforced.
 - Move to a real time settlement of transaction no later than T+3 required by international norms.
 - Market order system should be reviewed and improved, where necessary, to insure effective operation of this system.
 - Auction procedures should be reviewed for compliance with international norms in support of price transparency, particularly for privatization over this electronic exchange.
 - Improved training of broker/dealers should be implemented, including continuous education programs to improve exchange operations.
 - SRO operations should be enhanced to provide for effective control and enforcement of broker/dealer operations.
- Steps should be taken to consolidate the remaining mostly dormant stock exchanges through voluntary mergers or license revocation improving the price transparency critical for privatization and non-state pension fund investments. In view of the dormant status of these institutions, it is highly recommended that licenses be revoked to eliminate the problems resulting from fragmentation of the market. Limited resources should be consolidated to improve the operations in the market.
- The licenses of inactive broker/dealers should be revoked.

- Every effort should be made to address the adverse consequences of the November 24, 2005 Presidential Decree on the development of a capital market meeting international best practices.
- The SSMSC should implement more visible and effective licensing procedures; securities market oversight, supervision, regulatory and enforcement presence.
- In order to improve its regulatory function, the SSMSC should request an IOSCO assessment of its institutional capacity and regulatory operations leading to improvement of its operations and increased trust and respect for this critical regulator.
- The GOU, SSMSC, and market participants, with international donor organization assistance, should conduct a shared program to encourage open joint stock companies, particularly proposed privatized companies, to be listed and traded on a well-regulated exchange and available to portfolio investors including non-state pension funds.